1995 Underwriting Survey

Comptroller of the Currency
Administrator of National Banks

Washington, DC 20219

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To: Chief Executive Officers of National Banks

In April, before the Bankers Roundtable, I urged bankers to remain vigilant about their lending standards as the business cycle matures. At that time I announced the formation of a National Credit Committee to look for ways the OCC can improve its ability to identify and respond to changes in credit risk that could affect the safety and soundness of the banking system.

This letter is intended to reinforce those cautions and to transmit the results of a survey of underwriting policies and practices recently completed by the National Credit Committee. The survey questionnaires, which were completed by examiners for each of the 40 largest national banks, compare lending practices in May 1995 with the underwriting policies and practices in place one year earlier.

Although most banks had not formally changed their underwriting standards, the survey indicates that banks had in fact relaxed underwriting standards for some products, primarily in retail lending. Banks had also made more policy exceptions for individual credits that did not conform to their established loan policy.

I continue to be concerned that, in their efforts to be competitive, banks should not lose sight of the effect of new lending on the risk in their portfolios. To help you understand what our examiners found at the 40 largest banks, I am attaching a report that provides more detail about the stringency of lending standards and the direction in which they are moving.

I continue to believe that vigilance, by bankers and regulators, is the best way to avoid future problems. As always, I am interested in your response to this material.

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Eugene A. Ludwig
Comptroller of the Currency

Attachment: Survey of Underwriting Policies and Practices

Survey of Underwriting Policies and Practices

(8/4/95)

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Executive Summary

Background

This report presents the results of a survey developed by the OCC's National Credit Committee (Committee) to determine whether national banks have relaxed loan underwriting in the last year.

Scope and Methodology

The National Credit Committee developed a survey questionnaire that was completed in May 1995 by the examiner-in-charge (or designee) at each of the 40 largest national banks. Although questions were discussed with bank management where necessary, the questionnaire was intended to collect the examiners' own, independent judgments, based upon their assessment of the bank at the last examination. In each case, the examiner discussed his or her responses to the survey with management of the bank.

The Committee analyzed the results of the survey on both a question-by-question and loan-type basis. The Committee's conclusions reflect the committee members' experiences and expertise and information obtained from other related efforts, including the recently completed horizontal examination of bank credit card activities and the 1994 study of underwriting standards for shared national credits.

Summary Conclusions

Although most banks have not formally changed their underwriting standards, the survey indicates that banks have in fact relaxed underwriting standards for some loan products, and made more policy exceptions for individual credits that do not conform to the bank's established loan policy. The reasons most frequently cited for relaxed underwriting were:

- To meet competitive pressures, and
- Because of changes in the bank's market strategy.

The examiners reported that overall credit risk had generally not been affected by underwriting changes. At most of the surveyed banks, examiners reported that credit risk was unchanged or had declined somewhat since the previous examination.

Although the survey responses indicate that processes are in place to monitor and manage underwriting, the Committee has some concern about the effectiveness of these processes when portfolios are subjected to the stress of significant loan growth and changes in economic conditions. Of greatest concern to the Committee is the possibility that some banks may not have adequately assessed the additional risk they assume when they change their lending practices in response to competition.

Retail Credit

Of the reported changes in underwriting, most were reported in retail credit products, particularly home equity and indirect loans. Those changes include:

- Raised loan-to-value ratios,
- Longer maturities,
- Lower loan fees and interest rates, and
- More use of teaser rates.

Examiners reported that most new loan products and efforts to expand existing loan products were retail-oriented. The most frequently cited new retail products were 100 percent home equity loans, credit card products, indirect auto loans, direct auto leases, low-documentation and credit-scored small business loans, and affordable housing programs.

Commercial and Industrial and Commercial Real Estate

Fewer underwriting changes were reported in the commercial and industrial and commercial real estate portfolios. Changes reported include:

- Lower loan fees and interest rates,
- Higher advance rates on inventory and accounts receivable,
- Longer maximum maturities, and
- Eased guarantor requirements.

Loan Policy Exceptions

The results show that most of the surveyed banks have at least adequate systems to approve and report **individual** loan policy exceptions. However, many examiners expressed concern about the banks' ability to monitor the **aggregate** level of loan policy exceptions.

Loan Review

All examiners reported that loan review systems were adequate for risk rating. The comments, however, did not reflect what role loan review played in monitoring underwriting.

Concentrations

All examiners reported that systems were effective in identifying and managing risk associated with concentrations of credit, but noted a wide variance in the degree of sophistication of the systems. The comments, however, did not provide any insight into the role concentration management plays in underwriting.

Analysis by Loan Type

The questionnaire asked for responses concerning 11 listed loan types: commerciai and industrial and syndicated (SNC), middle market, small business, agriculture, international, commercial real estate, residential real estate, affordable housing, home equity, indirect consumer, and direct consumer. The percentages reported in this discussion were calculated based on the entire population of the 40 large banks covered by the survey. When data do not total to 100 percent, it is because of omitted responses, responses of "N/A" (not applicable), or rounding.

