Inside

Credit Management Information Systems: A Forward-Looking Approach

Underwriting Trends and Other Highlights from the FDIC’s Credit and Consumer Products/Services Survey

Regulatory and Supervisory Roundup
Supervisory Insights is published by the Division of Risk Management Supervision of the Federal Deposit Insurance Corporation to promote sound principles and practices for bank supervision.

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Articles

Credit Management Information Systems: A Forward-Looking Approach

Forward-looking credit Management Information Systems (MIS) provide a powerful tool in the risk management and strategic decision-making process. Whereas performance metrics primarily convey what has occurred in the portfolio, forward-looking metrics assist in identifying underlying risks that could potentially affect future performance. The FDIC conducted a horizontal review of credit MIS programs that identified strong and weak practices. This article illustrates how banks can strengthen credit MIS by incorporating forward-looking risk indicators and establishing a sound governance framework.

Underwriting Trends and Other Highlights from the FDIC’s Credit and Consumer Products/Services Survey

Since 2009, FDIC examiners have completed the Credit and Consumer Products/Services Survey (Credit Survey) at the conclusion of each risk management examination to gather examiner insights on underwriting practices, new and evolving banking activities and products, commercial real estate market conditions, and funding practices. This article shares recent Credit Survey results with a focus on lending activity — including trends in underwriting, loan growth, and funding. The results suggest that credit risk and liquidity risk are increasing, as reflected in a higher frequency of surveys that report risks associated with loan growth, out-of-territory lending, and credit and funding concentrations.

Regular Features

Regulatory and Supervisory Roundup

This feature provides an overview of recently released regulations and supervisory guidance.
Loan growth has been a key driver of increasing earnings in the banking industry, and well-managed institutions understand that it is prudent to implement effective policies and procedures to monitor this growth. This issue of *Supervisory Insights* focuses on the importance to banks of adopting a forward-looking approach to identifying and managing credit risk.

The implementation of an effective credit management information system (MIS) is a critical component of an institution’s overall credit risk management program. Performance metrics, including trends in charge-offs, delinquency ratios, nonaccruing loans, restructured loans, and adversely classified assets, are an integral part of a credit MIS program. However, an overreliance on these lagging indicators may make it difficult for management to adequately identify emerging risks in the loan portfolio.

Forward-looking indicators, such as an increase in policy exceptions, an easing of underwriting standards, and higher concentration levels, promote the identification of emerging risks and tend to be more predictive of future performance. “Credit Management Information Systems: A Forward Looking Approach” examines the use of a forward-looking MIS, which can be a powerful tool in a bank’s strategic decision-making process. The article also emphasizes the importance of establishing and maintaining a strong governance framework to effectively administer the MIS and credit risk oversight.

“Underwriting Trends and Other Highlights from the FDIC’s Credit and Consumer Products/Services Survey” (Credit Survey) summarizes examiners’ views of credit and funding risks at FDIC-supervised institutions. The results suggest that credit risk and liquidity risk are increasing, as reflected in a higher frequency of surveys that report risks associated with loan growth, out-of-territory lending, and credit and funding concentrations. The article also explores the concept of layered risk, which has been on the rise as institutions rely more on noncore or potentially volatile funding sources to support loan growth. This article is the most recent in a series of *Supervisory Insights* articles that summarize the results of the post-examination Credit Survey.

This issue of *Supervisory Insights* also includes an overview of recently released regulatory and supervisory guidance.

We hope you take the time to read both articles in this issue and find them to be valuable resources. We encourage our readers to provide feedback and suggest topics for future issues. Please email your comments and suggestions to SupervisoryJournal@fdic.gov.

Doreen R. Eberley  
*Director*  
*Division of Risk Management Supervision*
The ability to identify and manage credit risk is a critical part of a bank’s overall risk management program. Banks with sound credit risk management programs are well-positioned to proactively modify policies and underwriting practices to respond to emerging risks. A key component of an effective risk management program is a strong credit management information system (MIS), which uses loan-related data to develop timely and meaningful reporting for a bank’s board of directors and senior management. Credit MIS reports are used by senior management and board members to oversee lending activities and support strategic decision making. The complexity of credit reporting may vary based on the size of the institution and the nature of the lending activities, but the principles of sound credit MIS apply to all institutions.

The FDIC conducted an analysis of the credit MIS programs at 24 large state nonmember banks1 representing a range of lending activities and geographic markets. Typically, these credit MIS programs did a good job tracking loan delinquencies, charge-offs, and other measures of current loan portfolio performance. Such metrics tend to be “lagging” indicators of risk, in the sense that they provide after-the-fact evidence of a credit-quality issue. Many of the credit MIS programs in our review had significantly less coverage of “forward-looking” risk indicators, which can be indicative of future performance and should be the focus of a sound credit MIS program to proactively identify and mitigate risk exposure. This article illustrates how banks can strengthen credit MIS by incorporating forward-looking risk indicators and establishing a sound governance framework. The article is intended as an informational resource for interested persons. It does not create new requirements or supervisory expectations and is not required reading for any banker.

Forward-looking and Lagging Risk Indicators

Performance metrics — such as charge-off rates, delinquency ratios, nonaccrual loans, and restructured loans — are an integral part of a credit MIS program. The board and senior management can use these ratios to help assess the bank’s current asset quality and overall financial condition. Management often will establish thresholds for these ratios to help define the institution’s risk appetite.2 However, once these ratios fall outside risk thresholds, it can be difficult for senior management to prevent further deterioration in asset quality. Regular review of more forward-looking indicators can help management to proactively assess risks that drive these performance ratios. The following scenario describes how a credit MIS program that relies too heavily on performance-based, lagging risk indicators can result in inadequate risk identification, and lead to decisions based on an incomplete understanding of the risks facing the institution.

