Comptroller of the Currency
Administrator of National Banks

# 1996 Survey of Credit Underwriting Practices

National Credit Committee

September 11, 1996

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# 1996 Survey of Credit Underwriting Practices

## Introduction

The Office of the Comptroller of the Currency (OCC) conducted its second annual "Survey of Credit Underwriting Practices" during the second quarter of 1996. The survey's goal was to identify trends in credit risk within the national banking system taking place since the previous survey of May 1995. Specifically, the questionnaire sought to identify changes in lending standards and requirements and growth trends for a variety of lending products currently offered by many national banks. The OCC examiners-in-charge of the largest national banks in the country were asked to respond to the survey based on their firsthand knowledge of the banks they supervise. The Comptroller's National Credit Committee subsequently compiled and analyzed the results of the survey. This committee includes a cross-section of the most experienced credit examiners from around the country, along with individuals from headquarters representing a variety of policy disciplines within the agency. The committee's members have an average of 21 years experience in bank regulation.

## Primary Findings

- ***Among Banks that Changed Lending Standards, a Trend Toward Easing Standards for Commercial Loans Emerged***

The committee found that, in most cases, banks had not changed their lending standards and requirements in the previous 12 months. Where changes had been made, however, examiners reported that more banks eased rather than tightened standards. This trend was far more pronounced in the commercial lending portfolio than in the retail lending portfolio.

- ***Largest Banks are Tightening Retail Lending Standards***

Although the committee found that some banks have continued to ease lending standards, this trend was not universal among

surveyed banks. Instead, the committee found that the largest national banks were more likely to have tightened their standards and requirements for retail loans than to have eased them. This trend was most evident in credit card lending, where survey results showed that 43 percent of the larger banks tightened lending standards. This was not the case in 1995, where the committee found that banks that had changed their retail product lending standards were more likely to have eased rather than tightened standards.

- ***Competition Continues to Drive Changes in Lending Standards***

Examiners cited competitive considerations as the predominant reason why banks changed lending standards and requirements. Growth as a market strategy was the second most frequently cited reason for changes in lending standards. The effects of competition are most apparent in the easing of pricing for all categories of commercial loans. In this area of lending, banks are competing not only among themselves, but in many cases they also are competing with other financial intermediaries as well as the capital markets.

- ***The Level of Credit Risk in Both Retail and Commercial Portfolios is Increasing***

As compared with a year ago, at most of the banks surveyed the level of inherent credit risk has increased in one or more of the product components of their loan portfolios. Increased levels of credit risk were most frequently noted in the credit card and indirect consumer components of banks' retail portfolios, and in the middle market and syndicated/national credit components of commercial portfolios. In the course of the normal examination schedule, OCC examiners are evaluating, on a bank-by-bank and portfolio-by-portfolio basis, how well their assigned banks manage the risk in their loan portfolios. In each case where examiners determined that the bank's information systems and controls for managing credit risk were deficient, or that reserves or capital were inadequate for the level of risk assumed by the bank, examiners have recommended corrective action to management and the board and will follow-up on those recommendations.



## Survey Implications

The National Credit Committee's review of the survey indicates a moderate but discernable trend of increasing credit risk within the national banking system, despite a stable economy and generally favorable leading economic indicators. The committee has some concern that the currently favorable economic conditions, coupled with the relatively high credit quality currently found in most banks may be masking the increase in inherent credit risk and that bank management should monitor closely the effects of competitive pressures and growth strategies on lending standards.

The committee's concerns stem from its finding that more banks relaxed their lending standards and requirements than tightened them. This is a continuation of a trend previously indentified in the 1995 survey. Reports of intense competitive pressures coupled with ambitious growth strategies at many banks appear to have combined to produce more aggressive lending practices. Examiners cited aggressive practices in a number of product lines, including middle market, small business, and international lending in commercial portfolios, and home equity loans in retail lending portfolios. Only the credit card product line revealed a mixed approach to risk, as examiners reported that many of the very largest banks began to tighten standards in 1996, while a number of banks below the top tier in size continued to ease standards.

In addition to easing standards, examiners perceived increasing inherent credit risk at the banks they supervise. Examiners most frequently cited middle market and syndicated/national credits in the commercial portfolio and credit card and indirect consumer loans in the retail portfolios as the product lines with the most increased credit risk.

## Report Methodology

The National Credit Committee supports the OCC's risk-based approach to bank supervision by identifying factors that may impact credit quality within the banking system. The analysis of the survey results helps the Committee achieve its mission to "improve the OCC's ability to identify and respond to credit

risks that could significantly affect the safety and soundness of the national banking system." Objectives of the committee include identifying adverse changes in underwriting standards for loan products and advising OCC policy makers on an appropriate supervisory response to significant credit risks.

The 1996 survey covered a broader population of banks than in 1995. In 1995, the survey covered only the 40 largest bank holding companies in asset size. In 1996, the survey was expanded to cover the 82 largest bank holding companies. The aggregate loan portfolios of national banks in this survey totaled $1,361 billion as of June 30, 1996, or approximately 83 percent of all outstanding loans in national banks. Included in this survey are banks classified as Tier I, II, or III. This tiered system, used by the OCC to administer the national banking system, classifies Tier I and II banks generally as those owned by the largest bank holding companies in asset size. Tier III banks are owned by other bank holding companies having national bank assets greater than $1 billion. Of the 82 companies surveyed in 1996, 29 companies with 282 national bank affiliates fall into the Tier I or II category. The remaining 53 companies with 193 national bank affiliates are in the Tier III category.

In many cases, the Committee's analysis of the results of the survey noted differences between the commercial and retail portfolios of the surveyed banks. For the purposes of this survey, commercial loans include: syndicated/national credits, middle market loans, small business loans, international credits, commercial real estate loans, and agricultural loans. Retail loans include: residential real estate loans, affordable housing loans, home equity loans, credit cards, other direct consumer loans, and indirect consumer paper (loans originated by others, e.g., car dealers).

Part I of this report discusses in more detail the overall results of the survey. Part II contains the results of the survey by type of loan.

