Survey of Credit Underwriting Practices 2004

Office of the Comptroller of the Currency
National Credit Committee
October 2004

Table of Contents

Part I: Overall Results

Part II: Graphs and Tables

Introduction

The Office of the Comptroller of the Currency (OCC) conducted its tenth annual survey of credit underwriting practices during the first quarter of 2004. The survey identified trends in lending standards and credit risk for the most common types of commercial and retail credit offered by national banks.

The 2004 survey included the 72 largest national banks and covered the 12-month period ending March 31, 2004. Although mergers and acquisitions have altered the survey population somewhat, the surveys for the last nine years have covered substantially the same group of banks. All companies in the 2004 survey have assets of $2 billion or greater. The aggregate loan portfolio of banks included in the 2004 survey was approximately $2.3 trillion as of December 31, 2003. This represents 91 percent of all outstanding loans in national banks.

The OCC examiners-in-charge of the surveyed banks were asked a series of questions concerning overall credit trends for 18 types of commercial and retail credit. Commercial credit for purposes of this survey included 10 categories of loans: syndicated/national loans, structured finance (leveraged finance), asset-based loans, middle market loans, small business loans, international credits, agricultural loans, residential construction, commercial construction, and other commercial real estate. Retail credit consisted of eight categories of loans: residential real estate mortgages, affordable housing, credit cards, other direct consumer loans, indirect consumer paper (loans originated by others, such as car dealers), consumer leasing, conventional home equity, and high loan-to-value (HLTV) home equity loans.

The term “underwriting standards,” as used in this report, refers to requirements, such as ones related to collateral, loan maturities, pricing, and covenants, that banks establish when originating and structuring loans. Conclusions about “easing” or “tightening” of underwriting standards are drawn from OCC examiners’ observations since the 2003 survey. A conclusion that the underwriting standards for a particular loan category have eased or tightened does not indicate that all the standards for that particular category have been adjusted. It indicates that the adjustments that did occur had the net effect of easing or tightening such underwriting criteria.

Part 1 of this report discusses the overall results of the survey. Part II depicts the survey results in graphs and tables.

Part 1 – Overall Results

Primary Findings

- ***The 2004 survey results for commercial credit underwriting indicate increased easing, and a significant decrease in tightening of standards. Stepped-up competition and a more optimistic economic outlook are the primary drivers for the easing.***

- ***Underwriting standards for retail credit products also reflected more easing and less tightening, but the change from prior years was less pronounced.***

- ***Examiners are more positive in their assessment of the credit risk environment for both commercial and retail credit portfolios. On net, they report that credit risk has declined during the past year, and they expect it to remain at lower levels during the next year.***

Commercial Underwriting Standards

In 2004, slightly more banks eased credit underwriting standards than tightened them. Examiners reported that 13 percent of banks eased, 12 percent tightened, and 75 percent did not change their commercial underwriting standards. In 2003, by contrast, many more banks tightened than eased: examiners reported that 47 percent of the banks tightened and only 5 percent eased standards. In 2002, no banks were reported to have eased commercial underwriting standards, two-thirds tightened, and one-third made no change. In summary, banks have shifted toward easing over the past few years. In 2002, the net change in standards favored tightening by 62 percent. In 2003, the net difference in favor of tightening slackened to 42 percent. By 2004, net change favored easing by 1 percent.

Commercial underwriting trends at the product level confirm this shift toward easing. The two commercial products that experienced the greatest amount of tightening during the last four years — structured finance and syndicated/national loans — are the front-runners in the swing toward easing. Structured finance provides the most conspicuous example of this shift. In 2004, examiners reported that 15 percent of the banks eased and no bank tightened underwriting for structured finance, compared with no easing and 96 percent tightening four years ago. Examiners also reported a return to net easing for middle market and asset-based loans. While tightening was slightly more prevalent than easing for the remaining commercial products, the percent of banks reported to have tightened in 2004 was much lower than in 2003. Large banks made more adjustments in underwriting standards than smaller banks, and most of their adjustments eased standards.

Examiners cited stronger competition as the primary reason why banks eased commercial standards, followed by an improving economic outlook and risk appetite. When easing standards, banks commonly lowered pricing, lengthened maturity, increased the amount of the credit line, and adjusted covenants. For banks that tightened commercial underwriting standards, the primary reasons cited were risk appetite and the economic outlook. When tightening standards, banks commonly adjusted covenants, lowered the amount of the credit line, and increased collateral requirements.

Examiners reported that credit risk trends in commercial portfolios have moderated. They reported that the percentage of banks with decreased commercial credit risk slightly exceeded those banks with increased risk. While the difference between increased and decreased risk is small, the shift is significant — this is the first time that survey results indicate that more banks experienced a net decrease of credit risk in the commercial portfolio. The shift in risk is attributed to improvements in portfolio quality, external conditions, and portfolio management practices. Structured finance and syndicated/national loans were perceived to have the greatest decrease in risk. Examiners also reported that banks expect credit risk to decline during the next 12 months.

Retail Underwriting Standards

Retail credit tends to be less volatile than commercial credit and, accordingly, retail underwriting standards tend to be more stable. For retail portfolios, although the number of banks easing (13 percent), tightening (13 percent), or making no change (74 percent) is remarkably similar to that reported for commercial credit, the change from tightening to easing has been far more gradual. At the product level, there was only a modest change in underwriting standards from the prior year. For most products, tightening exceeded easing, but the amount of tightening has moderated. Examiners reported that easing outweighed tightening for home equity products; credit cards also experienced easing.

