Report on Underwriting Practices

Federal Deposit Insurance Corporation — February 1995 to February 1996

Characteristics of the Underwriting Report

- Coverage: 2,001 FDIC-supervised, state-chartered depository institutions were covered. Included were all scheduled examinations nationwide since June 1995; earlier results were from all exams in selected states.
- Time period: Reports were filed during the year ending February, 1996.
- Charter-types: 90 percent of the institutions were state-chartered commercial banks and 10 percent were state-chartered savings banks.
- Size distribution of institutions included: four percent over $1 billion in assets, 30 percent with assets greater than $100 million but less than $1 billion, and 66 percent with assets less than $100 million.
- Proportion of the industry covered (as of December 31, 1995): nine percent of FDIC-insured assets; 17 percent of FDIC-insured institutions.

Highlights

- No significant deterioration in underwriting standards nor widespread concerns about the overall quality of current lending practices were discovered.
- However, in just over ten percent of the institutions being examined, recent lending standards were characterized as having "more-than-normal" risk.
- Relatively risky practices -- such as lending for speculative real estate construction or failure to require timely reductions in principal -- were noted frequently in some markets. Also, examiners cited concern over the potential impact on outstanding loans of the possible elimination of agricultural subsidies.

Purpose and Design of the Report

Beginning in early 1995, the FDIC required its examiners to report formally on the riskiness of underwriting practices at the conclusion of each examination for institutions the agency supervises. The program was initially tested at selected examination sites beginning January 1995, and it was extended on June 1, 1995 to cover all xaminations. Through February 1996, reports from just over 2,000 institutions have been received.

One aim of the survey was to establish a benchmark, during a period of relative economic stability, against which to compare future reports about trends in underwriting. However, the first year's results also provided a picture of recent trends in underwriting -- and the extent of risk-taking -- at state-chartered depository institutions that the FDIC supervises, including many small and community banks. As such, the observations extend recent efforts of other Federal bank egulators to monitor similar developments at larger institutions.

The report is designed to monitor trends and practices in the underwriting of new loans. Normally, examiner observations of credit quality problems from on-site examinations are systematically tabulated only when loans become troubled. This report is an effort to identify changes in underwriting standards and to assess the overall riskiness of new lending. It is meant to provide an "early warning" mechanism for identifying potential lending problems.

The questions focus on three topics: material changes in underwriting standards, the degree of risk in current practices, and specific underwriting practices for major loan categories. The latter set of questions addresses specific practices that have caused problems in the past at banks across the country, or are likely to cause problems as markets change. The types of lending reviewed in the earlier reports included business credits, construction lending, and commercial real estate credits. At midyear, the report was expanded to include questions on practices for consumer lending, home-equity loans, and agricultural credits.

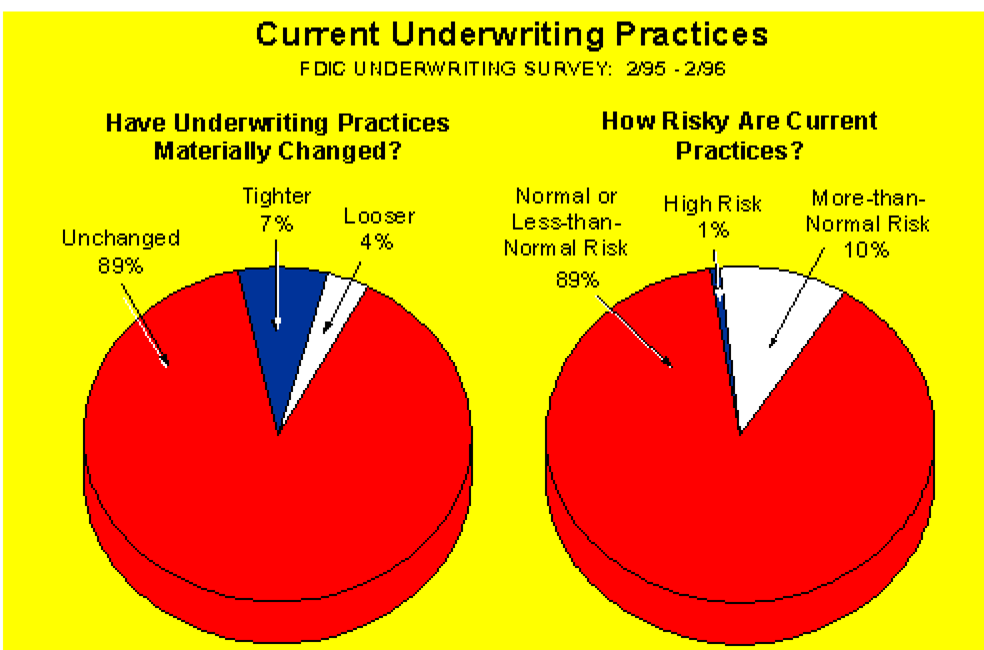
Examiners were asked to evaluate practices based on their experience and generally-accepted industry standards. In some cases, they were asked to rate the risk associated with underwriting practices at the institution they had just examined as above, below, or at normal or average levels. In other cases,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

