United States General Accounting Office

GAO

Report to Congressional Committees

September 1993

BANK REGULATION

Regulatory Impediments to Small Business Lending Should Be Removed

GAO/GGD-93-121

GAO

United States
General Accounting Office
Washington, D.C. 20548

General Government Division

B-253848

September 7, 1993

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Chairman, Committee on Banking, Housing,
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United States Senate

The Honorable Alfonse M. D'Amato
Ranking Minority Member
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The Honorable Henry B. Gonzalez
Chairman, Committee on Banking, Finance
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House of Representatives

The Honorable James A. Leach
Ranking Minority Member
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The Honorable John M. Spratt, Jr.
Chairman, Subcommittee on Commerce, Consumer, and
Monetary Affairs
Committee on Government Operations
House of Representatives

The Honorable Christopher Cox
Ranking Minority Member
Subcommittee on Commerce, Consumer, and Monetary Affairs
Committee on Government Operations
House of Representatives

This report was undertaken in response to congressional concerns regarding bank credit to small businesses and the impact that regulations currently exert on its availability. Our specific objective was to identify whether there are areas where the burden of regulations on small business lending could be safely reduced.

Access to bank credit is essential to the viability of many of the smaller companies that have been a principal source of job growth in this country. According to the U.S. Bureau of the Census, the majority of the net increase in employment during the 1980s occurred in firms with fewer than 100 employees. Although many businesses obtain credit from nonbank sources, the 1989 National Survey of Small Businesses sponsored by the Federal Reserve Board and the Small Business Administration concluded that local commercial banks remain the dominant suppliers of most of the financial services used by small- and medium-sized businesses.[1]

Results in Brief

Lending to small businesses is risky because many such businesses fail. However, traditional small business lending (i.e., lending to established small businesses for purposes other than real estate acquisition, construction, or development) has not been a primary source of the safety and soundness problems that caused high levels of bank failures and deposit insurance losses in the late 1980s and early 1990s.

As part of this assignment, we interviewed bankers and regulatory officials in various parts of the country about small business lending. The most common view was that the demand for loans on the part of creditworthy businesses was relatively weak. Also, we were told that compared to several years ago banks now were more insistent in seeking assurances that small business loans could be repaid from the cash flows of businesses rather than from personal guarantees or from the liquidation of real estate or other collateral. This shift toward tighter, more traditional credit standards was attributed primarily to a response by the banks to the extraordinary loan losses incurred by the industry in the late 1980s and early 1990s and to current uncertain economic conditions, particularly in some regions of the country.

Nevertheless, there are actions that federal banking agencies can take to reduce regulatory impediments to small business lending without compromising essential safety and soundness standards. These actions, which do not require legislation, are needed to make clear that sound banks have flexibility in applying good business practices to their small business lending programs.

Specifically, we believe that real estate appraisal requirements can be safely modified when applied to collateral taken as supplementary support for traditional small business loans. Therefore, we agree with those aspects of the rule changes recently proposed by the banking regulators to

[1]Gregory E. Elliehausen and John D. Wolken, "Banking Markets and the Use of Financial Services by Small and Medium Sized Businesses." This Federal Reserve Staff Study is summarized in the Federal Reserve Bulletin, September 1990.

expand the exemptions from mandatory appraisals as they pertain to such loans.[2]

Also, the guidance the agencies give to banks about how to evaluate real estate collateral when an appraisal is not required is not consistent and is subject to varying interpretations by banks. This guidance should be clarified so that bankers in sound institutions are encouraged to use their judgment in determining the most cost-effective way to evaluate the collateral for small business loans that are immaterial to the condition of a bank.

In another effort to spur bank lending, the agencies have undertaken an interagency policy initiative to allow banks with adequate capital and satisfactory management to place some loans in a "basket" with minimum documentation requirements and examiner attention. Many of the bankers with whom we spoke said this regulatory initiative will likely have limited impact on small business lending because, as indicated earlier, banks have voluntarily increased their documentation and underwriting standards. Moreover, banks using the basket concept will have to track those loans separately.

The initiative by the regulatory agencies to allow sound institutions greater flexibility in the administration of their small business loan program is consistent with the approach to regulation contained in the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA). That act underscores the importance of capital and management and makes distinctions among banks based on how sound they are. However, we believe that a more effective way for the agencies to ensure that the bank examination process does not inhibit the small business lending activities of sound banks is to focus their examinations on banks' systems of internal controls. If tests show that the bank is adhering to good business practices, examiners would not have much reason to challenge management judgments regarding individual small business loans. Thus, we once again urge the regulatory agencies to place greater emphasis on internal controls in the performance of their examinations.[3]

In the near term, the changes we recommend with regard to appraisals and supervision are not likely to make a big difference in the volume of lending

[2]It should be noted that this report and our comments regarding the proposed appraisal regulation apply only to the use of appraisals in situations in which real estate collateral is used to support loans to small businesses for such purposes as working capital and equipment purchases.

[3]Bank and Thrift Regulation: Improvements Needed in Examination Quality and Regulatory Structure (GAO/AFMD-93-15, Feb. 19, 1993).

because of the importance of other factors, such as demand in determining the amount of such lending that takes place. However, these changes are nonetheless important because they would help soundly managed banks to respond more confidently to an increase in loan demand. Building up a greater degree of trust between the industry and the regulators, based on a common understanding of good business practices, can only be beneficial to the economy.

Factors other than safety and soundness regulation also were cited by bankers as affecting small business lending by banks. These factors include the cumulative effect of regulations placed upon banks through all laws, regulations, and supervision; the increased presence of nonbank credit providers in the economy; and the increased incidence of borrower bankruptcies and the special risks to lenders contained in environmental liability laws. We have work in progress for the House and Senate Banking Committees to assess various studies of the issues relating to regulatory burden, including studies performed by the bank and thrift regulatory agencies.

Scope and Methodology

The scope of this study was limited to identifying whether regulatory impediments exist to small business lending by banks that could be reduced without sacrificing safety and soundness or other public interest objectives. The small business sector of the economy is large and complex, and there is no uniform definition among the lending institutions, the government agencies, or the trade associations regarding a small business or a small business loan. For example, some banks will identify these companies according to annual sales, but the maximum sales figure varies widely. Other banks will define small business lending according to loan size or a combination of loan and sales sizes.

For the purposes of this study, we defined small business loans to be nonfarm, non-real estate acquisition, construction, or development loans in amounts not exceeding $1 million to established businesses with annual sales of less than $10 million. These loans consist generally of short-term lines of credit for working capital needs and/or longer term credits for plant or equipment purchases. The definition of small business lending we used is similar to that used by many of the banks that we contacted, although the vast majority of small business loans at even the larger banks we visited were considerably smaller than $1 million. The annual sales definition adopted for this study encompasses the vast majority of the business establishments in the country.[4]

As part of this study, we conducted interviews during March, April, and May of 1993 with officials of the Federal Reserve, the Federal Deposit Insurance Corporation (FDIC), the Office of the Comptroller of the Currency (OCC), and bankers in various regions of the country. The banking officials with whom we spoke were chief executive officers, chief credit officers, and other executives involved with the small business credit activities of the banks.

The purpose of these unstructured interviews was to learn the views of a small number of bankers and the bank regulators regarding their perspectives about small business lending. In particular, we were looking for insights into ways safety and soundness regulation or supervision may be inhibiting the ability of sound banks to make traditional small business loans that would otherwise be justified by market conditions.

After consulting with regulatory officials and other sources, we judgmentally selected banks in different areas of the country that were considered to be active lenders to small businesses. While the selection provided insights into small business lending activities under diverse economic conditions, the views of officials from the banks selected cannot be generalized to the small business lending operations of all banks. As of year end 1992, of the 38 banks we contacted, 21 have assets of less than $1 billion. The 38 banks are located in Alabama, California, Massachusetts, Minnesota, New Jersey, Ohio, Pennsylvania, and Texas. We also consulted with officials from two nonbank financial institutions and five trade associations.

