FEDERAL RESERVE BANK
OF DALLAS

DALLAS, TEXAS
75265-5906

October 20, 1999

Notice 99-88

TO: The Chief Executive Officer of each
state member bank and foreign agency
in the Eleventh Federal Reserve District

SUBJECT

Examination Guidance Cautioning Against Possible Relaxation of Credit Discipline

DETAILS

The Board of Governors of the Federal Reserve System has issued guidance cautioning against possible relaxation of credit discipline at banks. The guidance describes three key areas in which some banks may have strayed from historically sound lending practices. The key areas are as follows:

- Approving loans based on a very optimistic assessment of a borrower's operating prospects or on the assumption a borrower will always have ready access to financial markets;

- Failing to perform meaningful stress tests—or, if performed, to take such tests adequately into account—of a borrower's ability to withstand events such as unexpected shocks to operating income; and

- Weakening internal controls critical to maintaining the rigor and discipline of lending decisions.

The guidance instructs Federal Reserve examiners and supervisors to be alert for indications that undue reliance on favorable assumptions about borrowers or the economy and

financial markets more generally has led banks to reduce the rigor of their credit decisions or delay recognition of emerging loan weakness. If examiners observe any of these indications, they should carefully consider whether the developments warrant a downgrade in one or more elements of the bank's overall supervisory rating for safety and soundness.

ATTACHMENTS

Copies of the Board's press release and supervisory letter are attached.

MORE INFORMATION

For more information, please contact Marion White, (214) 922-6155, at the Dallas Office Banking Supervision Department, or Dick Burda, (713) 652-1503, at the Houston Branch Banking Supervision Department. For additional copies of this Bank's notice, contact the Public Affairs Department at (214) 922-5254.

Federal Reserve Release

For immediate release **September 28, 1999**

The Federal Reserve today issued examination guidance cautioning against possible relaxation of credit discipline at banks. Although at this time loan portfolios remain sound overall, indications of departures from proven sound lending practices—in particular, over-reliance on optimistic views of the borrowers' prospects and favorable economic and financial conditions—have been a recurring theme emerging from recent supervisory reviews of bank credit quality.

At the same time, over the past several quarters the volume of weak or potentially weak loans—that is, those falling into the classified or special mention categories used by supervisors—has risen at some institutions. Although the increases are generally attributable to industry-specific or global economic developments, these increases are significant because they have appeared despite the continued favorable economic and financial climate in the United States.

Supervisory reviews indicate that the vulnerability of these loans was heightened in some cases by weak underwriting practices. The guidance, contained in a supervisory letter sent to Federal Reserve bank examiners and supervisors as well as banking organizations supervised by the Federal Reserve, describes three key areas in which some banks may have strayed from historically sound lending practice:

- Approving loans based on a very optimistic assessment of a borrower's operating prospects or on the assumption a borrower will always have ready access to financial markets.

- Failing to perform meaningful stress tests—or, if performed, to take such tests adequately into account—of a borrower's ability to withstand events such as unexpected shocks to operating revenue.

- Weakening internal controls critical to maintaining the rigor and discipline of lending decisions.

"While loan portfolios are currently sound at the vast majority of banks, any trends toward laxity need to be reversed where they exist to ensure that the banking system remains strong and vibrant and retains the ability to lend to sound borrowers in good times and in bad," wrote Richard Spillenkothen, director of the Federal Reserve's Division of Banking Supervision and Regulation.

The guidance instructs Federal Reserve examiners and supervisors to be alert for indications that undue reliance on favorable assumptions about borrowers or the economy and financial markets more generally has led banks to reduce the rigor of their credit decisions or delay recognition of emerging loan weakness. If examiners observe such undue reliance, delays in recognition of problem loans, or significant weakening of internal risk management processes, they should carefully consider whether these developments warrant a downgrade in one or more elements of the bank's overall supervisory rating for safety and soundness.

Supervisory letters are the Federal Reserve's primary means of communicating key policy directives to its examiners, supervisory staff, and the banking industry. Supervisory letters can be viewed on the Board's World Wide Web home page at www.federalreserve.gov/boarddocs/srletters.

