Report on Underwriting Practices

Federal Deposit Insurance Corporation **April 1996 to September 1996**

Characteristics of the Underwriting Report

- **Coverage:** 1,383 FDIC-supervised, state-chartered depository institutions
- **Time period:** These results cover reports filed between April 1, 1996 and September 30, 1996
- **Charter-types:** 89 percent of the institutions were state-chartered commercial banks and 11 percent were state-chartered savings banks.
- **Size distribution of institutions included:** 3 percent over $1 billion in assets, 29 percent with assets greater than $100 million but less than $1 billion, and 68 percent with assets less than $100 million.
- **Proportion of the industry covered (as of March 31, 1996):** for BIF-insured members -- 6 percent of assets and 13 percent of institutions; for SAIF-insured members -- 3 percent of assets and 4 percent of institutions.

Highlights

- During the six months ending September 30, 1996, 90 percent of the reports from examination sites showed no material change in underwriting practices. The remaining reports were balanced between 5 percent reporting tighter practices and 5 percent reporting looser practices.
- The overall level of riskiness of current lending practices was rated as above average at 12 percent of the banks examined.
- The effects of farm subsidy phaseouts were raised as a potential concern at many banks active in agricultural lending; among banks active in credit-card lending, few potential problems were noted.

Purpose and Design of the Report

Beginning in early 1995, the FDIC instituted a system to report on the riskiness of current underwriting practices at the conclusion of each bank examination it conducts. Those banks examined are primarily small, state-chartered depository institutions. The first results were published in April 1996. This report covers responses during the six-month period from April through September 1996.

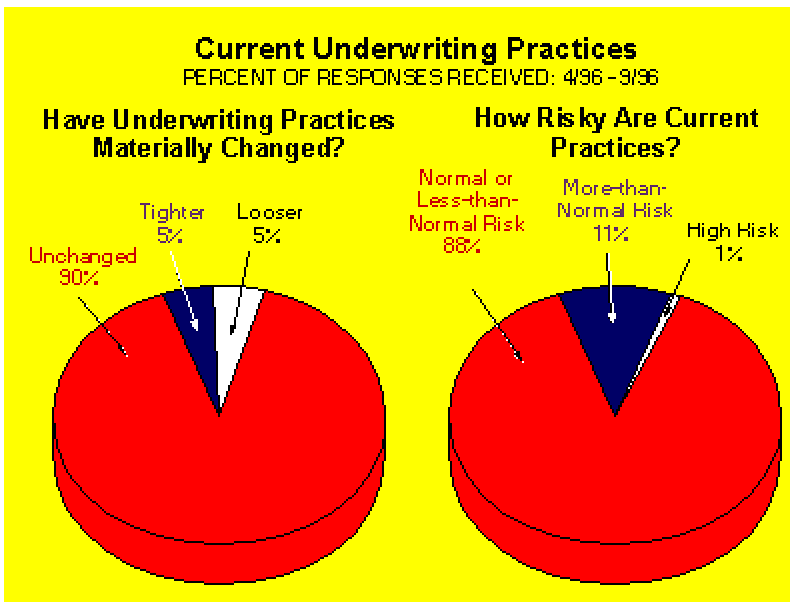
By systematically collecting observations from examination sites, the survey is designed to provide an "early-warning" mechanism for identifying potential lending problems. The primary source of information on trends in credit quality problems--the institutions' "Call Reports"--only provides information after loans become troubled. Another goal of the survey is to establish a benchmark, during a period of relative economic stability, against which to compare future reports about underwriting practices.

The survey focuses on three topics: material changes in underwriting standards, the degree of risk in current practices, and some specifics of the underwriting process for major loan categories. Questions about the latter topic focus on weaknesses that have caused problems in the past at banks nationwide. Loan types covered include business credits, construction lending, commercial real-estate loans, general consumer lending, credit-card loans, home-equity loans, and agricultural credits.

Examiners evaluate underwriting practices based on both their experience and generally-accepted industry standards. In some cases, they rate the risk associated with underwriting practices at the institution just examined as above, below, or at normal or average levels. In other cases, examiners classify the frequency of specific practices as "common" or "frequent enough to warrant notice."

Results: General Underwriting Trends and Practices

Most reports received during the six months ending September 30, 1996 showed neither widespread tightening nor loosening in underwriting practices. Nationwide, examiners noted no material change in overall underwriting practices since the prior exam at 90 percent of the almost 1,400 examination sites reporting. Of the 10 percent of reports citing a change, just under 5 percent (70 reports) showed a loosening in recent lending practices; just over 5 percent (77) showed practices had tightened. Where standards were relaxed, examiners most frequently attributed the change to loan growth goals or increased competitive forces.