Commercial and Industrial and Syndicated (SNC) Loans

In general, examiners completing the survey were not concerned about lending standards for these loans nor were they concerned about the degree of risk in this portfolio. At most banks examiners characterized this lending as "moderate" or"somewhat conservative." There were no responses of "somewhat liberal" or "very liberal." Most examiners reported that bank's lending standards for these loans were "unchanged," although 22 percent indicated that standards had "eased somewhat."

When asked to identify industries where standards were changing, examiners mentioned many different industries. The only individual industries mentioned more than once, however, were:

- **Cable** – At two banks examiners mentioned that standards for cable lending had "eased somewhat," and at one that they had "eased significantly."
- **Health care** – At three banks examiners said standards had "tightened somewhat."
- **Agriculture** – At two banks examiners said that standards had "tightened somewhat," and at one that they had "tightened significantly."

When examiners were asked to indicate which terms or conditions had eased or tightened, they most frequently said "loan fees or rate spreads," followed by "maximum maturity" and then "maximum size." The reason most frequently given for this change was "change in competitive market." Examiners were not alarmed by the changes they saw. Fifty percent said the degree of risk in the banks' SNC portfolios was "unchanged," while another 37 percent reported that risk had "declined somewhat."

Middle Market Lending

At the previous examination, underwriting standards for middle market lending were described as:

- "Moderate" at 60 percent of the banks,
- "Somewhat conservative" at 33 percent,
- "Somewhat liberal" at one bank, and
- "Very conservative" at two banks.

Standards for middle market lending had "eased somewhat" at 22 percent of the surveyed banks; however, the rest had not changed those standards since the previous examination.

Although most of the banks had not changed their standards, the number of exceptions to policy in these loans had increased.

Overall credit risk in the middle market loan portfolio was described as:

- "Unchanged" in 48 percent of banks,
- "Declined somewhat" in 33 percent of banks, and
- "Increased somewhat" in 18 percent of banks.

Competition in the middle market appears quite strong, which has created competitive pressures to make exceptions to policy and relax underwriting standards. Thirteen banks cited "change in competitive environment" as the reason for changing their middle market lending standards.

A number of banks showed across the board easing of loan terms and conditions, specifically in terms of:

- "Downward pressure on pricing and fees" – 9 banks
- "Maximum maturity" – 8 banks
- "Collateral requirements" – 7 banks
- "Loan covenants" – 6 banks
- "Maximum size of credit line" – 5 banks.

Examiners comments provided other, more specific examples of eased terms, including:

- Increased advances on receivables – from 75 percent to the 80 to 85 percent range,
- Increased advances on inventory – from 50 to 60 percent; and,
- Reduction from full guarantees to partial/limited guarantees.

Examiner comments also indicated that two of the surveyed banks had modified their standard loan covenants. In one of those cases, the bank's intent was to make the covenants more relevant and enforceable.

Although the easing in underwriting standards for middle market loans increased the inherent risk in the portfolio at some banks, examiners indicated that risk is currently mitigated by the generally stronger credit quality of the borrowers. Adversely rated and non-performing credits to middle market borrowers at most of the surveyed banks remain stable or continue to decline.

Middle market lending appears to be an area of targeted growth by many of the surveyed banks. Several instances were noted where banks were attempting to expand their market penetration in the middle market, either through acquisitions or by expanding their previously defined trade area. One bank had begun offering a new product for middle market lending – a "fixed rate" loan on which pricing can be adjusted downward if rates decline. (The bank preserves its spread through hedging.)

In the area of new product offerings, two of the surveyed banks again began to provide highly leveraged transaction financings to their middle market customers.

Small Business Loans

The small business market is increasingly more competitive. In general, the survey indicated an increased emphasis on small business banking, a movement toward credit scoring, and a determination by banks to protect existing customer relationships by whatever means available. No examiners identified unreasonable risks or declines in credit quality in the small business portfolio because of relaxed underwriting standards. The ability of those portfolios to survive an economic downturn while maintaining reasonable credit costs, however, is unproven.

Lending standards for small business loans at the last examination were considered:

- "Moderate" at 58 percent of the surveyed banks,
- "Somewhat conservative" at 30 percent,
- "Somewhat liberal" at two banks, and
- "very conservative" at one bank.

Most of the banks had not changed their lending standards for small business loans since the previous examination. However, at 18 percent of the surveyed banks standards "eased somewhat," while at two banks they "tightened somewhat."

The reasons most frequently cited for the easing of lending standards were "change in market strategy", at 10 banks, and "change in competitive environment", at five banks. The standards most frequently mentioned as having changed were:

- "Loan fees or rate spreads" – 5 banks
- "Collateral requirements" – 3 banks
- "Maximum maturity" – 3 banks.

Several common themes were noted in the comments.

- Five of the surveyed banks have or are implementing a credit scoring system for small business loans; a sixth bank is considering implementing such a credit scoring system.
- Survey comments for five banks indicated that they have minimal financial requirements or are doing less credit analysis on small business loans.
- Five banks were reported to be targeting growth in small business loans, but in three cases there had been no growth in that area.
- Four banks were noted to have new or increased products in the small business lending area.

Overall credit risk in the small business portfolio was "unchanged" in 50 percent of the surveyed banks, had "declined somewhat" in 30 percent of the banks, and had "increased somewhat" in 15 percent of the surveyed banks.