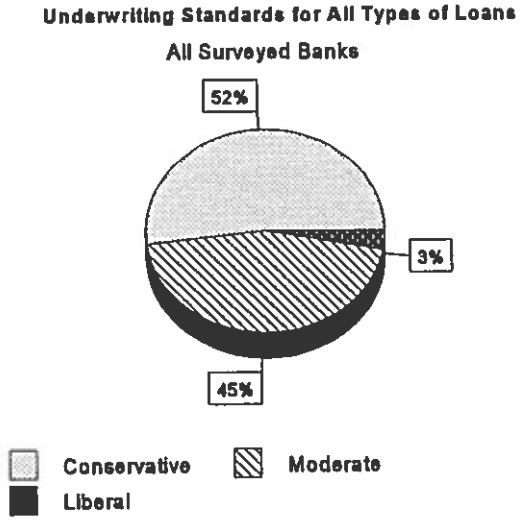


# Part I — Overall Results

## Underwriting Standards

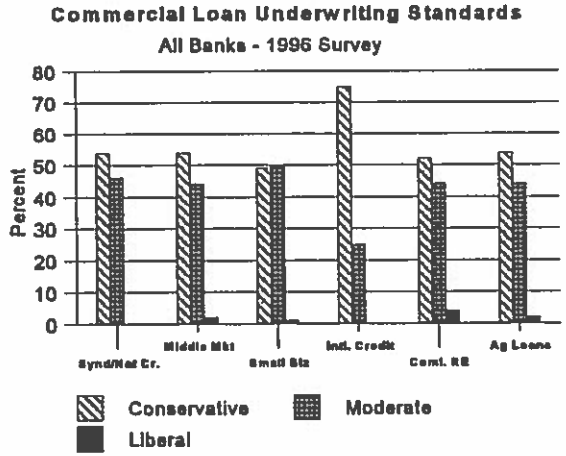
Overall underwriting standards at most of the surveyed national banks remain conservative or moderate.

Examiners completing the survey were asked to characterize the overall underwriting standards of each bank as "conservative," "moderate," or "liberal." The following chart reflects the fact that OCC examiners consider the overwhelming majority of banks to be moderate or conservative lenders.

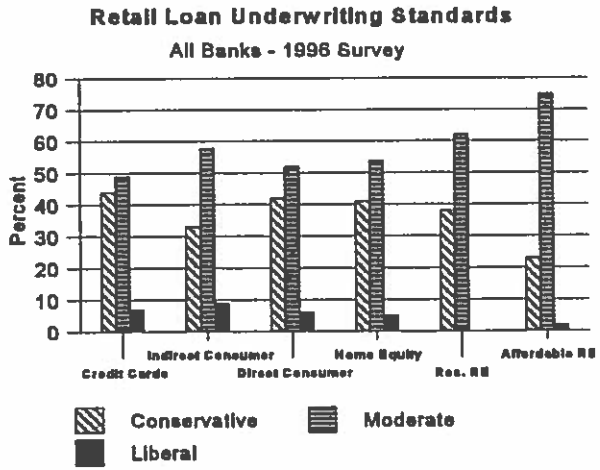



It should be noted that the conclusions presented in this and the next two charts are based largely on comparisons with other peer banks with which examiners are familiar. Viewed separately, changes in individual lending standards and requirements may seem relatively minor, however; the overall effect on credit quality of changes in several individual standards is cumulative and thus more difficult to assess. Furthermore, because some banks are already more (or less) conservative than their peers, any judgements about whether a particular change in

lending standards and requirements is "good" or "bad" can only be made on a bank-by-bank basis. Until loan problems begin to become apparent, it can be difficult to recognize when the easing of overall underwriting standards (in both the bank and the peers it is compared with) has adversely effected credit quality.




The two charts on this page present findings about overall underwriting standards in the commercial and retail lending portfolios of surveyed banks by type of loan.





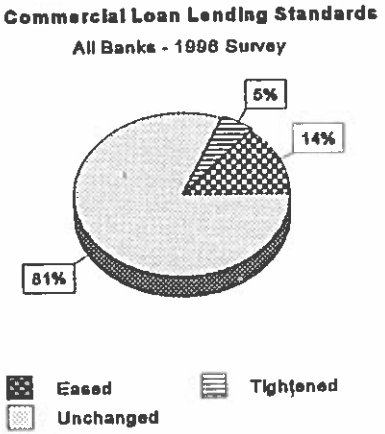

Examiners completing the survey clearly consider liberal standards for granting credit to be more prevalent in banks' retail portfolios than in their commercial portfolios.

## Changes in Lending Standards

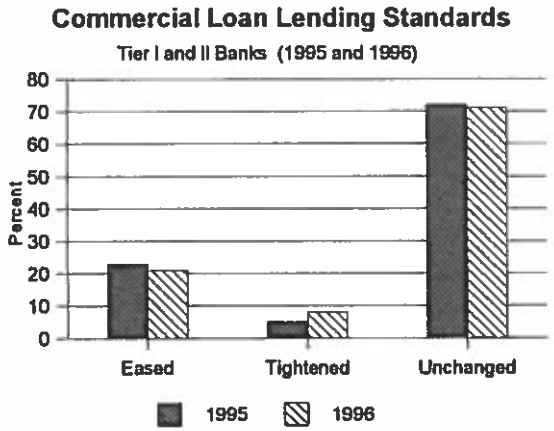
The 1996 survey found that, in most cases, banks have not made any changes in the last year to the individual lending standards and requirements used to control the level of credit risk they are willing to accept.

### *Changes in Commercial Lending Standards*

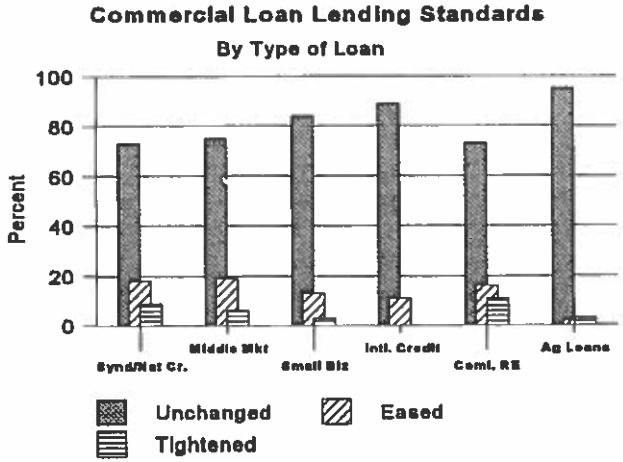
Of the banks reported to have changed lending standards and requirements since May 1995, examiners cited the easing of individual lending standards most frequently in commercial portfolios, particularly in the middle market, small business, and international loan categories. Nevertheless, fewer Tier I and II banks were reported to have eased lending standards for commercial loans in 1996 than in 1995.