1 The analysis included state nonmember banks with over $10 billion in total assets.
2 A risk appetite statement defines the types and levels of risks that the bank is willing to accept in key areas in order to achieve its strategic goals.
Bank A

The President of Bank A reviews various loan-related reports monthly with the board. At the most recent meeting, the President states that current credit quality is excellent: delinquencies remain low, charge-offs are at historical lows, and nonaccrual loans are minimal. She points to the loan performance reports that support her conclusion, and requests that the board approve an increase in the commercial real estate (CRE) concentration limit from 350 percent to 400 percent of total capital. The President states that the portfolio has experienced strong growth during the past two years, and the Bank does not want to turn away profitable business. In addition, the President indicates that consideration should be given to making a reverse provision to the allowance for loan and lease losses (ALLL) this quarter as charge-offs during the past two years have been a fraction of the current allowance for loan and lease losses (ALLL) balance. The Bank is improving its reporting practices based on recommendations at the last FDIC examination, namely tracking loan policy exceptions and trends in underwriting. However, the President emphasizes that the Bank has maintained strong asset quality for many years without the benefit of those reports and has a seasoned group of lenders. The board approves the concentration limit increase and the reverse ALLL provision. The bank also continues with an aggressive dividend payout policy.

Two years later, the Bank is experiencing deterioration in the CRE loan portfolio as the market softens. The board engages an independent party to perform a thorough review of the CRE portfolio. The review determines that the bank was in significant non-compliance with its own underwriting policy, including a significant number of loans with liberal interest-only repayment terms that were underwritten using very low capitalization (cap) rates. The independent party recommends numerous credits be downgraded to adverse classification and placed on non-accrual. The Bank’s adverse classification ratio more than doubles to 80 percent of the Bank’s capital. Management realizes that the institution’s ALLL is significantly underfunded, and that the Bank will need to raise additional capital as the condition of the portfolio likely will continue to deteriorate.

Bank B

Bank B operates in the same market as Bank A. Bank B’s President reviews loan-related reports monthly with the board. At the most recent meeting, the President states that current credit quality is excellent: delinquencies remain low, charge-offs are at historical lows, and nonaccrual loans are minimal. However, she reviews several of the Bank’s internal credit MIS reports with the board that indicate some emerging risks. The President states that although some competing institutions in the Bank’s market area are rapidly growing loan portfolios, that growth appears to be largely fueled by those institutions’ willingness to offer liberal repayment terms and approve weaker deals. Bank B is adhering to its underwriting standards, closely tracking loan policy exceptions, and is in compliance with all board-approved limits. However, the concentration report notes that the overall risk in the CRE concentration was changed from “stable” to “increasing” earlier this year due to concern that speculation is driving the rapid rise in CRE prices.

Loan migration graphs indicate some downward loan grade migration in the CRE portfolio. The President notes migration within the Pass grades as these movements do not emerge in the Bank’s Classified or Criticized reporting. The President states that although the portfolio is performing well now, she is recommending that the ALLL allocation for CRE concentration risk be increased this quarter and that the Risk Management Committee update the capital adequacy analysis to incorporate these emerging risks. The board agrees with this approach and requests an update before the next meeting.

Two years later, Bank B is also experiencing some deterioration in performance metrics due to softening in the CRE market. The Bank’s performance metrics experience a decline; however, they remain within the board’s risk appetite. This outcome is attributable to the proactive risk management approach taken by senior management and the board.
These examples are intended to suggest the importance of forward-looking risk indicators as part of credit MIS programs in driving strategic decisions regarding lending. Bank A’s board and senior management did not consider what was driving loan growth (e.g., underwriting quality), or how it potentially skewed the Bank’s performance metrics. Poor underwriting practices can take time to manifest in performance ratios, particularly when growth inflates the denominator of those ratios. Effective risk management practices were lacking in Bank A. The board should have understood what was fueling the Bank’s loan growth before making strategic decisions.

Forward-Looking MIS Considerations

The federal bank regulatory agencies have communicated the importance of forward-looking MIS reporting. Part 364 of the FDIC’s Rules and Regulations – Standards for Safety and Soundness states that an institution should provide periodic asset reports with adequate information for management and the board of directors to assess the level of asset risk. For commercial loans, useful forward-looking information that often is tracked by effective credit MIS programs includes portfolio stratification by loan-to-value (LTV) for loans secured by real-estate, debt service coverage ratio (DSCR) policy exceptions, and loan grade migrations. For retail loans, effective credit MIS programs often track production and portfolio trends by product, credit score, LTV, debt-to-income (DTI) ratio, lien position, market, and property type as applicable. The table on page 6 provides an overview of selected metrics that credit MIS programs can track to provide useful, forward-looking risk information that supports strategic decisions regarding banks’ lending programs.

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3 Section 29 of the Federal Deposit Insurance Act requires the federal banking agencies to prescribe, by regulation or guidelines, standards for safety-and-soundness that include, in relevant part for purposes of this article, standards regarding information systems, internal controls and credit underwriting. The FDIC codified these standards as guidelines in Appendix A of Part 364 of its rules and regulations.