Agricultural Lending

Underwriting standards for agricultural loans since the last examination were described as:

- "Unchanged" in 48 percent of the banks,
- "Eased somewhat" in two banks,

- "Tightened somewhat" in two banks, and
- "Tightened significantly" in one bank.

Sixteen of the surveyed banks were reported to have no (or minimal) agricultural exposure.

While exposure at the surveyed banks is modest, at two banks the overall risk in the agriculture portfolio had increased because of weakening commodity prices.

Tightened underwriting standards in this area include a reduced maximum size for the credits and additional collateral requirements.

International Credits

Eighty-seven percent of the surveyed banks had made no significant changes to their underwriting standards for international credits. In two banks, there had been some easing of standards for pricing, the size of credits/portfolio, collateral requirements, and other terms. Two other banks had tightened their lending standards for international credits in response to developments in Mexico and Latin America.

Compared to findings at the previous examination, credit risk in international loan portfolios was considered to be "unchanged" in 73 percent of the surveyed banks and to have "declined somewhat" in 15 percent of the banks. Recent developments in Mexico and other emerging markets contributed to a somewhat increased credit risk at 12 percent of the banks. However, where the risk increased, the examiners indicated it is well managed and/or of relatively small size.

Four of the surveyed banks entered new international markets, including Latin America, Eastern Europe, and Asia. At several banks, "country exposure" was identified as a concentration, and for one of those the concentration was with Japanese banks. The examiners' comments indicate that concentrations in international portfolios are well-managed, subject to internal monitoring and limits, and reported to senior management and the boards of directors.

Commercial Real Estate Loans

Lending standards for commercial real estate loans at the previous examination were considered to be "somewhat conservative" at 60 percent of the surveyed banks, "moderate" at 33 percent, and "somewhat liberal" at one bank.

Most of the surveyed banks had not changed their lending standards for commercial real estate loans since the previous examination. However, at 25 percent of the surveyed banks standards were considered to have "eased somewhat," while at four banks they had "tightened somewhat."

Overall credit risk in the commercial real estate portfolio was described as:

- "Unchanged" at 38 percent of the banks,

- "Declined somewhat" at 40 percent of the banks,
- "Increased somewhat" at 15 percent, and
- "Declined significantly" at two banks.

The most frequently cited reasons for the easing of lending standards were: "change in economic outlook" and "change in competitive environment" (eight banks), followed by "change in market strategy" and "change in bank's financial condition" (five banks). At 12 banks examiners commented that lending practices at competing banks had influenced the bank's commercial real estate lending standards.

The most frequently mentioned changes in lending standards were:
- "Loan fees or rate spreads" – 7 banks
- "Collateral requirements" – 5 banks
- "Maximum maturity" – 5 banks
- "Maximum size of credit lines" – 3 banks
- "Loan covenants" – 3 banks.

At three banks examiners reported an increase in commercial real estate loans on owner-occupied properties, multi-family residential properties, retail strip centers, and construction. The majority of surveyed banks, however, had not significantly increased their exposure to commercial real estate loans during the last year.

Six of the surveyed banks were reported to have concentrations of commercial real estate loans. Some of the banks monitor commercial real estate concentrations by segment (e.g., retail, multi-family), while others monitor commercial real estate concentrations on just an aggregate basis. The most frequently cited method of managing commercial real estate concentration risk was stress testing, either annually or when interest rates change significantly. Other methods mentioned included establishing limits on loans to the sector as a percent of total loans, a percent of total assets, or to identified geographic areas.

Residential Real Estate Loans

Lending standards for residential real estate loans at the last examination were described as:
- "Moderate" at 60 percent of the banks surveyed,
- "Somewhat conservative" at 25 percent,
- "Somewhat liberal" at three banks, and
- "Very conservative" at one bank.

Since the previous examination, most of the surveyed banks had not changed their lending standards for residential real estate loans, although 25 percent were identified as having "eased somewhat." Banks that were lowering their residential lending standards generally were responding to a need to grow and competition. Eased standards noted include:
- Higher loan-to-value ratios,
- Lower debt service coverage ratios, and
- Higher thresholds for requiring formal appraisals.

Overall credit risk in the residential real estate portfolio was considered to be "unchanged" in 70 percent of the surveyed banks. At the two banks where risk was considered to have increased, the increase was the result of the increased level of loans or a generally less desirable mix of residential loan types in the portfolio. With the increased credit risk, examiners noted no increase in problem loans or past due percentages, which would signal deterioration of the portfolio.

The reasons for the easing residential real estate lending standards most frequently stated were:

- "Change in market strategy" – 7 banks
- "Change in competitive environment" – 6 banks
- "Change in economic outlook" – 4 banks

The changes most frequently noted were in "collateral requirements," which changed at four banks, and in "loan fees or rate spreads," which changed at three banks. Specific examples of liberalized standards include:

- Increased maximum loan-to-value percentages on home equity loans – moved from 80 percent to 100 percent.
- Increased maximum financing on residential loans – moved from 80 percent to 90 percent.
- Liberalized housing and total debt service percentages.
- Increased home equity loan maturities – moved from 15 years to 20 years.