According to examiners, banks eased retail standards primarily because of increased competition and changes in market strategy. When easing, banks reduced debt service requirements, extended amortization schedules and lowered collateral requirements. Sixty-five percent of banks cited risk appetite as the primary reason for tightening, followed by product performance and a change in market strategy. Banks adjusted score-card cutoffs and increased debt service requirements to tighten underwriting standards.

Examiners reported that 75 percent of the banks surveyed reported no change in the overall level of retail credit risk for the past 12 months, and 69 percent of banks expect retail credit risk will remain stable for the next 12 months. At the product level, only three of eight retail products were reported to have a net increase in credit risk in the past 12 months — credit cards and the two home equity products. Examiners cited a decline in the quality of credit card portfolios and concern about external conditions for credit cards and the two home equity loan products as the reasons for the increased risk.

Commentary

With our tenth survey of credit underwriting practices, we have come a full cycle. In 1995, the first year of the survey, we reported banks were relaxing underwriting standards because of increasing competition. Now, ten years later, banks again are relaxing their underwriting standards — and for the same reason.

Much has changed in ten years, and banks are in a better position to evaluate and manage the risk associated with easing underwriting standards. Advancements in credit risk management have given banks better tools to differentiate risk and understand the implications of underwriting changes. Additionally, the condition of the banking industry is sound with strong capitalization and record profits. A favorable interest rate environment and an economy that is gradually gaining strength also contribute to the positive credit outlook.

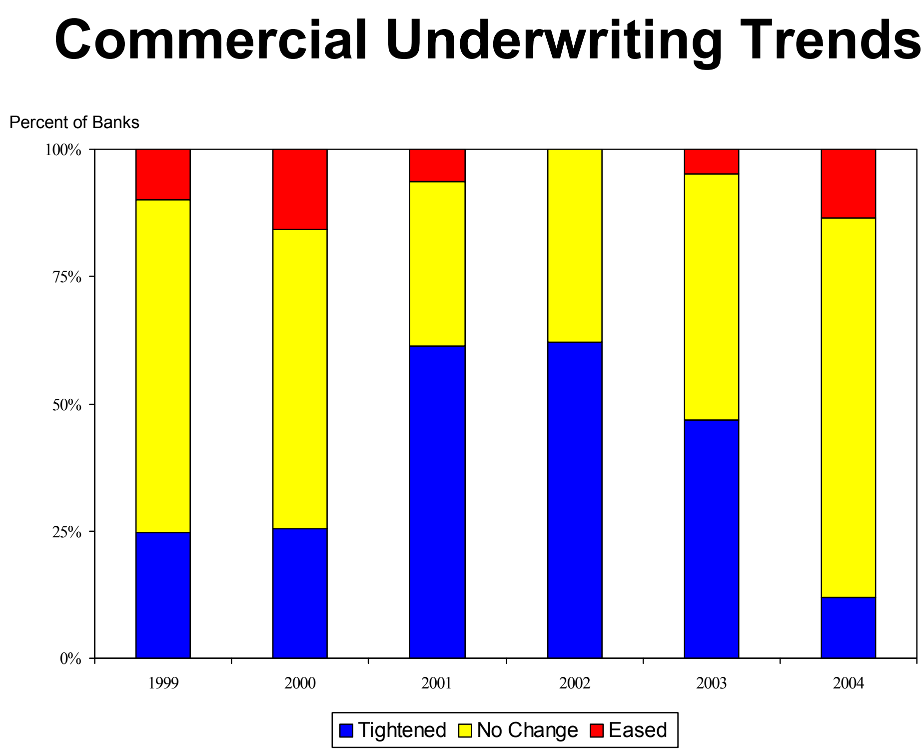
At this phase in the credit cycle, some adjustments to underwriting criteria are to be expected. After several years of sluggish demand for commercial loans, banks are anxious to make deals. However, ambitious growth goals in a highly competitive market can create an environment that fosters imprudent credit decisions. It is now that banks need to be disciplined and adhere to the enhanced credit risk management practices they implemented during the past few years. Exceptions to underwriting standards need to be carefully controlled and monitored and relationship managers must be held accountable for both the quality and the quantity of their deals.

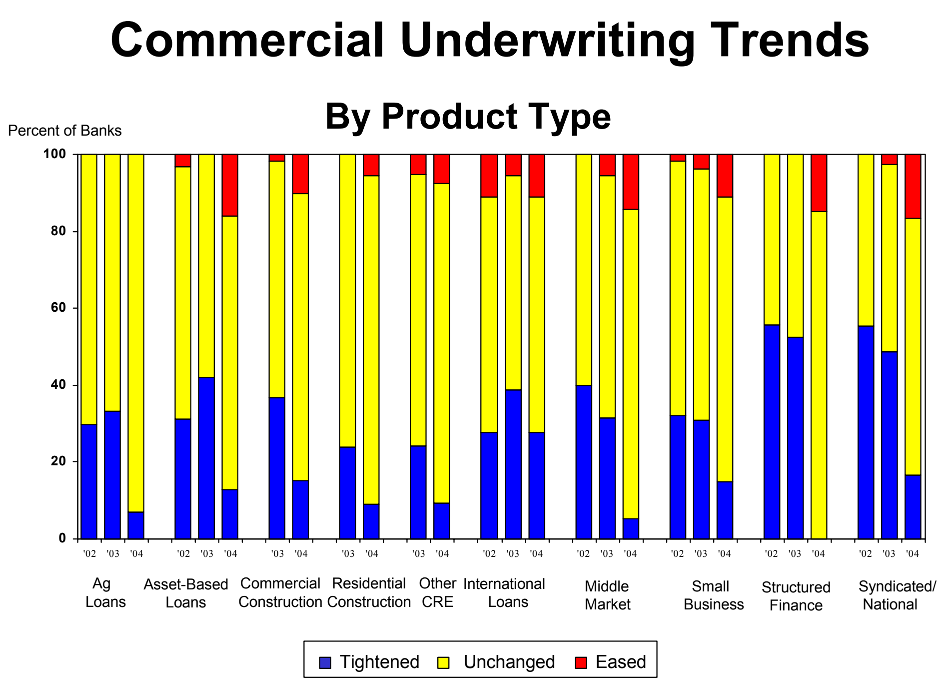
Although many factors contributed to the weakness in commercial credit portfolios during the last cycle, certainly excessive leverage was one of the primary causes. Many observers have commented on how quickly creditors' tolerance for higher leverage has rebounded. Bankers are urged to maintain prudent limits on leverage in their underwriting criteria and should refer to OCC Bulletin 2001-18, "Leveraged Finance — Sound Risk Management Practices," for guidance.