This report also draws on our past work concerned with bank regulation and examination and the implementation of FDICIA. We did not attempt to analyze all factors in the economy that influence the availability of credit to small businesses or to make quantitative estimates of the amounts by which loans to small businesses would increase in response to changes in the regulatory environment.

[4]According to the Bureau of the Census, 6.1 million businesses—about 98 percent of the businesses in the nation in 1989—employed 100 employees or less and together accounted for about half of all employees in business establishments. By looking at sales per employee ratios, we estimate on an order of magnitude basis that firms with about 100 employees roughly correspond to firms that are often likely to have annual sales in the $10-million range. Census figures also show that 87 percent of all businesses have fewer than 20 employees.

Our work was done in accordance with generally accepted government auditing standards between February and June of 1993.

The Federal Reserve, FDIC, and OCC provided written comments on a draft of this report. Their major points are summarized and evaluated at the end of the report. The comments are reprinted in their entirety as appendixes I, II, and III.

Perspective on the Relationship of Bank Safety and Soundness to Small Business Lending

Small business lending provides an important and timely example of how regulation can be made less burdensome without compromising safety and soundness. Regulation, of course, is just one factor that affects the volume of bank lending to small business. However, especially given the weakness in the economy, it makes sense to ensure that safety and soundness regulation does not have the unintended side effect of impeding this lending.

Studies, such as that of the Congressional Budget Office,[5] show that problems with credit availability to businesses have been particularly severe when banks failed or were so weak that they had to struggle to maintain their capital. These studies underscore the point that all businesses benefit from the reliable sources of credit that are associated with safe and sound banking. In addition, prudent underwriting standards are crucial for ensuring that the nation's financial capital is invested in ways that bring maximum benefit to the economy.

Bankers reported to us that their lending to small businesses has become more conservative in recent years, confirming the widely held perception that lending standards have tightened considerably since the late 1980s.[6] Credit and loan officers from banks of all sizes told us that in today's environment small business lending decisions are founded upon the capacity of the borrower to repay the loan from the cash flows generated by the business operations. Bankers also said that general lines of credit for working capital purposes are, with only rare exceptions, supported by personal guarantees and collateral. They said this collateral, in most instances, consists of owner-occupied commercial or residential real

[5]Congressional Budget Office, Regional Analysis of Bank Lending, February 1993.

[6]Quarterly Federal Reserve surveys conducted of bank credit officers confirmed the growing trend toward strengthened loan underwriting standards in the periods preceding the enactment of FDICIA on December 19, 1991.

estate.[7] However, they also said the real property is assigned only to support the credit and to ensure that it is not pledged to outside creditors. They do not consider it the principal source of repayment for the loan.

The bankers with whom we spoke also indicated that banks have the capacity to make loans to creditworthy small business borrowers and that the demand for such loans is relatively weak. However, they acknowledged that marginally creditworthy borrowers are likely to encounter difficulties in securing credit. This is especially the case in regions of economic distress where a large number of banks have failed, leaving many small businesses "orphaned," i.e., without a banking relationship.

The current, more conservative credit environment for small business lending was attributed by the bankers primarily to economic conditions and prudent business decisions by the banks. One banker explained that he learned the hard way about the importance of prudent credit standards; although his bank survived the losses incurred in the credit environment that prevailed a few years ago, the other four banks in town did not. However, another banker was concerned that the risk-averse stance that many banks in the industry had adopted was an overreaction to past problems and would have the long-run effect of accelerating the movement of small business credit outside of insured depository institutions.

Although our discussions with bankers led us to believe that the slow growth in loan volume to small businesses at the present time is largely related to factors other than safety and soundness regulation, we did encounter comments that aspects of the current way in which banks are regulated and supervised place an unnecessary burden on small business lending. Two areas cited frequently concerned (1) real estate appraisal requirements and (2) the manner in which small business loans are reviewed by the examiners. In both instances, the complaint was basically that the way banks are regulated and supervised does not give enough credit to the judgments of officials in strongly capitalized, well-managed banks, with the result that such banks are inhibited from making loans they otherwise would make. Because they were cited so frequently in our discussions, and were of concern to industry associations as well as being

[7] While banks often take a lien on the business' inventory or receivables as collateral for financing, little reliance is placed on those assets as sources of repayment. This is because of the costs involved in maintaining strict monitoring procedures of the value and quality of the assets assigned. Complications arising from bankruptcy proceedings also were cited as a factor for obtaining strong collateral support for the credit.

the subject of proposed actions by the regulators, we concentrated on the two areas of appraisals and supervision.

Removing unnecessary regulatory impediments to small business lending does not mean putting pressure on banks to abandon sound business practices, which both bankers and regulators said many in the industry lost sight of during the last decade. Instead, the key to reducing burden is recognizing that the purpose of safety and soundness regulation is not to eliminate risk from lending. The purpose of such regulation is to ensure that the risks that banks take are well-managed and are commensurate with banks' capital, reserves, and earnings. Less burdensome approaches to regulation and supervision should be able to take advantage of the management systems already used by successful small business lenders that follow sound business practices.

High failure rates of small businesses indicate that lending to such firms involves considerable risk. Yet, while some losses are to be expected, the evidence also indicates that many banks indeed have been successful in managing this risk. Although small businesses and banks often experience difficulty when local economies suffer downturns, we did not uncover evidence that small business lending of the types discussed in this report (working capital and equipment financing to established businesses) has been responsible for the widespread safety and soundness problems that resulted in high deposit insurance losses in the late 1980s and early 1990s. Some of this evidence is indirect in that studies of bank failures of which we are aware do not single out traditional small business lending as a major problem area. The principal reasons for bank failures in the late 1980s and early 1990s, cited by regulators and found in our own studies of bank failures, include insider lending, large poorly underwritten commercial real estate construction and development loans, excessive growth, fraud, lack of effective internal controls, and other management deficiencies.[8]

In view of the success that many banks have had in lending to small business, we believe some changes in the areas of both appraisals and

[8]For example, see Bank Failures: Independent Audits Needed to Strengthen Internal Control and Bank Management (GAO/AFMD-89-25, May 31, 1989); Bank Supervision: Prompt and Forceful Regulatory Actions Needed (GAO/GGD-91-69, Apr. 15, 1991); Failed Banks: Accounting and Auditing Reforms Urgently Needed (GAO/AFMD-91-43, Apr. 22, 1991); Deposit Insurance: A Strategy for Reform (GAO/GGD-91-26, Mar. 4, 1991); Bank Supervision: OCC's Supervision of the Bank of New England Was Not Timely or Forceful (GAO/GGD-91-128, Sept. 16, 1991); and Bank and Thrift Regulation: Improvements Needed in Examination Quality and Regulatory Structure (GAO/AFMD-93-15, Feb. 19, 1993).

supervision will be helpful in removing impediments to small business lending by sound banks.

Real Estate Appraisal Requirements

Because inadequate or overstated appraisals contributed to costly thrift and bank failures during the 1980s, Congress directed the banking agencies in 1989 to strengthen the requirements for estimating the value of real estate that is to be pledged as collateral for a loan. Congressional action in this area was contained in Title XI of the Financial Institutions, Reform, Recovery, and Enforcement Act of 1989 (FIRREA). While there is no question that action to correct abuses was needed, a problem for traditional small business lending was created by the scope of the regulations adopted by the agencies.