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM

WASHINGTON, D. C. 20551

DIVISION OF BANKING
SUPERVISION AND REGULATION

SR 99-23 (SUP)
September 28, 1999

TO THE OFFICER IN CHARGE OF SUPERVISION AND APPROPRIATE SUPERVISORY AND EXAMINATION STAFF AT EACH FEDERAL RESERVE BANK AND TO EACH DOMESTIC AND FOREIGN BANKING ORGANIZATION SUPERVISED BY THE FEDERAL RESERVE

SUBJECT: **Recent Trends in Bank Lending Standards for Commercial Loans**

Overview

Ongoing supervisory monitoring of lending practices at banks of all sizes, together with published and private reports from market participants, provides evidence that banks in some cases have relaxed their credit discipline in certain key areas. At the same time, over the past several quarters the volume of weak or potentially weak loans (i.e., those falling into the classified or special mention categories used by supervisors) has risen at some institutions, albeit from a very low base. In most cases, the triggering events for the growth in these categories of loans have been industry-specific, such as those related to commodity prices, agriculture, and health care, or the aftereffects of global developments such as the liquidity shock experienced in 1998. Although modest thus far, these increases are significant because they have appeared despite the continuing favorable economic and financial climate in the United States.

Surveys and market reports indicate that some standards were tightened in the wake of last year's market turmoil, but information obtained through supervisory activities suggests that certain deeper issues remain. A recurring theme emerging from supervisory reviews is that credit is being extended to some borrowers based largely on the expectation that the current strong financial performance of these borrowers will continue indefinitely, and with potentially undue reliance on aggressive or optimistic views of their future prospects. In particular, there appear to be more frequent instances in which banks accept ambitious financial targets on the part of their borrowers as the "most likely" outcome, and rely heavily on the uninterrupted continuation of favorable conditions in the economy in general and in financial markets more specifically to provide support for that view. These instances of reliance on favorable conditions have often been coupled with a failure to perform meaningful stress tests of the borrower's performance or alternatively, when such testing is performed, a failure to take stress test results adequately into account. Thus, while specific events may have triggered the recent increase in problem loans, the vulnerability of these loans to such events has been heightened by underwriting practices that, in some cases, have placed undue reliance on an uninterrupted continuation of favorable conditions.

These recent indications of departure from accepted sound lending standards are troubling because of the near-term effect on credit quality that is already evident, and the greater vulnerability of weakly underwritten credits to future cyclical deterioration in economic conditions. The historical record clearly shows that when banks depart from proven sound lending practices, asset quality suffers and the condition of the banking system invariably worsens. While loan portfolios are currently sound at the vast majority of banks, any trends toward laxity need to be reversed where they exist to ensure that the banking system remains strong and vibrant and retains the ability to lend to sound borrowers in good times and in bad.

The purpose of this SR letter is to highlight for examiners and supervisors, and for banking organizations supervised by the Federal Reserve, the risks of overly aggressive lending practices and the key actions and control processes needed to take and manage credit risk prudently. While much of the evidence cited here is drawn from larger banks and lending relationships, the principles described in this letter apply equally well to community banks and smaller lending relationships. Accordingly, Reserve Banks should take the necessary steps to ensure that the guidance provided in this SR letter is fully implemented in their examination, inspection, and other supervisory activities in a timely manner.

This guidance builds upon earlier statements on sound lending practices. For example, SR

letter 98-18, "Lending Standards for Commercial Loans," highlights certain specific issues for supervisory attention and several areas of sound practice in extending commercial credit. SR letter 99-3, "Supervisory Guidance Regarding Counterparty Credit Risk Management," emphasizes the need for thorough evaluation of counterparties to financial markets transactions. This letter extends previous guidance by addressing specific issues related to possible over-reliance on optimistic views of borrowers' prospects and favorable economic and financial conditions in making credit decisions, and to possible weakening of key internal controls in the lending process.

The Key Issue: Rigor of Credit Risk Assessment

Lending by its nature involves risk to the bank and its shareholders, and thus prudent lending decisions call for careful and critical assessment of that risk. Recent supervisory indications regarding trends in bank lending, including information gathered from the 1999 Shared National Credit program (an annual interagency review of large syndicated loans),[1] provide evidence of departures from historically sound lending practices. While internal processes and requirements for underwriting decisions should be consistent with the nature, size and complexity of the banking organization's activities, such departures can have serious consequences for institutions of all sizes. These departures are evident in three pivotal and related areas.

i.) Undue reliance on optimistic outlooks for borrowers and continued favorable economic and financial market conditions : The long and continuing economic expansion has led to more frequent instances in which banks base their decision to lend on a very optimistic assessment of the borrower's operating prospects. Moreover, timely principal repayment is often based on the assumption that the borrower will have ready access to financial markets in the future. Such reliance, especially if across a significant volume of loans, is not consistent with sound credit risk management.