While demand for commercial credit has been lackluster, demand for retail credit has been robust. Many banks have grown their retail portfolios in recent years, largely because of strong consumer demand for residential mortgages and home equity products. Low interest rates, appreciation in home values, and innovative products have sparked the demand. Because of the wave of refinancings, many banks have relatively unseasoned mortgage and home equity portfolios. Additionally, the growing component of adjustable-rate mortgages and the protracted interest-only period associated with many home equity lines of credit mean that many borrowers could be exposed to much higher payments when interest rates rise and principal amortization begins. Banks are encouraged to make sure that risk management practices keep pace with the changing risk characteristics of their retail portfolios brought about by changes in underwriting practices.

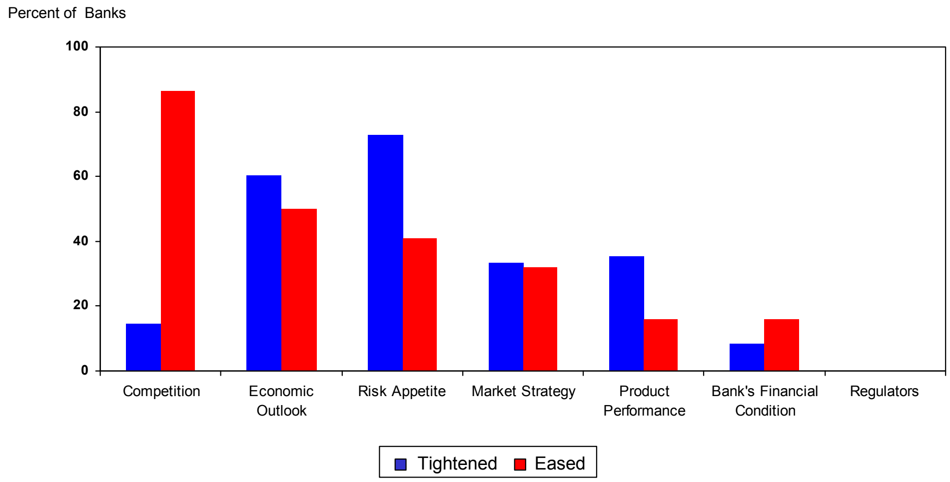
The OCC will continue to focus supervisory attention and resources to ensure that credit risk in national banks is appropriately identified and that credit risk management practices are commensurate with risk levels.

Part II – Graphs and Tables

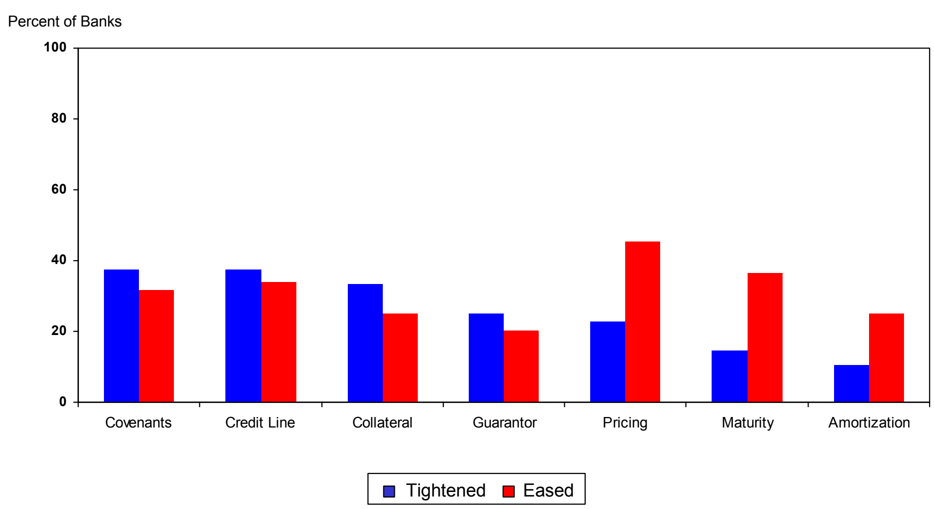




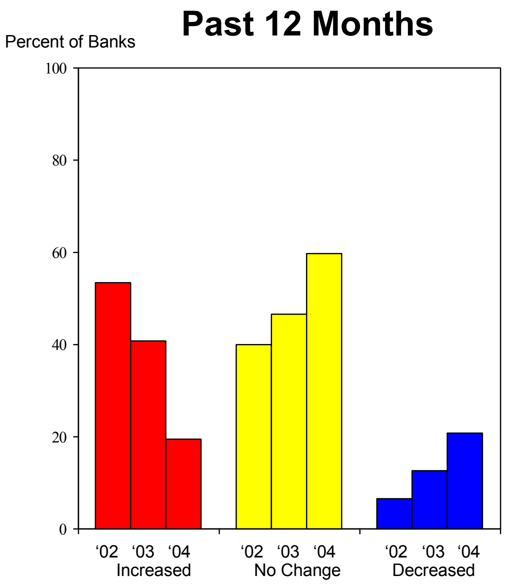
Reasons for Changing
Commercial Underwriting Standards