The regulations often require some type of appraisal to be performed when real estate is taken as collateral for small business loans. These regulations affect small business lending because, as noted earlier, in today's credit environment small companies are usually required to provide collateral for loans. Although comprehensive statistics on the use of real estate to secure traditional business lending are not available, one larger bank we talked with estimated that real estate is used to collateralize over 60 percent of its small business loans. Other bankers we interviewed also said they commonly require real estate as collateral in making small business loans even when they do not rely on it for repayment.

The basic purposes of the appraisal requirements in Title XI were not singled out for criticism in our discussions with bankers. However, we also found a consensus that the implementing regulations were inhibiting small business lending, although the scope of our work did not permit us to quantify such effects.

How Regulations for Mandatory Appraisals Affect Small Business Lending

Under Title XI of FIRREA federal regulatory agencies define which categories of real estate related financial transactions require appraisals.[9] The 1992 amendments to Title XI also set out agency authority to establish threshold levels for the value of such transactions at or below which appraisals will not be required.[10] The law specifies that when appraisals are required, they must be written, made by state licensed or certified appraisers, and conform to standards promulgated by federal regulators.[11]

Currently, the regulations each agency has adopted exempt banks from the requirement to obtain an outside appraisal by a certified or licensed appraiser when a loan secured by real estate is for $100,000 or less. Another exemption from the appraisal requirement, potentially important in many loans to small business, can be granted when a lien on real estate has been taken solely through "an abundance of caution"—which basically means that the real estate was held only as supplementary collateral. However, to qualify for this exemption, banks have had to demonstrate that the terms of the transaction are not more favorable than they would be in the absence of a lien.[12] Our discussions have led us to believe that this exemption has rarely been used by banks because the proviso about loan terms is difficult to demonstrate and because of the consequently narrow interpretation of this exemption by many regulators.[13] Because small business loans often may exceed $100,000, and because the abundance of caution exemption is seldom applied, we believe there may

[9]Before FIRREA, banks were subject to banking agency guidelines rather than statutory requirements in relation to real estate appraisals. In 1987, the Federal Reserve, OCC, and FDIC jointly adopted guidelines for real estate appraisal policies and review procedures. The agencies stated at the time that the guidelines simply reaffirmed their long-standing policies on real estate appraisals. The appraisal standards were expressed in general terms rather than in a list of specific appraisal requirements. The guidelines did not contain such prescriptive features as specific threshold amounts above which appraisals were required. However, the guidelines stated the importance of a bank including an effective appraisal program, approved and monitored by its directors, as part of a bank's written lending policy. Examiners were expected to review bank performance in this area. Deficiencies were regarded as unsafe and unsound practices.

[10]According to the 1992 amendments, the regulatory agencies are to determine in writing that established threshold levels do not represent a threat to the safety and soundness of financial institutions. Section 954, Public Law 102-550.

[11]A number of states also have established appraisal requirements.

[12]The regulations also contain other exemptions, including transactions resulting from the renewal of a maturing credit, provided that the borrower's performance was satisfactory and that no new monies were advanced other than as previously agreed and assuming that the borrower's credit standing and the value of the property have not deteriorated.

[13]The scope of this work does not allow us to comment on how, exactly, examiners have interpreted this provision in their examination of individual banks. In addition, there appears to be a difference in philosophy among the agencies regarding the concept of abundance of caution. Federal Reserve officials have indicated to us that they intend the abundance of caution to be interpreted very narrowly, whereas FDIC officials indicated that a more flexible interpretation is intended.

be many instances where appraisals have been performed when they were not needed.

Bankers said that the requirement for appraisals has resulted in significant additional costs for customers and delays in loan approval time. They said the minimum cost to perform the necessary appraisals on commercial real estate property used as collateral for small business loans is approximately $3,000.[14] The appraisal fees are generally absorbed by the borrowers, increasing their financing costs. For a small business this can represent a significant expense.[15]

In view of the successful small business lending that many banks appear to have achieved, we believe the appraisal regulations can be safely modified when they apply to real estate collateral taken as a part of traditional small business lending, provided that the lender is not relying on revenues generated by that real estate to repay the loan. Regardless of regulatory requirements, banks following prudent underwriting standards will no doubt often obtain appraisals to support their credit decisions. However, we see no compelling reason why regulations should unduly limit the ability of officials in sound banks to exercise judgment concerning the need for and scope of formal appraisals in connection with their small business loans. Making real estate appraisals a matter of regulation in such situations results in examiners having to spend time checking compliance with the procedures.[16] The agencies have the authority to require appraisals whenever they believe sound business practices are not being followed.

[14]While bankers we interviewed told us the cost approximated $3,000, a recent American Bankers Association study reported that the average cost of appraisals was $1,966 in March 1992, with an average completion time of 43 days. The $1,966 cost represented a 48-percent increase from March 1991, and the completion time rose 72 percent.

[15]For example, for a typical $100,000 line of credit to a small business, a $3,000 appraisal cost is equivalent to a one-time 3-percent charge that is usually required to be paid in advance. Should the bank subsequently increase the line of credit, a new appraisal is required. Furthermore, the expense of an appraisal may be incurred even in situations in which the value of the collateral pledged may substantially exceed the amount of the loan.

[16]In supervising banks, examiners must not only determine whether appraisals were obtained but also if the appraisals are in compliance with applicable regulations, policy, and guidelines. In this connection, the examiner is under an obligation to bring compliance problems to the attention of the top officials of a bank, creating the potential for confrontation between the examiner and the bank in areas that may have little to do with actual safety and soundness issues. Bankers we interviewed frequently pointed out to us their awareness that the law provides for penalties relating to federal bank regulator enforcement actions of up to $1 million per day.

Recent Regulatory Initiative

The financial regulators' joint initiative, published June 4, 1993, seeks comments on proposed amendments to ease the appraisal regulations. The proposal lists 12 exemptions from the general rule that Title XI appraisals are required for real estate related financial transactions. Three important exemptions are those in which (1) the transaction value is $250,000 or less (formerly $100,000); (2) the definition of "abundance of caution" is broadened by eliminating the condition that "the terms of the transaction as a consequence have not been made more favorable than they would have been in the absence of a lien"; and (3) a new exemption is created for any business loan below $1 million that is not dependent upon the sale of, or rental income derived from, real estate collateral as the primary source of repayment of the loan.[17]

The proposed regulations are designed, among other things, to reduce regulatory impediments for small business lending while preserving restraints against the egregious abuses FIRREA was intended to address. For example, regulatory officials advised us that the proposed regulations are expected to expand significantly the discretion bankers have in applying the abundance of caution provision. There are insufficient data available to quantify the number of small business loans that will be affected by these proposed changes. However, agency officials anticipate that the modifications would result in a reduction in the number of transactions that require the services of an appraiser. In this connection it should be noted that for many small banks the $250,000 threshold would effectively eliminate most mandatory appraisals, since the threshold approaches legal lending limits and limits on loan size imposed by bank boards of directors.[18] Under the proposal, the agencies would retain their authority to require an appraisal for any loan for which the appraisal might otherwise have been exempted.

We support broadening the abundance of caution provision as it applies to real estate related transactions involving supplementary collateral on traditional small business lending activities. However, the scope of our work on this report does not allow us to comment on the appropriateness

[17]In view of the proposed blanket $250,000 transaction exemption, the $1 million business loan exemption is particularly relevant in the $250,000 to $1 million range.

[18]For example, there are about 2,500 banks with assets of less than $25 million. Many of these banks would not make loans in excess of $250,000.

of the specific limits in the proposed $250,000 threshold level or the $1 million business loan exemption.[19]

Agency Guidance When Appraisals Are Not Required

The issue of how real estate appraisals affect small business lending goes beyond the definition of when an appraisal must be performed. It also includes what banks think regulators expect them to do in evaluating real estate collateral when an appraisal is not required. Agencies need to clarify this matter because at present their guidance is inconsistent and is also subject to varying interpretations by banks.