Of the banks surveyed in 1996, 81 percent made no changes in their lending standards and requirements in the last year for commercial loans. In the 19 percent of banks in which examiners reported that lending standards and requirements had been changed, however, about three times as many banks (14 percent) eased their lending standards for one or more types of commercial loans as banks that tightened their standards (5 percent).




Tier I and II banks were surveyed in both 1995 and 1996 to identify any changes in lending standards and requirements for commercial loans (see previous chart). Although the difference narrowed somewhat in 1996, in both of the last two years a substantially higher percentage of these largest banks eased their lending standards and requirements for commercial loans than tightened them. Of the Tier III banks surveyed for the first time in 1996, examiners judged that 87 percent had not changed their lending standards for commercial loans in the last year. Nine percent of the banks in this group were believed to have eased their standards and the remaining 4 percent to have tightened them.

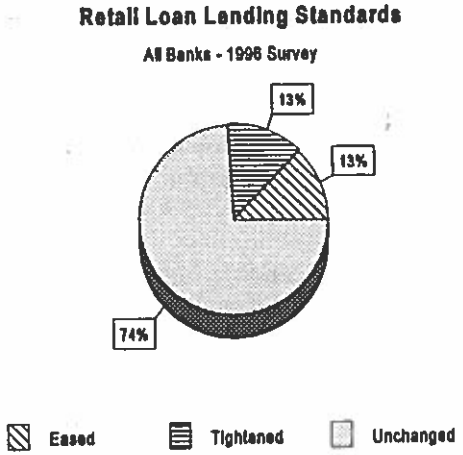





Of the six categories of commercial lending surveyed (see chart above), examiners reported that banks had the strongest tendency toward easing lending standards and requirements for middle market, international, and small business loans. Specifically, last year, 19 percent of the 72 surveyed banks making middle market loans had eased their standards for this component of their portfolio, while only 6 percent had tightened them. While fewer banks had changed their standards for small business loans, survey results revealed a similar situation, with 14 percent of the small business lenders easing their standards and only 1 percent tightening them. Among the 36 banks that are engaged in international lending, examiners reported that 11 percent had eased their standards, while none had tightened them. Lending standards for syndicated/national credits were eased by 18 percent of the 55 surveyed banks lending in this market and tightened by 9 percent. For the 75 commercial real estate lenders, examiners reported that 16 percent had eased their standards in the last year while 11 percent had tightened them. Respondents indicated that agricultural lending standards and requirements were the least frequently changed, with 2 percent of the 59 agricultural lenders reported as easing and 3 percent as tightening their standards.

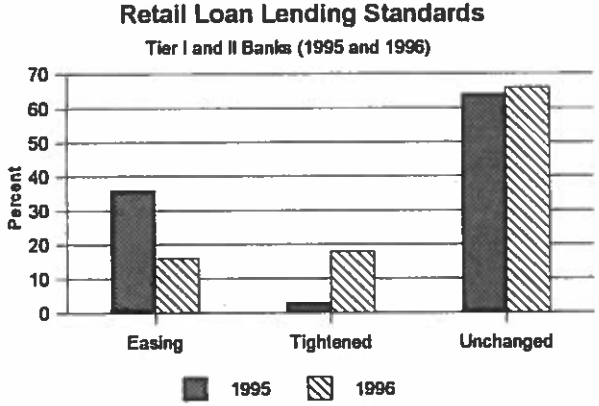
## *Changes in Retail Lending Standards*

In contrast to the commercial portfolio, home equity loans are the only category of retail lending in which there is a clear



tendency among banks for easing lending standards. significant shift toward tighter lending standards for credit cards, particularly among the larger banks.

Of the banks surveyed in 1996, 74 percent made no changes in their lending standards or requirements for retail loans in the last year (see chart above). Examiners reported 13 percent eased and 13 percent tightened their standards.

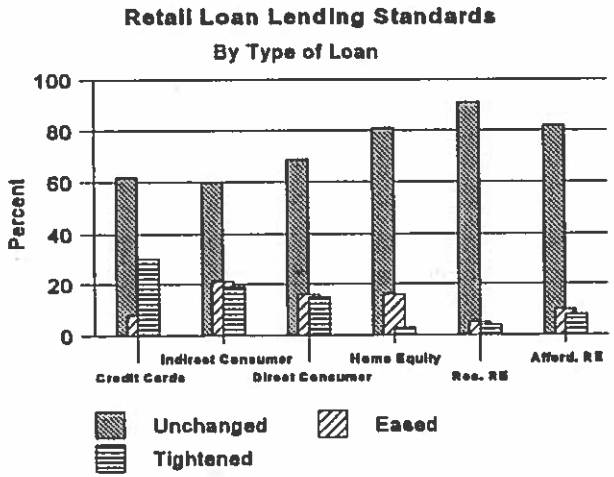



Compared with 1995, however, results indicate a dramatic change in the attitude of many larger banks toward retail credit during 1996 (see chart above). Among the Tier I and II banks that were surveyed, examiners reported that approximately 36 percent of the banks had eased their standards for one or more types of retail credit in the 1995 survey. That figure dropped to 16 percent in the 1996 survey. More significantly, the percentage of Tier I and II banks that *tightened* lending standards and requirements for one or more types of retail credit increased from less than 5 percent of the surveyed banks in 1995, to 18 percent this year.

Among the categories of retail lending surveyed (see next chart), the most notable changes have occurred in the lending standards for credit cards. Among Tier I and II banks in particular, there has been a significant shift toward tighter lending standards for credit cards. Forty-three percent of these largest banks had tightened



their standards for credit cards, while only 9 percent had eased them. A similar, but less pronounced, shift has occurred among the Tier III banks, with 23 percent tightening and 7 percent easing their standards for credit cards in the last year.

