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FDIC Report Assesses Prospects for Bank Credit Quality

Performance remains strong in the three largest loan categories at FDIC-insured institutions, but surging loan volumes and relaxed underwriting point to the possibility of rising losses in the future, according to the Summer 2006 edition of ***FDIC Outlook*** released today.

The latest report focuses on bank credit quality in the context of what is referred to as the credit cycle -- a periodic fluctuation in the volume and quality of credit. While cycles of expanding and then contracting credit volumes are common in financial markets, they tend to play out in different ways across the various banking lines of business. Today's report concludes that while loan performance remains historically strong in the three largest categories -- mortgage lending, commercial and industrial (C&I) lending, and commercial real estate (CRE) lending -- credit quality may have peaked. Rising loan volumes, loosened underwriting standards and untested products raise concerns about future credit losses.

"Despite today's low loss rates, credit risk remains the most important long-term threat to bank earnings," said FDIC Chief Economist Richard A. Brown. "Bankers and bank regulators need to remember that rapid expansion in loan volumes often leads, over time, to declining credit quality."

In the report, the FDIC studies the nature of credit cycles and what the future could hold for an industry in which the three largest loan categories have grown rapidly in recent years but loan losses remain at or near historic lows.

Perhaps the most far-reaching changes have been observed in U.S. mortgage lending, where the use of interest-only mortgages (in which borrowers pay only the interest for the first five or 10 years of the loan) and pay-option mortgages (in which borrowers may elect to adjust their monthly payments under certain conditions) increased dramatically in 2004 and 2005. Use of these products has led to concerns about the risks they may pose to lenders and to homeowners, although mortgage loan performance at FDIC-insured institutions remained strong through March 2006.

Regarding commercial and industrial lending, FDIC analysts find that while risk management practices have undergone large-scale changes over time, the outlook for C&I credit quality continues to depend on the financial health of nonfinancial businesses.

Commercial real estate lending, too, has been transformed. The availability of better information about market developments and new, market-based sources of capital may have dampened loan losses as vacancy rates rose after 2000. Still, rapid expansion in bank CRE lending has contributed to concentrations of CRE loans that are, by some measures, higher now than at their last peak in the late 1980s.

An introductory article in today's edition of ***FDIC Outlook*** traces the historical evolution of the concept of the credit cycle and points to the possibility that credit cycles may play a more important role in shaping bank financial performance today as a result of banking deregulation in the 1980s and 1990s.

The Summer 2006 edition of ***FDIC Outlook*** is available on the Web at www.fdic.gov/bank/analytical/regional/index.html.