

Joint Release

Board of Governors of the Federal Reserve System
Federal Deposit Insurance Corporation
Office of the Comptroller of the Currency
Office of Thrift Supervision

NR 2006-102
FOR IMMEDIATE RELEASE
September 25, 2006

**Shared National Credit Data Reflect Good Credit Quality Performance, Large Increase in Credit¹
Commitment Volume, and Small Rise in Riskier Deals**

September 26, 2006

Note: This version of the September 25, 2006, release of the Shared National Credit data corrects several discrepancies. Specifically, the non-accrual amounts in the second paragraph of the Overview on page 2 and in Table 1 have been revised. These amounts now match the non-accrual amounts previously reported in Table 2. In Appendix B, the section titled "All Industries (Total)" corrects the line items titled "% Classified" and "% Special Mention" for the years 2001, 2002, and 2003.

The volume of syndicated credits rose rapidly, in part reflecting a rise in merger and acquisition activity over the past year, according to the Shared National Credit (SNC)² review released today by federal bank and thrift regulators. The review noted a small increase in problem credits as a share of commitments in 2006. The bulk of this increase was associated with credits held by nonbank³ entities while problem loans at regulated institutions, particularly those with insured deposits, grew slightly. Deterioration in exposures to the manufacturing sector, primarily the automotive industry, accounted for most of the softening in asset quality. The review affirmed that most other industries exhibit improved credit quality from peak problem levels experienced only a few years ago. Examiners also found, however, a continued easing of underwriting standards in the syndicated lending market in general, particularly in non-investment grade or leveraged credit facilities.

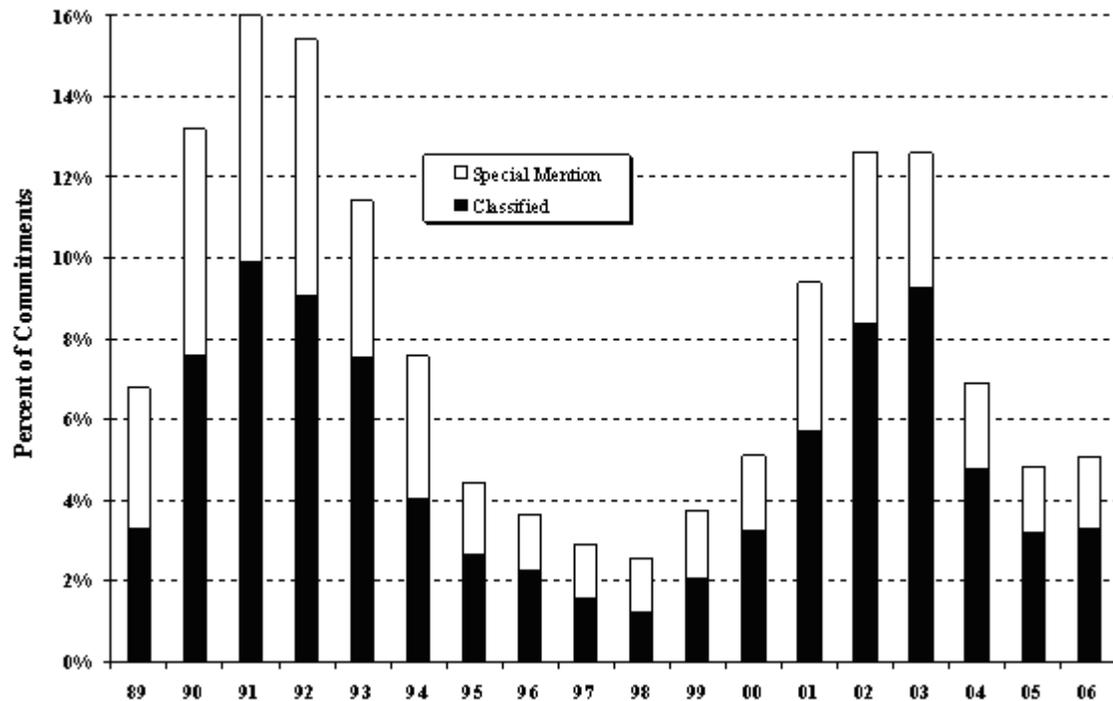
The results--reported by the Board of Governors of the Federal Reserve System, the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, and the Office of Thrift Supervision--are based on analyses prepared in the second quarter of 2006 and reflect business and economic conditions at that time.

