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Comptroller Warns on Industry Lending Practices

WASHINGTON -- Comptroller of the Currency Eugene A. Ludwig today urged banks to tighten loan underwriting standards and said his agency is preparing to release new guidance that will help institutions develop and apply advanced portfolio management techniques.

"Not all banks need to have state-of-the-art portfolio management capabilities, but many of those that do -- the institutions with the largest, most complex loan portfolios -- clearly lack them, despite the demonstrable link between loan losses and shareholder values," Mr. Ludwig said. "Clearly this is one area where banks have a need to improve."

Mr. Ludwig said the industry suffers from an abundance of liquidity, a condition that has led to serious problems for banks in the past. Much of this liquidity is coming from abroad -- including East Asia -- as investors seek safety in U.S. markets.

"Even before Asia, razor-thin margins, lengthening tenors and highly-leveraged transactions had become increasingly common," he noted. "Many bankers wondered aloud how they could possibly make money on some deals, but chose to do them nevertheless for fear that a customer might be lost to the competition."

The Comptroller said the agency's examiners have nearly completed a round of talks with the chief executive officers of all national banks that he ordered last October after an OCC survey found that loan underwriting trends were growing weaker.

Mr. Ludwig said he was pleased at the corrective action taken by some institutions. For example, some large banks that made strategic decisions to take on additional risks in specific markets have created loan workout units despite the current low level of problem assets. Some community banks have revised their loan policies, while others are beefing up their collection capabilities.

However, these steps "apply only to a minority of the institutions under our supervision," he said, and it is vital that prudent, anticipatory action become the rule throughout the industry."

In reviewing bank loan portfolios, OCC bank examiners have recently identified three specific categories of concern about their banks' credit practices, Mr. Ludwig said. The examiners found that some banks are:

Entering new product lines for which they lack appropriate expertise;

Making a conscious decision to accept higher risk by granting structural concessions in existing product lines -- for example, by loosening repayment and recourse terms for commercial loans, waiving financial analysis or financing 100 percent of a developer's hard and soft costs; and Developing worrisome concentrations in portfolios where the product line is vulnerable to developing market trends or predictable business cycles.

Attachment

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Remarks by

Eugene A. Ludwig
Comptroller of the Currency

Before the

Exchequer Club
Washington, D.C.

February 18, 1998

It is a great pleasure to be with you again for what is undoubtedly my last opportunity to talk with you in my capacity as Comptroller. By periodically bringing together citizens from the private and public sectors to discuss the pressing issues of our day, the Exchequer Club and organizations like it around the country play a vital role in our democratic system. The Exchequer Club is particularly near and dear to my heart because it was here that I first discussed in public some of the important measures that our office has implemented, such as derivatives guidance and Part 5 of our rules.

The Exchequer Club provides a convivial setting for such discussions. It is the sort of environment in which a Thomas Jefferson would have felt at home. Jefferson was a giant in most respects, but a contradiction in at least one way. Seat him with guests around a luncheon table, and he was one of the great raconteurs of his day. But in public, he was virtually mute. During his entire eight years in the White House, he gave just two speeches -- his two inaugural addresses. Even his State of the Union messages were sent up to the Hill for someone else to read for him -- abandoning the practice of his predecessors and setting a precedent that lasted for over a hundred years.

You wouldn't expect this kind of tight-lipped reticence from one of the most prolific and brilliant statesmen in American history. But Jefferson considered himself a poor orator -- and most of his contemporaries agreed. Here, at least, is one trait that he and I may have in common!

More to the point, though, Jefferson decried the tendency of politicians to play to the crowd and to clutter public forums with fulsome rhetoric that generated more heat than light. The affairs of state, Jefferson believed, required sober deliberation and

rational discourse conducted behind the scenes -- not public spectacle or propaganda.

Given the volume of words and images that assail us day in and day out, we might well feel nostalgia for the simpler world in which the Sage of Monticello lived. Yet, as historian Joseph Ellis makes clear in his recent biography, Jefferson's presidency and his reputation suffered because of his failure to use his office as a bully pulpit. He adopted policies that might have worked -- his embargo, for example, designed to force England and France to stop attacking American merchant shipping. But those policies, which involved painful short-term sacrifice for the American people, never had a chance -- in part because Jefferson chose not to take his case to the people.

