Remarks by

Eugene A. Ludwig
Comptroller of the Currency

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A regulator, as some of you may have heard me say in the past, is a paid worrier. Of course, being a paid worrier can be an unpopular role, particularly now, when we're reminded every day that tis the season to be jolly. But the regulator's job is to look past the holidays, if you will, to that time when the bills come due, or -- as it's often said -- to be the one who takes away the punch bowl just as the party's getting started. Today, as I am sure you have guessed, I'm not here to talk about Christmas shopping. Rather I'm here to suggest that for the banking industry, this is the season to be prudent.

Protecting the safety and soundness of the banking industry -- both long-term and currently -- has been my primary focus as Comptroller. The very first pillar in our four pillar program has been to improve safety and soundness supervision and regulation -- most evident by our adoption of Supervision by Risk.

I believe it is critical to think about safety and soundness in a broad context. If banking is to be safe and sound and profitably serve the needs of American consumers and businesses, it must evolve as the financial services industry as a whole evolves. And we have taken steps as an agency to permit the prudent and progressive evolution of banking, most recently with changes to our Part 5 rule.

I believe just as strongly that, as banking evolves, the industry must never lose sight of the fundamentals -- particularly the time-tested fundamentals of sound underwriting standards.

Now we all know that there is and needs to be some variability in underwriting standards. And underwriting standards evolve over time. As the democratization of credit over the last 200 years has shown, increased market knowledge, technological innovation, more diverse portfolios and changing consumer attitudes and educational levels with respect to credit have all had an important impact on what constitutes prudent underwriting standards.

With this said, we also are all aware that at any given time it is worrisome when the credit underwriting pendulum swings too far

in either direction.

For example, by the end of the last business cycle in the early 1990s, underwriting standards had tightened markedly. Indeed, it seems like only yesterday that we were hearing the hue and cry -- from Congress as well as the business community -- that the pendulum had swung too far and that underwriting standards had become too tight. When I came into office in 1993, what had become known as the "credit crunch" was still being felt by many.

With the return of a robust economy, coupled with intense competition in the credit markets, underwriting standards began to loosen, as one would expect at that point in the business cycle. In fact, the loosening of standards proceeded at a rather rapid pace through the spring of 1995. Even though underwriting standards remained generally sound although looser, the pace at which these standards were weakening caused me great concern. In April of 1995, in a speech before the Bankers Roundtable, I admonished the industry to be cautious. At that time, I also announced the creation of the OCC's National Credit Committee, a team of some of our most experienced examiners, to monitor credit underwriting practices and work with the industry to ensure the standards remain prudent. Other federal regulators -- as well as the RMA -- also made cautionary comments during this time. Your association issued an advisory you termed a "wake-up call," urging the industry not to compromise on asset quality goals. You reminded bankers that loans extended with relaxed terms during good times can come back to haunt them as problem assets during economic recessions.

During the remainder of last year and into the beginning of 1996, underwriting standards generally stabilized at many though not all institutions. In a number of areas, we have continued to see loosening, but at a slower pace.

Today, our credit experts at the OCC -- along with RMA credit specialists -- appear to agree that the precipitous drop in underwriting standards is not continuing. Some institutions continue to have strict underwriting criteria and some areas of lending have also maintained strong standards.

However, in some credit areas, underwriting standards continue to erode and have eroded to a point where there is not much farther they can go and remain prudent.

One example of an area where we are seeing this disturbing trend is the syndicated credit market. The 1996 Credit Committee survey, which we released in September, found that the syndicated credit market had experienced easing of traditional financial covenants since a year ago, with 30 percent of larger banks easing lending practices. In this market, a variety of factors have coalesced in such a way that downstream participants in syndicated deals are frequently left with thinner margins and less than desirable underwriting standards. Factors that have led to this result include considerable investor demand for higher yield paper, increased competition, and the structure of the market itself where the originators are frequently not

investors.

To be more precise, we have found some transactions where the pricing does not appear to adequately reflect risk. Examiners have also found -- in these and other transactions -- longer repayment tenors, higher leverage ratios and more liberalized financial covenants than are desirable.