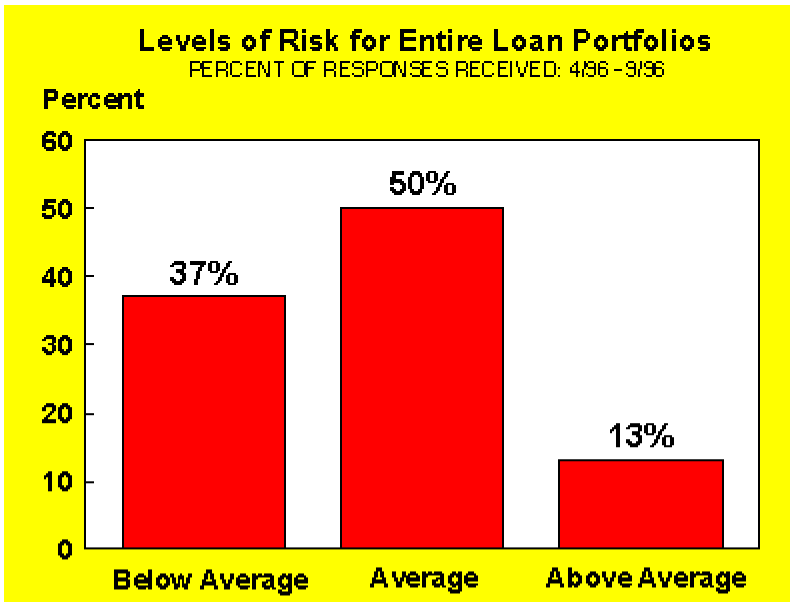
These results were little different from the earlier report released last April in which 89 percent of the responses had no change in underwriting practices. The results from the six-month report, however, showed a slightly lower percentage of responses with tighter standards, and a small increase with looser standards.

When asked to rate the overall level of riskiness of current lending practices, examiners indicated that underwriting standards showed "more-than-normal" or "high" risk in 12 percent of the examination sites nationwide. The proportion also was about the same as in the earlier report. Higher-than-normal risk in current practices occurred most frequently at institutions with assets less than $25 million (18 percent). At depository institutions with more than $300 million in assets, only 7 percent of the responses revealed underwriting was riskier-than-normal.

Although the report focuses on the underwriting of new credits, examiners also were asked to characterize the level of risk of the entire loan portfolio at the institution they reviewed. Thirteen percent of responses nationwide showed "above-average" levels of risk in existing loan portfolios.

Several follow-up questions were asked concerning general underwriting practices. One focused on the role of competition on the institution's underwriting standards. Examiners reported that the degree of competitive pressures was "above average" at just under 20 percent of the banks.

The failure to adjust current loan pricing based on loan quality continued to be a commonly-observed weakness. Almost 5 percent of responses had inadequate pricing as a "common" problem, and an additional 28 percent were noted with failure to adjust pricing to loan quality "frequently enough to warrant notice." Among the institutions that were reported to have higher-than-average risk profiles for new underwriting, almost 60 percent also were characterized as having pricing weaknesses.



