FEDERAL RESERVE BANK OF NEW YORK

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CHESTER B. FELDBERG
EXECUTIVE VICE PRESIDENT

AT-10789

June 30, 1995

TO THE CHIEF EXECUTIVE OFFICERS OF ALL STATE MEMBER BANKS, BANK HOLDING COMPANIES, STATE-LICENSED BRANCHES AND AGENCIES OF FOREIGN BANKS, AND EDGE CORPORATIONS IN THE SECOND FEDERAL RESERVE DISTRICT

SUBJECT: Bank Lending Terms and Standards

Recent experience suggests that credit underwriting terms have eased from those prevailing in the early 1990s. Such adjustments by banks that had previously tightened credit standards significantly in response to serious credit problems and weak banking conditions may be a natural consequence of improved conditions. In today's intensely competitive lending markets, however, there is the potential that some banks may be relaxing lending terms beyond prudent bounds. Federal Reserve examiners have been advised to be alert for such easing.

In this regard, we wish to share with you the enclosed letter issued by the Division of Banking Supervision and Regulation of the Board of Governors of the Federal Reserve System as guidance to examiners on this issue. It reiterates the Federal Reserve's long-standing policy and examination procedures as they relate to evaluation of a banking organization's loan portfolio and underwriting practices. As the letter states, this is not meant to indicate a fundamental shift or change in the Federal Reserve's approach to assessing credit quality nor is it intended to suggest the existence of widespread problems regarding lending terms or standards. It is intended, however, to encourage a continued balanced approach to the review of the loan portfolio by Federal Reserve examiners and to assist bank management in better understanding this aspect of the examination process.

If there are any questions regarding the content of this letter, please contact John A. Greco, Examining Officer, in our Financial Examinations Function (Tel. No. 212-720-8398).

Sincerely,

Chester B. Feldberg

Enclosure

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

DIVISION OF BANKING
SUPERVISION AND REGULATION

SR 95-36 (SUP)

June 19, 1995

TO THE OFFICER IN CHARGE OF SUPERVISION AT EACH FEDERAL RESERVE BANK

SUBJECT: Bank Lending Terms and Standards

Introduction

Federal Reserve supervisory officials and examiners monitor lending standards and practices in connection with ongoing supervisory activities and the conduct of on-site examinations. For some time, surveys of senior lending officers, reports from examiners, anecdotal information on competitive conditions from bankers, and discussions with trade and advisory groups have indicated that commercial banks have been easing terms and conditions on loans to their business customers. Such adjustments may be altogether appropriate if they are being made prudently by banks that significantly tightened their credit standards in the late 1980s and early 1990s in response to serious credit problems and weak banking conditions. In today's intensely competitive lending markets, however, there is the potential that some banks may be relaxing, or may be inclined to relax, lending terms and conditions beyond prudent bounds in efforts to obtain new customers or retain existing customers.

Supervisory experience suggests that credit underwriting terms have eased from those prevailing in the early 1990s in a variety of ways which include, but are not limited to, smaller loan fees, narrower spreads, larger credit lines, lower debt service coverage ratios, lengthening of maturities, lower collateral coverage, less frequent personal guarantees and generally fewer or more liberal protective covenants. In addition to the easing associated with commercial loans, some lenders have loosened terms on credit card and home equity facilities to individuals.

Examination Considerations

The process by which banks alter their lending terms and standards, as well as their overall appetite for risk-taking, can involve decisions by senior management and boards of directors to amend operating policies and procedures. Alternatively, a change in a bank's risk profile can sometimes result from more subtle or gradual revisions or modifications in how a bank's lending policies and procedures are applied in practice. The latter process may be less apparent, but both can, if not controlled over time, result in significant loan problems. Senior bank management and bank examiners need to be sensitive to both types of credit easing and their potential impact on a bank's risk profile.

Banking necessarily entails making business judgements about taking and pricing risks and, of course, the potential for loss is inherent in the lending process. Banks must have the discretion to make reasonable adjustments to lending rates, fees and other terms in order to serve their communities and customers, maintain market position, and operate profitably. However, sound banking practice requires that banks have policies and procedures in place to ensure that all credit risks are properly identified, monitored, and controlled, and that loan pricing, terms, and other safeguards against non-performance and default are commensurate with the level of risk undertaken. The experience of the recent past demonstrates that lax lending standards or practices can lead to heavy loan losses that place a material strain on earnings and capital.