Total adversely rated credits⁴ rose slightly to 5.1 percent of total commitments from 4.8 percent a year ago (see [Chart 1](#)). Similarly, the ratio of classified commitments to total commitments rose slightly to 3.3 percent from 3.2 percent last year. Total classified commitments rose by \$9.4 billion, or 18 percent, since 2005, compared with a net decrease of \$21.5 billion, or 29 percent, the previous year. Commitments rated special mention increased by \$7.5 billion, or 29 percent, in contrast to 2005 when they fell by \$7.0 billion, or 21 percent.

Classified commitments held by United States (U.S.) domiciled banking organizations increased to \$13.1 billion from \$11.9 billion in 2005, but the classified ratio remained at only 1.6 percent due to growth in these companies' syndicated credit portfolios.

These discussions of adversely rated credits and their ratios do not include the effects of hedging or other techniques that organizations often employ to mitigate risk.

Chart 1: Adversely Rated Credits



Overview

In aggregate, the 2006 SNC Program covered 7,009 credits totaling \$1.9 trillion in credit commitments to 4,833 borrowers. Total SNC commitments increased by nearly \$250 billion, a 15.2 percent increase from 2005, the largest annual expansion in nearly eight years. The current level of commitments is slightly below the 2001 peak of \$2.0 trillion, while adversely rated commitments are only 40 percent of their peak level in 2002. The increase in 2006 total commitments reflects, in part, substantial merger and acquisition financing provided over the past year. Total outstandings, or drawn amounts, of \$626 billion were up 20 percent from the prior year.

For the 2006 review, total commitments classified as substandard rose \$14.0 billion, or 32 percent from the prior year, while doubtful credits decreased \$3.1 billion, or 55 percent (see [Table 1](#)). Commitments classified as loss fell \$1.5 billion, down 56 percent from the prior year. Nonaccrual⁵ classified credits fell 29 percent to \$17.7 billion.

Table 1: SNC Adversely Rated Commitments (\$ billions)

	Total Commitments						% Change 2005-2006
	2001	2002	2003	2004	2005	2006	
Substandard	87.0	112.0	112.1	55.1	44.2	58.1	32%
Doubtful	22.5	26.1	29.3	12.5	5.6	2.5	-55%
Loss	8.0	19.1	10.7	6.4	2.7	1.2	-56%
Total Classified	117.5	157.1	152.2	74.0	52.5	61.8	18%
Percent of Commitments	5.7%	8.4%	9.3%	4.8%	3.2%	3.3%	
Memo: Nonaccrual Classified	N/A	74.1	68.4	37.6	24.8	17.7	-29%
Special Mention	75.4	79.0	55.2	32.8	25.9	33.4	29%
Total Criticized	192.8	236.1	207.4	106.8	78.3	95.2	22%
Percent of Commitments	9.4%	12.6%	12.6%	6.9%	4.8%	5.1%	
Total SNC Commitments	2,049	1,871	1,644	1,545	1,627	1,874	15.2%

Note: Figures may not add to totals due to rounding

Industry Trends

The volume of classified SNCs improved slightly in most industries (see [Appendix B](#))⁶, with the notable exception of the Manufacturing sector. While commitments to this sector increased 8.4 percent, weakness in the automotive industry during the year led to a \$15.6 billion, or 147 percent, increase in classified credits. This softness in the manufacturing sector overshadowed notable improvements in loan classifications in the Oil, Gas, Pipelines & Utilities sector, the Lodging & Transportation sector, the Construction & Real Estate sector, and the Professional, Scientific & Other Services sector, each with classified volumes falling by approximately one-third. Classified commitments also declined for the Telecommunication and Cable industry (by \$2.4 billion or 14 percent), but remain elevated at 10 percent of total commitments.

The volume of special mention SNC credits increased 29 percent or \$7.5 billion, with increases observed in most industries except Manufacturing and Professional Services.