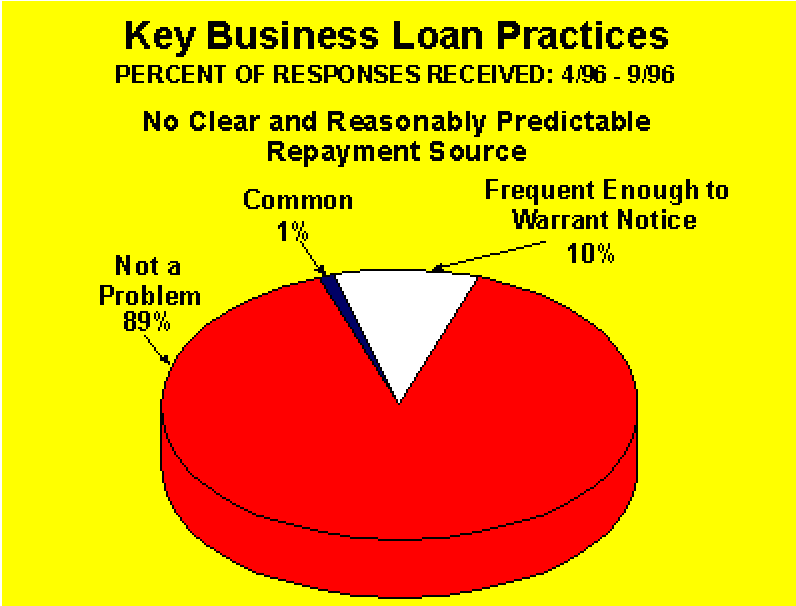
Individual Loan Types

Reports on the quality of underwriting were received for a wide array of loan categories. Approximately 93 percent of the institutions were active consumer lenders, and 90 percent were making business loans. A majority of institutions also were active lenders in other loan areas: commercial real-estate loans (73 percent), new construction loans (62 percent), and agricultural loans (59 percent). Only 46 percent were active home-equity lenders.

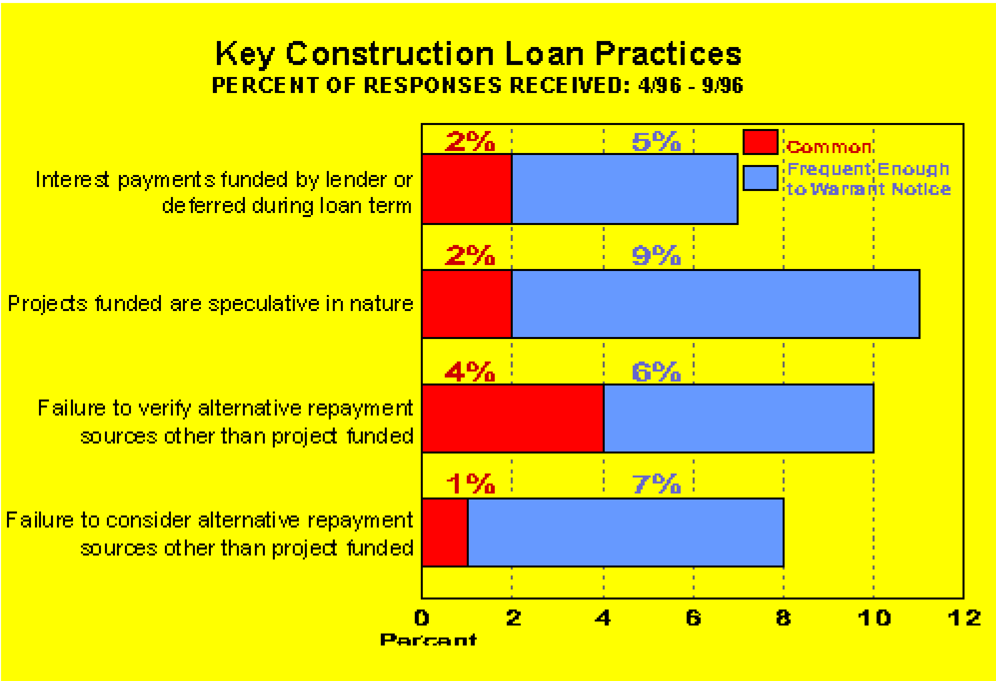
Examiners were asked to comment on specific questionable practices at institutions actively lending in each loan type. A few questionable practices were commonly noted by examiners in a number of institutions. However, examiners did not suggest that any loan type was particularly risky due to multiple deficiencies in underwriting practices.

Business Loans. Business loans represent a large percentage of the loan portfolio of most commercial banks. The strength of the borrower and the quality of the collateral pledged are both important elements in business lending.

- The lack of a clear and reasonably predictable repayment source was cited as a "common" problem in only ten of the 1,227 institutions actively making business loans. An additional 10 percent of institutions examined exhibited this weakness "frequent enough to warrant notice." While still the most common weakness cited, the incidence of this practice was somewhat less frequent for the institutions examined during the six months ending in September than for those included in the earlier results. This practice was detected most frequently in smaller banks (14 percent compared with 5 percent in banks with assets greater than $300 million).



- Weakness in the monitoring of collateral for asset-based business loans also was noted by a number of examiners. The 11 percent of responses with monitoring designated as "inadequate" was up from 8 percent reported earlier.



Construction Loans. Construction credits can be particularly risky as a project typically does not generate funds to repay the loan fully until its completion. Lenders have inserted a variety of terms into such loans to reduce the risk involved. Still, examiners cited a number of practices that have led to problems in construction lending in the past. For every practice surveyed, the percentage of responses showing problems was down during this six-month period from the earlier period.