When the property to be pledged is exempted from an outside appraisal, OCC and the Federal Reserve require by regulation that the banks they supervise[20] perform their own evaluation of the property pledged.[21] FDIC does not require the state-chartered banks it supervises to perform evaluations, but it expects them to perform evaluations in many circumstances.[22]

Officials from two agencies told us that detailed agency guidelines related to evaluations were developed in order to deflect possible criticism of the agencies for having exempted certain transactions from the appraisal requirement. This is understandable; but, in the case of banks with sound small business lending performance records, there is a probability that examiners will, in self-defense or defense of their agencies, be more demanding than is necessary.

The guidance under which evaluations are performed sets out that they must be in writing and that file documentation should support the estimate of value and include sufficient information for an individual to fully understand the evaluator's analysis. The agencies point out that the guidance does allow the banks discretion in the scope of individual

[19] As required by Section 954 of the Housing and Community Development Act of 1992, we are required to study the adequacy and quality of appraisals or evaluations conducted in connection with real estate related financial transactions below the threshold level. We are to report at the end of 18 months and 36 months after the act's effective date. We will be initiating that statutorily mandated study shortly and will discuss the implications, if any, of the threshold and exemption changes originally established in regulation and currently proposed modifications of those regulations.

[20] OCC supervises national banks and the Federal Reserve supervises state banks that are members of the Federal Reserve System.

[21] The Federal Reserve requirements are contained in 12 C.F.R. 225.63(a). The OCC requirements are contained in 12 C.F.R. 34.43(a). Both regulations set out that such evaluations are to be "consistent" with agency guidance related to real estate evaluations.

[22] The FDIC requirements are contained in 12 C.F.R. 323.3(a).

evaluations.[23] Under OCC guidelines the scope of an evaluation should correlate to the complexity of the transaction and type of real estate collateral, with more complex transactions generally requiring a more detailed analysis. FDIC and Federal Reserve guidelines set out that financial institutions should establish prudent standards for evaluations, with more detailed evaluations performed as an institution's exposure increases. This guidance sounds reasonable. However, many bankers told us they nonetheless feel constrained to do more detailed evaluations than the transactions warrant; they said they also did this as a defensive measure against adverse examiner comment. Agency guidelines set out that failure to establish or maintain acceptable appraisal and evaluation programs or to comply with applicable regulations and policies is considered an unsafe and unsound practice. Several bankers expressed a fear of being subject to substantial civil money penalties if their examiner's judgment was too strict. Many of the bankers we visited said that the evaluation policies and procedures they believe they must follow are nearly as onerous as full-scale Title XI appraisals.

The proposed regulations discussed earlier that would give banks more discretion regarding appraisals do not appear to have developed a consistent, clear agency position concerning the use of evaluations. As noted previously, in the newly proposed rules for real estate appraisals, there are 12 circumstances under which a transaction will be exempted from a Title XI appraisal requirement. However, for three of those exemptions, the proposed rules state that the transaction "nevertheless should have an appropriate evaluation of real property collateral that is consistent with agency guidance." The three exemptions, which are likely to be applicable to much of the small business lending, are (1) transactions at or below the $250,000 threshold; (2) transaction involving business loans under $1 million in which the real estate is not the primary source of repayment; or (3) transactions resulting from an existing extension of credit when there has been no adverse change in the real estate collateral. FDIC views this language as not requiring an evaluation, while the Federal Reserve and OCC say it does.

In addition, for a bank seeking to avoid conflict with the regulators, there may be little practical difference whether evaluations are mandatory or voluntary under the proposed regulation. The joint agency statement explaining the proposed regulations states the following:

[23]The three agencies established revised real estate appraisal and evaluation guidelines on September 28, 1992.

"Under the proposed amendment, regulated institutions would be expected to obtain an evaluation whenever necessary to assist the institution in its decision to enter into a real estate-related financial transaction. These include transactions below the threshold level, business loans below $1 million where real estate is not the primary source of repayment, and transactions resulting from an existing extension of credit." 58 Fed. Reg. 31878,31883 (1993).

We think that a banker reading this language could reasonably decide to obtain evaluations in all cases in order to avoid criticism by bank examiners.

We believe that further clarification of the agency guidance on evaluations is warranted so that it is clear to bankers that they have discretion in how to establish the value of collateral for small business loans that are not material to the condition of the banks. This will require efforts to develop consistent examination practices and to explain the policy to banks, as well as changes in regulations and written guidelines. Implementation of this approach will take time. As bankers become more confident of supervisory behavior in this area, they also should be less inclined toward unnecessary caution and paperwork.

Bank Supervision for Small Business Lending

Safety and soundness supervision of banks is essential for regulators to accurately assess the condition of the institutions. The core of the supervisory process is the on-site examination. In a bank examination, examiners generally review the policies and procedures, look at a sample of performing loans, and examine problem loans more intensively. They use this information to assess bank performance compared to industry "best practices" in such areas as the proper classification of loans and the adequacy of loan loss reserves.

On March 30, 1993, the bank regulatory agencies issued an interagency policy statement that was intended to reduce impediments to small business lending that might be attributable to the bank examination process. The regulators announced that the strongest banks and thrifts (those with strong capital positions and the highest regulatory ratings) would be allowed to lend with minimum documentation to small- and medium-sized businesses and farms. The total of such loans is limited to an amount equal to 20 percent of total capital, and each loan included in the minimum documentation basket cannot exceed $900,000 or 3 percent of the institution's capital, whichever is less. Under this interagency policy, a loan in the basket would not be reviewed by an examiner unless it becomes nonperforming, i.e., the borrower is not repaying the loan as promised.

In our discussions, many bankers expected that this interagency initiative would have little effect on lending because the credit and associated documentation standards they now apply are an integral part of their systems for managing and controlling risks. These bankers pointed out that adequate documentation is required for prudent lending, and they were concerned that the approach would send the wrong signal to the marketplace regarding credit standards.[24] Some also raised the point that the tracking mechanism involved in this concept would result in yet another regulatory burden.[25]

We believe that a more effective way for regulators to make examination less burdensome for sound banks' small business lending activities would be to focus examinations to a greater extent on banks' systems of internal controls. These controls include policies and procedures regarding credit underwriting, director participation, officer and loan committee lending authority, credit documentation, monitoring of loan performance, and other aspects of loan administration.

[24]Bankers repeatedly emphasized the link between good documentation and underwriting based on cash flow of the borrower. We therefore found few differences between large and small banks in the documentation they said they wanted to obtain from their borrowers. This documentation is basically consistent with the standards for good industry practices set forth by Robert Morris Associates, an association of bank loan and credit officers. According to Robert Morris Associates, a well-documented business loan file would include 3 years of business financial statements and tax returns, financial projections over the life of the loan, personal financial statements and tax returns of guarantors, certified appraisals on business property, listing and valuation of any other collateral to be pledged, and credit checking.

Loan application packages provided to us by some of the banks contacted sought this type of information. It is generally recognized, however, that for smaller businesses—especially ones that do not have full-time controller positions—it is often difficult to obtain all of this information. The use of appraisals in traditional small business lending was discussed earlier.

[25]According to the statement establishing the basket of minimum documentation loans: "Assignments of loans to the exempt portion shall be made in writing, and an aggregate list or accounting segregation of the assigned loans shall be maintained, including the performance status of each loan." "Interagency Policy Statement on Documentation for Loans to Small- and Medium-sized Businesses and Farms," March 30, 1993.