### Credit Management Information Systems

**FORWARD-LOOKING CREDIT METRICS**

<table>
<thead>
<tr>
<th>Report Type</th>
<th>Purpose</th>
<th>Wholesale Metrics</th>
<th>Retail Metrics</th>
<th>Effective Practices</th>
</tr>
</thead>
<tbody>
<tr>
<td>Loan Policy Exceptions</td>
<td>Monitor compliance with board approved policies. Evaluate changes to policies and/or practices based on results.</td>
<td>• LTV • DSCR • Amortization requirements • Maximum maturity • Guarantor requirements • Interest reserves (^5) • Hard equity • Financial statements • Loan Extensions</td>
<td>• Credit Bureau scores • Debt-to-Income ratios • Advance rates and down payments • LTV • Co-signer requirements • Maximum maturity • Amortization • Payment Extensions / Deferrals</td>
<td>• Exceptions are tracked based on number and dollar amount. (^6) • Exceptions are segmented by loan type as well as type of exception. • Formal exception limits are established and monitored. • Reports are provided on volume of loans that were approved with exceptions.</td>
</tr>
<tr>
<td>Underwriting Trends</td>
<td>Track trends in key underwriting metrics to help assess level and direction of portfolio credit risk.</td>
<td>• LTV • DSCR • Amortization • Cap rates by property type</td>
<td>• LTV • Debt-to-Income Ratios • Amortization • Credit Bureau scores</td>
<td>• Use of risk layering (combining metrics to further segment risks) is implemented. For example, reporting focuses on the distribution of loans by LTV and certain DSCRs.</td>
</tr>
<tr>
<td>Loan Grading</td>
<td>Analyze distribution of loan grades and migrations over time.</td>
<td>• Includes Pass, Watch List, Special Mention, and Adversely Classified risk grades</td>
<td>• As retail loans are not typically subject to loan grading, refreshed credit bureau scores are frequently used as a proxy.</td>
<td>• Shows loan grade distributions for new originations vs. the portfolio. • Shows migrations in and out of individual loan grades over time (particularly Watch, Special Mention, and Adversely classified grades). • “Roll rate” reports(^7) on past-due loans are useful for the retail portfolio.</td>
</tr>
<tr>
<td>Concentrations</td>
<td>Track large credit exposures in relation to capital.</td>
<td>• Loan category – C&amp;I, CRE • C&amp;I breakout by industry • CRE breakout by property type • Geographic • Individual borrower • Related borrowers • Amortizing/interest-only</td>
<td>• Loan category (auto, 1-4 family, Home Equity Line of Credit, unsecured) • Prime/subprime • Geographic • Payment resets (conversion from interest-only to amortizing)</td>
<td>• Provides insights into concentrations that highlight trends in loan grades within concentrations and industry/economic conditions. • Identifies concentrations that are approaching or have exceeded limits. • Establishes exposure strategies (decrease, maintain, increase).</td>
</tr>
<tr>
<td>Risk Appetite</td>
<td>Monitor performance and risk indicators against policy limits and risk appetite statement.</td>
<td>• Considers volume of loan policy exceptions, underwriting trends, loan grade migrations, and concentration risks. • Measures key metrics against risk limits and policy parameters.</td>
<td>• Considers volume of loan policy exceptions, underwriting trends, loan grade migrations, and concentration risks. • Measures key metrics against risk limits and policy parameters.</td>
<td>• Conveys metrics that are approaching or have exceeded limits. • Banks may use green, yellow, and red indicators (low, medium, high) to illustrate risk levels.</td>
</tr>
</tbody>
</table>

\(^5\) An interest reserve allows a lender to periodically advance loan funds to make interest payments on the borrower’s debt. Improper use of interest reserves can result in the masking of delinquencies and the failure to identify and report problem loans.

\(^6\) Appendix A to Part 365 of the FDIC’s Rules and Regulations requires that real estate loans originated in excess of Supervisory LTV Guidelines be identified in the institution’s records, and their aggregate amount reported at least quarterly to the institution’s board of directors. The aggregate amount of all loans in excess of the supervisory loan-to-value limits should not exceed 100 percent of total capital. Moreover, within the aggregate limit, total loans for all commercial, agricultural, multifamily or other non-1-to-4 family residential properties should not exceed 30 percent of total capital. An institution will come under increased supervisory scrutiny as the total of such loans approaches these levels.

\(^7\) A roll-rate report uses historical delinquency and default data to analyze the migration of delinquent loans. For example, a bank may track monthly delinquency volume to determine what percentage of retail borrowers that become 30 days delinquent typically become 60 days delinquent, and what percentage of those 60 day delinquencies result in defaults. This analysis is beneficial in analyzing delinquency trends, as well as providing support for allocations to the ALLL.
In summary, the Effective Practices highlighted in the table share a common theme: the need for reporting that effectively identifies and analyzes existing and potential risks. For example, looking at the Concentrations category, it is not uncommon for banks to simply list the concentration limit and the outstanding exposure, without providing additional information. An institution relying on this type of reporting may not have an adequate basis for considering whether that limit continues to be appropriate, and if new risks are emerging. As illustrated in the table, Effective Practices include analyzing the risks within those exposures, including the distribution of internal loan grades that comprise that concentration and what stage of the economic cycle that particular industry is in. Simply put, credit MIS should provide a meaningful tool for the board and management to effectively address the inherent and emerging risks facing the bank.

There is no “one size fits all” approach to determining the content and format of credit MIS, and tracking all the items described above may not be necessary for some institutions. For any institution, however, credit MIS reports that track forward-looking metrics of risk in the loan portfolio (that is, that go beyond tracking lagging risk measures such as delinquencies and charge-offs) can enhance management’s ability to make sound decisions about the strategic direction of the lending function.

**Governance**

An effective governance framework consists of sound policies and processes that provide a strong control environment and support strategic decisions. The formality and structure of a governance program can vary greatly depending on the size and complexity of an institution. However, governance as it relates to credit MIS is straightforward: the board and senior management should receive timely, meaningful, and accurate reporting in a format that clearly identifies risks and this information should be considered by management as it makes strategic decisions about the lending function. Consideration of a few basic questions can help ensure effective governance of a bank’s credit MIS programs.

- Are credit MIS reports being used to inform decision-making as an integral part of the risk management process, and does adequate documentation exist to support this process?