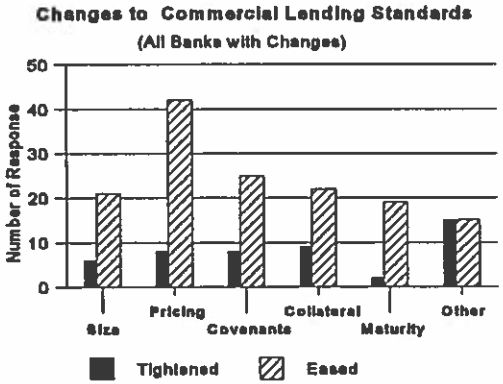



Home equity loans were the only category of retail credit in which banks showed a clear bias toward eased lending standards and requirements. Among the 74 surveyed banks making home equity loans, 16 percent had eased their standards and only 3 percent had tightened them. The easing of standards for home equity loans continues a trend noted in the 1995 survey. No clear trends were apparent in the underwriting standards for the other categories of retail lending.

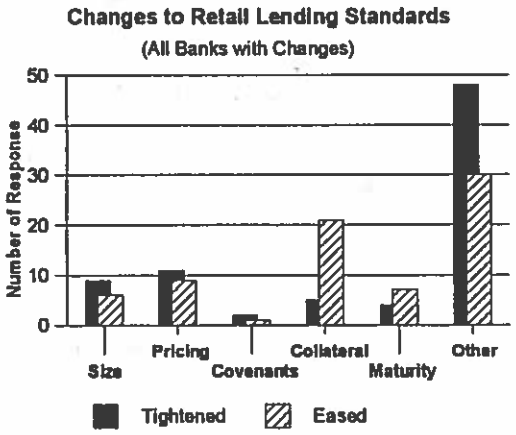
## Techniques Used to Change Lending Standards

Examiners completing the survey were next asked to identify how banks eased or tightened standards from among the following choices: maximum size of credit line, pricing (loan fees and/or rate spread), loan covenants, collateral requirements, maximum maturity, or other reasons.

The trend toward an easing of individual lending standards and requirements among the surveyed banks was more pronounced in commercial portfolios than in retail portfolios.



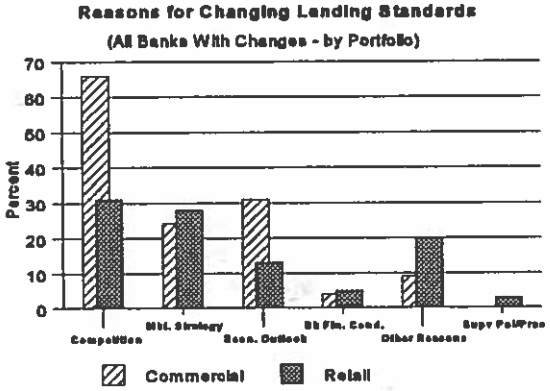

For commercial loans, examiners reported substantially more instances of eased individual standards and requirements than of tightened standards (see chart above). Providing more favorable pricing (loan fees and/or rates) has been the predominant method of easing standards for all categories of commercial loans. Changes in guarantor requirements were the most common "other" type of change cited by examiners. For retail loans, examiners reported that more banks have shown a willingness to increase their advance rate against pledged collateral, and to lengthen the maturity of their retail loans in an effort to ease requirements (see chart below). The majority of banks reported to have tightened their standards for retail loans in "other" ways chose techniques such as tightening requirements for credit card solicitations and instituting higher cut-off scores for all types of credit-scored loans.



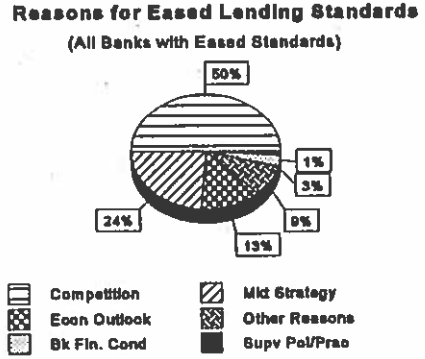



## Reasons for Changed Standards

Examiners cited competition as the predominant reason for changing lending standards and requirements for commercial loans. Competition was also the most frequently mentioned reason for changed standards on retail loans, followed closely by the bank's market strategy.



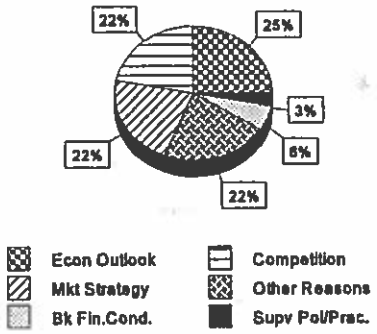

In those banks that have made changes in their lending standards and requirements over the last year, examiners were asked to characterize the reasons for easing or tightening standards from among the following choices: change in the bank's financial condition, change in economic outlook, change in competitive environment, change in market strategy, changes in supervisory policies or practices, and other reasons. In many cases, examiners cited more than one reason for the change, and the reasons often varied from one loan product to the next.



Although the reasons for changes in lending standards and requirements varied between banks and by category of loan, competitive considerations clearly predominated in those cases in which standards were eased (see previous chart). Examiners most frequently cited economic outlook as the reason for tightened standards, followed closely by competition, market strategy, and "other" reasons (see following chart).

**Reasons for Tightened Lending Standards**

(All Banks with Tightened Standards)




## Credit Risk in Loan Product Portfolios

As compared with a year ago, at most of the banks surveyed, the level of inherent credit risk has increased in one or more of the product components of their loan portfolios. Examiners reported increased levels of credit risk most frequently in the credit card and indirect consumer components of banks' retail portfolios, and in the middle market and syndicated/national credit components of commercial portfolios.

Because changes in lending standards and requirements can, over time, affect the level of credit risk in the bank's loan portfolio, examiners were asked to characterize the level of credit risk in each of the 12 loan products covered by the survey. Their assessment of the level of risk considered only the risk inherent in the individual loan products, and did not take into account the relative importance of the loan product to the bank's

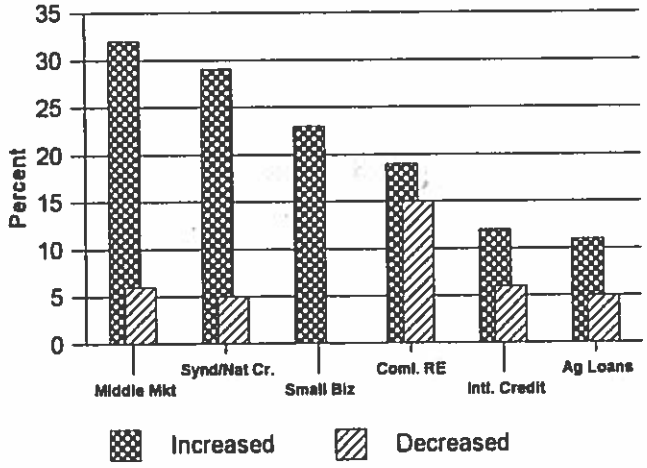


balance sheet, or any measures the bank had taken to manage the risk in the portfolio.