Trends by Entity Type

During 2006, the portion of SNC commitments held by U.S. domiciled banking organizations edged down 0.5 percentage points to 44 percent, a level mostly unchanged in the past five years. Compared to last year, the portion held by foreign banking organizations (FBOs) also slipped 0.5 percentage points to 41 percent in 2006 (see [Table 2](#)).

Over the past ten years, lenders not affiliated with banks, such as brokerage firms, mutual funds, insurance companies, and hedge funds, have taken on larger positions in the syndicated market. These nonbank entities have increased their share to 14 percent of total commitments compared to 8 percent five years ago and 2 percent in 1996.

The quality of holdings also varied among entity types with classified commitments amounting to 1.6 percent of total commitments at U.S. banks compared with 2.2 percent at FBOs and 11.8 percent at nonbanks. Nonbank holdings of classified commitments increased even more dramatically over the past five years than their overall syndicated credit holdings, increasing from 21 percent of all classified credit commitments in 2001 to 51 percent in 2006. U.S. banks only held 21 percent of classified commitments in 2006. Total nonaccrual loans improved for U.S. banks and FBOs, but worsened for nonbanks. Nonbank entities held 58 percent of nonaccrual loans in 2006 with U.S. banks only holding 16 percent.

Table 2: Exposures by Entity Type

Share of Total Commitments (%)

	2001	2002	2003	2004	2005	2006
US Banking Institutions	46.2	45.3	45.4	46.5	44.8	44.3
Insured	43.8	42.8	42.5	43.4	41.5	40.8
Uninsured(*)	2.3	2.5	2.9	3.1	3.3	3.5
FBOs	45.4	44.8	43.8	41.6	42.1	41.5
Insured	5.0	5.1	5.4	5.5	6.0	6.2
Uninsured	40.4	39.7	38.4	36.1	36.1	35.3
Nonbanks	8.4	9.9	10.8	12.0	13.1	14.3

Total Classifications (\$ billion)

	2001	2002	2003	2004	2005	2006
US Banking Institutions	48.5	53.7	43.6	18.8	11.9	13.1
Insured	43.9	47.6	37.8	16.0	8.6	9.0
Uninsured(*)	4.6	6.0	5.8	2.8	3.2	4.1
FBOs	44.0	60.0	65.0	31.3	15.5	17.3
Insured	7.3	8.4	6.8	2.8	1.5	1.6
Uninsured	36.7	51.6	58.3	28.5	14.0	15.7
Nonbanks	25.0	42.1	43.6	24.0	25.0	31.5
Totals	117.5	155.8	152.2	74.2	52.5	61.8

Classified as % of Commitments

	2001	2002	2003	2004	2005	2006
US Banking Institutions	5.1	6.4	5.8	2.6	1.6	1.6
Insured	4.6	5.7	5.1	2.2	1.2	1.1
Uninsured(*)	0.5	0.7	0.8	0.4	0.4	0.5
FBOs	4.7	7.2	9.0	4.9	2.3	2.2
Insured	0.8	1.0	0.9	0.4	0.2	0.2
Uninsured	3.9	6.2	8.1	4.4	2.0	2.0
Nonbanks	14.4	22.9	24.5	13.0	11.7	11.8
Totals	5.7	8.4	9.3	4.8	3.2	3.3

Total Nonaccrual Commitments (\$ billion)

	2001	2002	2003	2004	2005	2006
US Banking Institutions	n.a.	22.5	18.4	7.7	3.9	2.8
Insured	n.a.	19.4	16.5	0.1	3.1	1.8
Uninsured(*)	n.a.	3.1	1.9	7.6	0.8	1.0
FBOs	n.a.	30.5	29.5	17.6	9.0	4.7
Insured	n.a.	3.9	3.2	-	0.4	0.4
Uninsured	n.a.	26.6	26.3	17.6	8.6	4.3
Nonbanks	n.a.	21.1	20.5	12.3	11.9	10.2
Totals	n.a.	74.1	68.4	37.6	24.8	17.7

(*)Uninsured refers to organizations that do not take consumer deposits such as holding companies, brokerage firms, finance companies, etc.