Undue reliance on continued favorable economic conditions can be demonstrated by:

- Dependence on very rapid growth in a borrower's revenue as the "most likely" case;
- Heavy reliance on favorable collateral appraisals and valuations that may not be sustainable over the longer term;
- Greater willingness to make loans without scheduled amortization prior to the loan's final maturity; or
- Ready willingness to waive violations of key covenants, release collateral or guarantee requirements, or even restructure loan agreements, without corresponding concessions on the part of the borrower, on the assumption that a favorable environment will allow the borrower to recover quickly.

Among the adverse effects of undue reliance on a favorable economy is the possibility of delay in properly identifying problem loans. Timely identification of problem loans is critical for providing a full awareness of the institution's risk position, informing management and directors of that position, taking steps to mitigate risk, and providing a proper assessment of the adequacy of the allowance for credit losses and capital.[2]

Similarly, over-reliance on continued ready access to financial markets on favorable terms can come in many ways, including:

- Explicit reliance on future public market debt or equity offerings, or on other sources of refinancing, as the ultimate source of principal repayment, which presumes that market liquidity and appetite for such instruments will be favorable at the time that the facility is to be repaid;
- Alternatively, ambiguous or poorly supported analysis of the sources of repayment of the loan's principal, together with implicit reliance for repayment on some realization of the implied market valuation of the borrower (e.g., through refinancing, asset sales, or some form of equity infusion), which also assumes that markets will be receptive to such transactions at the time that the facility is to be repaid;
- Measuring a borrower's leverage (e.g., debt-to-equity) based solely on the market

capitalization of the firm without regard to "book" equity, and thereby implicitly assuming that currently unrealized appreciation in the value of the firm can be readily realized if needed; or

- More generally, extending bank loans with a risk profile that more closely resembles that of an equity investment, and under circumstances that leave additional bank credit or default as the borrower's only resort should favorable expectations not be met.

Indeed, as a result of this over-reliance, some banking organizations may find themselves with a potentially significant concentration of credit exposure that is at risk to a possible reversal in financial markets. Turmoil in financial markets in 1998 contributed to significant liquidity pressures in some sectors of the economy, but this turmoil ebbed quickly. There is no assurance that any such future turmoil will not persist longer. Especially under such circumstances, a borrower's ability to raise new funds in public debt or equity markets to repay maturing bank loans is far from guaranteed.

ii.) Insufficient consideration of stress testing : Meaningful stress testing of the prospective borrower's ability to meet its obligations is a vital part of a sound credit decision. Failure to recognize the potential for adverse events -- whether specific to the borrower or its industry (e.g., a change in the regulatory climate or emergence of new competitors) or alternatively to the economy as a whole (e.g., a recession) -- can prove costly to a banking organization.

Mechanical reliance on threshold financial ratios (and the "cushion" they imply) is generally not sufficient, particularly for complex loans and loans to leveraged borrowers or others that must perform exceptionally well to meet their financial obligations successfully. Scenario analysis specific to the borrower, its industry, and its business plan is critical to identify the key risks of a loan, and should have a significant influence on both the decision to extend credit at all and, if credit is extended, on decisions on appropriate loan size, repayment terms, collateral or guarantee requirements, financial covenants, and other elements of the loan's structure.

When properly conducted, meaningful stress testing can include assessing the effect on the borrower of the following situations or events:

- Unexpected reductions in revenue growth or reversals, including shocks to revenue of the type(s) and magnitude that would normally be experienced during a recession;
- Unfavorable movements in market interest rates, especially for firms with high debt burdens;
- Unplanned increases in capital expenditures due to technological obsolescence or competitive factors;
- Deterioration in the value of collateral, guarantees, or other potential sources of principal repayment;
- Adverse developments in key product or input markets; and
- Reversals in, or reduced access of the borrower to, public debt and equity markets.

Proper stress testing typically incorporates an evaluation of the borrower's alternatives for meeting its financial obligations under each scenario, including asset sales, access to alternative funding or refinancing, or ability to raise new equity. In particular, the evaluation should focus not only on the borrower's ability to meet near-term interest obligations, but also its ability to repay the principal of the obligation.

iii.) Weakening of key internal controls in the lending process: Adequate internal controls within the lending process, in particular loan review or credit audit, are critical for maintaining proper incentives for bank staff to be rigorous and disciplined in their credit analysis and lending decisions. A bank's credit analyses, loan terms and structures, credit decisions, and internal rating assignments have historically been reviewed in detail by experienced and independent loan review staff. These reviews have provided both motivation for better credit discipline within an institution and greater comfort for examiners -- and management -- that internal policies are being followed and that the institution continues to adhere to sound lending practice.