The FDIC has observed that often, board or committee minutes will simply state with regard to credit MIS, “reports reviewed and approved as presented,” with no further discussion. Credit risk reporting is most effective when it assists bank management in monitoring risks, setting risk limits, and providing support for strategic decisions. For larger institutions, bank supervisors typically expect such reporting and metrics should be developed and analyzed as part of the bank’s independent risk management process.
Are the reports being received in a timely manner, allowing sufficient time for review and discussion before important decisions are made?

Committee and board packets are often lengthy. If the board or committee members receive the reports shortly before a meeting, there may be insufficient time for thoughtful review of the materials which is critical for informed decision-making.

Is the complexity and detail of the reporting adjusted for different levels within the organization?

Reporting is most effective when it is tailored to the specific audience. Although it may be appropriate for a line of business to have detailed reports, that level of reporting may not be helpful to board or senior management committee members. A more high-level report that succinctly describes key risks may be more suitable for this audience.

Is ad hoc reporting effectively used?

Assessing credit risk is a dynamic process. As new risks emerge, an effective credit MIS program is sufficiently flexible to expand or develop new reporting to assess the effect those risks may have on the institution’s operations.

Does reporting include appropriate trend analysis?

Generally speaking, credit MIS reporting is likely to be most useful when it encompasses trend analysis looking back several years. A report that tracks the volume of loan policy exceptions only over recent quarters may suggest a rather nominal exception rate; however, when measured over the longer term, those exception rates may be material.

Does reporting overly rely on the use of averages?

Credit MIS reports that rely heavily on averages to capture the level of risk may miss important aspects of the risks facing banks. For example, using the average DSCR to conclude that a bank’s loans have strong repayment capacity ignores the fact that an average may include loans with inadequate DSCRs that pose direct risk of loss to the bank.
Preserving data integrity also falls under the governance framework. To be useful for decision-making, credit MIS reports should be based on accurate and timely data. For larger institutions, the process may include the use of a data warehouse and a centralized reporting group. Challenges may occur when a bank converts to a new data processing system, or acquires another institution that may have different data management and reporting capabilities. Developing and maintaining a strong data integrity function would typically involve:

- Coordinating with the institution’s data service provider or internal Information Technology (IT) department to determine reporting options and the use of data fields.

- Developing a method to internally track and retain important loan-related data (LTV, net operating income (NOI), credit bureau scores, DSCR, etc.).

- Ensuring consistency of data use and calculations. For example, are the DSCRs used in reporting based on the most recent loan presentation, independent loan review report, or calculation provided by the applicable loan officer?

- Incorporating a review of data integrity within the internal or external audit scope.

Data availability and integrity challenges may vary between large and small banks; however, the quality of information used in credit MIS reports that support strategic decisions about lending is a topic of relevance to all institutions.

### Conclusion

Credit risk management is a dynamic process that, to be effective, requires the use of meaningful reporting within a strong governance structure. An effective credit MIS program provides a bank’s board of directors and senior management with critical information to identify and proactively respond to emerging risks and support strategic decisions. Strengthening credit MIS to reflect a more forward-looking view of credit risk may enhance an institution’s risk management framework and contribute positively to its long-term success.

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The quality of an institution’s lending portfolio is key to its long-term financial success. As such, the FDIC closely monitors changes in underwriting practices and credit risk trends industrywide and at individual institutions. Risk management examiners assist by completing the post-examination Credit and Consumer Products/Services Survey (Credit Survey). This article summarizes survey results for examinations of FDIC-supervised institutions completed through October 3, 2017. To summarize the findings, survey responses indicative of increasing credit risk and liquidity risk are becoming more frequent.

Background

Since 2009, FDIC examiners have assessed lending conditions and risks at the conclusion of each examination using the Credit Survey. Completion of the Credit Survey yields information about loan underwriting practices, including whether underwriting is becoming tighter or looser; local economic conditions; out-of-area lending; and new or evolving products and activities. In addition, credit, funding and asset/liability management strategies are evaluated at all institutions. Additional information on credit-risk management practices and local market conditions is collected at institutions with elevated levels of commercial real estate (CRE) or acquisition, development, and construction (ADC) loans. Responses to the survey questions are based on the examiner’s assessment of the entire portfolio, rather than just the sample of loans reviewed during the examination.

FDIC examiners generate surveys from roughly 45 percent of all FDIC-supervised institutions each year. The Credit Survey supplements the collection of more traditional examination data to promote a more forward-looking analysis and view of the banking industry’s lending practices and credit risk profile. Credit Survey results are shared regularly with the public through articles published in the Supervisory Insights journal.

Current Lending Conditions

The banking industry’s profitability reached a post-crisis high in second quarter 2017, and new loan activity is a prominent driver in the industry’s growth. Loan volume continues to grow as the economy expands for the ninth consecutive year. Total loans and leases reported by FDIC-insured institutions increased to $9.5 trillion as of June 30, 2017, up 3.7 percent from a year ago. The proportion of institutions growing loan portfolios remains high; 78 percent of insured institutions expanded loan portfolios through the first half of 2017, in line with 79 percent the year before. The level of unused loan commitments, $7.3 trillion as of June 30, 2017, also has

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1 An earlier version of the underwriting survey, that was less amenable to horizontal analysis of results, dates back to 1995.


been increasing, and is up 3.9 percent from a year ago. While the growth in unused loan commitments has slowed for six consecutive quarters, it remains an indicator that loan growth may continue into the near term.

Overall, loan performance appears favorable, as indicated by the near record low level of the industry’s past due and nonaccrual (PDNA) ratio, which measures loans 30 days or more past due or in non-accrual status as a percentage of total loans. As of June 30, 2017, the PDNA ratio for all institutions was 1.84 percent, down 29 basis points from a year ago. During the past 33 years, the industry has reported only 12 quarters with a lower PDNA ratio, all of which were in the years leading up to the crisis from 2004 to 2007. However, the PDNA can be a lagging indicator of loan quality, particularly during cycles of new loan growth as borrowers generally do not default immediately after a loan is disbursed.