The following chart reflects, by loan type, examiners' views of changes over the last year in the inherent credit risk in the commercial loan portfolios of surveyed banks. Examiners found that the middle market component of loan portfolios in 32 percent of the 72 surveyed banks making this type of loan had an increased level of credit risk as compared with a year ago. The level of credit risk associated with middle market lending had decreased at 6 percent of the banks. Among the 55 surveyed banks with portfolios that included syndicated/national credits, 29 percent of the banks were judged to have an increased level of credit risk, and five percent to have a lower level, in this category of lending. Examiners considered the inherent credit risk for small business loans to be higher in 23 percent of the 75 banks making these loans than it was a year ago. There were no banks in which credit risk on small business loans was seen to have decreased. Competition, loan growth, and the acceptance of higher risk borrowers were common factors cited for the increased level of credit risk in commercial portfolios.

**Changes in Credit Risk in Commercial Portfolios**

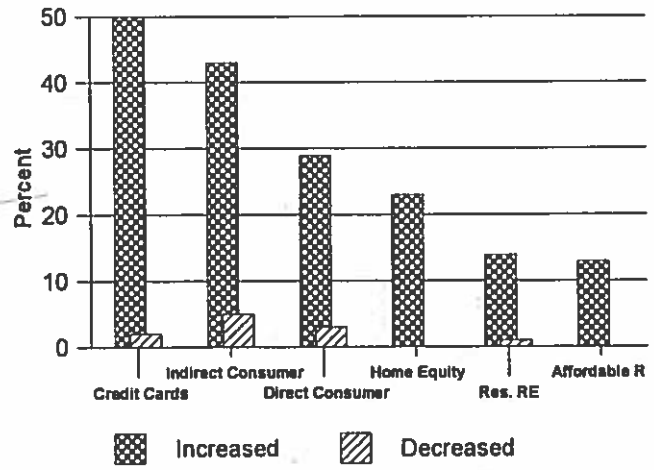
(by Product Component)



Examiners' assessments of the changes over the last year in the level of inherent credit risk in the retail portfolios of surveyed banks are reflected in the next chart. Examiners found an increased level of credit risk in the credit card component of portfolios in fully 50 percent of the 68 surveyed banks engaged in credit card lending compared with a year ago. Only 2 percent of credit card lenders were considered to show decreased credit risk associated with this activity. The level of credit risk had increased in the indirect consumer loan component of portfolios in 43 percent of the 67 surveyed banks making such loans, and had decreased in 5 percent. For other direct consumer loans, examiners judged that the credit risk associated with this component of the portfolio had increased in 29 percent of the 75 surveyed banks making this type of loan, and had decreased in 3 percent. Examiners most often cited competition, the rising rate of consumer bankruptcies, and general economic conditions for the increased levels of credit risk in the retail portfolio.

**Changes in Credit Risk in Retail Portfolios**

(By Product Component)




Because the size and importance of the individual product components, relative to the entire loan portfolio, can vary significantly between banks, the impact of an increased level of



inherent credit risk for a particular loan category can only be assessed on a bank-by-bank basis. The survey included, for example, several banks that are primarily or exclusively credit card lenders. However, for all federally insured commercial banks, credit card lending accounts for less than 9 percent of total outstanding loans. Among the other components of retail portfolios, the indirect and direct consumer loan categories combined account for approximately 12 percent of total outstandings for all banks, while home equity lending accounts for about 3 percent. Among commercial products, the syndicated/national credit component of commercial portfolios represents approximately 14 percent of total loans.

In the course of the normal examination schedule, OCC examiners are evaluating, on a bank-by-bank and portfolio-by-portfolio basis, how well their assigned banks are managing the risk in their loan portfolios. Examiners completing the survey were asked to describe any comments or recommendations that the OCC has provided to the bank since the last survey. In each case where examiners determined that the bank's information systems and controls for managing credit risk were deficient, or that reserves or capital were inadequate for the level of risk assumed by the bank, examiners have recommended corrective action to management and the board, and will follow-up on those recommendations.

# Part II — Results by Loan Type

## Commercial Lending Portfolios

### *Syndicated/National Credits*

The syndicated/national credit market experienced additional reductions in pricing (loan fees and/or rate spread) and the easing of traditional financial covenants since the 1995 survey. Loan demand has not been as strong as in prior years because the greater financial strength of many major corporations has enabled them to obtain funding in the capital markets and from other financial service providers. Yet liquidity is plentiful among banks, and they are eager for the opportunity to invest in large syndicated deals despite shrinking profit margins. One-third of the largest banks surveyed (Tiers I and II) indicated significant growth in this portfolio over the past year. The preponderance of this growth can be attributed to mergers and acquisitions completed within this time frame and to ongoing portfolio strategies.

Overall, the majority of banks included in this survey did not significantly change their formal loan policies or lending guidelines in response to the intense competitive pressures in the syndicated/national credit market. Nevertheless, some banks are easing their lending practices. This may be because originators, most of whom are the largest banks, are still the primary beneficiaries of the origination, syndication, and agent fees in this market.

While formal policy changes were not widespread, examiners reported that 30 percent of Tier I and II banks eased lending practices in syndicated/national credits. In contrast, examiners observed that only eight percent of Tier III banks eased lending practices. Only one of the banks surveyed actually tightened standards. Examiners most frequently cited competitive pressure and, to a lesser degree, pressure to increase income, as reasons for easing standards. Techniques to ease standards included compressed pricing, which generates marginal revenues, and the imposition of fewer financial covenants with

less restrictive performance measures. Tenors of revolving facilities are continuing to lengthen; facility size is larger and terms are extended.

