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# Regulator Cautions Banks About Loan Standards

BOSTON, MA -- Comptroller of the Currency Eugene A. Ludwig today cautioned bankers that loan underwriting standards have continued to slip. In a speech to the American Bankers Association annual convention in Boston, the Comptroller announced a series of actions his office will take to address this slippage.

"Our examiners tell me that, over the past year, underwriting standards have continued to loosen in most lending categories," Mr. Ludwig said. "The trend is particularly pronounced in commercial lending, but there has also been some loosening in segments of the retail market."

The Comptroller said sources outside the Office of the Comptroller of the Currency (OCC) confirmed examiners' assessments of loan underwriting standards. He cited data from the Loan Pricing Corporation that showed non-rated and non-investment grade syndicated credits now account for more than half the total market. The data also show that the price spread between BB- and AA-rated credits has narrowed by almost 40 percent since the first half of 1991 and that the pay-back time for these large loans has increased.

Mr. Ludwig noted similar trends in retail lending. "Our examiners have found that banks have tightened credit card lending standards," he said, "but this tightening is offset by an easing of terms for home equity and residential real estate loans." In addition, he said, examiners report an increase in credit risk in almost every category of loans except for agricultural loans.

In response to this slippage, the Comptroller announced actions the OCC will take to ensure banks identify and address any weaknesses in their loan portfolios:

Examiners will review credit underwriting standards with senior management at every national bank.

Examiners will personally meet with the chief executive officer of every national bank to discuss any loans that demand the CEO's attention.

Examiners will evaluate every national bank's ability to deal with increases in problem loans and follow up with bank management to make sure any weaknesses are corrected.

The OCC and other federal financial institution regulators will move quickly to review comments and decide how to act on a proposed rule on classification and charge-off policies for retail credit.

The OCC will complete definitive guidance for national

banks on techniques to manage risk for loan portfolios as a whole.

"The maintenance of sound credit standards and supervisory vigilance today will have little or no noticeable impact on economic growth now and will avoid more serious consequences in the future," the Comptroller said.

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and 66 federal branches and agencies of foreign banks in the U.S., accounting
for more than half the nation's banking assets.  Its mission is to ensure a
safe, sound and competitive national banking system that supports the citizens, communities and economy of the United States.

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Remarks of Eugene A. Ludwig
Comptroller of the Currency

before the

Annual Convention of the American Bankers Association
Boston, Massachusetts

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This will be the fifth time I have had the pleasure of talking with you as Comptroller of the Currency. So, in thinking about what I wanted say today, I went back and dusted off the speech I gave at my first ABA convention, back in November 1993. Rereading that speech helped me put into perspective some of the changes that have taken place in the past four years. Now, four years is not very long in the larger scheme of things, but for bankers and bank regulators the world of today is certainly a different place than the world as it was when I appeared before you in 1993.

Recall those days with me, if you will. Although the economy was in the early phases of recovery, the recriminations were still flying fast and furious, with bankers and regulators both being blamed and blaming each other for the credit crunch that had aggravated the recession. Bankers groaned under an onerous, outdated, and -- worse -- apparently ineffectual regulatory burden, hampering their efforts to adapt to the rapid-fire changes in the financial marketplace. It was a time when many pundits were prophesying the end of the banking system as we knew it. You would almost have had to conduct an all-points search to find a banker, regulator, or community activist with anything positive to say about the Community Reinvestment Act. It was a time of bank failures, of worries about the liquidity of the bank insurance fund, and of acute demoralization in the industry and the regulatory community.

What a long way we've come together! When I spoke to you in the fall of 1993, despite the incipient economic recovery, the industry's fundamentals still seemed distinctly unfavorable. At that time I referred to this state of affairs as "a temporary cyclical upturn amidst a powerful secular decline." Today I am much more optimistic about the industry's long term future. The strength of the industry's recovery and its strategic decisions over the past four years suggest something more promising than a mere transitory uptick in a long term downward spiral. Capital is at record levels, and so are profits. We have not had a single bank failure in the past year. Bank stocks continue to be in heavy demand on Wall Street.

Perhaps even more significant, banks have used this window of opportunity to reposition and restructure themselves to meet the challenges of the future. There is no doubt that a big part of

the industry's problems in the 1980s and early 90s stemmed from over-concentration. Many banks were tied to regional economies, and when those economies ran into trouble, so did the banks. Other banks simply placed too many eggs in a single basket -- energy lending, highly leveraged transactions, commercial real estate, loans to developing countries, or what have you. When the market for those products declined -- or, in some cases, collapsed -- some banks suffered ruinous losses. In many cases, mismanagement was to blame. But, to some degree, management's hands were tied by law and regulation, which foreclosed many profitable alternate outlets for their products and services. Banks were also stymied by structural prohibitions and disincentives that prevented them from taking advantage of efficiencies of scale, from operating across state lines, and from organizing their activities in the way that best served their own corporate objectives. And these restrictions all took their toll.