In previous reports we have urged the agencies to place increased emphasis on the evaluation and testing of internal controls.[26] With respect to small business lending, this testing would still involve an examiner's review of a sample of loans, but in the context of ensuring that the prescribed controls are operating effectively and that the risks of such loans are in line with capital, reserves, and earnings. If the controls are found to be effective and the risks are well-managed, examiners should be able to reduce the number of individual loans they would otherwise examine in detail.

The initiative by the regulators to reduce the examination burden on the small business lending of sound banks is consistent with the approach to regulation contained in FDICIA. That act recognizes the desirability of making distinctions between sound banks and others by placing greater regulatory requirements on institutions that are not well-managed. The act accomplishes this objective through such provisions as prompt corrective action and the prohibition placed on weak banks from accepting brokered deposits.

In the examination area, the emphasis on internal controls found in FDICIA provides the basis for identifying which banks are sound with a minimum amount of regulatory burden. Since bank management, external auditors, and audit committees have increased responsibilities for assessing internal controls under FDICIA, an increased emphasis on internal controls by examiners should complement other efforts to improve bank internal control systems. In this context, the examination process and the associated discussion and presentation of examination results can be focused on the effectiveness of all of the internal controls that help ensure safe and sound operations, rather than on the specifics of individual loans. In short, when banks operate their small business lending operations according to sound business practices, examiner time will be saved and

[26]For example, see Bank Regulation: Improvements Needed in Examination Quality and Regulatory Structure (GAO/AFMD-93-15, Feb. 16, 1993). This report summarizes the recommendations we made in separate reports to the four regulators. To improve examinations, we recommended that, among other things, "banking and thrift regulators should

- ensure annual comprehensive internal control reviews are performed, using, where appropriate, assessments conducted by bank/thrift management and their auditors;
- require examiners to obtain and document current and complete data for loan quality reviews; and
- develop and implement a sound methodology to quantify risks in assessing the adequacy of loan loss reserves."

banks will have less reason to worry about being criticized by examiners for loan decisions.[27]

In our discussions with bankers we found no basic disagreement with the need for effective examinations. However, some officials at both larger and smaller banks said that the examination process was more burdensome on their small business lending activities than was justified on safety and soundness grounds. Some representatives of larger banks said that the loan-by-loan nature of the examination process was likely to magnify the importance of individual problem loans. They also said it does not adequately take into account the systems such banks use to manage the risks in their entire small business loan portfolios. Some representatives of smaller banks felt that the current system devoted too much time to reviewing the details of performing loans at sound banks. As noted earlier, the scope of our work does not allow us to evaluate the significance of these comments. But to the extent that such comments are valid, we believe that the agencies can effectively address the concerns that are expressed by focusing their examinations of small business lending on internal controls.

In the past, several of the smaller banks we visited were examined relatively infrequently. As a result of FDICIA, however, all banks will be subject to a comprehensive examination every year (or every 18 months in the case of healthy and well-capitalized banks with less than $100 million in assets that have not undergone a change in control within the past year). More frequent examinations have the potential to increase regulatory burden. However, to some degree this may be alleviated if the examination process adopts a focus that emphasizes the evaluation and testing of internal controls.

Other Issues

During our discussions, bankers raised other issues that they view as having an impact on bank lending to small businesses. Many of these issues are longer term in nature and do not pertain to safety and soundness regulations.

[27]We are concerned that the limited regulations (12 C.F.R. 363) issued by FDIC on June 2, 1993, may result in a serious weakening of FDICIA's requirements for annual independent audits, strengthened management of internal control systems, and strengthened audit committees of banks' boards of directors. These reforms were intended to prevent a recurrence of the breakdowns in internal controls and flawed systems of corporate governance that contributed to many bank failures over the past several years. The potential efficiencies in the examination process also will be limited if these reforms are not implemented effectively.

Cumulative Effect of Regulatory Compliance

Other than as discussed above, no one with whom we spoke pointed to a particular provision of FDICIA as inhibiting lending activities. However, all agreed that the cumulative effect of regulatory compliance, tracking, and reporting is burdensome. We are addressing the regulatory burden issue in a separate study that looks at both the benefits and costs of regulation.

Competition With Nonbanking Firms and Other Developments Within the Financial Services Industry

Barriers among financial providers are becoming increasingly obscured. Nonbanks are competing for both loans and deposits with banks, including small banks. For example, some banking officials pointed out that they are competing for deposits with mutual funds, investment banks, and credit unions. Similarly, on the loan side, they say they are competing with insurance companies, finance companies, and investment banks in extending credit to businesses. Although most banks have sufficient capital and liquidity to meet current loan demand, some bankers expressed the view that funds that have recently left the banking system and certain product lines may be lost permanently. By implication they suggest this may narrow the availability of credit for small businesses in the future. Evaluating these concerns was beyond the scope of this study. The nature of competition in financial markets and the degree to which regulation influences that competition are, however, clearly important oversight issues that may affect small business lending.

Small business lending is characterized by what is termed relationship banking. The standardized lending procedures followed by many of the larger banks—as well as the nonbank lenders included in our study—currently appear to be less suited to the needs of the smallest businesses than are the more personalized procedures adopted by small banks. Conversely, while various proposals to facilitate the securitization of small business loans may increase the amount of credit available to many small businesses, they may have little immediate impact on the segment of the small business market served by small banks because of the need for personalized or customized credit terms and conditions. Because of the close ties between small banks and small businesses that currently exist, the issues of the competitive position of small banks within the financial services industry and of the ability of other financial providers to meet small business needs are also important oversight issues.

Bankruptcy and Environmental Liability Considerations

Other factors in addition to regulation that bankers told us were exerting influence on today's credit environment include the increasing incidence of business and personal bankruptcies and the potentially very high costs of environmental liability. The former is cited by bankers as contributing to the demand for more detailed loan documentation and collateral and is another explanation of the banks' unwillingness to rely upon personal guarantees for small business loans as often as they may have in the past. In addition, bankers told us that because bankruptcy laws allow some retention of assets by the debtor, they are inhibited from making riskier small business loans. Concern over financial liabilities resulting from environmental claims virtually eliminates certain types of lending opportunities, according to several small bank executives. For instance, they said that funding for projects to convert abandoned gas stations, old factory sites, or railroad yards to other uses is virtually impossible to grant. Thus, we recognize that there are many factors that constrain the availability of credit to small businesses.

Conclusions

Bankers acknowledged to us that they have become more conservative in small business lending decisions largely because of economic considerations. They did, however, bring to our attention a regulatory burden related to appraisal requirements that has affected their lending decisions. For real estate taken as supplementary collateral on small business loans, their specific concerns were the requirements for appraisals and guidance on how to evaluate real estate when appraisals were not required.

A recent interagency initiative resulted in proposed regulations that modify the appraisal requirements. The proposal addresses some of the bankers' concern about appraisals being required on real estate taken as supplementary collateral. Further clarification and more consistency are needed regarding evaluations for real estate taken as supplementary collateral.

Bankers also told us that placing small business loans in a basket with minimum documentation requirements and examiner attention is likely to have limited impact on small business lending. We believe a more effective way to reduce any impediments to small business lending may result from examinations that place greater emphasis on the evaluation and testing of internal controls. This can help to reduce the extent of individual loan review when controls are found to be effective. By focusing examinations and discussions of examination results on internal controls and the risk exposure of the bank, regulators may be able to reduce the burden on banks and also help achieve FDICIA's intent by providing banks with incentives and flexibility to improve bank management.

Recommendations

In order to remove regulatory and supervisory impediments to small business lending by banks, the Comptroller of the Currency; Chairman, Federal Reserve Board; and Acting Chairman, Federal Deposit Insurance Corporation, should

- clarify the guidance provided to banks for evaluation of real estate pledged as supplementary collateral for small business loans that are not material to the condition of a bank, and
- focus examinations of small business lending activities on the adequacy of banks' internal control systems.