Results: General Underwriting Trends

The results of the 2,000-plus reports on underwriting practices for the year ending in mid-February 1996 did not reveal widespread deterioration in underwriting standards nor significant areas of concern. However, examiners reported a noticeable incidence of troublesome practices in some areas of the country.

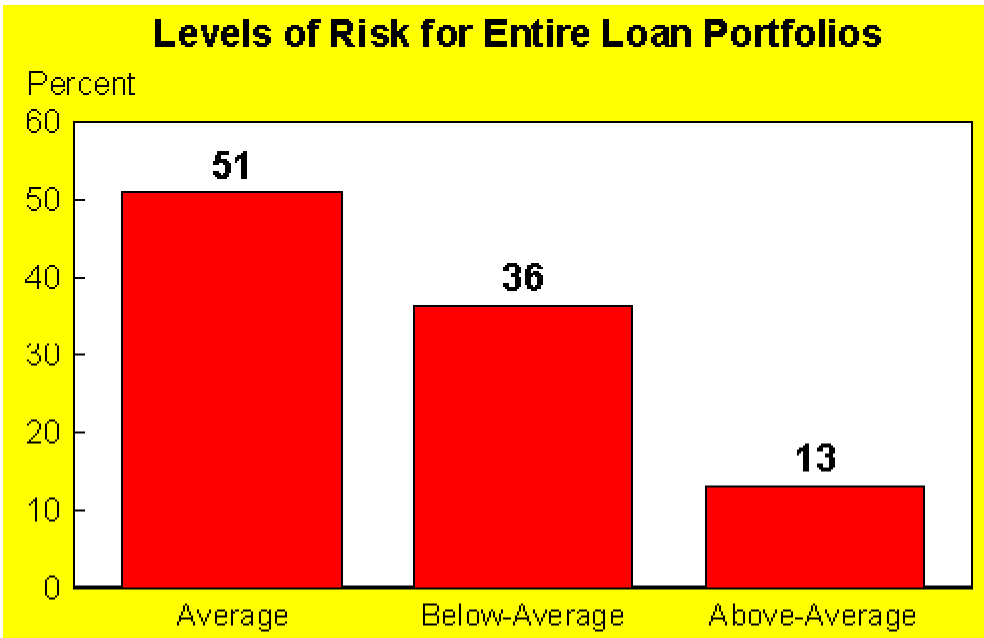
Examiners were asked to comment on recent changes in underwriting practices at the banks they were examining. Less than 75 reports of the 2,000 received noted a material deterioration in recent lending practices. In fact, more than twice that number reported practices had tightened. Where standards were relaxed, it was primarily attributed to increased competitive forces and/or to achieve loan growth goals. However, only two percent of the reports cited both looser underwriting standards and rapid loan growth.

When asked to rate the overall level of riskiness of current lending practices, over 11 percent of the reports nationwide indicated that underwriting standards involved "more-than-normal" or "high" risk. This proportion held fairly steady throughout the first year of reporting. Reports of higher-than-normal risk in current practices occurred most frequently at smaller institutions. At depository institutions with more than $300 million in assets, only 4.5 percent of the examinations revealed underwriting was riskier-than-normal.