Since then, banks have made impressive strides toward diversification. In the last four years, banks have become vigorous competitors in the market for annuities, mutual funds, brokerage services, and more. New products and services are being steadily rolled out. Innovation and diversification should mean that fewer banks will be susceptible to the sectoral downturns of the future.

Diversification has also had a geographic dimension that should help some banks weather the next downturn. The last recession highlighted the significance of regional differences in national growth patterns. Even as the northeast was floundering back then, other parts of the country were experiencing growth. The formation of truly national banking organizations, a process made possible in large part by changes in federal law, should help cushion those banks when the ride starts getting bumpy -- as it surely will.

Just as important as these more measurable changes, I sense a change in attitude among bankers: a new confidence that they can hold their own in head-to-head competition against nonbank providers. And, in light of all the changes that have taken place over the past four years, I believe this confidence is generally warranted.

In all modesty, I do not believe that one can tell the whole story of the industry's rebound over the past four years without mentioning the role of regulatory reform. When I addressed this group four years ago, regulatory burden was the central theme of my remarks. Today, the OCC has gone a long way in fulfilling the promise I made to you at that time: to reduce regulatory burden to the maximum extent possible, consistent with safety and soundness. We have simplified examination procedures for noncomplex community banks. We led the way among financial regulators in creating an office of the ombudsman to resolve disputes and improve bank-to-agency communications. We have cut fees and assessments. We have given our examiners the technological tools they needed to conduct examinations more efficiently. We spearheaded the drive for CRA reform, to focus

on results rather than on paperwork and process. We adopted a new supervisory strategy based on the banks' underlying risk characteristics, so that we could focus more OCC resources on the banks or activities within banks that exhibited the greatest risk.

We also completed a top-to-bottom review of our regulations, and weeded out those that no longer made sense in the modern banking environment. In the process, we have been able to authorize well-managed, well-capitalized national banks to engage in a variety of new activities closely related to banking. OCC legal decisions have interpreted the national bank charter as a broad grant of authority intended by Congress to evolve with changes in the marketplace, and those decisions have been ratified by the United States Supreme Court in a series of landmark unanimous rulings. These rulings confirm that national banks have the flexibility to meet the demands of a changing market for financial services and new opportunities to achieve the kind of product diversification that is essential to the long term safety and soundness of the banking system.

Certainly this is all good news. It should be a time for celebration and patting each other on the back. So let me ask you this: if, as I believe, the industry's long term prospects seem so much brighter than they did to me four years ago, why am I so uneasy about the near future of the banking system? I ask myself that question quite a lot these days. Of course, anxiety is an occupational hazard for anyone who holds my job. I sometimes describe the bank regulator as a professional worrier. But the fact remains that we today face objective perils that would disconcert even an inveterate optimist.

One thing that keeps me awake at night is the strategic risk for banks inherent in the current legislative debate about financial modernization. As some of you have heard me say before, I believe strategic risk -- the risk of not being able to offer the products and services that the market demands -- is, in the long term, the greatest risk facing the banking industry.

Advances in technology have, over the last several decades, fundamentally changed how information is created, processed, and delivered -- the heart of what banks do. The information needed to make prudent and profitable loans is now more easily available, and less costly to access, than ever before. These advances have allowed new participants to compete in the banking arena and have blurred differences among existing financial products.

In addition, economic globalization has made the financial services markets increasingly competitive. A 1997 OCC study of foreign banks operating in the United States reported that foreign banks' share of the assets of U.S. commercial, savings institutions, and credit unions nearly tripled between 1980 and 1995, from 4.6 percent to 12.7 percent.

Finally, the mix of products and services that consumers want and need has changed and is continuing to change. An older,

more sophisticated population is demanding a broader variety of investment options for its savings. So we have witnessed a remarkable migration of savings from insured deposits to mutual funds that offer a wider range of risks and rewards. Last year, for the first time in U.S. history, assets held in mutual funds exceeded assets held in insured deposits. At the end of the second quarter of 1997, mutual fund assets exceeded commercial bank deposits by almost 25 percent.

In this increasingly competitive and constantly changing marketplace, if banks are not able to offer new products and to evolve as the markets evolve, they will not survive. That is why I have championed the flexible view of the national bank charter that the Supreme Court has ratified.

Regulatory innovation is but one route to needed change. I have also been a strong supporter of efforts to enact legislation to modernize the financial system. But I have been equally vocal in urging that financial modernization legislation move the financial services industry forward, not hold it back. Above all, no bank should be forced to sacrifice the flexibility that current law already provides in exchange for a cosmetic reshuffling of existing activity restrictions. Such a sacrifice would compromise the long term health of our financial services industry and its ability to serve the American economy. It is a sacrifice you don't have to make.

I believe we can craft legislation that provides greater safety and soundness, increased competition, more choices for consumers, and improved access to financial services. That is the essence of genuine reform. We should take the time necessary to achieve it.