**Credit Survey Highlights**

Information in the Credit Survey reflects examiners’ view of emerging credit and funding risks in each institution’s balance sheet. In addition, survey questions solicit examiners’ comments about new or evolving products or activities identified at the institution or from competitors. In 2016 and 2017, around 13 percent of surveys indicate institutions are adding new products or activities that could pose additional risks. Among the most frequently cited features includes the following:

- Out-of-area lending (including whole loan purchases, loan participations, and shared national credits);
- Growth in loans, ADC or CRE concentrations, assets, or deposits; and
- Higher risk practices in lending or underwriting, often in response to increased competition.

In 2016 and 2017, examiners characterized 17 percent of the institutions surveyed as “low” credit risk, 72 percent as “moderate” risk, and 11 percent as “high” risk. This is a notable improvement from the Survey’s worst reports for credit risk, recorded in 2010, when 42 percent of surveyed institutions were characterized with “high” credit risk. When comparing credit risk more recently, and more granularly among the specific loan products assessed, agricultural loan portfolios are characterized more often as “high” risk compared to other portfolios, and the percentage of surveys that designate agricultural loan portfolios as “high risk” has more than doubled during the past two years (see Chart 1). This reflects developments in the agricultural economy, as discussed later in this article.

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4 The Credit Survey asks examiners to characterize the institution’s level of risk associated with various loan products as “low,” “moderate,” or “high,” loan products listed include commercial and industrial loans and leases, ADC loans, permanent CRE loans, residential mortgage loans, home equity loans, agricultural loans, consumer loans, and credit card loans. These descriptors apply only to institutions with lending portfolios representing more than two percent of total assets (“de minimis portfolio rule”).
While the Credit Survey results suggest that the level of credit risk is manageable for most institutions, the results also indicate the more forward-looking metrics are showing signs of increasing risk at some institutions. As lending has increased, so has the percentage of surveys reporting concentrations of credit, use of potentially volatile funding sources, and out-of-area lending. This article will discuss trends in examiner responses to these areas.

**Surveys Note Risks Among Faster Growing Institutions**

Credit Surveys prompt examiners to assess an institution’s underwriting practices for eight loan products. Since January 1, 2016, examiners characterized underwriting practices at 20 percent of the surveyed institutions as “generally conservative,” 70 percent as “about average,” and 10 percent as “generally liberal.” In general, examiners identify the majority of the institutions surveyed as following appropriate credit risk management practices. Within the survey, examiners also characterize the risk associated with loan growth or with significant changes in lending activities. Among the institutions surveyed in 2016 and 2017, examiners categorized such risks as “immaterial” in 19 percent of surveys; as “low” in 36 percent of surveys; as “moderate” in 41 percent of surveys; and as “high” in 4 percent of surveys. Since 2015, the proportion of institutions described with “moderate” or “high” risk associated with loan growth or significant changes in lending activities has increased about 7 percentage points, most predominantly in the “moderate” category.

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5 The Credit Survey asks examiners to describe current underwriting practices as “Generally Conservative,” “About Average,” or “Generally Liberal.” The eight portfolios considered are commercial and industrial, ADC, permanent CRE, residential mortgage, home equity, agricultural, consumer, and credit card. These descriptors apply only to institutions with lending portfolios representing more than two percent of total assets (“de minimis portfolio rule”).
The proportion of institutions assigned a composite rating of “1” or “2” and growing loans by more than 10 percent is also increasing. Five years ago, around 23 percent of institutions surveyed and assigned a composite rating of “1” or “2” reported loan growth over 10 percent; last year, that percentage increased to 38 percent and is down slightly through the first nine months of 2017 at 33 percent (see Chart 2). Looking specifically at results for these institutions surveyed between January 2016 and September 2017, examiners characterized more than 65 percent with moderate to high risk relating to loan growth or lending changes (see Chart 2). This is up from 57 percent in 2015. In addition, the proportion of these faster-growing institutions characterized as having “high” risk related to loan growth has increased to over 7 percent, more than double what it was three years ago.

Among those institutions surveyed with year-over-year loan growth over 10 percent and a composite rating of “1” or “2,” 2017 survey results reflect for the first time a higher proportion of institutions loosening underwriting practices (10 percent) compared to those that are tightening (9 percent) (see Chart 3). About 81 percent of survey responses for this faster growing group of institutions reported no material changes in underwriting trends in comparison to the last examination. For comparison, among 2017 surveyed institutions assigned composite ratings of “1” or “2” that report loan growth less than 10 percent of total assets, 85 percent indicate no material changes in underwriting standards, 9 percent indicate standards are tightening, and 6 percent indicate standards are loosening.

Chart 2: Risk in Loan Growth at Institutions Assigned Composite Ratings of “1” or “2” with Year-Over-Year Loan Growth Over 10 Percent

![Chart 2: Risk in Loan Growth at Institutions Assigned Composite Ratings of “1” or “2” with Year-Over-Year Loan Growth Over 10 Percent](image)

Source: FDIC Credit and Consumer Products/Services Survey and FDIC Call Reports

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Other Factors Affect Loan Underwriting

Competitive forces, changes in economic conditions, and response to regulatory findings or actions influence underwriting practices. An institution operating in a favorable economy with strong competition may ease credit standards to remain competitive. Conversely, institutions in an area where the economy is stressed may respond by tightening credit standards to limit potential credit loss. Similarly, institutions experiencing unfavorable regulatory ratings or corrective supervisory actions may respond by tightening underwriting standards to control additional risks of loss.

In surveys that indicated loosening standards, the factors most commonly listed for influencing changes in underwriting practices included competitive forces, growth goals, or changes in economic conditions.