At three of the banks residential real estate loans had increased significantly since the previous examination. In addition, two banks were identified as having a concentration in residential real estate lending. Only one bank managed concentrations in residential real estate by setting a limit on such lending as a percent of total loans.

Affordable Housing Loans

For affordable housing, lending standards were described as

- "Moderate" or "somewhat conservative" at 85 percent of the banks surveyed,
- "Somewhat liberal" at three banks, and
- "Very liberal" or "very conservative" at none.

Since the previous examination, lending standards for affordable housing were described as:

- "Unchanged" at 53 percent of the surveyed banks,
- "Tightened somewhat" at three banks
- "Eased somewhat" at 23 percent of the banks, and
- "Eased considerably" at one bank.

At two of the banks that had eased their standards, examiners noted they were permitting higher loan-to-value and debt-to-income ratios and, in some cases, were waiving points and the requirement for private mortgage insurance.

The level of credit risk in affordable housing loan portfolios was described as:

- "Unchanged" at 74 percent of the surveyed banks,
- "Increased somewhat" in one bank
- "Increased significantly" in one bank, and
- "Declined somewhat" at 20 percent of the banks.

Three banks had introduced new affordable housing loan products since the previous examination. The examiners judged that the relative risk of the new products was moderate to high. One bank was reported as having increased its efforts to make FNMA-guaranteed low-income housing loans.

Home Equity Loans

At the previous examination, lending standards for home equity loans were considered to be "moderate" at 53 percent of the surveyed banks, "somewhat conservative" at 33 percent, and "somewhat liberal" at four banks.

Home equity lending was one of the most frequently identified categories of lending to have changed underwriting standards since the previous examination. In some cases, examiners reported banks were viewing and underwriting home equity loans as unsecured, rather than collateralized, debt. Lending standards for home equity loans were considered to have "eased somewhat" at 48 percent of the surveyed banks.

Overall credit risk in the home equity portfolio was considered:

- "Unchanged" at 58 percent of the surveyed banks,
- "Increased somewhat" at 23 percent,
- "Declined somewhat" at 15 percent, and
- "Declined significantly" at one bank.

The most frequently cited reasons for the easing of lending standards for home equity credits were:

- "Change in competitive environment" – 13 banks
- "Change in market strategy" and to increase loan volume – 9 banks
- "Change in economic outlook" – 3 banks.

"Collateral requirements" was the most frequently mentioned change in lending standards, affecting 12 banks, followed by "maximum size of credit lines," which applied to three banks. Specific examples of how underwriting standards had been eased include:

- Eased loan-to-value requirements – most commonly, being raised to 100 percent.
- Eased debt-to-income standards.
- More frequent overrides of score-based credit decisions.
- Higher thresholds for requiring appraisals.

Indirect Consumer Lending

At the previous examination, lending standards for indirect consumer lending were considered:

- "Moderate" at 43 percent of the surveyed banks.

- "Somewhat conservative" at 30 percent, and
- "Somewhat liberal" at 15 percent.

Twelve percent of the banks surveyed do not offer this product.

Indirect consumer lending was the category most frequently identified as having experienced increased credit risk since the last examination. It was also the category in which easing of lending standards was mentioned second most frequently – after home equity lending.

Overall credit risk in the indirect consumer loan portfolio was described as:
- "Unchanged" in 48 percent of the surveyed banks,
- "Increased somewhat" in 35 percent, and
- "Declined somewhat" at 13 percent.

The survey found that since the previous examination, lending standards for indirect consumer lending were considered:
- "Unchanged" at 45 percent of the banks,
- "Eased somewhat at 33 percent,
- "Tightened somewhat" at two banks, and
- "Tightened considerably" at one bank.

The easing of underwriting standards is reflected in:
- Lengthening of maximum maturities – 8 banks
- Relaxation of collateral requirements – 4 banks
- Reduction of fees or spreads – 3 banks.

The two most common reasons for the easing of lending standards were competitive pressure, mentioned at 10 banks, and changes in the bank's market strategy to include aggressive growth targets for indirect lending, which affected nine banks.

A number of banks had recently moved to credit scoring systems, which made judgments on the direction in which credit standards were moving difficult. However, examiners did not report concerns about the eased standards for this type of lending. Some mentioned studies that suggested that easing standards would not unduly increase loss exposure. In general, their lack of concern was due, at least partially, to the fact that at most of the surveyed banks, this type of lending represents a very small proportion of total lending.

Direct Consumer Lending

As in indirect consumer lending, a number of banks had recently moved to credit scoring systems for their direct consumer lending. Again, this made judgments on the direction of changes in credit standards difficult. However, examiners frequently cited direct consumer lending as showing increased credit risk and eased lending standards since the previous examination.

At the previous examination, lending standards for direct consumer lending were considered:

- "Moderate" at 68 percent of the surveyed banks,
- "Somewhat conservative" at 28 percent, and
- "Somewhat liberal" at one bank.

Since the previous examination, underwriting standards for direct consumer loans were considered:

- "Unchanged at 73 percent of the banks,
- "Eased somewhat" at 18 percent, and
- "Tightened somewhat" at two banks.