One underwriting practice stood out: the failure to adjust loan pricing based on loan quality. Ten percent of the reports indicated inadequate pricing was a "common" problem, and an additional 36 percent noted failure to adjust pricing to loan quality "frequently enough to warrant notice." The frequency of reports of weakness in loan pricing, however, diminished considerably during the course of the year.

Although the report focused on the underwriting of new credits, examiners also were asked to characterize the level of risk of the entire loan portfolio that they had just reviewed. Thirteen percent of examiners nationwide reported "above-average" levels of risk in existing loan portfolios. In some areas of the country such reports occurred more frequently than elsewhere in the country. For instance, reports from examined banks in several states with relatively competitive markets cited overall portfolio risk as "above-average": California (38 percent), Louisiana (25 percent), and New York (24 percent).



Regional Differences:General Underwriting Trends

According to the results from completed examinations between February 1995 and February 1996, the quality of underwriting varied considerably across the country. Examiners operating out of the FDIC's San Francisco and Dallas regional offices, for example, reported a loosening of underwriting standards twice as frequently as examiners in other parts of the country. This primarily reflected relatively frequent reports of loosening in most Western states as well as in Texas and Louisiana.

A similar regional diversity was found with respect to the assessments of the overall risk of current underwriting practices. Examiners in the West noted some concern regarding the risk of current underwriting standards more frequently than elsewhere in the nation. This result was heavily weighted by reports from California. However, various other states outside the West also came in with a relatively frequent incidence of reports of above-average risks. In fact, reports from examined banks in such diverse states as Louisiana, New Hampshire and New Mexico indicated above-average risk more frequently than in California.

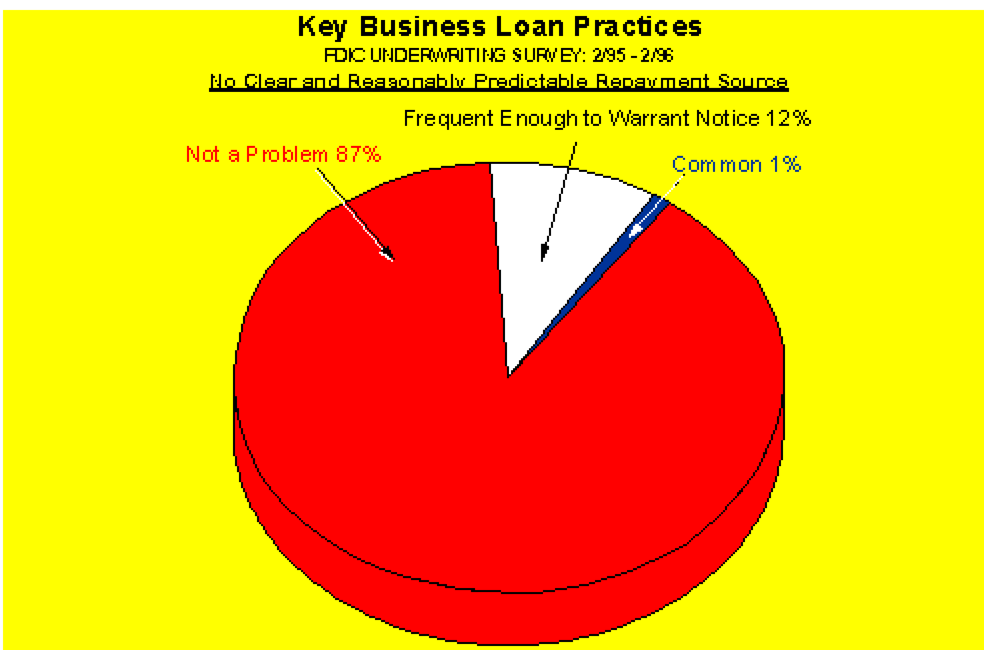
Individual Loan Types

Reports on the quality of underwriting were received for a wide array of loan categories. At over 90 percent of the examination sites, the institution was an active business lender, 65 percent were making new construction loans, 77 percent were making commercial real estate loans, 67 percent were making agricultural loans, and 93 percent were making consumer loans. The least represented loan type was home-equity loans; nonetheless, half of the institutions were active in this area.