Over the last several years, consumers and business borrowers have generally experienced quite favorable financial and economic conditions, which have contributed to the recent growth and strong performance of bank loan portfolios. However, examiners should recognize that these conditions have been affected, in part, by the particular circumstances of the business cycle. The performance of loans, especially those that are not properly structured, can be adversely affected should the condition of borrowers deteriorate. Therefore, banks should ensure that their loan underwriting terms and standards for both consumer and commercial loans are appropriate to a variety of borrower and economic conditions -- they should not be based solely on "best case" scenarios for the particular borrower or for the economy overall. Current loan delinquency and default rates reflect, in part, the relatively recent vintage of many loans, as well as the prevailing economic environment, and may not be indicative of the performance of the loan portfolio over time. It is the borrower's ability to repay in the future, that is, at maturity -- when the borrower's condition or the economic environment may be different -- that ultimately determines whether a loss will be suffered on a loan. As part of the credit risk management process, banks should consider the potential effect of a wide range of borrower default rates and losses on the institution, especially on loans with more relaxed terms.

Examination Procedures

One of the principal objectives of an on-site examination is to evaluate loan underwriting practices and the quality of bank loan portfolios. As part of the routine procedures for evaluating bank loan portfolios, examiners should ascertain whether credit terms and standards have eased since prior examinations, and if so, whether the bank's lending activities remain within the bounds of prudent underwriting practice. Accordingly, examination procedures for consumer and business loans should, where appropriate, continue to emphasize the following:

- o Identification of changes in loan policies or in credit underwriting terms, standards or practices since the last examination.

- o Comparison of credit terms on noncriticized (pass) loans of comparable risk between the current and prior examinations.

- o Evaluation of trends in the number, volume and frequency of any loans that involve exceptions to the bank's loan policies and underwriting standards.

- o The quality of the bank's internal credit scoring or loan risk rating system and the ongoing effectiveness of the loan review process.

- o Evaluation of trends in the number and volume of credits in higher risk categories based upon the bank's internal credit scoring or loan risk rating systems.

- o Assessment of changes in concentration levels, especially for credits with higher risk ratings.

- o The quality, accuracy and timeliness of management information systems on internal loan risk ratings and loan portfolio performance.

- o The degree to which the bank considers the potential performance of the portfolio under various economic and financial scenarios, including, where appropriate, stress testing.

- o Assessment of the loan loss reserve methodology in light of any changes in credit terms or standards.

- o The overall effectiveness of the credit risk management process and internal controls in light of any changes in credit terms and standards.

- o Degree of independent oversight over the lending process provided by the board of directors.

After each examination, the exit interview should include a general discussion of the bank's lending policies and practices. As part of this discussion, an effort should be made to determine management's views on the bank's current lending terms and standards, as well as on market practices more generally. Where applicable, management and directors should be reminded of the necessity to take into account the potential effects of eased standards and changing economic conditions when evaluating the adequacy of loan loss reserves and capital, assigning internal loan risk ratings, and interpreting management reports.

If questionable or unwarranted easing is identified, examiners should discuss their findings in detail with senior management and, if necessary, the board of directors, and include appropriate comments and recommendations in the examination report. This should be done regardless of whether or not classified assets or other quantitative indicators of problem loans have begun to increase. Care should be taken to ensure that management and directors are fully aware of the risks that questionable or imprudent lending standards or practices could present to the safety and soundness of their institutions in the event of a change in general economic conditions or in the condition of individual borrowers.

The steps outlined above are consistent with the Federal Reserve's longstanding examination policy of assessing the impact of the quality of a bank's loan portfolio and credit risk management procedures on its overall financial condition and risk profile. This letter is intended to ensure a continuing balanced review of asset quality during on-site examinations; nothing in this letter is meant to bring about or suggest a fundamental change in the scope, content or depth of System examinations.

Richard Spillenkothen
Director