Note: Figures may not add to totals due to rounding

Risk Management by Banks

Strong market competition and a highly liquid secondary loan market have contributed to easing of credit underwriting standards in large corporate and leveraged loans. Demand for bank loans from non-bank institutional investors has influenced underwriting terms and pushed credit spreads lower. Of note is the

increasing volume of term loans with nominal amortization required prior to maturity and loosened financial loan covenants such as leverage and fixed charge coverage ratios.

Although credit risk in SNC portfolios of U.S domiciled banking organizations is low and generally stable, rapid portfolio growth, easing of underwriting standards, and the increase in adversely rated commitments over the past year are indicative of increasing credit risk. Banking organizations should ensure that competitive pressures and easing of underwriting standards do not unduly compromise their tolerance for credit risk. In addition, advanced credit risk management systems should exist to appropriately measure, monitor and control risks in large corporate portfolios.

FDIC: PR-84-2006

¹Credits include syndicated loans and loan commitments, letters of credit, commercial leases, as well as other forms of credit. Credit commitments include both drawn and undrawn portions of credit facilities. This release reports only the par amounts of commitments; these may differ from the amounts at which loans are carried by investors.

²The Shared National Credit (SNC) Program was established in 1977 by the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, and the Office of the Comptroller of the Currency. In 2001 the Office of Thrift Supervision became an assisting agency. With a few exceptions, the annual program, which seeks to provide an efficient and consistent review and classification of large syndicated loans, generally covers loans or loan commitments of at least \$20 million that are shared by three or more regulated financial institutions.

³Nonbanks include a wide range of institutional investors including brokerage firms, mutual funds, insurance companies, and hedge funds.

⁴Adversely rated credits (also known as criticized credits) are the total of credits classified substandard, doubtful, and loss—and credits rated special mention. Classified credits are only those rated substandard, doubtful, and loss. Under the agencies' Uniform Loan Classification Standards, classified credits have well-defined weaknesses, including default in some cases. Special mention credits exhibit potential weaknesses, which may result in further deterioration if left uncorrected.

Excerpt from Federal Reserve's SR Letter 79-556 defining regulatory classifications:

Classification ratings are defined as "Substandard," "Doubtful," and "Loss." A Substandard asset is inadequately protected by the current sound worth and paying capacity of the obligor or of the collateral pledged, if any. Assets so classified must have a well-defined weakness or weaknesses that jeopardize the liquidation of the debt. They are characterized by the distinct possibility that the bank will sustain some loss if the deficiencies are not corrected. An asset classified as Doubtful has all the weakness inherent in one classified Substandard with the added characteristic that the weaknesses make the collection or liquidation in full, on the basis of currently existing facts, conditions, and values, highly questionable and improbable. Assets classified as Loss are considered uncollectible and of such little value that their continuance as bankable assets is not warranted. This classification does not mean that the asset has absolutely no recovery or salvage value, but rather it is not practical or desirable to defer writing off this basically worthless asset even though partial recovery may be effected in the future.

Excerpt from June 10, 1993 Interagency Statement on the Supervisory Definition of Special Mention Assets:

A Special Mention asset has potential weaknesses that deserve management's close attention. If left uncorrected, these potential weaknesses may result in deterioration of the repayment prospects for the asset or in the institution's credit position at some future date. Special Mention assets are not adversely classified and do not expose an institution to sufficient risk to warrant adverse classification.

⁵Nonaccrual loans are defined for regulatory reporting purposes as "loans and lease financing receivables that are required to be reported on a nonaccrual basis because (a) they are maintained on a cash basis due to a deterioration in the financial position of the borrower, (b) payment in full of interest or principal is not expected, or (c) principal or interest has been in default for 90 days or longer, unless the obligation is both well secured and in the process of collection." In Table 1, nonaccrual classifieds are those funded or outstanding portions of loans classified as substandard and doubtful which are not accruing interest.

⁶Note that the current industry totals categorize borrowers using 2002 NAICS codes, in contrast to prior release of SNC data which categorized borrowers using 1997 NAICS codes.

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Related Links

- [Appendix A](#)
- [Appendix B](#)

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