Jefferson's experience has come to mind as I mulled over the proper course of action in dealing with the decline in lending standards unmistakably evident throughout the U.S. banking system. Beginning almost three years ago and at intervals ever since, the OCC has expressed its concerns to the industry, issued advisories, and taken what we believed to be the appropriate supervisory actions. In an April 1995 speech, I urged the industry not to compromise on asset quality goals. In a December 1996 speech, I called attention to the emerging warning signals of excessive relaxation of lending standards, especially in the syndicated loan market. In August of last year, we issued an advisory alerting national banks to the dangers of declining loan loss reserves, which we were seeing at some banks throughout the country. Just last October, in a speech before the American Bankers Association, I announced a series of supervisory actions that we were taking in response to an increase in credit risk in most lending categories.

Now, with the approach of the end of my five years in office, I have heard some suggest that we give it a rest. The economic expansion, they say, has not petered out; who can say with complete assurance that it won't go on indefinitely, in defiance of all historical experience?

To some degree, they say, our admonitions over the past three years appear to have had their intended effect: banks have indeed tightened underwriting standards in some areas, as in credit cards. Others urge me to stop pressing the point, because if our worst fears were to materialize and banks were again to suffer heavy losses due to imprudent lending and a deteriorating economy, bankers would have no one but themselves to blame. After all, these folks say, you warned them; you took supervisory action; you can lead a horse to water, but you can't make him drink.

So the advice from some quarters has been for me to stop worrying, to close out things out with a succession of feel-good, farewell speeches, and, above all, to avoid unpleasantness or controversy. It's bad enough to rain on someone else's parade -- but to rain on your own? At this point in my term, as I begin to say my goodbyes, it seems almost churlish to continue hammering at an issue that everyone by now has heard before and that, truth be told, some really did not want to hear even the first time.

But I just cannot sit silent. To do so, I believe, would be negligent.

For I have come away from five years at the OCC with an enhanced appreciation for the importance of a safe, sound, and competitive national banking system to the economic well-being of the American people. The extraordinary revival of commercial banking from the depths of the early nineties has been a big factor in the solid economic gains we have registered as a nation in recent years. A healthy, profitable banking system has helped fuel the growth of businesses large and small and has furthered the development and rehabilitation of our nation's communities. Many Americans are better-housed than they were five years ago, in large part because banks have stretched the envelope and found ways to make housing finance available to segments of our population who would never have been able to qualify before.

We cannot afford to abandon these gains or leave future gains to chance. We have an important obligation not only to the banking system per se, but to all those who benefit from and depend on it.

This is one reason I feel compelled to raise these safety and soundness issues again. Moreover, raising these issues cannot wait. It is essential that we focus NOW -- not six or twelve months from now -- on the safety and soundness implications of underwriting standards that, in some areas, regrettably, continue to slip. If we care about a robust, dynamic banking system capable of supporting the people and the economy of the United States, it is essential from a safety and soundness perspective that we not only do what is necessary to allow the system to evolve into new areas of finance, but also take strong actions to ensure that banks continue to adhere to the fundamentals of traditional banking.

That's why I am speaking to you today and will speak out again on this subject several times in my remaining weeks as Comptroller.

The ironic fact of the matter is that some of the serious banking problems we have confronted in recent

times stemmed from too much liquidity in the system rather than too little. During the 1970s, oil-producing nations flush with cash poured funds into U.S. and European banks, which in turn sank record sums into less-developed countries. Over time, many of these loans turned sour, and the result was the LDC debt crisis of the early 1980s. The same basic dynamic was at work in the U.S. southwest twenty years ago. Energy prices skyrocketed in 1981, and the proceeds found an outlet in southwestern real estate, which soon became overbuilt. When oil prices collapsed, it set off a chain reaction that led to major losses in energy and real estate loans, and the eventual failure of hundreds of banks, including nine out of the ten largest bank holding companies in the state of Texas.

Today the U.S. banking system is again awash in liquidity. Senior OCC examiners tell me that money is more widely available at more reasonable prices from a greater variety of sources than at any time in recent memory. Much of this liquidity is coming from abroad -- including East Asia -- as investors seek sanctuary in the superior safety and stability of the U.S. dollar and U.S. financial institutions.

This vote of confidence from the international investment community should be a source of pride to us. But with that trust comes responsibility. Long before the current Asian problems appeared on our screens, we were seeing too much money in the banking system chasing too few good deals -- a point I have made again and again. Even before Asia, razor-thin margins, lengthening tenors, and highly-leveraged transactions had become increasingly common in bank loan portfolios. Many bankers wondered aloud how they could possibly make money on some deals, but chose to do them nonetheless for fear that a customer might be lost to the competition. The OCC's 1997 survey of credit underwriting practices, which covered national banks in 80 of the country's largest bank holding companies, found that the level of inherent credit risk had increased in most parts of the loan portfolio, with especially significant easing of standards for commercial loans.