Among institutions surveyed with an assigned composite rating of “1” or “2,” more than 51 percent of those reporting loosening credit standard practices identified competition as a leading factor. Other frequently cited factors included an institution’s growth goals (noted in 42 percent of surveys that reported loosening credit standards), followed by the economic environment (identified in 34 percent of those surveys).

Among those institutions tightening underwriting standards, changes in economic conditions and responses to regulatory findings or actions were the most common factors driving the changes. Again, looking at institutions assigned a composite rating of “1” or “2,” about 41 percent of those tightening underwriting standards cite the economic environment as a reason for that change, and about 36 percent listed regulatory actions as an influencing factor.
**Out-of-Area Lending Activity is Increasing**

As loan growth continues industrywide, out-of-area lending is also on the rise (see Chart 4). In the years leading up to the crisis, out-of-territory loans swelled as more institutions extended credit in areas of the country experiencing strong economic conditions. Frequently, these loans were underwritten by other financial institutions or non FDIC-insured loan brokers and purchased whole or through participations. As discussed in a Winter 2013 Supervisory Insights article, during the crisis many of these out-of-territory loans deteriorated quickly. Problems experienced by institutions that made these loans were often exacerbated by weak due diligence, unfamiliarity with the credit market where the loan originated, and over-reliance on a third party that failed to properly manage the loan.

Immediately following the crisis, Credit Survey results indicated that out-of-territory lending was on the decline, dropping to as low as 13 percent of surveys. Since 2014, that trend has reversed, and now over 23 percent of 2017 surveys note out-of-area loans. The risk within those loan portfolios also is increasing. In 2017, roughly 7 percent of surveys indicate out-of-area lending is a common or standard practice. Further, the

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*See footnote 2.*
number of institutions holding out-of-territory loans that “warrant notice” has been climbing steadily during the past three years. Almost 17 percent of institutions surveyed in 2017 had out-of-territory loans that warrant notice, up from 15 percent in 2016 and from less than 14 percent in 2015. Among the surveys recorded in 2017 with out-of-area lending, over 80 percent of that activity is listed in direct or indirect commercial lending.

More Surveys Note Concentrations in Credit and Funding

As aggregate loan balances have increased during the past few years, concentrations in credit and funding also have been on the rise. Among the Credit Surveys collected through third quarter 2017, nearly 68 percent identify either a credit or funding concentration. This represents an increase since 2015 when less than 56 percent of surveys noted some type of credit or funding concentration. When comparing results from 2015 and 2017, the increase in the percentage of surveys reporting concentrations was most pronounced in the category of “volatile funding” (see Table 1). The majority (about 52 percent) of Credit Surveys in 2017 recorded an industry, product line, or collateral-type concentration, with about a sixth of those (8 percent of all Credit Surveys) also recording a vulnerability to economic stress.

Layered risk, or the combination of two or more risks, is emerging at institutions with credit and funding concentrations. Among the 2017 Credit Surveys that recorded an

<table>
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<tr>
<th>Table 1: Credit and Funding Concentrations in 2015 and Year-to-Date 2017</th>
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<tr>
<td>Credit and Funding Concentrations</td>
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<tr>
<td></td>
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<tr>
<td>Individual, Borrower/Project or Single Repayment Source</td>
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<td>Industry, Product Line, or Type of Collateral</td>
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<tr>
<td>Single Funding Source</td>
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<td>Volatile Funding Source(s)</td>
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*Survey responses for Material Growth in Concentrations and Concentrations Vulnerable to Economic Stress are provided only for institutions for which a concentration has been identified. All percentages in the table are relative to the total number of surveys.

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The Credit Survey asks examiners to characterize an institution’s level of engagement in direct or indirect out-of-area lending for three different loan products as “never or infrequently,” “frequently enough to warrant notice,” or “commonly or as standard practice.” Loan products include Commercial (including CRE/ADC and Ag), Residential Mortgage/Home Equity, and Other Consumer (excluding credit cards). Indirect lending includes purchased out-of-area participations and whole loans, and all loans purchased from non-FDIC insured entities/brokers regardless of the location.

The credit and funding concentration is divided into four types: “Individual, Borrower/Project, or Single Repayment Source,” “Industry, Product Line, or Type of Collateral,” “Single Funding Source,” and “Volatile Funding Source(s).” The Credit Survey asks examiners to respond to credit or funding concentration observations as “Concentration Identified,” “Material Growth in Concentration between Examinations,” “Concentration Vulnerable to Economic Stress,” or “none.”
industry, credit product, or collateral concentration, half also listed a funding or potentially volatile funding source concentration (see Chart 5). During the past three years, this trend has been evident as institutions are growing their loan portfolios and searching for accessible sources of liquidity to fund that growth.

**Chart 5: Half of Surveyed Institutions with Credit Concentrations have Funding Concentrations**

<table>
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<tr>
<th>Year</th>
<th>% of Surveys with Credit Concentrations</th>
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<tr>
<td>2015</td>
<td>30%</td>
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<tr>
<td>2016</td>
<td>37%</td>
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<tr>
<td>YTD 2017</td>
<td>50%</td>
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Source: FDIC Credit and Consumer Products/Services Survey

*The above chart excludes survey data prior to 2015 for congruency. In 2014, the FDIC updated the Report of Examination Concentrations page instructions to provide expanded details for improved identification and risk analysis of concentrated credit and funding exposures. Several concentration-related Credit Survey questions were also revised to reflect those changes.*

Credit concentrations most commonly noted by examiners completing the Credit Survey included CRE, agricultural, and to a lesser extent, ADC and 1-4 family residential real estate. Studies following the 2008 crisis have shown that poorly managed CRE concentrations, particularly in conjunction with a reliance on potentially volatile funding sources, were highly correlated with failure.