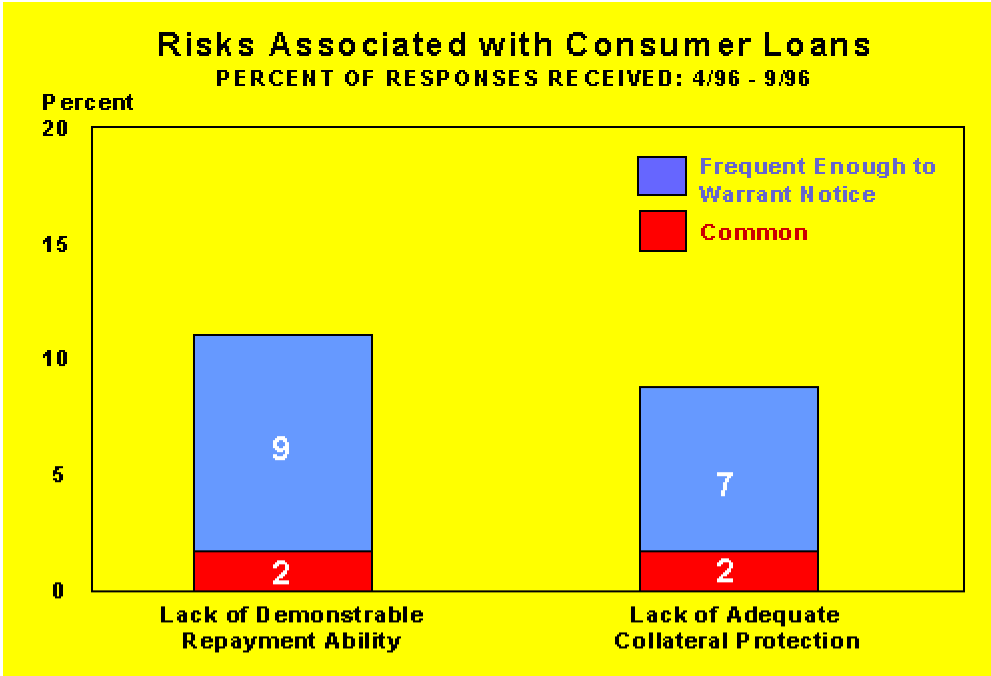
- Just over 11 percent of responses indicated that "speculative lending" which lacks meaningful take-out financing or occupancy commitments was standard practice or "frequent enough to warrant notice." This was the weakness cited most often during the six months.
- Examiners in 8 percent of the examination sites indicated that construction loans were being made without consideration of alternative repayment sources. Additionally, when alternative repayment sources are required, examiners in 10 percent of the cases reported that loans were being made without verification of required alternative repayment sources.
- The practice of funding, or deferring, interest payments during the term of the loan was reported as a common or frequent practice in just under 7 percent of the cases. This practice was particularly prevalent in California where in 28 percent of the institutions this weakness was characterized as standard procedure or "frequent enough to warrant notice." Still, the California result was much improved from first results when nearly one-half of the institutions examined made loans on this basis.

Commercial Real-Estate Loans. In commercial real-estate lending, the income generated from the property is the primary source of repayment. However, because such income often is subject to uncertainty, underwriting practices generally include providing for alternative sources of repayment. As was the case in the earlier results, no widespread weaknesses were detected at examinations conducted during the six-month period.

- While the use of short-term loans having minimal amortization and large balloon payments continued to be the most common concern, only 8 percent of the institutions examined were cited for such practices "frequently enough to warrant notice." Another 2 percent were cited as using this practice as standard procedure.
- Another potential weakness observed by examiners was lack of consideration of secondary repayment sources. This practice was considered to be "frequent enough to warrant notice" in only 7 percent of the responses, and a "common" problem in less than 1 percent. These results comport with practices in banks examined earlier.
- The use of appraisal values that seem unrealistic relative to current economic conditions was not widely cited as a weakness.