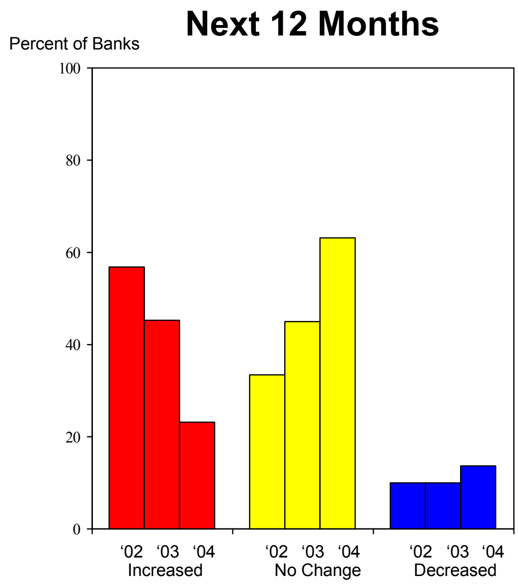


Methods Used to Change
Commercial Underwriting Standards

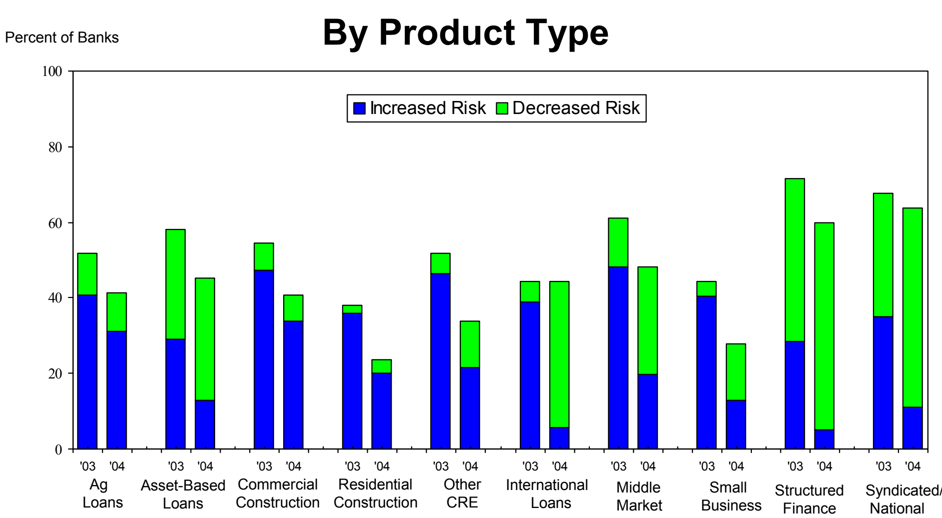


Commercial Credit Risk Trends

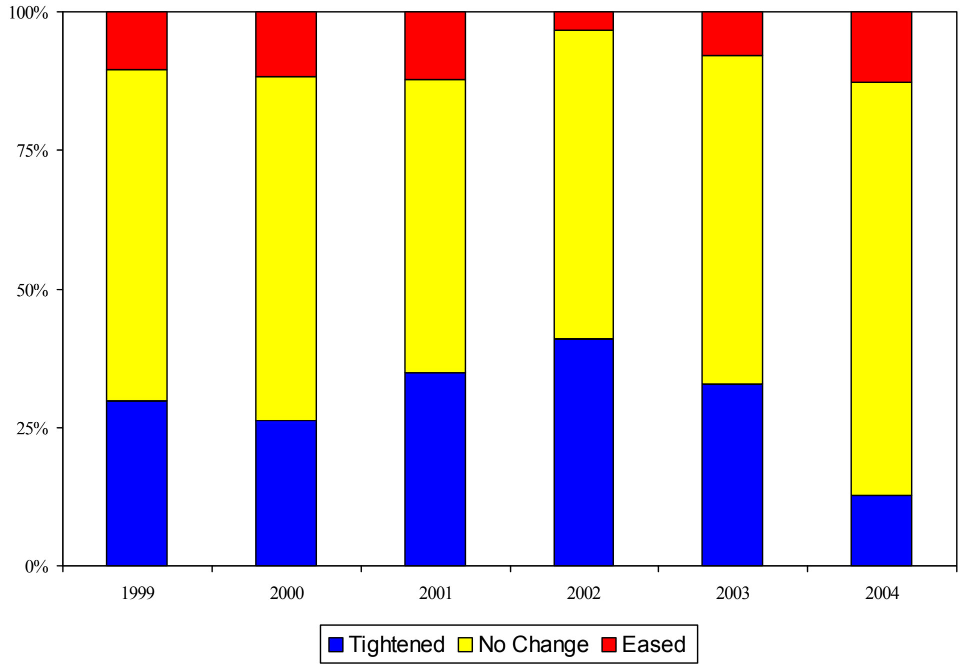




Commercial Credit Risk Trends

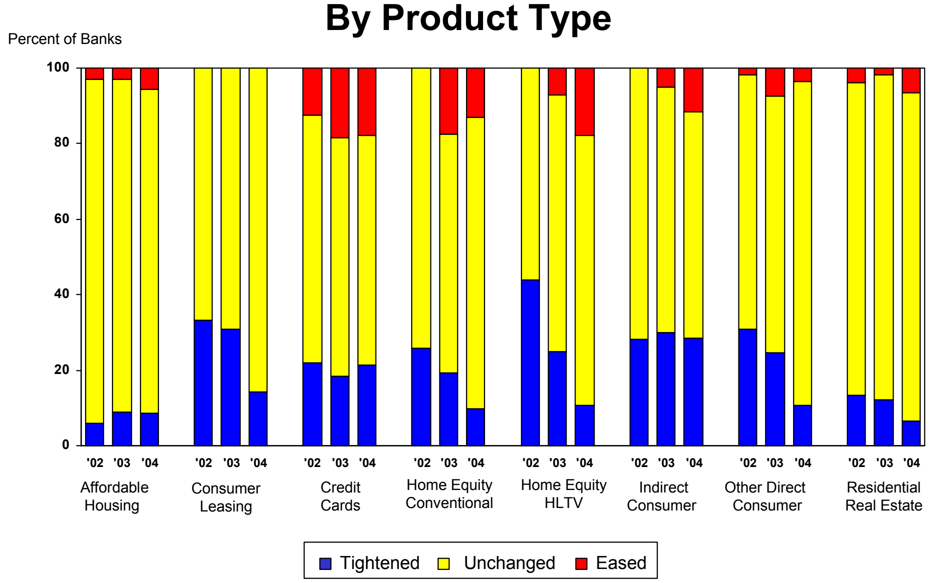