The easing of lending practices does not necessarily mean underwriting practices have weakened. Examiners noted that the majority of surveyed banks operating in this market followed conservative lending practices. They cited effective credit supervision processes, including the maintenance of strong credit cultures, as evidence of conservative lending practices. In addition, examiners reported that Tier I and II banks reduced exposures to certain industries including: retailers (10 banks), commercial real estate (four banks), textiles (2 banks), forest products (two banks), and trucking industries (two banks).

Examiners reported that the level of credit risk inherent in the syndicated/national credit portfolios has increased somewhat in 25 percent of Tier I and II banks, and in 11 percent of Tier III banks. Heightened risk is not necessarily a direct result of competitive pricing pressures, but rather a reflection of the weakening of restrictive financial covenants, lending to new industries, and engaging in higher risk activities such as highly leveraged transactions and acquisition financing.

## *Middle Market Lending*

Strong competition in the middle market has continued to pressure banks to ease underwriting practices and to increase the number of exceptions to policy. Of the banks that reported changes in middle market underwriting, one-half cited changes in the competitive environment as the major reason for changing their standards. Other factors included changes in the economic outlook (24 percent) and revisions in market strategy (15 percent). Additionally, while the majority of the banks (73 percent) reported no change in the trend of exceptions to middle market policies and standards, examiners reported that 20 percent of the banks did increase their use of exceptions. Since a significant majority of banks surveyed have earmarked this customer segment for additional portfolio growth, the trend toward easing lending practices may continue.



Examiners reported that the middle market lending standards were unchanged in 75 percent of the banks surveyed. Nineteen percent of the banks were reported to have eased their standards, while the remaining 6 percent tightened standards. The terms and conditions used most often to ease standards include: further declines in interest rates and fees, increased maximum size of credits, the extension of maturities, less stringent loan covenants, and the easing of guarantor requirements. Interestingly, examiners also reported that banks most often relied on loan covenants to tighten underwriting standards in the middle market.

Examiners described the total credit risk in the middle market loan portfolio as increasing in 32 percent of all banks included in the survey. They reported decreased risk in only 6 percent of the banks. The trend toward increasing risk was more pronounced in the Tier I and II banks. They reported that credit risk in the middle market portfolios of these banks had increased in 46 percent of the Tier I and II banks. Only eight percent of these banks were described as decreasing the levels of credit risk in their middle market portfolios.

Although banks included in the 1995 survey had a similar level of easing in their lending practices, examiners perceived the level of credit risk to be lower because of stronger overall portfolio quality. Respondents to the 1996 survey have clearly noted an increased level of risk in the middle market portfolios in the larger Tier I and II banks.

## *Small Business Lending*

Rapid growth, both planned and actual, and the easing of underwriting standards continue to represent trends in the small business lending activities of the surveyed banks. The pace of growth and change in underwriting, however, is not as pronounced as it was in the last survey. Examiners reported that fewer banks saw the small business loan as a target for more than normal growth. At the same time, innovations are appearing as banks try to deliver small business loans more efficiently by using techniques such as credit scoring. Examiners in this and the previous survey also cited reductions in the

amount of up-front financial analysis required as part of the loan approval process. Examiners reported the level of credit risk inherent in this portfolio to have increased in 23 percent of surveyed banks.

Examiners reported that the 85 percent of banks included in the survey had not changed either their underwriting policy or their actual lending practices. Fourteen percent had eased and the remaining one percent had tightened their lending practices.

As in the prior survey, reasons cited for easing of standards centered on decisions to remain competitive in the market place and growth strategies. Changes in underwriting most often cited included a reduction of fees and spreads, with a few banks reported to have relaxed covenants, collateral requirements, and maximum maturities.

Credit scoring continued to be used as a tool to increase the efficiency of the approval process for this product. This was sometimes combined with a decision to increase the maximum size for this type of loan. Another continuing trend in small business lending is the use of credit cards to replace lines of credit for small business borrowers.

Examiners regarded the overall lending standards of surveyed banks to be moderate or conservative in all but one of the surveyed banks engaged in small business lending. Examiners in 47 percent of surveyed banks rated the level of approved exceptions to policy for small business loans as moderate, low, or negligible. Only one bank was reported to have a high level of exception approvals.

## *Commercial Real Estate Lending*

Examiners reported that the underwriting standards for commercial real estate loans at a significant number of the largest banks in the survey had eased somewhat during the last year due largely to their competitive environment and growth strategies. The reduction of loan fees and rate spreads and easing of collateral requirements and loan covenants were the most frequently noted changes. Survey results also indicated an



increased incidence of approved policy exceptions for commercial real estate loans in Tier I and II banks.

Since the previous survey, a majority (59 percent) of the Tier I and II banks had not changed their underwriting standards. Standards at 26 percent of all surveyed banks, however, were considered to have eased somewhat. Other respondents reported lending standards to be tightened somewhat at 15 percent of the surveyed banks.

Overall credit risk in the commercial real estate portfolio was considered unchanged in 44 percent of the Tier I and II banks compared with 38 percent in last year's survey. The overall credit risk in Tier III banks was reported to be unchanged in 66 percent of the banks. Of all surveyed banks, examiners in 19 percent of them thought that inherent credit risk had increased somewhat while 14 percent indicated that it had decreased somewhat. Credit risk declined significantly in one bank and there were no banks in which it had increased significantly.

Examiners described the lending standards for commercial real estate loans as somewhat conservative at 44 percent of the Tier I and II banks compared with 60 percent noted in last year's survey. Examiners reported that 48 percent of these larger banks had moderate standards, while two banks had somewhat liberal standards. Among Tier III banks, examiners described 16 percent as very conservative, 40 percent as somewhat conservative, and 42 percent as moderate. One bank's lending standards were described as somewhat liberal.

Examiners identified reductions in loan fees or rate spreads as the most frequent method of changing standards (10 banks) followed by eased collateral requirements (eight banks) and eased loan covenants (seven banks).

Examiners cited competition as the main reason that banks changed lending standards (18 percent of all surveyed banks and 31 percent of Tier I and II banks). A change in the economic outlook was the next most frequently cited reason (11 percent of all banks and 21 percent of Tier I and II banks.)

while one bank tightened them. Examiners did not cite any other lending standard for agricultural loans as being changed by more than a single bank. The most frequently cited reason for changes in lending standards for agricultural loans was change in competitive environment (three banks). Examiners at two banks cited both change in economic outlook and change in market strategy as reasons for changed standards.