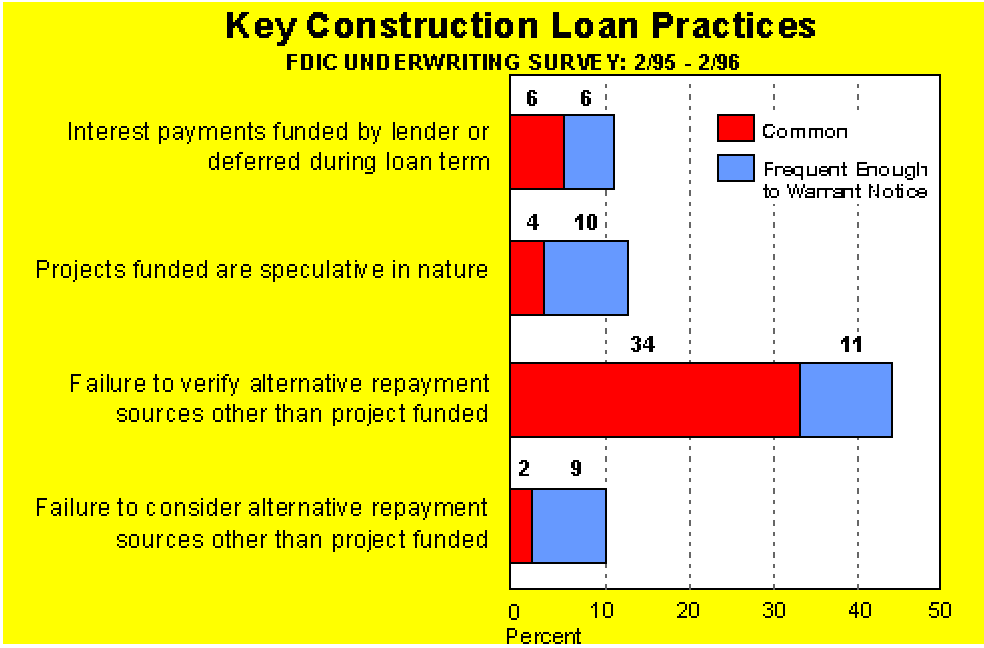
Examiners were asked to comment on specific questionable practices at institutions actively lending in each area. A few common questionable practices were noted by examiners in a number of institutions. However, specific weaknesses must be viewed in the context of the institution's overall standards to determine whether they will lead to higher-than-normal risk levels. One or two weaknesses can often be offset by strengths in other underwriting factors. Multiple weaknesses generally can not. Thus, it is important to note that in no lending area did examiners suggest that a specific loan type was particularly risky due to multiple deficiencies. Nonetheless, early detection of any risky practice provides valuable information that can be used for supervisory actions to limit -- or reverse -- trends before they become serious problems.

Business Loans. 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 20 out of almost 2,000 examinations (one percent). An additional 12 percent of respondents nationwide cited this problem as frequent enough to warrant concern. This weakness was noted often at the banks that were examined in a number of states (such as Oklahoma, Tennessee, and Missouri) and disproportionately at smaller banks.
- The monitoring of collateral for asset-based business loans drew some attention from examiners, with eight percent of respondents characterizing monitoring as "inadequate."
- Examiners were generally satisfied with the documentation of financial strength by unsecured borrowers.



Construction Loans. Construction credits can be particularly risky, as the project typically does not generate funds to repay the loan fully until it is completed at some future date. 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.



- The practice of funding, or deferring, interest payments during the term of the loan was reported as a common or frequent practice in just over twelve percent of the cases.
- Nearly 14 percent of respondents felt that "speculative lending" -- lacking in meaningful "take-out" financing or occupancy commitments -- was standard practice or "frequent enough to warrant notice." In many states this practice was nonexistent at banks being examined; in other areas such as California, Florida, Connecticut, and Oklahoma, this practice reportedly was fairly common.
- Of note were frequent reports of lenders failing to verify the quality of alternative repayment sources. Nationally, just over one-third said this failure was a common problem; almost 11 percent cited this as frequent enough to warrant notice. This was reported to be a frequent weakness in many states including Texas, New York, and California.
- Almost 11 percent of the examiners reported that loans were being made without consideration of alternative repayment sources, and almost eight percent reported the frequent use of unrealistic appraisals.