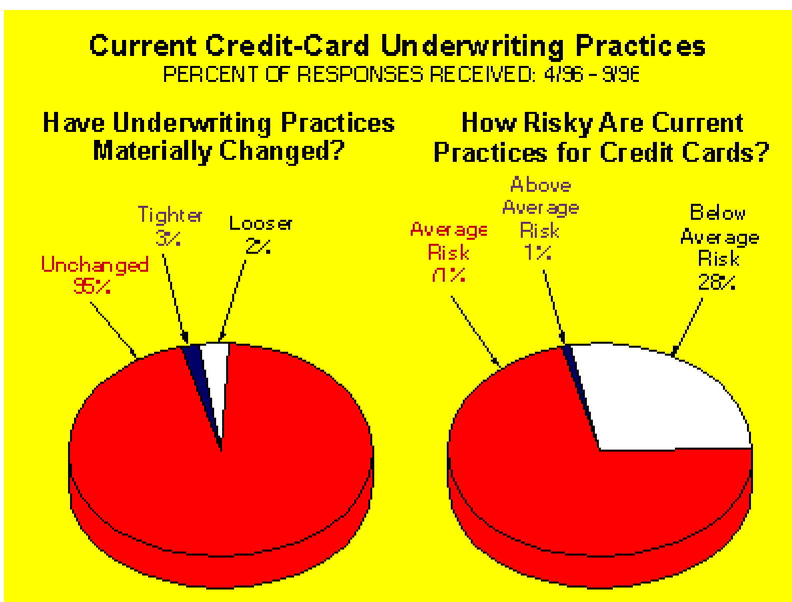
Agricultural Credits. Many FDIC- supervised depository institutions are active agricultural lenders, and such credits often comprise a large portion of the lender's loan portfolio. Earlier results suggested that examiners had some concerns regarding the phasing out of farm subsidies and its subsequent impact on banks with large agricultural loan portfolios. Accordingly, after the Congress passed legislation to implement such phaseouts, the survey was revised to evaluate the effect specifically of the new legislation.

- Over 40 percent of responses from active agricultural lenders indicated significant concern over banks' exposure to the farm subsidy reductions. This was a major concern in banks across the mid-West. For institutions making agricultural loans in the Kansas City region, 58 percent had significant concern.
- Examiners reported little evidence of lending based on artificially-inflated land values, but lending based on unrealistic cash-flow projections was identified as a weakness in just under 10 percent of institutions examined during the six months.



Consumer Loans. Examiners were asked about both the level of risk in general consumer lending and more specifically about credit-card lending. No major problems were reported in either aspect of consumer lending.

- For consumer loans in general, the most frequently cited concern continued to be the lack of demonstrable repayment ability. This practice was considered to be "frequent enough to warrant notice" in 9 percent of responses, and a "common" problem in 2 percent.
- Almost as many responses showed weakness in collateral quality (7 percent "frequent enough to warrant notice and 2 percent with a "common" problem).



Credit-Card Loans. Beginning in April 1996, the survey included revised questions regarding credit-card lending. Just over 20 percent of the institutions examined during the six months ending in September 1996 were reported to be active in such lending. Of these institutions, six were credit-card specialty banks. (None of the six showed "above-average" risk in their current underwriting practices for new credit-card loans). The remaining institutions were not major players in the credit-card area, holding, on average, just 1 percent of total assets in such credits.

- Ninety-five percent of all institutions active in credit-card loans showed stable underwriting practices for new credit-card lending. The remaining responses were balanced between 2 percent with looser practices and 3 percent with tighter practices.
- Ninety-nine percent of responses indicated "average" or "below-average" risk in underwriting practices for new credit-card loans.

Home-Equity Loans. Reports on the underwriting of home-equity loans continued to reveal few deficiencies among the approximately 650 institutions actively making home-equity lines of credit.

- Only 21 banks were extending credit in excess of 90 percent of collateral value.
- Thirteen banks were making loans in areas marked by rapidly escalating collateral appraisal values; additionally, six were qualifying borrowers based on initially-discounted "teaser" loan rates.

Regional Differences:General Underwriting Trends

The specific insured depositories for which reports are received in any given period depends on examination scheduling requirements that reflect such factors as the financial condition of the banks, coordination with state regulators, and the availability of staff. Thus, regional differences can vary from period to period and must be interpreted cautiously. Nonetheless, the most recent results suggest no widespread changes in underwriting standards nor any serious concentration of risky practices in any given region during the six months ending in September 1996. These patterns are consistent with the earlier results.

For this reporting period, the institutions examined in the San Francisco region stood out as having tightened underwriting more frequently and loosened less frequently than other regions. With regard to the overall riskiness of current practices, banks examined in the Boston and New York regions were rated as having less risky underwriting than elsewhere. At the same time, examiners in the San Francisco region continued to find a disproportionate number of institutions with above-average risk.

Last Updated 7/8/1999