Retail Underwriting Trends

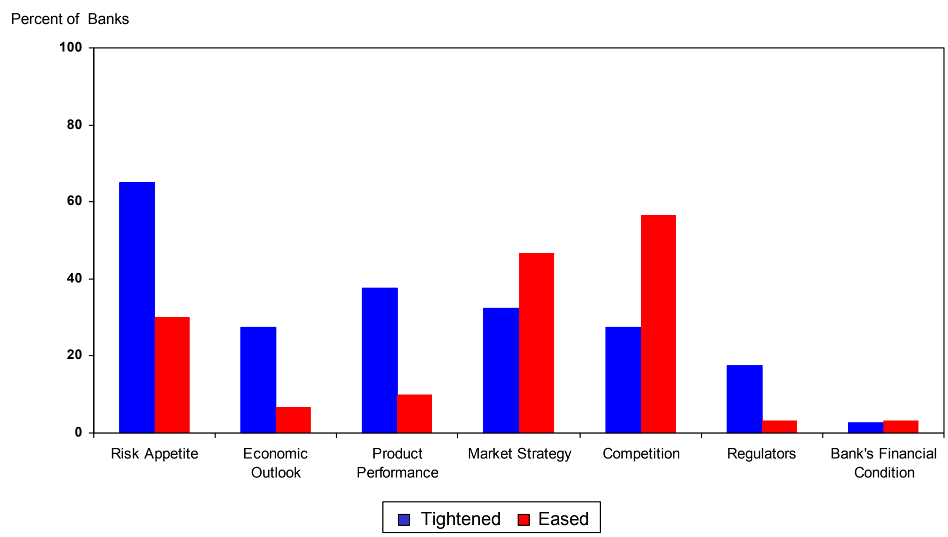


Retail Underwriting Trends

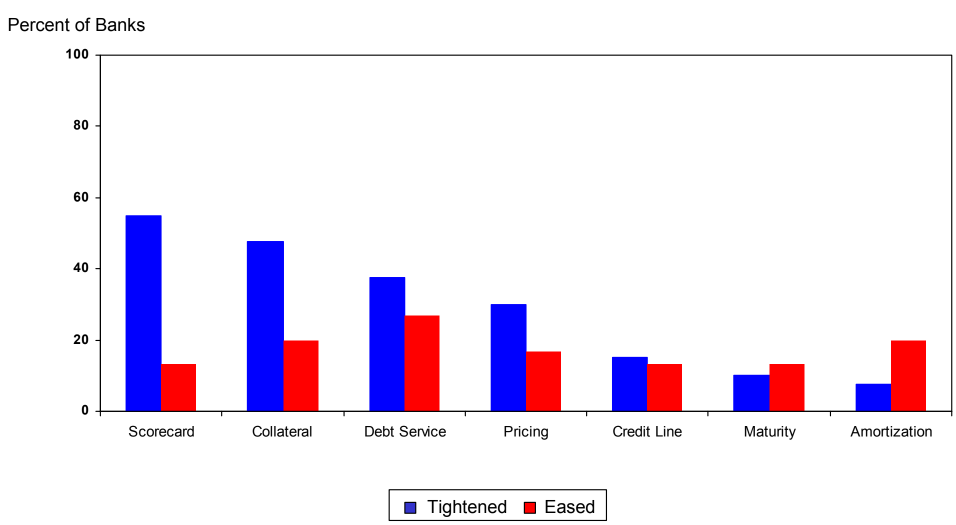
By Product Type



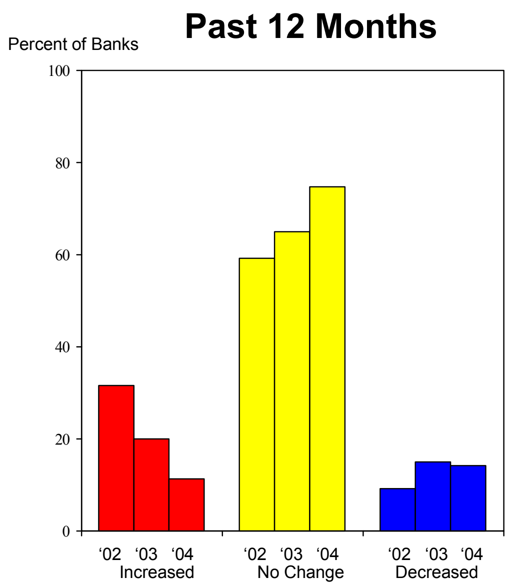
Reasons for Changing Retail Underwriting Standards