The problems in East Asia add weight to our concerns about liquidity and underwriting standards.

I alluded earlier to the speech I gave to the American Bankers Association last fall in which I announced a series of supervisory steps we would take in response to these observed weaknesses in underwriting. One of these steps required OCC examiners to sit down with the CEO of each national bank to discuss our underwriting survey, to review potential problem loans, and to evaluate the bank's capacity to deal

with a potential increase in those loans. The idea was for examiners to explain how our systemic concerns related to each institution, and to do it in a way that would gain top-level attention and lead to quick remedial action where such action was warranted.

An interim survey of our examiners shows that this approach is beginning to show some results. Our examiners tell me that some community banks are revising their loan policies. Others are beefing up their collection capabilities as a contingency in case problem loans increase. In some cases, examiners have requested a written plan of action that would be implemented if deterioration in the economy had an adverse impact on asset quality.

Among larger banks that have made strategic decisions to take on additional risk in specific product markets, some are enhancing workout units, despite the current low level of problem assets, to ensure they have the necessary expertise should problems arise. And in other banks, information systems are being upgraded to better identify and administer problem loans.

Unfortunately, not all banks are taking such prudent, pro-active measures. OCC examiners report credit practices at some banks that I find worrisome. They have found banks entering new product lines for which they lack appropriate expertise -- for example, a predominantly agricultural lender that, without careful study, enters the volatile subprime auto loan market. Some bankers are making a conscious decision to accept higher risk by granting structural concessions in existing product lines -- for example, loosening repayment and recourse terms for commercial loans and funding 100 percent of a real estate developer's hard and soft costs.

Finally, examiners have called attention to undue concentrations in some lenders' portfolios where the product line is vulnerable to developing market trends or predictable business cycles -- for example, agricultural loans based on rising land values where the cash flow does not support increased debt or a growing volume of unsecured loans.

Bringing our concerns about such practices to the attention of management is one way we help those banks willing to help themselves. Where we do bring those issues to management's attention, we expect management to respond positively. We have had considerable cooperation in this regard. However, let me be clear: in those instances -- and I expect they would be few -- where management does not follow through as we would expect, we will make certain that our admonitions are followed. This is clearly our responsibility and it is clearly what Congress intended in enacting the safety

and soundness provisions of FDICIA.

An additional and very significant step we will be taking in the credit underwriting area will be the issuance in the next few weeks of guidance on loan portfolio management techniques. The need for such guidance was demonstrated recently with the release of a study conducted by Robert Morris Associates and First Manhattan Consulting Group. That study found that only four of the 64 largest North American banks practiced what the authors called advanced techniques of portfolio risk management. Let me say parenthetically that not all banks need to have state-of-the-art portfolio management capabilities. But certainly the institutions with the largest, most complex loan portfolios need to improve their risk management techniques. And all banks would benefit by adopting more pro-active risk management and measurement practices. Clearly, this is an area in which banks have a need to improve.

The forthcoming release of the OCC's guidance on loan portfolio risk management should help them do just that. It will be the most comprehensive policy document on OCC expectations for loan management that we have ever issued. But it is more than that. This guidance will provide a full breakdown of the lending process, enabling bankers and examiners in effect to see both the forest AND the trees. It should serve as a primer for bankers seeking to better understand the concepts and application of loan portfolio risk management: the interrelationships among loans, the importance of analyzing risk across different boundaries, and how this process can aid in the management of overall risk before it jeopardizes bank solvency. Used properly, the practices outlined in the OCC's guidance will provide management with a more complete picture of the bank's credit risk profile and with more tools to analyze and control that risk. This vital guidance will be published and in the hands of national bankers by the time I leave office.

I spoke earlier of the challenges we face, challenges made even more pressing by the financial instability abroad. But the problems in Asia provide us with confirmation as well as challenge. During my recent Asian trip, I found it encouraging that, while the work goes on to stabilize financial systems and repair the damage to local economies, the leaders of that region are also taking a hard look at what went wrong and what they can do to ensure that the debacle does not recur. Many of the senior officials to whom I spoke pointed to shortcomings in their supervision of the financial sector as a significant factor in bringing on their problems. And, almost as one, they look to the United States as a model for the reforms

that they know must be undertaken.

The OCC's innovations in the supervision of derivatives and supervision by risk have not only improved bank supervision world-wide, but have become symbols of what can be achieved in our field. If we are to continue to serve as a model of supervisory excellence, we have to be just as serious and farsighted in our approach to underwriting standards and loan portfolio management. I am confident that the fine men and women of the OCC, with whom it has been my honor to serve over the past five years, are up to this task.

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