Recent supervisory reviews at banking institutions indicate that, in the current environment of relatively low levels of problem loans and credit losses, there is increasing pressure within institutions to reduce the resources committed to loan review functions. These reductions may include a reduction in staff, more limited portfolio coverage, and less thorough reviews of individual loans. Although undoubtedly some useful efficiencies have been gained, there are indications that at some institutions the scope and depth of loan review activities may have been reduced beyond levels that are prudent over the longer horizon. If reduced too far, the integrity of the lending process and the discipline of identifying unrealistic assumptions and discerning problem loans in a timely fashion may deteriorate, especially because a large proportion of today's bank lenders may not have had direct experience with a downturn in the credit cycle.

Supervisory and Examination Guidance

Supervisors and examiners should be alert for indications of insufficiently rigorous risk assessment at institutions they supervise, in particular for excessive reliance upon strong economic conditions and robust financial markets to support the capacity of their borrowers to service their debts, as well as inadequate stress testing. Examiners should also be attentive in reviewing an institution's assessment and monitoring of credit risk to ensure that undue reliance on favorable conditions does not lead that institution to delay recognition of emerging weaknesses in some loans.[3]

If examiners observe significant and undue reliance on favorable assumptions about borrowers or the economy and financial markets more generally, or observe that this reliance has slowed the institution's recognition of loan problems, they should give careful consideration to downgrading, under the applicable supervisory rating framework, an institution's risk management, management, and/or asset quality ratings and, if deemed sufficiently significant to the institution, its capital adequacy rating. Similarly, if supervisors or examiners find that loan review activities or other internal control and risk management processes have been weakened by staff turnover, failure to commit sufficient resources, or inadequate training, such findings should be considered in supervisory ratings as well.

In developing their findings, examiners should conduct sufficient loan reviews and transaction testing in the lending function to determine accurately the quality of bank loan portfolios and other credit exposures. If deficiencies in lending practices or credit discipline are indicated as a result of the pre-examination risk assessment or the conduct of the examination itself, sufficient supervisory resources should be committed to in-depth reviews, including transaction testing, that are adequate to ensure that the Reserve Bank achieves a full understanding of the nature, scope, and implications of the deficiencies.

Important findings should be noted in the examination or inspection report and, as appropriate, plans for remedial actions discussed with bank management and boards of directors. In addition, any weaknesses or deficiencies identified at the parent holding company or corporatewide level that could adversely affect affiliated insured depository institutions should be conveyed to the primary federal or state supervisor of the insured institution.

This letter should be sent to all domestic and foreign banking organizations supervised by the Federal Reserve. Officers in charge of supervision at each Reserve Bank should ensure that the guidance contained in this SR letter is incorporated in a timely and effective manner into the supervisory evaluations and examinations conducted by the Federal Reserve.

Richard Spillenkothen
Director

Cross-References: SR letters 99-22, 99-18, 99-3, 98-25, 98-18.

Notes:

1 Each year the three federal banking agencies, with the participation of state supervisors, conduct a joint assessment of the quality of large syndicated loans, in large part to ensure that such loans are

accorded equivalent treatment by examiners from different agencies across banking organizations. Under the Shared National Credit program, examiners review a sample of loans among those larger than $20 million in total exposure and for which participations in the loans are held by at least three banks. These reviews generally take place at the offices of the agent bank, and focus in particular on determining whether loans in this sample should be placed in one of the regulatory problem asset grades. The resulting regulatory rating (pass, special mention, or one of the classified ratings) is then applied to that loan for all banks participating in the credit.

2 These issues are discussed more fully in SR letter 98-25, “Sound Credit Risk Management and the Use of Internal Credit Risk Rating Systems at Large Banking Organizations,” SR letter 99-22, “Joint Interagency Letter on the Loan Loss Allowance,” and SR letter 99-18, “Assessing Capital Adequacy in Relation to Risk at Large Banking Organizations and Others with Complex Risk Profiles.” As these and other SR letters make clear, Federal Reserve guidance on credit risk management and mitigation covers both loans and other forms of on- and off-balance-sheet credit exposure.

3 Examiners should recognize that an increase in classified or special mention loans is not per se an indication of lax lending standards. Examiners should review and consider the nature of such increases and surrounding circumstances in reaching their conclusions regarding the asset quality and risk management of an institution.

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