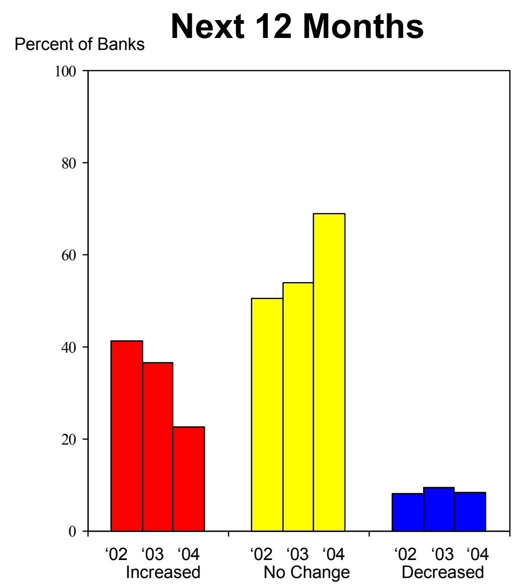


Methods Used to Change Retail Underwriting Standards

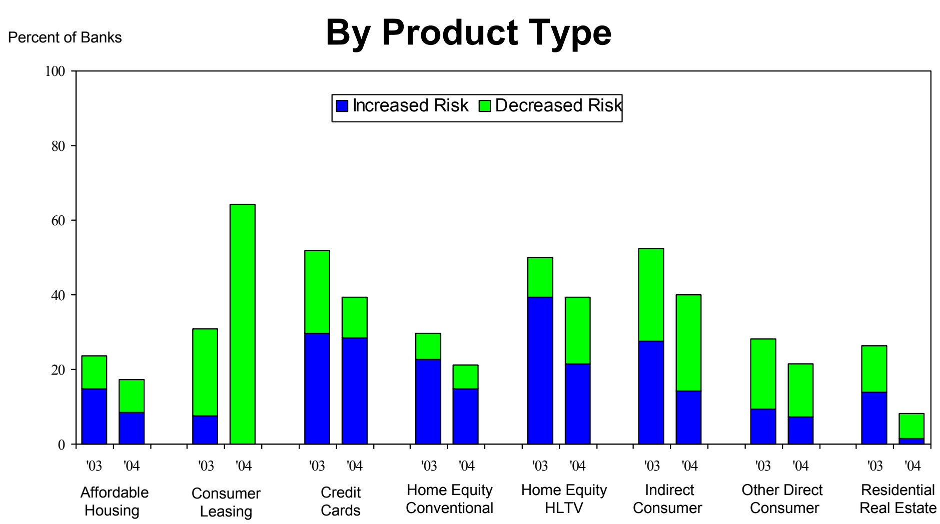


Retail Credit Risk Trends





Retail Credit Risk Trends



Commercial Lending Portfolios

Agricultural Lending

Twenty-nine of the 72 banks in the survey were engaged in some form of agricultural lending.

Changes in Underwriting Standards in Agricultural Loan Portfolios
(Percent of Banks)

	Eased	Unchanged	Tightened
1999	3	79	18
2000	3	71	26
2001	3	71	26
2002	0	70	30
2003	0	67	33
2004	0	93	7

Changes in the Level of Credit Risk in Agricultural Loan Portfolios
(Percent of Banks)

	Declined Significantly	Declined Somewhat	Unchanged	Increased Somewhat	Increased Significantly
1999	0	6	42	49	3
2000	0	15	41	44	0
2001	0	17	43	34	6
2002	0	7	63	30	0
2003	0	11	48	41	0
2004	0	10	59	31	0
Future 12 Months	0	17	66	17	0

Asset-Based Loans

Thirty-one of the surveyed banks were engaged in this type of lending.

Changes in Underwriting Standards in Asset-Based Loan Portfolios
(Percent of Banks)

	Eased	Unchanged	Tightened
1999	10	78	12
2000	11	67	22
2001	5	53	42
2002	3	66	31
2003	0	58	42
2004	16	71	13

Changes in the Level of Credit Risk in Asset-Based Loan Portfolios
(Percent of Banks)

	Declined Significantly	Declined Somewhat	Unchanged	Increased Somewhat	Increased Significantly
1999	0	10	66	24	0
2000	0	8	62	30	0
2001	5	8	42	45	0
2002	0	0	50	50	0
2003	3	26	42	29	0
2004	3	29	55	13	0
Future 12 Months	0	13	64	23	0

Commercial Real Estate Lending — Commercial Construction

Fifty-nine of the 72 banks in the survey were engaged in commercial construction lending.

Changes in Underwriting Standards in Commercial Construction Loan Portfolios
(Percent of Banks)

	Eased	Unchanged	Tightened
2003	2	61	37
2004	10	75	15

Changes in the Level of Credit Risk in Commercial Construction Loan Portfolios
(Percent of Banks)

	Declined Significantly	Declined Somewhat	Unchanged	Increased Somewhat	Increased Significantly
2003	0	7	46	42	5
2004	0	7	59	34	0
Future 12 Months	0	5	70	25	0

Commercial Real Estate Lending — Residential Construction

Fifty-five of the 72 banks in the survey were engaged in residential construction lending.

Changes in Underwriting Standards in Residential Construction Loan Portfolios
(Percent of Banks)

	Eased	Unchanged	Tightened
2003	0	76	24
2004	5	86	9

Changes in the Level of Credit Risk in Residential Construction Loan Portfolios
(Percent of Banks)

	Declined Significantly	Declined Somewhat	Unchanged	Increased Somewhat	Increased Significantly
2003	0	2	62	34	2
2004	0	4	76	18	2
Future 12 Months	0	4	69	27	0

Commercial Real Estate Lending — Other

Sixty-five of the 72 banks in the survey were engaged in other commercial real estate lending.