Another feature of some transactions is "pocket underwriting." With pocket underwriting, the agent bank and borrower agree to a series of covenants or terms that are kept off the table unless the syndication runs into problems and cannot be sold or completed without these more restrictive terms or covenants. If they are needed to close the transactions, the terms are taken out of the pocket and placed into the controlling document. In effect, the underwriting process begins with the weakest possible terms when it is clear that the borrower would accept terms that offer investors more protection.

Fortunately, most banks that are participants in this market continue to pay close attention to the financial and structural fundamentals of sound underwriting. But increasingly, that majority is shrinking. And today, the loosened standards in this market are beginning to infect other business credit markets.

What we're seeing in the syndicated loan market today reflects the fact that there is more demand for high yield paper than there is a supply of investment quality transactions. We are also seeing, in some cases, investors willing to accept inferior standards simply to stay in the market.

Accordingly, it is clear that the industry must exercise heightened discipline with respect to syndicated credits as well as other business credits. We believe there are several steps institutions should take at this time.

First, senior management should take a careful look at its existing underwriting standards and the nature of exceptions and number of exceptions it has permitted to those standards. In situations where there are numerous exceptions, management should re-evaluate its commitment to market share and its existing business strategy in these markets more generally.

Second, senior management should make sure that when its bank participates in a syndicated credit, the bank engages in its own thorough analysis. This analysis should not only focus on the business and financial fundamentals, but should also incorporate stress testing. Management must be certain that the exposure meets its own well-defined risk acceptance criteria so that it is taking on a level of risk that is acceptable for the bank over the term of the transaction.

Third, senior management must ensure that its institution engages in appropriate due diligence in underwriting and that credit specialists involved in the decision making process have enough stature to override -- when necessary -- the marketing officers.

Fourth, senior management should not allow tight time frames to push them into decisions that don't make sense for its institution. When there is not sufficient time to engage in an independent credit analysis, the bank should be prepared to decline the deal. And the comprehensive nature of the credit analysis should not be streamlined because of the names of any institutions originating or participating in the deal.

Fifth, senior management should ensure that its bank has high quality and timely management information systems with the capability to track and report exceptions, as well as to aggregate overall risk exposure. Effective management information systems provide institutional management with early warning of any erosion on the part of a borrower or within a segment of the market. The timeliness of management information systems is critical, since early intervention is essential to the successful management of any potential credit problem.

Sixth, senior management should subject its institution's portfolio to periodic stress testing. Portfolio managers should identify the vulnerabilities that could impact portfolio exposures and values and perform periodic stress tests to analyze the resulting performance and risk profile of the portfolio. Stress testing helps management introduce active portfolio management strategies or hedging strategies to insulate against portfolio shocks.

And seventh, senior management must ensure that its credit officers have a pre-determined exit strategy for individual exposures, as well as major portfolio segments. Coupled with the pre-determined exit strategies should be established thresholds

for considering the implementation of exit strategies. Strategic thinking about minimizing credit exposure for contingencies should be an active part of the underwriting process.

In addition, to better evaluate performance hurdles, some banks are investing in more sophisticated capital allocation tools that incorporate economic capital measures to more effectively measure risk and reward. This is a welcome development. Within the next several weeks, the OCC will issue the results of a survey we conducted to analyze how national banks are making greater use of capital allocation.

I have also asked OCC examiners to discuss the steps I just outlined with bank management and work with them to improve the safety and soundness of bank participation in the syndicated loan market and in business credits more generally.

Conclusion

I am speaking out on these issues now -- not only because of what I believe banks must do today -- but also because of the long-term impact these issues could have on your individual institutions. I echo the observation RMA Chair Dorothy Horvath made in October, when she noted that bankers should remember what happened during the last downturn and in its wake. As she wisely pointed out at your fall conference in Toronto, to a very great extent, the actions taken by your banks now will determine the extent of credit quality problems if and when the economy begins to soften.

I am also speaking out on these issues now because risk-based supervision makes it possible for me to do so. With supervision by risk, we can spot trouble areas before they boil into real dangers to institutions and the industry. Supervision by risk has given us the means to identify emerging areas of risk. And it has challenged the banking industry to manage risks responsibly and with discipline. You have it within your power to make sure your bank is among those that weather any economic problems of the future. Today, as I call your attention to these issues, I urge you to take advantage of this early warning and exercise the necessary discipline to continue the momentum for a more sound, more vigorous banking industry.

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The OCC charters, regulates and supervises approximately 2,800 national banks
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.