Of the seven banks that had eased standards, four had lengthened maximum maturities and three had eased collateral requirements. The primary reasons given for the easing of standards were competitive pressures, which was mentioned for six banks, and changes in market strategy to include aggressive growth targets for direct consumer lending, which affected eight banks.

Overall credit risk in the direct consumer lending portfolio was described as:

- "Unchanged" in 65 percent of the surveyed banks,
- "Increased somewhat" in 18 percent of the banks, and
- "Declined somewhat" in 15 percent of the banks.

Question-by-Question Analysis

The percentages in this section were calculated based on the entire population of the 40 large banks covered by the survey. When data do not total to 100 percent it is because of omitted responses, responses of "N/A" (not applicable), or rounding.

1. **Please describe how the bank's policies outlining lending standards are communicated. Does the Board-approved loan policy include specific, measurable standards to which individual loans can be compared, or are the specific standards articulated in separate guidelines or procedures established by management?**

   Official lending standards and the degree of detail they include varies from bank to bank. In 92 percent of the 40 banks, specific and measurable lending standards are communicated by Board-approved loan policies and management guidelines. Lending standards are communicated:

   - By means of a variety of committees,
   - As written guidelines and policies,
   - Through the interaction of line personnel with credit administration, and
   - By mentoring.

   Three banks rely primarily on "cultural" mechanisms to communicate their official lending standards, including:

   - Prescreening of loan committee documents by more senior credit personnel,
   - The loan committee approval process,
   - Formal and informal training,
   - Interaction between line lending personnel and credit administrators, and
   - Mentoring of junior loan officers by more experienced, senior officers.

2. **Since the previous examination, has the bank made any significant changes in its lending standards? Were the changes discussed with or approved by the board?**

   Since the last examination, only 15 percent, or 6, of the surveyed banks made significant changes in their lending standards. In five of those banks, the changes had been discussed with or approved by the Board of directors, and Board approval was pending at the sixth.

   At all six banks with significant changes, the changes involved some easing of lending standards, but the changes were reportedly balanced by increased controls. Examples of significant changes include:

   - Adopted new risk acceptance criteria and easier credit approval requirements that give officers higher approval thresholds and authorize more officers to approve loans.
   - Provided more guidance to officers on standards for interest rate protection products that emphasizes "appropriateness" and inherent credit risk.

- Liberalized retail credit standards while instituting risk-based pricing to maintain profitability at the higher risk level.
- Introduced simpler credit analysis and approval for small business loans under $100,000 and developed a performance-based rating process and credit scoring for small business loans up to $250,000.
- Increased the maximum loan-to-value ratios for commercial real estate lending.
- Adopted easier and more flexible terms for revolving lines of credit – e.g., maturities increased to five years and likely go further; some maturities already increased to seven years.
- Increased the limit for new and existing direct credit to a single borrower.

Comments from the examiners completing the questionnaire also provided examples of less significant changes in banks' lending standards and practices. The examiners reported that various banks had:

- Eased approval thresholds for scored credits.
- Priced loans more aggressively – in some cases, at rates below prime.
- Enhanced post-disbursement review, including a focus on underwriting, documentation, and administration of credit exposure.
- Developed specific, measurable guidelines for all major types of credit.
- Eased covenant and guarantee requirements somewhat.
- Redefined credit exposure, tightened hold limits, clarified requirements for the frequency of field examinations, and modified criteria for which loans require senior credit committee approval.
- Added a new program for underwriting mortgages that do not meet current industry requirements for agency and private label securitization.

3. **Compared with competing banks you are familiar with, characterize the bank's lending standards at the previous examination for the listed types of loans from "very liberal" to "very conservative." [The listed loan types are commercial and industrial and syndicated, middle market, small business, agriculture, international, commercial real estate, residential real estate, affordable housing, home equity, indirect consumer, and direct consumer.]**

The overwhelming majority of the banks were reported to have "moderate" or "somewhat conservative" lending standards. Of the 440 responses across all loan types (including 51 marked "not applicable") standards were described as:

- "moderate" or "somewhat conservative" 358 times,
- "very conservative" 9 times,
- "somewhat liberal" 21 times, and
- "very liberal" once, in affordable housing loans.

Although six of the somewhat liberal standards were reported in consumer indirect lending, overall 29 of the 40 banks were reported to have "moderate" or "somewhat conservative" standards in that area.

4. **How have the bank's lending standards changed since the previous examination for each of those 11 types of loans?**

Commercial and Industrial

At 70 percent of banks, lending standards for the four categories considered to comprise commercial and industrial loans (commercial and industrial and syndicated loans, middle market loans, small business loans, and international credits) remain relatively unchanged. However, the number of loans made as "exceptions" to established loan policy has increased. Exceptions to loan policy included lower pricing, extended maturities, longer grace periods for amortization, higher advance rates, and easier requirements for guaranties.

Standards for these loans were reported to have "eased somewhat" in 22 percent of the banks, and "tightened somewhat" in two banks.

Consumer Loans

Examiners reported the largest number of changes in underwriting standards in the four categories comprising consumer lending (residential real estate, home equity loans, indirect consumer loans and direct consumer loans). Relaxation of underwriting standards was reported most often for indirect auto loans (loans with loan-to-value ratios over 100 percent) and home equity loans (loans with 100 percent loan-to-value ratios). Both those areas are growth areas for many of the banks in the survey (*see* questions 10 and 11).

