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OCC's Williams Warns of Credit Risk In the Banking System; Calls for Bankers to Scrutinize Loan Portfolios More Closely

WASHINGTON -- The results of the 1999 Shared National Credit Review -- a survey by federal bank regulators of all commercial loans that are shared among three or more banks and exceed $20 million -- show "a marked increased in classified and special mention credits," according to Julie L. Williams, first senior deputy comptroller and chief counsel of the Office of the Comptroller of the Currency (OCC).

Ms. Williams reported that 59 percent of the adversely rated shared national credits had been rated "pass" in 1998, and she expressed particular concern about the 14 percent of the adversely rated loans that went to new borrowers. "Banks," she said, "are booking new loans that are weak at their inception. These results reflect the increasing portfolio risk building up in the (banking) system as a result of weakened underwriting and risk selection standards."

Pointing to the release last week of the OCC's 1999 Survey of Credit Underwriting Practices, Ms. Williams said that the OCC would continue its close scrutiny of loan portfolios. That survey found some tightening of both commercial and retail loan standards, but also found that embedded risks in loan portfolios grew for the fifth straight year as a result of weaker standards in previous years.

Speaking today at the Robert Morris Associates Lending and Credit Risk Management Conference, Ms. Williams said, "Most banks have room to improve the accuracy and timeliness of their problem loan identification. Even the most sophisticated banks can improve the level of precision and reliability of distinctions among various risk levels of pass' rated credits. This becomes particularly imperative for the additional reason that today consideration is being given to using those internal risk ratings to set components of banks' capital requirements."

"Unfortunately," Ms. Williams said, "in too many banks today, risk management advancements and management information systems to provide timely risk analysis information to senior management and the board of directors are not being pursued with the same vigor as new business and revenue generation opportunities are being pursued. In practical terms, this is akin to ignoring termites in the foundation of your house while you're busy adding a sun room to the second floor."

Ms. Williams also expressed concern with the continuing relative decline in banks' allowance set aside for loan and lease losses. The average ratio of the allowance to loans for all national banks is at its lowest level since 1986. That ratio, which was maintained above 2 percent between 1987 and 1995, dropped to 1.82 percent at the end of June 1999. Ms. Williams said "it would be more appropriate for banks to be increasing their reserve coverage, rather than decreasing it."

Ms. Williams also warned bankers that "enterprise value" -- often a calculated multiple of the borrower's historical or projected cash flow -- is not collateral. " Enterprise value,'" she said, "is a volatile, disappearing intangible, inherently prone to vanish when it is most needed. ... There is a reason why market professionals refer to the enterprise value component of the support for a loan as the air ball.'"

She said that where identified financing gaps -- the "air ball" -- are large relative to the overall portfolio, the bank's loan allowance, or its capital, "bankers should be developing plans to reduce these gaps in an orderly manner and to augment the allowance or capital as necessary."

Banks should not assume reliance on their securities affiliate to handle the market transaction that will extract the bank from the loan by refinancing the gap when a loan comes due, Ms. Williams said. "Where a bank has such an affiliate, it must not only guard against that assumption infiltrating its credit decisions, but also ensure that its conflict of interest policies are up to date and vigorously enforced."

"With the prospect of financial modernization' legislation that will enhance the ability of banks and securities firms to be affiliated, it becomes essential that bankers assure that their credit decisions are not being shaded by the prospect that they will be rescued from questionable loans by their securities affiliate," she said.

Ms. Williams said that bank CEOs should be asking: "Are my independent risk identification and control functions telling me what I want to hear, or what I need to hear?"

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The OCC charters, regulates and examines approximately 2,400 national banks and 60 federal branches and agencies of foreign banks in the United States, accounting for 58 percent of 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.