But it is not just a legislative misstep that worries me. I am also concerned about a slippage in credit standards throughout the banking industry. Back in 1995, I formed a National Credit Committee, composed of some of our most experienced examiners, to monitor underwriting standards and credit risk factors throughout the national banking system. From time to time, I have expressed my views to the industry and have issued advisories and taken supervisory steps based on our findings. In an April 1995 speech, I admonished the industry not to compromise on asset quality goals. Thereafter, the slippage in credit standards slowed. Similarly, in a speech delivered last December, I called attention to the emerging warning signals of excessive relaxation of lending standards, especially in the syndicated loan market. Just two months ago, in August, we issued another advisory, alerting national banks to the dangers of declining loan loss reserves, which we were seeing at some banks throughout the country.

I recently discussed with members of our National Credit Committee the group's assessment of credit underwriting standards at the largest national banks. Unfortunately, there is every indication these standards have slipped further. Our examiners tell me that, over the past year, underwriting standards have continued to loosen in most lending categories.

The trend is particularly pronounced in commercial lending, but there has also been some loosening in segments of the retail market.

This assessment is confirmed by outside sources. According to data from the Loan Pricing Corporation, since 1993, non-rated and non-investment grade syndicated credits have risen from 35 percent to 54 percent -- more than half of the total market. Pricing has declined at the same time that leveraging has increased. Since the first half of 1991, the spread in pricing between BB-rated credits and AA-rated credits has dropped from 77 basis points to 48 basis points. In other words, the spread has narrowed by almost 40 percent. And tenors have lengthened as well.

The same trends are in evidence on the retail side. By almost any measure, consumer debt is high. Today, consumer debt service payments as a share of disposable personal income are approaching levels reached in the 1980s. Our examiners have found that banks have tightened credit card lending standards in response to increasing delinquencies and losses. But this tightening is offset by an easing in terms for home equity and residential real estate loans. And, increasingly, consumers are turning away from secured retail loans to unsecured credit cards to finance purchases of durable goods, such as automobiles.

Although more and more banks are securitizing loans, in the banking industry as a whole, loan-to-deposit ratios are high by the standards of recent history. This ratio is increasing at the same time that our examiners are reporting that credit risk over the past year has increased in almost every category of loans we analyzed, with the single exception of agricultural loans.

What are we to make of these findings? And, more to the point, what are we to do about them?

Overwhelmingly, bankers tell us that -- more than any other factor -- competition from both banks and nonbanks is driving them to make loans that might or might not make sense on their merits. They tell us that if they don't make these loans, a competitor will. In the process, a good potential customer might be lost forever. Besides, the argument goes, similar loans are paying out now, so that if such loans add little to the bank's bottom line, neither are they doing it any damage.

Without getting into the pros and cons of these arguments, let me say this: true or not, such arguments will be small consolation when the economy becomes more volatile and the loans turn sour. We have learned before that imprudent loans made in the heady atmosphere of good times come back to haunt you when the good times fade. No one wants to learn that lesson one more time.

Accordingly, in addition to alerting the industry today about these disturbing trends, I am announcing initial steps we will be taking designed to help banks identify and address any

weaknesses in their loan portfolios, so they can safely weather the inevitable vicissitudes of the national economy.

First, when we finalize our report on bank credit underwriting standards, I will ask all OCC examiners-in-charge (EICs) to discuss with senior bank management what the report means for banking generally and for that bank particularly.

Second, I will ask all EICs to bring to the personal attention of the bank CEO a sample of the bank's new loans, if any, that seem particularly deserving of the CEO's attention.

Third, over the past several years, we have seen cutbacks in bank staff experienced in dealing with troubled loans and borrowers. I will, therefore, ask OCC examiners, in the course of their regular examinations, to evaluate the bank's capacity to deal with a potential increase in its workload of problem loans. Where examiners identify weaknesses in banks' systems for working through problem loans, they will draw these weaknesses to the attention of senior management and follow up to make sure the bank takes appropriate corrective action.

Fourth, the Federal Financial Institutions Examination Council has just released for comment new guidance governing classification and charge-off policies on retail credit. We will carefully review the comments on this proposed guidance and work with the other regulators through the FFIEC to provide final guidance in this area as quickly as possible.

Finally, as I previously announced, the OCC is in the process of completing definitive guidance on loan portfolio management techniques.

If we take measured steps now, we can avoid serious problems later. The maintenance of sound credit standards and supervisory vigilance today will have little or no noticeable impact on economic growth now and will avoid more serious consequences later.

The past four years have been exhilarating ones in many respects. If we can steer clear of the potholes in the road that I have just marked out, I believe the next four years can be even more exciting ones for the banking industry.

This is an industry that is uncommonly blessed. It is an industry peopled by men and women rich in talent, integrity, and dedication. By working in partnership to break down barriers to innovation and to uphold safe and sound standards, we can ensure a bright future -- for the banking industry, for the banking public, and for the American economy as a whole.

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