Commercial Real Estate Loans. In commercial real estate lending, the income generated is the primary source of repayment. Because such income often is subject to uncertainty, underwriting practices focus on ensuring loan paydown and providing for alternative sources of repayment.

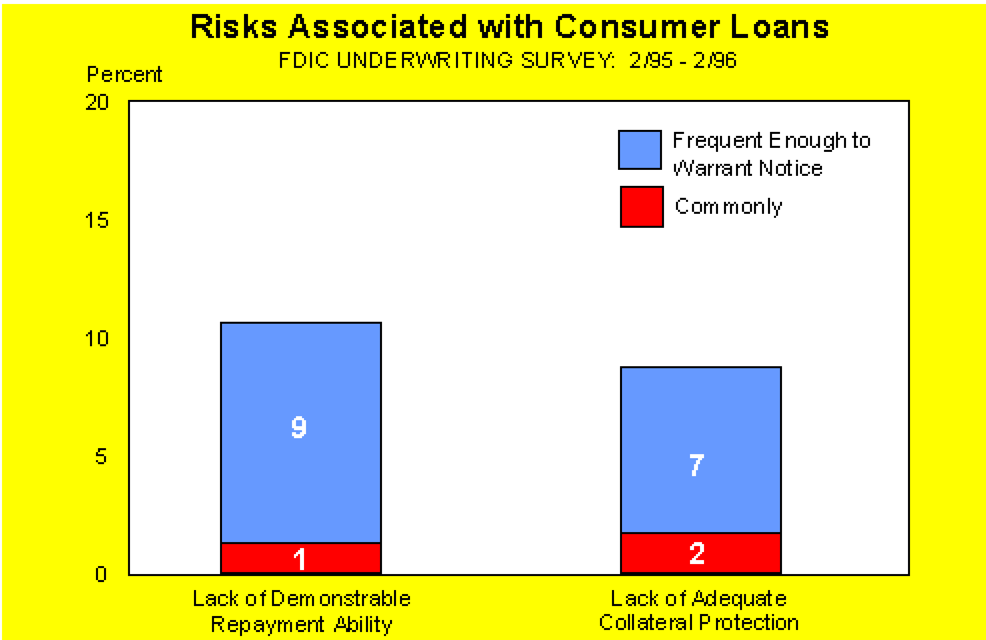
- The use of short-term loans having minimal amortization and large balloon payments was reported to be fairly widespread. At just over ten percent of the institutions being examined, this relatively risky type of credit was cited as a noticeable practice. Another five percent said it was a common practice. This practice was reported much more frequently in states such as California, Florida, and New York than in most other markets.
- A weakness observed by a number of examiners was lack of consideration of secondary repayment sources. This practice was considered to be "frequent enough to warrant notice" by eight percent of the respondents, and a common problem by just over one percent. This concern was noted relatively often in the New England area.

Home-Equity Loans. Despite the wide-spread perception of increasing competitive pressures in home-equity lending, reports on the underwriting of home-equity loans revealed few reports of deficiencies.

- Of the almost 550 institutions actively making home-equity lines of credit, less than 20 were extending credit in excess of 90 percent of collateral value.
- Few banks were making loans based on rapidly escalating collateral appraisal values, and only four were qualifying borrowers based on initially-discounted "teaser" loan rates.

Agricultural Loans. Many FDIC-supervised depository institutions are active agricultural lenders. Often such credits comprise a large portion of the lender's entire portfolio.

- Examiners reported little evidence of lending based on artificially-inflated land values and took only modest notice of lending based on unrealistic cash flow projections.
- However, over 40 percent of the respondents reported significant concern over banks' exposure to substantial farm subsidy reductions; this was a major concern in banks across the Midwest and far West.



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

- For consumer loans in general, the most frequently cited concern related to the lack of demonstrable repayment ability. Almost ten percent of respondents reported the practice as frequent, and only one percent reported it as common.
- With respect to collateral quality, nine percent cited weaknesses in the adequacy of collateral protection.

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