Consumer lending category standards were reported as:

- "Unchanged" at 57 percent of the banks,
- "Eased somewhat" at 31 percent, and
- "Tightened somewhat" at 2 percent.

Ten percent of the responses were omitted or "N/A."

Affordable Housing Loans

Lending standards for affordable housing loans were noted to have eased in more than 26 percent of the banks surveyed. Examiners commented that, in order to attract these loans, standards are allowing higher loan-to-value and debt-to-income ratios. In some banks examiners observed waivers of points and the requirement for private mortgage insurance associated with making these loans.

For affordable housing loans, standards were reported as:

- "Unchanged" at 53 percent of the banks,
- "Eased somewhat" at 23 percent,
- "Eased significantly" at 3 percent, and
- "Tightened somewhat" at 8 percent.

Thirteen percent of responses were omitted or "N/A."

5. **Have the bank's lending standards for any particular industry changed since the last examination?**

Real Estate
Lending standards for real estate (including commercial, residential, home equity, and affordable housing) were the most eased since the last examination. The most notable relaxation of underwriting standards occurred in home equity and affordable housing loans, where examiners noted higher loan-to-value and debt-to-income ratios.

Cable
Examiners recorded several observations regarding underwriting on loans to the cable industry.

- One bank had nominally tightened its guidelines for loans to the industry, but the number of exceptions made to those guidelines had increased dramatically.
- Another bank had not formally changed its underwriting standards, but showed a significant increase in the number of policy exceptions on its loans to the cable industry. Exceptions were observed in the areas of interest coverage, fixed charge coverage, leverage, capital expenditures, maturities, and pricing.
- Two other banks were reported to have eased their standards "somewhat."
- One bank reported it had eased its standards "significantly."

Other
The health care and agriculture industries were each reported by three banks to have been subjected to tightened underwriting standards. While no other industries merited mention at more than one bank, of specifically mentioned industries, most had experienced somewhat eased standards or standards that were unchanged, but with increased numbers of exceptions.

6. **With respect to loan policy exceptions, characterize the bank's systems and procedures for:**
   - **Approving and reporting individual exceptions**
   - **Monitoring the aggregate level of exceptions.**

The survey found that, on a loan-by-loan basis, exception reporting is good. Ninety-two percent of the surveyed banks were identified as having either adequate or highly satisfactory systems for approving and reporting individual exceptions to loan policy. However, at the portfolio level, systems for monitoring the aggregate level of exceptions were generally reported to be less effective. Fully 40 percent of the banks had systems and procedures for monitoring the aggregate level of exceptions that were considered inadequate.

Examiners' reported that management at some of the banks that lacked good systems for tracking aggregate exceptions, believe that if an individual review of the loan finds merit in approving a credit outside of policy, the frequency of such exceptions is not significant. Banks that seem most satisfied with their systems often use the credit process to approve initial policy exceptions, and use their loan review systems to track exceptions over time.

7. **If the answers to questions 4 or 5 indicate that lending standards have changed since the previous examination, please indicate further what particular terms and conditions were tightened or eased.**

The survey results found that competition is forcing an easing of underwriting standards in both larger, syndicated credits and smaller, retail credits. The first signs of an easing of underwriting standards are compromises on loan fees and rates, relaxation of collateral requirements, and lengthening of maturities. However, several examiners commented that his or her bank had eased its lending standards from "very conservative" to "conservative."

Commercial and Industrial Loans
For the commercial and industrial loan categories (commercial and industrial and syndicated loans, middle market loans, small business loans, and international credits), terms and conditions were most often changed for syndicated and middle market lending. For syndicated loans, the changes generally were in loan fees and spreads, with 28 percent of the banks showing tightening. In 25 percent of the banks, maturities for these larger credits were lengthening. Four responses indicated some easing of guarantor requirements, and several banks were reported to be experimenting with credit scoring for small business lending.

Real Estate Loans
For real estate loans, most changes occurred in the terms and conditions for home equity and affordable housing loans. For home equity lending, 30 percent of the surveyed banks showed an easing of collateral requirements (loan-to-value limits). For affordable housing loans, 20 percent indicated some loosening of collateral requirements.

Consumer Lending
For consumer loans, 20 percent of the surveyed banks showed lengthening maturities for indirect consumer loans. Retail lending standards are showing clear signs of competition from both banks and nonbanks. In two cases, examiners indicated that the banks are moving into C- and D-grade auto paper and B- and C-grade residential mortgages.

8. **Which considerations/motivations affect the bank's loan pricing decision?**

For 50 percent of the surveyed banks, the most important consideration in pricing is to retain the existing relationship. Establishing a new relationship was the second most important pricing consideration. By comparison, 33 percent of the banks surveyed, ranked risk considerations as the most important factor affecting loan pricing. Overall, 48 percent of the banks mention risk as a factor, but not the primary one, in setting prices.

Almost all of the surveyed banks have a pricing model, often elaborate "risk adjusted return on capital" types. However, most banks admit that competition drives their pricing decisions. Most banks run all of their larger loans through their pricing model and then price to meet the competition.