This is a reminder that strong risk management practices, crucial for all institutions, are especially important for institutions with elevated concentrations in CRE and volatile funding. As discussed in the Summer 2016 *Supervisory Insights* article on matters requiring board attention, supervisory recommendations most frequently made to institutions with elevated CRE concentrations included

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10 Potentially volatile funding sources most commonly listed in the surveys include uninsured large depositors; borrowings, including wholesale; brokered deposits; Internet, listing service, and high-rate deposits; and public funds.


an emphasis on strong board and management oversight, appropriate portfolio management, and CRE portfolio stress sensitivity testing.\textsuperscript{13}

Credit Survey results report a rise in agricultural lending concentrations likely due to an increase in farmers' demand for bank financing. Farmers experienced several high-earning years early in this decade, which allowed many of them to self-finance operations. However, a drop in commodity prices has depressed farm income and producers' working capital levels, resulting in higher agricultural loan demand for many institutions in or near agricultural areas. These institutions are susceptible to commodity price, weather, and land value volatilities. Therefore, it is important for institutions engaged in agricultural lending to maintain sound underwriting standards, strong credit administration practices, and effective risk management strategies.

In addition, Credit Survey results have evidenced rising levels of potentially volatile funding concentrations. Examiners have identified increases in funding concentrations, most commonly in uninsured large deposits; Federal Home Loan Bank borrowings; brokered deposits; and Internet, listing service, or high-rate deposits. Credit Survey results continue to indicate a risk-building environment with many institutions growing balance sheets with higher levels of potentially non-stable funding sources.

For instance, in 2015, examiners identified funding concentrations at 21 percent of institutions surveyed; in 2017, that level had increased to 40 percent. For those institutions increasing loans while reducing holdings in liquid assets, it is imperative that strong underwriting standards are maintained, and prudent liquidity risk management is practiced.

\section*{Risk Management}

The FDIC has longstanding expectations for responsible credit risk management and liquidity risk management, which include implementing and adhering to prudent underwriting practices appropriate for the size and complexity of the institution's business model and maintaining strong board and management oversight of lending activities and funding strategies, including having appropriate contingency funding plans. Since loans make up the largest asset class at most institutions, it is especially important for institutions' board and management teams to establish a strong risk management program for the lending function and implement appropriate strategies when funding additional growth. As loan portfolios are growing and concentrations are building, the best time to focus on strong risk management practices is before financial metrics are adversely affected.

Conclusion

Recent Credit Survey results suggest that the direction of risk is increasing in the industry, as reflected by more frequent reports of credit concentrations, increases in potentially volatile funding sources, and more out-of-area lending. The lending provided by insured institutions plays an essential role in supporting credit creation and economic activity, and institutions are benefitting from loan demand with positive earnings performance. Particularly when loan demand is strong, competition can prompt institutions to loosen underwriting standards to build or maintain market share. Historically, institutions that have experienced the most consistent financial success and stability throughout the economic cycle have achieved it through prudent underwriting, sound funding strategies, and strong and forward-looking risk management practices.

Continued analysis of Credit Survey results, in tandem with other financial and economic data, enables FDIC supervisory staff to effectively monitor the overall financial condition of insured depository institutions. The FDIC will continue to evaluate Credit Survey data together with other sources of information to proactively identify and address lending matters or emerging trends at the institutions we supervise.

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Overview of Selected Regulations and Supervisory Guidance

This section provides an overview of recently released regulations and supervisory guidance, arranged in reverse chronological order. Press Release (PR) and Financial Institution Letter (FIL) designations are included so the reader can obtain more information.