Changes in Underwriting Standards in Other Commercial Real Estate Loan Portfolios
(Percent of Banks)

	Eased	Unchanged	Tightened
2003	5	71	24
2004	8	83	9

Changes in the Level of Credit Risk in Other Commercial Real Estate Loan Portfolios
(Percent of Banks)

	Declined Significantly	Declined Somewhat	Unchanged	Increased Somewhat	Increased Significantly
2003	0	5	48	43	4
2004	0	12	66	20	2
Future 12 Months	0	8	68	23	1

International Lending

Only 18 of the 72 banks in the survey were active in international lending.

Changes in Underwriting Standards in International Loan Portfolios
(Percent of Banks)

	Eased	Unchanged	Tightened
1999	4	54	42
2000	14	72	14
2001	29	57	14
2002	11	61	28
2003	6	55	39
2004	11	61	28

Changes in the Level of Credit Risk in International Loan Portfolios
(Percent of Banks)

	Declined Significantly	Declined Somewhat	Unchanged	Increased Somewhat	Increased Significantly
1999	8	8	42	38	4
2000	0	33	53	14	0
2001	0	14	53	33	0
2002	0	22	39	28	11
2003	0	6	55	33	6
2004	6	33	55	6	0
Future 12 Months	6	11	61	22	0

Middle Market Lending

Fifty-six of the 72 banks in the survey were engaged in middle market lending.

Changes in Underwriting Standards in Middle Market Loan Portfolios
(Percent of Banks)

	Eased	Unchanged	Tightened
1999	18	73	9
2000	18	66	16
2001	11	48	41
2002	0	60	40
2003	6	63	31
2004	14	81	5

Changes in the Level of Credit Risk in Middle Market Loan Portfolios
(Percent of Banks)

	Declined Significantly	Declined Somewhat	Unchanged	Increased Somewhat	Increased Significantly
1999	0	8	56	36	0
2000	0	2	50	46	2
2001	0	2	35	59	4
2002	2	8	22	66	2
2003	0	13	39	44	4
2004	0	28	52	18	2
Future 12 Months	2	16	57	25	0

Small Business Lending

Fifty-four of the 72 banks in the survey are lending in the small business market.

Changes in Underwriting Standards in Small Business Loan Portfolios
(Percent of Banks)

	Eased	Unchanged	Tightened
1999	13	75	12
2000	8	73	19
2001	5	63	32
2002	2	66	32
2003	4	65	31
2004	11	74	15

Changes in the Level of Credit Risk in Small Business Loan Portfolios
(Percent of Banks)

	Declined Significantly	Declined Somewhat	Unchanged	Increased Somewhat	Increased Significantly
1999	0	8	67	23	2
2000	0	3	72	22	3
2001	0	3	60	37	0
2002	0	2	56	40	2
2003	0	4	56	38	2
2004	0	15	72	13	0
Future 12 Months	0	13	57	30	0

Structured Finance

Twenty of the 72 banks in the survey provided structured finance loans.

Changes in Underwriting Standards in Structured Finance Loan Portfolios
(Percent of Banks)

	Eased	Unchanged	Tightened
1999	24	44	32
2000	35	45	20
2001	0	4	96
2002	0	44	56
2003	0	48	52
2004	15	85	0

Changes in the Level of Credit Risk in Structured Finance Loan Portfolios
(Percent of Banks)

	Declined Significantly	Declined Somewhat	Unchanged	Increased Somewhat	Increased Significantly
1999	0	4	36	56	4
2000	0	0	20	80	0
2001	0	4	8	46	42
2002	0	7	26	52	15
2003	10	33	28	29	0
2004	15	40	40	5	0
Future 12 Months	0	40	50	10	0

Syndicated/National Credits

Thirty-six of the 72 banks in the survey were active in the syndicated/national credit market.

Changes in Underwriting Standards in Syndicated/National Credit Portfolios
(Percent of Banks)

	Eased	Unchanged	Tightened
1999	18	50	32
2000	22	61	17
2001	0	34	66
2002	0	45	55
2003	3	49	48
2004	17	66	17

Changes in the Level of Credit Risk in Syndicated/National Credit Portfolios
(Percent of Banks)

	Declined Significantly	Declined Somewhat	Unchanged	Increased Somewhat	Increased Significantly
1999	0	0	45	45	10
2000	0	0	36	61	3
2001	0	6	17	63	14
2002	0	8	29	53	10
2003	5	27	33	30	5
2004	17	36	36	11	0
Future 12 Months	0	31	58	11	0

Retail Lending Portfolios

Affordable Housing Lending

For the purposes of this survey, affordable housing loans included all types of loans on affordable housing for low- and moderate-income individuals and families, including single- to four-family and multifamily dwellings. Thirty-five of the 72 banks in the survey were reported to be making affordable housing loans.

Changes in Underwriting Standards in Affordable Housing Loan Portfolios
(Percent of Banks)

	Eased	Unchanged	Tightened
1999	16	70	14
2000	10	84	6
2001	6	88	6
2002	3	91	6
2003	3	88	9
2004	6	86	8

Changes in the Level of Credit Risk in Affordable Housing Loan Portfolios
(Percent of Banks)

	Declined Significantly	Declined Somewhat	Unchanged	Increased Somewhat	Increased Significantly
1999	2	2	78	18	0
2000	0	6	83	11	0
2001	2	2	88	8	0
2002	0	6	73	21	0
2003	0	9	76	15	0
2004	0	9	82	9	0
Future 12 Months	0	0	86	14	0

Consumer Leasing

Consumer leasing was offered by 14 of the 72 banks in the survey.

