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# RISKS IN UNDERWRITING PRACTICES STABLILIZED BUT CAUTION STILL NECESSARY, FDIC REPORTS

Examiners say that the overall potential risk associated with current underwriting practices at FDIC-supervised banks decreased slightly. However, examiners also report that risky underwriting practices for agricultural, construction and commercial real estate lending remain causes for concern, according to the agency's latest Report on Underwriting Practices, which covers the six months ending March 31, 2000.

"These results signal yellow-caution," FDIC Chairman Donna Tanoue said. "While we are pleased that some underwriting practices appear to have stabilized, we are urging bankers to take a closer look at financial statements and sources of repayment."

The FDIC's report on loan underwriting practices, which was started in early 1995, is one of a number of agency initiatives aimed at providing early warnings of potential problems in the banking system. In addition, the information gathered during examinations helps the FDIC target future examiner resources and identify potential weaknesses in underwriting practices that will draw additional attention during on-site examinations.

Although risky underwriting practices overall have declined from peaks reported in 1998, examiners in the most recent report noted continued problems with agricultural loan "carryover debt" (loans not paid off at the end of the growing season). Approximately 31 percent of FDIC-supervised banks active in farm lending were found to have a "moderate" increase in the level of carryover debt (down from 37 percent during the previous period), and two percent showed a "sharp" increase (down from five percent).

"We are concerned about the risks in agricultural lending because we believe the decline in carryover debt was due, in large part, to record government payments to farmers and additional emergency assistance in 1999, and not to improvements in agricultural markets," added Chairman Tanoue.

In addition, examiners found that 17 percent of banks actively making commercial (nonresidential) real estate loans were making loans with minimal amortization terms and large balloon payments at maturity either "frequently enough to warrant notice" or "commonly or as standard procedure."

The FDIC also noted that other data regarding commercial real estate lending indicate that the new supply of office buildings exceeded the net absorption rate for the first time since 1991. "This excess indicates a potential problem in this type of lending," said Chairman Tanoue.

Examiners also reported slight increases from the previous period in the frequency of two risky underwriting practices in banks actively making construction loans: (1) funding, or deferring, interest payments during the loan term; and (2) making speculative construction loans, essentially projects unaccompanied by refinancing commitments. Fourteen percent of active construction lenders were funding or deferring interest payments during the loan term either "frequently enough to warrant notice" or "commonly or as standard procedure," and 25 percent were making speculative construction loans either "frequently enough to warrant notice" or "commonly or as standard procedure." Counterbalancing these concerns were examiners' reports of generally stable, and often declining, frequency of specific risky underwriting practices across loan types.

The most recent FDIC *Report on Underwriting Practices* summarizes responses from FDIC examiners to survey questions regarding the lending practices at 1,158 FDIC-supervised banks examined during the six months ending March 31, 2000. For the report, examiners give a general assessment of each bank's underwriting practices overall, as well as for major loan categories.