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<td><strong>Regulatory Capital Rules: Retention of Certain Existing Transition Provisions for Banking Organizations that Are Not Subject to the Advance Approaches Capital Rules (FIL-60-2017, November 21, 2017)</strong></td>
<td>The federal bank regulatory agencies have jointly issued a final rule to extend the 2017 transition provisions under the capital rules for certain capital deductions and risk weights as well as certain minority interest requirements for banking organizations not subject to the advanced approaches capital rules. The final rule extends the provisions for mortgage servicing assets, deferred tax assets, and certain investments in unconsolidated financial institutions.</td>
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<td><strong>Federal Banking Regulatory Agencies Announce Availability of 2016 Small Business, Small Farm, and Community Development Lending Data (PR-88-2017, November 21, 2017)</strong></td>
<td>The federal bank regulatory agencies announced the availability of data on small business, small farm, and community development lending reported by certain commercial banks and savings associations under the Community Reinvestment Act (CRA). The FFIEC has prepared aggregate disclosure statements of small business and farm lending for all metropolitan statistical areas and nonmetropolitan counties. These are available at <a href="https://www.ffiec.gov/cra/">https://www.ffiec.gov/cra/</a>.</td>
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<td><strong>Agencies Amend CRA Regulations to Conform to HMDA Regulation Changes and Remove References to the Neighborhood Stabilization Program (PR-86-2017, November 20, 2017)</strong></td>
<td>The federal bank regulatory agencies have amended their respective CRA regulations primarily to conform to changes made by the CFPB to Regulation C, which implements the Home Mortgage Disclosure Act (HMDA). The amendments to the CRA regulations take effect January 1, 2018.</td>
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<td><strong>Banker Teleconference Series: Small Business Resources for Community Banks (FIL-59-2017, November 15, 2017)</strong></td>
<td>The FDIC is conducting a teleconference on December 12, 2017, to discuss small business resources and research pertinent to community banks. Talking points include the Money Smart for Small Businesses financial education program; the FDIC’s Small Business Lending Survey; and CRA consideration for small business lending, services, and investments.</td>
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<td><strong>FDIC Announces Meeting of Advisory Committee on Community Banking (PR-84-2017, October 27, 2017)</strong></td>
<td>The FDIC is holding a meeting of the Advisory Committee on Community Banking on November 1, 2017. At the meeting, senior staff will brief Committee members on a number of topics, including resilience in the face of natural disasters, the FDIC’s Small Business Lending Survey, de novo applications, and initiatives to address the Economic Growth and Regulatory Paperwork Reduction Act review process. Staff also will discuss supervisory policy issues, such as efforts to implement HMDA procedures, and Current Expected Credit Loss Standards.</td>
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<td><strong>Agencies Issue Temporary Exceptions to Appraisal Requirements in Areas Affected by Severe Storms and Flooding related to Hurricanes Harvey, Irma, and Maria (FIL-56-2017, October 26, 2017, PR-81-2017, October 17, 2017)</strong></td>
<td>The federal bank regulatory agencies and the NCUA have temporarily eased appraisal requirements for real estate-related financial transactions in areas declared to be a major disaster. Financial institutions will not have to obtain appraisals for affected transactions if the properties involved are located in areas declared major disasters, if there are binding commitments to fund the transactions within 36 months of the date the areas were declared major disasters, and if the value of the real properties supports the institutions’ decisions to enter into the transactions.</td>
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<td>FDIC Announces Webinar on Financial Education and Financial Empowerment Resources that Support People with Disabilities (FIL-54-2017, October 23, 2017)</td>
<td>The FDIC is co-hosting a webinar with the CFPB on November 15, 2017. The webinar is providing an overview of two financial education resources that can be helpful for people with disabilities, FDIC’s Money Smart, and CFPB’s Your Money, Your Goals. The webinar helps familiarize participants with recent enhancements to the resources that are designed to promote economic inclusion of people with disabilities. See <a href="https://www.fdic.gov/news/news/financial/2017/fil17054.html">https://www.fdic.gov/news/news/financial/2017/fil17054.html</a></td>
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<td>Liquidity Coverage Ratio: Frequently Asked Questions (FIL-53-2017, October 23, 2017)</td>
<td>The federal bank regulatory agencies are issuing the FAQs to address questions received regarding the applicability of the liquidity coverage ratio rule in specific situations. The rule was adopted in September 2014 and implements a quantitative liquidity requirement for institutions with more than $10 billion in consolidated assets that are consolidated subsidiaries of internationally active banking organizations. See <a href="https://www.fdic.gov/news/news/financial/2017/fil17053.html">https://www.fdic.gov/news/news/financial/2017/fil17053.html</a></td>
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<td>FDIC Releases Interagency Designated Key HMDA Data Fields List (FIL-51-2017, October 17, 2017)</td>
<td>The federal bank regulatory agencies are issuing designated key HMDA data fields to support the efficient and effective evaluations of financial institutions’ compliance with HMDA requirements. Amendments to Regulations C are effective January 1, 2018, and establish the data that financial institutions will collect and report pursuant to HMDA requirements. See <a href="https://www.fdic.gov/news/news/financial/2017/fil17051.html">https://www.fdic.gov/news/news/financial/2017/fil17051.html</a></td>
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<td>FDIC Webinar to Highlight Spanish-language Financial Education Resources (PR-73-2017, September 28, 2017)</td>
<td>In recognition of Hispanic Heritage Month, the FDIC invites organizations that serve the U.S. Spanish-speaking population and members of their communities to participate in a webinar that will highlight the agency’s Spanish-language consumer resources. These sources include the Money Smart financial education program and deposit insurance coverage information. See <a href="https://www.fdic.gov/news/news/press/2017/pr17073.html">https://www.fdic.gov/news/news/press/2017/pr17073.html</a></td>
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<td>FDIC Adopts Final Rule on Qualified Financial Contracts (PR-72-2017, September 27, 2017)</td>
<td>The FDIC adopted a final rule to enhance the resilience and safety and soundness of state savings associations and banks supervised by the FDIC that are affiliated with systemically important U.S. and foreign banking organizations. Under the final rule, these institutions are required to ensure that their qualified financial contracts do not allow for immediate cancellation or termination under certain circumstances. See <a href="https://www.fdic.gov/news/news/press/2017/pr17072.html">https://www.fdic.gov/news/news/press/2017/pr17072.html</a></td>
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<td>Regulatory Capital Treatment of Certain Centrally Cleared Derivative</td>
<td>The FDIC issued guidance on the regulatory capital treatment of certain centrally cleared, settled-to-market derivative contracts. Certain central counterparties have revised their rulebooks such that variation margin is considered a settlement payment and not collateral. If an FDIC-supervised institution determines the transfer of variation margin on a centrally cleared, settled-to-market contract settles any outstanding exposure on the contract and resets the fair value of the contract to zero, the contract’s remaining maturity is the time until the next exchange of variation margin. This guidance may affect a derivative contract’s calculation of potential future exposure, which uses a conversion factor based, in part, on the contract’s remaining maturity.</td>
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<td>Agencies Extend Resolution Plan Filing Deadline for Certain Foreign</td>
<td>The FRB and FDIC extended the resolution plan filing deadline for 19 foreign banking organizations and two large domestic bank holding companies to December 31, 2018, to give the firms an additional year to address any supervisory guidance in their next plan submissions. Resolution plans must describe the company’s strategy for rapid and orderly resolution under bankruptcy in the event of material financial distress or failure of the company. For foreign banking organizations, resolution plans are focused on their U.S. operations.</td>
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<td>and Domestic Banks (PR-60-2017, August 8, 2017)</td>
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<td>Reviews of Shared National Credit Portfolio Find Risk Remains High</td>
<td>Risk in the portfolios of large syndicated bank loans declined slightly but remains elevated, according to the Shared National Credit (SNC) Program Review release by the federal bank regulatory agencies. The high level of credit risk in the SNC portfolio stems primarily from distressed borrowers in the oil and gas sector and other industry sector borrowers exhibiting excessive leverage. The review also found that credit risk management practices at most large agent banks continued to improve.</td>
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