Examiners characterized the frequency of approved exceptions to loan policy for agricultural loans as medium for five banks, and low for 43 banks. Respondents in all but one bank considered the trend in the rate of exceptions to standards to be unchanged. A trend of increasing exceptions on agricultural loans was noted in one Tier III bank.

Examiners considered the level of credit risk inherent in the bank's agricultural portfolio to be unchanged in 65 percent of Tier I and II banks, and in 93 percent of Tier III banks. They reported that credit risk had increased somewhat in 23 percent of Tier I and II banks, and in 2 percent of Tier III banks. They most often cited deteriorating collateral margins as the reason for increased risk.

## Retail Lending Portfolios

### *Credit Card Lending*

Increasing competition, high volume growth objectives, and higher consumer debt levels have led to increased risk in the credit card segment of the retail portfolio. Credit risk has increased, and perhaps because of this, a notable trend in the tightening of credit card standards was evident in the 1996 survey.

Thirty-four percent of all banks experienced credit card growth greater than 10 percent in the last year, while 22 percent planned to pursue this rate of growth in the next 12 months. Since the previous survey, 41 percent of the Tier I and II banks reported more than 10 percent growth in credit cards. Growth was concentrated in credit cards in 30 percent of Tier III banks. Twenty-four percent of Tier I and II banks as well as 28 percent



of Tier III banks projected greater than 10 percent growth in the coming year. Examiners in several banks identified the use of cobranding to enter new markets or expand an existing presence.

Examiners reported that 43 percent of Tier I and II banks tightened credit card standards compared with nine percent that eased standards. For Tier III banks, examiners reported that 23 percent had tightened standards while only seven percent had eased them. Overall, examiners reported that 30 percent of all banks tightened standards while eight percent eased them.

The majority of changes reported in lending standards reflected a tightening of standards. The survey disclosed that banks have most frequently changed their lending standards by requiring stricter adherence to policy standards, tightening of scorecard parameters, strengthening financial qualifications, and following tougher collection efforts. Examiners also reported that banks were using new or revised credit scorecards, revising solicitation criteria, increasing minimum credit scores, and considering factors such as the number of cards held by a consumer to tighten standards.

Examiners most frequently cited changes in the competitive environment, economic outlook, and market strategy as reasons for changing standards. Weak portfolio performance with rising delinquencies and charge offs, poor product selection, and changes in bankruptcy law were also identified.

Credit cards are the segment of the retail portfolio where examiners identified the largest increase in risk. Examiners described the degree of risk as unchanged at 48 percent of all banks surveyed; respondents thought the degree of risk had increased somewhat at 40 percent of the surveyed banks and had increased significantly at 10 percent of the banks.

For credit card lending, exceptions to policy are approved and controlled through the override process for credit scoring.

## *Home Equity Lending*

Examiners continue to describe home equity loans as one of the most popular retail product lines for the surveyed banks, especially the largest banks. Growth in home equity loans remains strong, as many banks continue to target this area in terms of both expanding current product offerings as well as introducing new types of home equity products. For those banks reporting 10 percent or better growth, 18 percent of the banks (24 percent of Tier I and II banks; 15 percent of Tier III) reported such growth over the last year. During the next year, 17 percent of the banks planned 10 percent or higher growth (31 percent of Tier I and II; five percent of Tier III banks). Home equity loans were the most commonly cited new product offering, with 12 percent of the banks reported to have new home equity products.

Survey results indicated that underwriting standards for 81 percent of the surveyed banks were unchanged. Examiners cited easing standards in 16 percent of surveyed banks and tightening standards in the remaining three percent of banks. This trend was also apparent in last year's survey.

The most commonly mentioned method to change underwriting standards was increased loan-to-value ratios (nine banks). Examiners identified competition (four banks) and market strategy (four banks) most frequently as reasons for changing standards.

Examiners report that overall credit risk for this product group has increased since the last survey. For Tier I and II banks, 35 percent were reported to have increased credit risk (24 percent increased risk in the last survey), with 65 percent unchanged, and none having decreased risk (as compared with 16 percent last year). For Tier III banks, respondents reported that 17 percent had increased credit risk, while the level of risk was unchanged in 83 percent of these banks. For all banks surveyed, survey results indicated 23 percent had increased risk, the risk in 77 percent was unchanged, and none had decreased risk.



## *Direct Consumer Lending*

Higher consumer debt levels and increases in delinquency and losses reflect the increased level of credit risk in the consumer direct segment of the retail credit portfolio. Growth exceeding 10 percent was reported by examiners in 13 percent of all banks surveyed. Examiners in seven percent of Tier I and II banks and 17 percent of Tier III banks were reported to have direct loan growth of more than 10 percent. There were no banks projecting growth greater than 10 percent. Many banks have found more opportunities for growth in the indirect segment of consumer lending.

For consumer direct loans, examiners reported that 16 percent of all banks eased underwriting standards while 15 percent tightened underwriting standards. Broken down by size, 22 percent of Tier I and II banks and 13 percent of Tier III banks indicated an easing in underwriting standards. Tightening of underwriting was reported for 19 percent of Tier I and II banks and 13 percent of Tier III banks.

The survey revealed that some banks had tightened lending standards through the implementation of credit scoring or through revised scorecards. Examiners also reported that many banks are more stringently monitoring and limiting policy exceptions as well as strengthening financial statement standards. Collection efforts are being strengthened.

On the other hand, about the same number of banks are easing lending standards. They are offering subprime products or may be expanding loan terms through longer maturities, easing of debt to income ratios, or extending 100 percent financing.

Changes in competitive environment and changes in market strategy were the most frequent reasons given for changes in standards.

Examiners identified the degree of credit risk in consumer direct portfolios increased in 29 percent of all surveyed banks and remained unchanged in 68 percent.

## *Indirect Consumer Lending*

Examiners report the level of risk in indirect consumer lending is increasing. They believe the following factors have contributed to increasing risk in this product line: the selection of customers granted credit, increasing competition, high volume growth objectives, and higher consumer debt levels. Standards have been liberalized in some banks to expand the offering of subprime products to meet competition and increase market share. Examiners in a number of banks responded that banks are considering or now offer this type of product. Respondents in 31 percent of surveyed banks reported that consumer indirect lending grew at a rate greater than 10 percent. This growth rate is second only to credit cards and is significantly higher than rates reported for any other loan category. Thirty-eight percent of Tier I and II banks and 28 percent of Tier III banks were reported to have indirect loan growth of more than 10 percent. Thirteen percent of all banks are projecting growth greater than 10 percent.