Changes in Underwriting Standards in Consumer Leasing Portfolios
(Percent of Banks)

	Eased	Unchanged	Tightened
1999	5	54	41
2000	0	50	50
2001	0	56	44
2002	0	67	33
2003	0	69	31
2004	0	86	14

Changes in the Level of Credit Risk in Consumer Leasing Portfolios
(Percent of Banks)

	Declined Significantly	Declined Somewhat	Unchanged	Increased Somewhat	Increased Significantly
1999	0	5	50	45	0
2000	0	5	67	28	0
2001	6	11	39	44	0
2002	7	13	26	47	7
2003	8	15	69	8	0
2004	43	21	36	0	0
Future 12 Months	29	43	21	7	0

Credit Card Lending

Twenty-eight of the 72 banks in the survey banks were engaged in credit card lending.

Changes in Underwriting Standards in Credit Card Loan Portfolios
(Percent of Banks)

	Eased	Unchanged	Tightened
1999	8	66	26
2000	9	75	16
2001	16	60	24
2002	12	66	22
2003	19	62	19
2004	18	61	21

Changes in the Level of Credit Risk in Credit Card Loan Portfolios
(Percent of Banks)

	Declined Significantly	Declined Somewhat	Unchanged	Increased Somewhat	Increased Significantly
1999	0	13	47	36	4
2000	0	16	66	16	2
2001	8	5	57	27	3
2002	0	6	54	31	9
2003	0	22	48	30	0
2004	0	11	61	25	3
Future 12 Months	0	18	57	21	4

Direct Consumer Lending

Fifty-six of the 72 banks in the survey were engaged in direct consumer lending.

Changes in Underwriting Standards in Other Direct Consumer Loan Portfolios
(Percent of Banks)

	Eased	Unchanged	Tightened
1999	7	74	19
2000	10	78	12
2001	7	73	20
2002	2	67	31
2003	8	68	24
2004	3	86	11

Changes in the Level of Credit Risk in Other Direct Consumer Loan Portfolios
(Percent of Banks)

	Declined Significantly	Declined Somewhat	Unchanged	Increased Somewhat	Increased Significantly
1999	0	7	65	28	0
2000	0	9	74	15	2
2001	0	7	71	20	2
2002	2	6	67	25	0
2003	2	17	72	7	2
2004	2	13	78	7	0
Future 12 Months	0	7	79	14	0

Home Equity —- Conventional Lending

Sixty-one of the 72 banks in the survey offered the conventional home equity lending product.

Changes in Underwriting Standards in Home Equity — Conventional Loan Portfolios
(Percent of Banks)

	Eased	Unchanged	Tightened
1999	23	67	10
2000	23	64	13
2001	7	70	23
2002	0	74	26
2003	18	63	19
2004	13	77	10

Changes in the Level of Credit Risk in Home Equity — Conventional Loan Portfolios
(Percent of Banks)

	Declined Significantly	Declined Somewhat	Unchanged	Increased Somewhat	Increased Significantly
1999	0	0	69	29	2
2000	0	5	73	20	2
2001	0	11	74	13	2
2002	0	7	71	22	0
2003	4	4	69	23	0
2004	0	6	79	13	2
Future 12 Months	0	0	67	33	0

Home Equity — High LTV Lending

Twenty-eight of the 72 banks in the survey offered the high LTV home equity lending product.

Changes in Underwriting Standards in Home Equity — High LTV Loan Portfolios
(Percent of Banks)

	Eased	Unchanged	Tightened
1999	20	61	19
2000	21	55	24
2001	11	54	35
2002	0	56	44
2003	7	68	25
2004	18	71	11

Changes in the Level of Credit Risk in Home Equity — High LTV Loan Portfolios
(Percent of Banks)

	Declined Significantly	Declined Somewhat	Unchanged	Increased Somewhat	Increased Significantly
1999	0	6	47	44	3
2000	0	13	58	24	5
2001	5	11	62	16	6
2002	0	12	40	44	4
2003	0	11	50	36	3
2004	0	18	61	18	3
Future 12 Months	0	7	57	36	0

Indirect Consumer Lending

Thirty-five of the 72 banks in the survey were engaged in indirect consumer lending.

Changes in Underwriting Standards in Indirect Consumer Loan Portfolios
(Percent of Banks)

	Eased	Unchanged	Tightened
1999	7	56	37
2000	7	60	33
2001	7	63	30
2002	0	72	28
2003	5	65	30
2004	11	60	29

Changes in the Level of Credit Risk in Indirect Consumer Loan Portfolios
(Percent of Banks)

	Declined Significantly	Declined Somewhat	Unchanged	Increased Somewhat	Increased Significantly
1999	2	23	42	33	0
2000	7	16	55	22	0
2001	2	21	39	33	5
2002	3	13	38	43	3
2003	5	20	47	28	0
2004	0	26	60	14	0
Future 12 Months	0	14	60	26	0

Residential Real Estate Lending

Sixty-two of the 72 banks in the survey were engaged in residential real estate lending.

Changes in Underwriting Standards in Residential Real Estate Loan Portfolios
(Percent of Banks)

	Eased	Unchanged	Tightened
1999	14	77	9
2000	7	85	8
2001	12	72	16
2002	4	83	13
2003	2	86	12
2004	7	86	7

Changes in the Level of Credit Risk in Residential Real Estate Loan Portfolio
(Percent of Bank)

	Declined Significantly	Declined Somewhat	Unchanged	Increased Somewhat	Increased Significantly
1999	3	5	71	21	0
2000	0	3	83	12	2
2001	0	9	76	15	0
2002	0	8	68	24	0
2003	0	12	74	12	2
2004	0	6	92	2	0
Future 12 Months	0	2	79	19	0