The recommendations are intended to make it clear to the industry that safety and soundness regulations are consistent with recognized sound business practices. Accomplishing this objective will no doubt depend to a great extent on the steps that are taken to train examiners and communicate with the industry.

Agency Comments and Our Response

We received written comments on the report from the Board of Governors of the Federal Reserve System, the Office of the Comptroller of the Currency (OCC), and the Federal Deposit Insurance Corporation (FDIC). The comments of the agencies were concerned principally with the recommendations regarding real estate appraisals and bank examinations and the surrounding discussion. In addition, FDIC questioned the impact of the recommendations and made some technical suggestions.

In responding to the comments, we have incorporated some changes as appropriate to clarify the discussion. The agency letters and our responses are attached in appendixes I, II, and III.

Appraisals

FDIC said that the draft incorrectly implied that current FDIC regulations as well as the proposed appraisal rule changes require banks to obtain evaluations of collateral taken in support of small business loans when appraisals are not required. However, it noted that there is concern and some confusion in the area and indicated that final regulatory action on the pending appraisal regulation may have to address clarifying the flexible and discretionary nature of the guidance that is intended. The Federal Reserve said it would consider our recommendation regarding guidance in formulating the final appraisal rule amendments. OCC said it would review the guidance concerning evaluations in light of any changes that are made to the appraisal regulation. It indicated, however, that to preserve the integrity of the rulemaking process that was currently under way it was not making any commitment to implement our recommendation.

We revised the draft to distinguish more clearly between the regulation that applies to mandatory appraisals and the guidance that exists with respect to evaluating real estate when appraisals are not required.

Examinations

OCC and FDIC indicated that there was not enough specific evidence in the report to comment on the recommendation regarding the value of further emphasis on internal controls. However, all three agencies emphasized the importance of looking at a sufficient quantity of individual loans in establishing the presence of effective internal controls and summarized their policies and procedures in this regard. They also stated the interest of their agencies in making sure that supervision was not responsible for imposing a burden greater than that associated with sound business practices.

Other GAO reports regarding bank failures previously cited in this report show that internal control weaknesses were a significant contributing factor to bank failures. These reports helped form the basis for the bank management, audit, and internal control reporting requirements mandated by FDICIA. The case has clearly been made for ensuring the effectiveness of internal controls during safety and soundness examinations. We agree that it is important to verify the existence of controls by looking at loans, and we have modified the discussion to attempt to make clearer the way in which implementation of FDICIA reforms can help reduce any burden attributable to examination of the small business operations of sound banks. As noted, we believe that emphasis on internal controls during an examination of small business lending can lead to more efficiency in reviewing individual losses in institutions that have effective controls and that have demonstrated their ability to successfully manage the risks inherent in small business lending.

Impact

Noting our observation that loan demand and market conditions were crucial factors, FDIC said that what the agencies can do to stimulate credit is very limited. We believe it is important that our recommendations be implemented, but we agree with FDIC that their significance must be viewed in the overall context within which small business lending takes place in the economy. Safety and soundness regulation is, of course, just one aspect of the whole picture. In the final analysis we cannot say how much difference this will make in the amount of bank lending.

To a large extent our recommendations can be viewed as seeking to remove fear of criticism from the regulatory process as it applies to small business lending by sound banks. This uncertainty is not unexpected, given the difficulties that the banking system has gone through, concern about the regulatory process in light of extensive bank failures, and the enactment of the comprehensive reforms in FDICIA that require both regulators and bankers to adapt to new requirements. Nonetheless, so that the banking system is able to meet the credit demands of a changing market, regulators should do everything possible to strengthen mutual trust through improved communication. In our work we found that the agencies were concerned with the same issue and found some encouraging signs of outreach toward the industry. At the same time, we noted a positive recognition from the bankers of the contributions played by the regulators in guiding the banking industry through the crisis. This suggests that better communication between regulators and the industry can help to develop a consensus.

We are sending copies of this report to the Comptroller of the Currency; Chairman, Federal Reserve Board; Acting Chairman, Federal Deposit Insurance Corporation; Acting Director, Office of Thrift Supervision; Secretary of the Treasury; and other interested parties. We will also make copies available to others on request.

The major contributors to this report are listed in appendix IV. Please contact me on (202) 512-8678 or Stephen C. Swaim, Assistant Director, at (202) 728-5807 if you or your staff have any questions concerning this report.

Sincerely yours,

James L. Bothwell
Director, Financial Institutions
and Markets Issues

Contents

Abbreviations

FDIC	Federal Deposit Insurance Corporation
FDICIA	Federal Deposit Insurance Corporation Improvement Act of 1991
FIRREA	Financial Institutions, Reform, Recovery, and Enforcement Act of 1989
OCC	Office of the Comptroller of the Currency

Comments From the Federal Reserve Board

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

ALAN GREENSPAN
CHAIRMAN

July 20, 1993

Mr. Charles A. Bowsher
Comptroller General of the United States
United States General Accounting Office
441 G Street, NW
Washington, D.C. 20548

Dear Mr. Bowsher:

Thank you for the opportunity to comment on the GAO's report on the regulatory impediments to small business lending. That report, entitled, "Regulatory Impediments to Small Business Lending Should Be Removed," attempts to identify areas of regulatory burden, which could be reduced without sacrificing safety and soundness or other public interest objectives. In particular, the draft report contains two recommendations: (1) the banking agencies should modify the requirements for an evaluation of real estate collateral for small business loans in which the collateral is not material to the bank; and (2) the banking agencies' should focus their examination procedures on the adequacy of financial institutions' internal control systems, and emphasize internal controls in the presentation of examination results.

Regarding the first recommendation, the GAO's report acknowledges that the Federal Reserve and the other banking agencies recently released a proposal to amend their appraisal regulations that addresses regulatory burden arising from the agencies' appraisal requirements. This proposal is intended to reduce burden imposed by the appraisal regulation while still requiring Title XI appraisals when such appraisals enhance the safety and soundness of financial institutions or otherwise further public policy interests. The Federal Reserve believes that the proposed amendments will improve credit availability by reducing the costs and delays imposed by the appraisal requirement in making small- and medium-sized loans.

As noted in the GAO study, the agencies' proposal contains a specific exemption that is designed to facilitate small- and medium-sized business lending. The proposed exemption would not require Title XI appraisals for business loans below $1 million, where the principal source of repayment of the loan is not the sale of, or rental income derived from, the real estate held as collateral on the loan. For such exempted transactions, however, the financial institution would be required to perform an appropriate evaluation of the real estate collateral. On the other hand, where cash flow from the real estate is closely linked to the ability of the borrower to repay the business loan, an appraisal would be required.

In an effort to further refine the agencies' proposal, the GAO recommends that banks should not be required to document evaluations for small business loans, "provided that the lender is not relying on revenues generated by that real estate to repay the loan and that such loans do not exceed existing measures for materiality, such as the established legal lending limit to single borrowers." As a practical matter, it would appear that the proposed changes to the appraisal regulation already largely achieve this objective, especially in view of the fact that the supervisory and regulatory attention directed to loans that are truly immaterial is minimal. Nevertheless, the Federal Reserve will consider the GAO recommendation in formulating the final appraisal rule amendments. At this time, the Board is still receiving comments on the proposed amendments with the comment period closing on July 19, 1993.

With regard to the Federal Reserve's examination procedures, the Board believes that its examination/inspection programs have been effective in enabling us to assess the safety and soundness of our regulated institutions. In fulfilling our supervisory responsibilities, the Board has stressed the importance of thoroughly reviewing the fundamental credit quality and performance of loan and investment portfolios, as well as directing appropriate attention to internal controls.