Cross-selling was frequently mentioned as a primary reason for lowering loan prices. The comments indicate a fairly significant move towards "relationship profitability" in evaluating the risk/return balance. However, a number of banks are having difficulty evaluating relationship profitability because of problems associated with measuring internal transfer pricing and expense allocation.

9. **If lending standards have changed since the previous examination, what were the main reasons for changes by types of loans?**

For the 15 percent of banks showing a significant change in lending standards, the primary reasons given for all categories of loans were:

- Changes in the competitive environment, and,
- Changes in market strategy.

There were two categories that were exceptions – commercial real estate and affordable housing. "Changes in economic outlook" and "Changes in the competitive environment" were the reasons given for changes in standards for commercial real estate loans. For affordable housing loans an additional reason was listed; "changes in supervisory policies or practices." This was the only category for which that additional reason was listed. Comments associated with several banks also mentioned "growth/maintenance of loan volume" and "income generation" as reasons for changing standards.

10. **Since the previous examination, has the bank introduced any new types of loan products? If Yes, please explain and comment on the relative risk of the new products.**

New loan products, primarily consumer oriented, were reported at 50 percent of the surveyed banks. The most frequently mentioned new products were:

- 100 percent loan-to-value home equity loans – 7 banks
- Low-documentation small business loans – 3 banks
- Credit-scored small business loans – 2 banks
- New credit card products – 4 banks
- Direct auto leasing – 3 banks
- Affordable housing programs – 3 banks.

Two other new consumer products identified in the survey were finance company products and consumer disaster loans. In addition, two banks were reported to have undertaken new commercial lending initiatives by implementing commercial real estate mezzanine financing and "tax retention operating leases."

At 12 banks, examiners commented on the relative risk of the new products. Those comments all acknowledged some increased risk in products such as pre-approved credit cards, 100 percent home equity lending, low-documentation small business loans, and affordable housing loans. Seven comments indicated that the additional risk was controlled and/or the level of interest in the new product was nominal.

11. Since the previous examination, has the bank significantly increased its exposure to a previously established loan product(s). If yes, please comment on the reasons for the increase and the relative risk of the products.

Sixty percent of the surveyed banks had significantly increased their exposure to one or more previously established loan product(s). Most of the increased exposure was to previously established consumer products. The most frequently cited increased exposures included:

- Credit card programs – 10 banks
- Indirect auto lending – 6 banks
- Retail/consumer products – 4 banks
- Commercial loans – 3 banks.

Of the 12 comments provided on the reasons for the increased exposure, those most frequently cited were "planned growth" and "competitive pressure." Of the nine comments provided on the relative risk of the products, three indicated relative risk had increased, four indicated increased risk that was controlled or well-managed, and two indicated the changes did not increase credit risk.

12. Since the previous examination, has the bank entered any new markets or expanded its presence in its existing markets? If yes, please explain and comment on the relative risk of the new and/or expanded markets.

Sixty-four percent of the surveyed banks were reported to have entered new markets. The most common method of expansion (13 banks) was through acquisition of another bank. Seven more banks were reported to have expanded their market share or regional presence through loan production offices or new branches. There did not appear to be any pattern of expansion into a specific area of the country.

13. Characterize what has happened to the degree of credit risk inherent in the bank's loan portfolio since the previous examination. If a change has occurred, please describe its nature and the degree to which it was the result of actions taken by the bank (as opposed to changes in economic conditions).

In general, the survey found overall credit risk at 57 percent of the banks "unchanged," while at 23 percent it had actually "declined somewhat." Only 14 percent of the surveyed banks showed increased credit risk. Although portfolio risk was often judged "unchanged," several examiners noted concern about how recent loan growth and easing of loan terms in the portfolios of some banks would affect their portfolios in the future.

They also had concerns about the ability of those portfolios to weather the next economic downturn.

Percent of Surveyed Banks Indicating Changes in Portfolio Credit Risk
since the last examination

Loan Type	*Significant Increase*	*Some Increase*	*Unchanged*	*Some Decline*	*Significant Decline*
Commercial and Industrial:					
Syndicated/National Credits	0	8	53	39	0
Middle Market	0	18	49	33	0
Small Business	0	16	53	32	0
International	3	9	73	15	0
Agriculture	0	7	81	11	0
Commercial Real Estate:	0	15	38	41	5
Retail:					
Residential Real Estate	0	3	72	26	0
Affordable Housing	3	3	74	20	0
Home Equity	0	24	61	16	0
Consumer-Direct	0	18	67	15	0
Consumer-Indirect	0	37	50	13	0

Credit risk appears to have declined, on a net basis, in the commercial and industrial and commercial real estate loan portfolios, and to have increased somewhat in retail portfolios. Credit risk in commercial and industrial and commercial real estate portfolios was reported to have "declined somewhat" in approximately twice as many banks as it had increased. The most common reason cited for this improvement was the continued decline in the level of problem and nonperforming loans, which was attributed to improvements in the economy and continued management success in working out problems.