Examiners reported that 21 percent of all banks offering indirect consumer loans eased underwriting standards while 19 percent tightened underwriting standards. Survey results indicated easing standards in 31 percent of Tier I and II banks and 15 percent of Tier III banks. Respondents reported tightening of underwriting in 23 percent of Tier I and II banks and in 17 percent of Tier III banks.

Banks are reevaluating the use of financial ratios in the credit decision making process and are increasingly relying on credit scoring to tighten standards in light of increasing delinquencies and losses. Examiners report some banks are also tightening policy compliance, strengthening collection efforts, revising solicitation criteria, and reassessing collateral coverage.

A group of banks surveyed, however, are exhibiting a higher tolerance for credit history weaknesses while using risk-based pricing to gain access to the subprime lending market. Some banks are also easing debt-to-income ratios, extending maturities, lowering credit scores, and allowing higher loan-to-value ratios with 100 percent financing for some products.



Changes in the competitive environment and changes in market strategy were the most frequent reasons given for changes in lending standards.

Examiners reported that the degree of credit risk had increased some in 43 percent of all surveyed banks and remained unchanged in 52 percent of all banks. For Tier I and II banks, 37 percent were reported to have an increased level of credit risk in the 1995 survey, as compared with 54 percent in the 1996 survey.

## *Residential Real Estate Lending*

The loan portfolios of 90 percent of the surveyed banks included residential real estate loans. The survey results indicated that significant loan growth in residential real estate continued during the past year. Almost one-fifth of all banks showed at least a 10 percent growth rate in residential real estate loans. Growth of 10 percent or more is not expected to be as widespread next year.

Survey results indicated that 76 percent of the Tier I and II banks engaged in residential real estate lending had moderate lending standards and 21 percent have somewhat conservative standards. Fifty-five percent of the Tier III banks are considered to have moderate lending standards, while 37 percent are described as somewhat conservative, and eight percent very conservative. Examiners believed that the majority of all surveyed banks had not changed their standards since last year. Examiners in only three banks cited tightening of credit line size, collateral requirements, and loan fees. Respondents in four banks reported that collateral requirements and fees had been eased.

Examiners cited changes in the economic outlook and changes in the competitive environment as reasons for changes in residential real estate lending standards in the largest and smallest of the surveyed banks. Respondents also indicated that changes in market strategy affected the decision to make changes in lending standards in the smaller banks.

Most respondents thought that credit risk had not changed; however, examiners in 14 percent of banks saw an indication of increasing credit risk in residential real estate loans. The increase more than likely can be attributed to substantial growth and some easing in collateral requirements.

Examiners in most banks characterized the frequency of approved exceptions to formal loan policy/standards in most banks as being low and, in a few instances, as being medium. Respondents reported an increasing trend in approved exceptions for two of the banks in Tier III.

### *Affordable Housing Lending*

Among the largest banks, the survey revealed some tightening of credit standards for affordable housing loans as compared with 1995. The tightening of standards reflects a change in market strategy in response to an increase in delinquencies as portfolios continued to season. According to some examiners, banks generally responded to delinquencies by tightening underwriting standards, which stabilized credit risk in this product. Examiners thought that Tier III banks, surveyed for the first time, showed some easing in underwriting standards. They described this as partially reflecting the fact that some of these banks recently had introduced affordable loan products. The banks' overall loss in their affordable housing loan portfolios was almost nonexistent and comparable with losses in their residential real estate portfolios. In most banks, however, the delinquency rate for the affordable housing portfolio was somewhat higher than for the residential real estate portfolio.

Affordable housing loan underwriting standards in 82 percent of the surveyed banks were unchanged. The majority of the examiners considered the standards of banks making affordable housing loans to be moderate (75 percent) to somewhat conservative (18 percent), with only three percent indicating somewhat liberal and four percent very conservative standards. Banks did not project any significant changes in growth for the product.



Examiners characterized the overall trend in underwriting standards for affordable housing loans as generally unchanged. Of those banks that did change their standards, more of the largest banks were tightening standards (15 percent tightening versus 8 percent easing) while the next tier of banks showed a bias towards easing their standards (11 percent easing versus 4 percent tightening). The largest banks tightened standards through stricter debt service coverage and more required pre-credit counseling. Examiners in Tier III banks described banks adding new affordable housing loan products for the first time as easing standards. For banks overall, examiners citing methods used to tighten standards identified debt service coverage, reduced rate discounts, income requirements (eight); loan fees/rate spreads (two), and loan size or maximum maturity (two). Respondents citing an easing of standards reported in collateral requirements (seven) and loan fees and rate spreads (two) as the standards that were eased.

Examiners cited the following reasons for underwriting standard changes: a change in the banks' market strategy (seven), changes in their competitive environment (four), and other reasons (eight) (e.g., standards tightened to control delinquencies, increased market share).

Examiners reported that the vast majority of banks with affordable housing loan programs (87 percent) showed no increased credit risk while 13 percent indicated an increase. They reported credit risk as unchanged in 97 percent of the Tier I and II banks, while examiners in 17 percent of Tier III banks thought it had increased.

Unlike 1995 survey results, examiners believed that none of the largest banks planned to introduce new affordable housing products. For Tier III banks, examiners indicated that some had already added new affordable housing loan products since the 1995 survey (four) or had plans to introduce new products in the future (three).

The majority of the surveyed banks (80 percent) have affordable mortgage portfolios, primarily comprised of mortgages that

could not be sold on the secondary market. Almost all of the largest Tier I banks (97 percent) and the majority of the Tier II banks (64 percent), originate and retain a small portion of these loans in their portfolios. For most banks (84 percent), these loans comprised less than 10 percent of the bank's residential real estate portfolio. Only 9 percent of the banks with affordable housing portfolios had dollar volume exceeding $200 million in their portfolios.

Delinquencies are generally higher in the affordable mortgage portfolios than in conventional real estate portfolios, except for seven banks. Almost all of the banks, however, reported either minimal (less than 0.1 percent) losses or no losses in their affordable real estate portfolios.