In assessing the impact of the examination process on small business lending, the GAO believes that examiners should focus on the evaluation and testing of internal controls and that less emphasis should be placed on reviewing the quality and status of loans. Further, the GAO recommends that the discussion and presentation of examination results should be focused on the effectiveness of internal controls to ensure safe and sound operations, rather than on the individual loans reviewed.

The Federal Reserve recognizes the importance of internal controls and agrees that examiners should give them adequate attention during the on-site examination. Nevertheless, our experience has been that it is the condition of the loan portfolio that is the principal cause of bank failures. Indeed, in our view, an adequate review of the loan portfolio is necessary to fully assess and confirm the effectiveness of internal controls.

In our April 28, 1993, response to the GAO on its report on federal examinations of banking organizations, we outlined the Board's examination and inspection policies, procedures and practices. As noted in our letter, the Federal Reserve has undertaken an internal project to review and, where appropriate, strengthen our examination process and address many of the recommendations previously raised by the GAO in its study on bank examination quality. In this regard, the principal areas under consideration are the procedures for examining a bank's internal controls to ensure that the internal controls are well specified, are being effectively adhered to, and are adequately documented in examination workpapers and reports.

Please be assured that the Federal Reserve will continue to monitor financial institutions' small business lending activity and to refine its supervisory procedures so as to lessen the regulatory impact that the Board's policies may have on such lending.

Sincerely,

Comments From the Office of the Comptroller of the Currency

Comptroller of the Currency
Administrator of National Banks
Washington, D.C. 20219

August 5, 1993

Mr. Johnny C. Finch
Assistant Comptroller General
U.S. General Accounting Office
Washington, D.C. 20548

Dear Mr. Finch:

We have received and reviewed the GAO's draft report titled Banking Regulation: Regulatory Impediments to Small Business Lending Should Be Removed. The study was undertaken to respond to congressional questions posed to the Comptroller General about the availability of credit to small businesses. GAO work consisted of interviews with lenders and regulators. The report contains two recommendations to the OCC and the other federal bank regulators.

Real Estate Appraisal Requirements

Title XI of the Financial Institutions Reform, Recovery and Enforcement Act of 1989 as amended in 1992 (FIRREA) requires that real estate appraisals for federally related transactions be written reports that conform to uniform standards and be completed by individuals whose competency has been demonstrated and whose professional conduct will be subject to supervision. GAO found that bankers support the basic purposes of the real estate appraisal requirements contained in Title XI but the consensus was that the implementing regulations were inhibiting small business lending. Without quantifying this information, the GAO recommends that the OCC, FRB and FDIC modify the requirements for evaluation of real estate pledged as supplementary collateral for small business loans provided that they are not material to the bank.

As noted in the draft report, the OCC and the other regulators published a proposed rule for comment on June 10 that, if finalized, would expand and clarify existing exemptions, identify new exemptions and reduce the number of exempt transactions that require evaluations. GAO is recommending that the OCC go further in revising its appraisal regulations by modifying the criteria for performing evaluations of real estate where an appraisal is not required. The guidelines for performing evaluations are contained in Banking Circular 225, revised, and are not a part of the regulation. OCC plans to review these requirements in light of changes made to the regulation, if any. To preserve the integrity of the rulemaking process, we are not making a commitment to implement GAO's recommendation.

Bank Supervision for Small Business Lending

GAO reports that bankers opined that the burden of extensive assessment and discussion of the quality and status of loans discourages small business lending. Therefore, GAO recommends that the regulators focus examinations on the adequacy of banks' internal control systems, and emphasize internal controls in the presentation of examination results.

The Comptroller's Handbook for National Bank Examiners includes comprehensive review procedures for examiners to use in determining the effectiveness of all principal aspects of a bank's internal control systems. Examiners are expected to test control systems to provide support for their evaluations. Testing naturally includes the review of individual loans in assessing the adequacy of controls over loan portfolio management, credit administration, etc. The extent of an examiner's review of individual loans is also affected by safety and soundness considerations. For example, examiners can be expected to concentrate their efforts on the large and the problem credits, because that is where a bank's exposure is greatest. Loan coverage in all banks is expected to be sufficient to determine the current condition of the loan portfolio and allow an assessment of the adequacy of the bank's systems and controls in the lending area as written in bank policies and as practiced. In all banks, loans analyzed include large loans, significant problem loans and loans to insiders. Where practical, valid statistical sampling techniques are used to analyze smaller commercial loans, performance paper, and the portfolios of less significant subsidiary banks of multibank holding companies, and to assess the adequacy of bank systems and controls. OCC currently requires examiners to sample at least 30% of banks' loan portfolios due to recent problems in banks' commercial loan portfolios.

The information presented in the draft report is helpful to us, because it corroborates and adds to what we have heard. However, we are reluctant to respond positively to a recommendation made solely on the basis of bankers' views. We would want to validate them in some way and to consider other factors before making any adjustment to our current practices. OCC's goal is to fulfill its responsibility for determining the condition of national banks while minimizing the intrusion and disruption that examinations can cause. The balance is difficult to achieve and to maintain.

Thank you for the opportunity to comment on the draft report.

Sincerely,

Eugene A. Ludwig
Comptroller of the Currency

Comments From the Federal Deposit Insurance Corporation

Note: GAO comments supplementing those in the report text appear at the end of this appendix.

FDIC
Federal Deposit Insurance Corporation
Washington, DC 20429

Office of Executive Director
Supervision and Resolutions

July 16, 1993

Honorable Johnny C. Finch
Assistant Comptroller General
U.S. General Accounting Office
Washington, D.C. 20548

Dear Mr. Finch,

Thank you for the opportunity to comment on your draft report entitled Banking Regulation: Regulatory Impediments to Small Business Lending Should be Removed.

The report calls for modification of requirements for evaluation of real estate collateral that is not material to a transaction and for an emphasis on banks' internal controls in the examination process and reports. While there may be room for clarification and some modification, we disagree with the emphasis GAO gives to these two matters. Moreover, reacting to any suggested change in regulatory or supervisory processes, we first note with agreement the following statement on Page 12 of the draft report:

Now on page 7.

See page 24.

> "This more conservative credit environment was attributed by the bankers primarily to economic conditions and prudent business decisions rather than a reaction to legislation, regulations, or pressures by bank examiners."

Given this conservative view point by both borrowers and lenders, what the agencies can do to stimulate credit is very limited indeed.

The GAO may want to adjust the following incorrect statements of fact before releasing the report:

Now on page 2.

See comment 1.

(1) Page 3: ". . . the agencies should modify regulations that require banks to perform evaluations and document those evaluations in order to establish the value of supplementary collateral supporting traditional small business loans." The FDIC has no such regulations. Section 323.3(a) of the FDIC

Rules and Regulations states: "supervisory guidelines, general banking practices or other prudent standards may also require an appropriate evaluation of real property collateral". This is a suggestion, not a requirement. In September 1992, the FDIC issued "Guidelines for Real Estate Appraisal and Evaluation Programs". A cursory reading of those guidelines will show that they are a statement of industry "best practices" and that they recognize that institutions have discretion and flexibility to do what they believe is appropriate for them on transactions which are not subject to the law and its implementing regulations.

Now on page 3.

See comment 2.

(2) Page 3: ". . . a recent regulatory initiative to allow well-capitalized and well-managed banks to place some loans in a 'basket' with minimum documentation . . .". In fact the inter-agency statement applies to a wider group of institutions, namely those both well- and adequately-capitalized and with CAMEL ratings of 1 or 2, which takes in satisfactory management.

See comment 3.

(3) Page 18: "According to the regulations, loan files should contain documentation that the appraisal received a detailed assessment to detect any deficiencies. . . . Non-material deficiencies in the valuation should be corrected before the transaction is completed, according to current regulations." Neither of these requirements is contained in FDIC regulations. Our guidelines do not suggest any documentation of a detailed assessment to detect faults. The guidelines do reflect the indicated advice on what to do if deficiencies are noted.