Where credit risk had "increased somewhat," notably middle market and small business portfolios (18 percent and 16 percent, respectively), the most common reasons given were growth or new products (6 portfolios) and easing of terms (5 portfolios).

The 12 percent of international portfolios reflecting increased risk is attributed to "turmoil" in Mexico and other emerging markets.

Retail portfolios, unlike commercial and industrial portfolios, reflected some increased credit risk. The consumer-indirect and home equity loan portfolios in the surveyed banks reflect the highest incidence of increased credit risk (37 percent and 24 percent, respectively). While credit risk was judged to have increased somewhat in 18 percent of consumer-direct lending portfolios. Reasons given for the increased risk include:

- Easier terms – 6 banks
- New products/marketing strategies – 6 banks
- Growth – 5 banks
- Increased delinquencies/losses – 2 banks.

14. Characterize the independence and effectiveness of the bank's loan review system.

Independence of loan review was rated "highly satisfactory" at 33 percent of the banks. Further, in all but one of the surveyed banks, independence was judged to be at least "adequate." Similarly, the effectiveness of loan review was considered at least "adequate" in all of the surveyed banks, while 60 percent were rated "highly satisfactory."

The survey found a wide variety of loan review structures and approaches. For example, at two banks, the loan review divisions report directly to a committee of the board of directors, both functionally and administratively. At several other banks, the loan review divisions report functionally to a committee of the board of directors, but administratively to a bank senior officer.

With regard to how the banks pursue loan review, in some banks, the loan review division performs annual, departmental loan reviews using a set portfolio penetration ratio. In other banks, loan reviews are not calendar-driven, rather the loan review division performs risk-based reviews based upon its perception of the level of risk in a particular portfolio. Yet other banks' loan review departments are moving to more continuous review or monitoring.

Examiner comments indicated that, at several banks, the loan review divisions operate with a "lean" staff size, but only two specifically mentioned that staff size had decreased over the last year.

15. Characterize the quality of the bank's overall credit administration system.

All of the surveyed banks had credit administration systems rated at least "adequate," and 43 percent had systems judged "highly satisfactory."

Some loan administration systems were reported to be centralized, while others were decentralized. Both types of systems function well. Examiner comments noted that five banks either recently enhanced their management information systems (MIS) or plan an enhancement. Three banks were identified as needing to improve some aspect of their MIS – exception tracking, portfolio analysis, documentation tracking, etc.

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18. **Does the bank have in place an effective system for identifying and managing the risk associated with concentrations of credit.**

Systems for identifying and managing concentrations of credit were effective at all but one of the 40 banks in the survey. In addition, comments indicated that most banks have effective systems for monitoring concentrations on an ongoing basis. The one bank without an effective system for identifying and managing concentrations is reported to have a relatively sophisticated system in development.

Industry concentrations are generally tracked using standard industry codes (SIC). Many of the banks in the survey also track concentrations other ways, for example, by specific specialized lending categories or geographic areas. The bank systems were reported to vary in their accuracy and completeness. Examiner comments also indicated a wide variety in the sophistication of systems for managing concentrations, with the less sophisticated systems generally in companies with more moderate levels of concentrations.

Many banks prepare and use industry analyses in evaluating concentrations. Twenty-four banks prepare industry studies on at least some industries internally and two others use externally prepared analyses.

Thirteen banks performed stress testing; however, several of that number have stress tested only their commercial real estate portfolios. Fifteen banks used limits or caps to manage their concentrations.

17. **Please identify the bank's five largest concentrations of credit.**

The most frequently reported concentrations were in the general categories of real estate, finance, manufacturing and agriculture. Ten banks were reported to have a total of 20 concentrations that exceeded 100 percent of capital. The most frequently cited of those were in real estate, finance/insurance, and loans to foreign countries.

Some banks looked for concentrations by lending product and geographic locations, others did not. Some used very broad categories, such as agriculture; others used very narrow, product or crop-specific, categories. In some banks, real estate was reported as one category, while other banks had as many as three real estate categories among their top five concentrations.

Number of Banks Reporting Concentrations*, by Broad Category
(concentration levels expressed as a percent of capital)

Loan category	Total	Concentration levels ≤25	25-35	35-50	50-75	75-100	≥100
Accounts Receivable	1						1
Agriculture	13		6	3	4		
Autos/Trucks/Dealers	3		1	1	1		
Brokers/Dealers	3				2	1	
Casinos	1	1					
Communications (inc. Cable)	9	1	6	1	1		
Chemicals	2			1	1		
Energy	5			1	2	2	
Financial Institutions	22	2	5	1	4	7	3
Geographic Location	6				1	2	3
Governments	1			1			
Health Care	7	1	1	3	1		1
Highly Leveraged Transact.	1		1				
Insurance	5		3	1			1
Investment Companies	1						1
Leasing	1				1		
Manufacturing	17	3	6	2	4		2
Placements	1						1
Real Estate	32	3	2	8	9	6	4
Retail Lending	6		1	3	1		1
Retail Trade	8		2	3	3		
Services	3		2		1		
Transportation	1		1				
Utilities	6	1		4			1
Wholesale	7		2	3	1		1
Totals	162	12	39	36	37	18	20

* Each bank could identify up to five concentrations, so the number of possible occurrences is 200.