Now on page 14.
See comment 4.

(4) Page 22: "The proposed regulations still require banks to document their analyses of outside appraisals, and evaluations are still required in instances in which real estate is taken as supplementary collateral for traditional business loans." Footnote 14 says that institutions "will be required to perform an evaluation of the real estate if the appraisal exemption was based on" certain conditions. This is not true. The regulations do not address in any manner the documentation of appraisal analysis. The regulations refer to guidelines which suggest that there are prudent "best practices" for documenting transactions including preparing collateral evaluations on loans which are exempt from the regulation but these practices cannot be said to "require" anything on such loans.

Now on page 16.
See comment 5.

(5) Page 24: ". . . such basic safety and soundness regulations as the proper classification of loans and the adequacy of loan loss reserves." There are no FDIC regulations on either of these subjects. These are matters of

examiner judgement and are based on industry "best practices" and there are no rigid rules or formulas that drive an examiner's decision.

The report notes, with favor, the initiative now in process to amend our real estate appraisal regulation. The proposal, if adopted, would expand and clarify on the types of transactions which are exempt from the technicalities of the regulation.

See comment 6.

Now on pages 10-11.

In particular, the so-called "abundance of caution" exemption is being expanded or clarified. Page 16 of the report states that under the existing rule "banks must demonstrate that the terms of the transaction are not made more favorable than they would be in the absence of a lien." This phrase in the existing regulation may have been interpreted with excessive strictness by some regulators and bankers (Page 17), but it has never been the official interpretation or implementation of the FDIC. Our examiners have been expected to liberally interpret the exemption and to place heavy reliance on the banker's decision in using it. The "terms not more favorable" provision was originally intended by FDIC to be an example of "abundance of caution", not a definition. We are pleased to clarify our intent and to obtain inter-agency agreement in the proposed revised language which would remove the "terms not more favorable" language.

See comment 7.

As indicated in the report, some bankers continue to mention the absence of a sufficient supply of qualified appraisers. By this, we assume they mean State licensed or certified appraisers, since those lenders had for many years been able to do their own estimates of collateral value without delay. However, it is important to note that the Appraisal Subcommittee reports that over 70,000 appraisers are now listed on the National Registry. Further, no State or any geographical subdivision of any State, nor the lenders or borrowers thereof, have asked for a waiver of the statutory appraisal requirements. A waiver is specifically authorized by Section 1119 of Title XI of FIRREA.

See comment 8.

Now on page 15.

It is clear that there is concern and some confusion over the agencies' guidelines calling for evaluations of collateral even when the real estate appraisal regulations do not apply. Section 323.3(b) of our proposed amended regulations states: "Transactions for which the services of a State certified or licensed appraiser are not required . . . should have an appropriate evaluation of real property collateral that is consistent with agency guidance." It may be that in our final regulatory action we will have to address this language to make clearer the flexible and discretionary nature of the admonishment. Contrary to the report's characterization on Page 22, the proposed regulation requires nothing on exempt transactions. The existing and proposed regulation try to make clear the time-honored safety and soundness standards that apply to loan underwriting. If you are going to take collateral as part of a loan, some indication of what it is worth is appropriate. How much one does to substantiate and analyze that worth depends on the nature of the collateral, the degree of reliance placed on it, the reason the collateral is taken, and any number of other factors. The agency guidelines are exactly that; they do not require but they attempt to describe the consensus of what lenders normally expect to be standard industry practice. Moreover, laws of many states require state chartered banks to obtain formal appraisals on real estate taken as collateral.

See pages 23-24.

Finally, as to the recommendation that FDIC place more focus in its examination work and reports on internal controls. We feel this is a matter of differing emphasis between us and the GAO. We do look at internal controls and the GAO continues to make its assertions without evidence that we do not. We believe that the final test of the adequacy of controls is in the actual results of operations and we must give important attention to results. We believe that examination reports should not emphasize controls to the exclusion of results. But we also acknowledge that the breadth or depth of discussion of individual loans should vary by the quality of the institution's policies and controls and that one must step back from the individual loan and make a judgement about an institution's overall risk profile and controls. This judgment will then impact the extent of individual review and discussion.

It is not obvious, nor does the report present evidence to support the claim, that greater examination emphasis on controls could lead to a reduction in the number of individual loans that examiners need to review or that there would be a net reduction in the burden of supervision on banks. In fact, we would hypothesize that the net burden, especially on smaller institutions, might well increase. The FDIC believes that the number of individual loans that it is already reviewing are at a relative minimum. Looking at non-performing credits and the largest performing credits seems to us to be a proper sampling. We do not disagree however that examiners can be reminded to address what the individual review says about the overall situation and factor that into examination planning.

See footnote 24 on page 16.

Regardless of what one believes about increased attention to review of controls versus review of individual loan files, it is not clear that the answer is properly relevant to the issue of impediments to small business lending. Lenders are always expected to document a loan using their own best judgement, a judgement which can be and is guided by industry standards. (See, for example, the industry list from Robert Morris Associates in Footnote 15 on Page 25.)

Except for statutorily mandated paperwork (which only Congress can address), the FDIC requires and expects no documentation and imposes no limits on credit terms beyond what is generally expected that a prudent lender would do for its own protection and decision making. So whether we read the loan file or not should have no impact on whether or how the banker makes the loan. If bankers would document a loan one way if they knew it was going to be read and another way if they knew it was not going to be read, they have a serious misunderstanding about the purpose of loan files and the criteria an examiner uses in reviewing the quality of the credit. To balance it out, however, examiners also must not discuss or analyze a loan to an excessive degree if the overall controls in the institution are acceptable.

We trust these comments have been helpful in better understanding the FDIC's view of the relationship between regulatory requirements and the availability of credit, especially to small business.

Sincerely,

Paul G. Fritts
Executive Director

The following are GAO's comments on FDIC's letter dated July 16, 1993.

GAO Comments

1. Text has been modified on page 2 to discuss independent appraisal requirements rather than internal evaluations guidelines.

2. Text has been modified on page 3 to show that the agency initiative applies to banks with adequate capital and satisfactory management.

3. The passage in the draft report that is referred to has been dropped. The passage was concerned with the clarity of the guidance that banking agencies give to banks regarding how to verify the accuracy of an appraisal. The issue involves more than whether the guidance is formally communicated by regulation or guideline. Although we still have concern about the clarity of guidance in this area, we have not included this in the text of the final report for two reasons: (1) pending agency regulations discussed in the report would reduce the number of times an appraisal would be required for the collateral associated with a small business loan; and (2) the same issue of clarity exists in an issue that we feel is now of greater importance in light of the pending regulation—namely, guidance given regarding evaluating collateral when an appraisal is not required.

4. Text has been modified on page 13. As discussed in comment 3, the report no longer singles out for special discussion the guidance to banks regarding the analysis of an appraisal. Furthermore, the revised text has been changed to reflect that FDIC's interpretation regarding evaluations differs from that of the other two agencies. The footnote has been deleted.

5. Text has been revised on page 15 to reflect FDIC's comments.

6. We revised our discussion on page 10 relating to the "abundance of caution" exemption to reflect the differences in philosophy among the agencies. Footnote 13 has been added to clarify our point.

7. Although the issue of the absence of a supply of qualified appraisers was raised by some of the small banks we interviewed, we have removed reference to it from the revised version of the report. This was decided in light of the fact that the sampling of banks interviewed was based on a judgmental selection and that we had no basis for commenting further on the availability of appraisers.

8. Text has been clarified on page 14 to highlight the differences among the agencies regarding evaluation requirements.

Major Contributors to This Report

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