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Bank Examination Policy and Loans to Business

In June of 1938 the Federal bank supervisory agencies--in other words, the Board of Governors of the Federal Reserve System, the Comptroller of the Currency, and the Federal Deposit Insurance Corporation--reviewed their policies and regulations in order to determine in what respects they might be improved and coordinated in order to facilitate the flow of credit to commerce, industry and agriculture. As a result, unanimous agreement was reached on a program designed to produce uniformity in the treatment of loans and securities by the Federal agencies in the administration of bank examinations. One of the fundamental purposes of the program was to broaden the opportunity for small and medium sized business concerns to obtain credit from banks on a sound basis. With this purpose in mind, the regulations of the Comptroller of the Currency regarding the purchase of investment securities by national banks were liberalized, the so-called "slow" classification in examination reports of banks was abolished, and concise definitions were given with respect to the classifications to be applied to loans.

It was felt at the time that the program agreed upon was substantially all that could be accomplished within the framework of the law in encouragement of the extension of credit to business. The program has on the whole worked very satisfactorily and it is doubtful whether any further changes in bank examination policies and procedures would bring about any substantial increase in loans by banks to small business.

The banking laws of the United States and of the States prescribe the limits within which the supervisory authorities make policy decisions with regard to bank examinations. Such laws express broad public policy with regard to bank assets and management through numerous detailed provisions. Many banking laws are necessarily in general terms, however, and authorize the supervisory authorities to implement their provisions by issuing regulations and to exercise a certain amount of discretion in the process. Nevertheless, neither legal restrictions nor general regulations attempt to define in detail the circumstances under which all loans and investments must be made. Bank management must exercise its own discretion and credit judgment within the framework of the prescribed limitations.

There are some provisions of the law which by their nature are restrictive upon the lending functions of banks but this does not mean that these laws should necessarily be repealed or substantially modified. For example, national banks are subject under Federal law to limitations in making loans secured by real estate. Such loans may not exceed 50 per cent of the appraised value of property or be for a longer term than five years except that if amortized they may go up to 60 per cent of the appraised value and may run for ten years if 40 per cent is paid off within that period. National banks are likewise subject to a basic limitation of 10 per cent of capital and surplus on loans to one borrower. But even though all such statutory restrictions were eliminated or substantially modified, there is little reason to believe that the volume of business loans would be greatly increased. This is because of the fact that when banks hesitate or decline to make loans, they do so because in their judgment such loans are not good credit risks, rather than because of bank examination policy or statutory restrictions.

It is believed that, all too frequently, bankers find it convenient to say to would-be borrowers that examiners would criticize them for making loans as requested rather than to advise borrowers of the real reason for declining such loans or to point out the unsound characteristics thereof. Thus the impact of examinations on the extension of credit by banks is greatly exaggerated, although it is perfectly true that many loans declined for such reasons would be criticized by examiners if made. The point is that the borrower is not given the banker's reason for considering the loan unsound and gains the impression that the examiner is prone to criticize loans which, in the opinion of the borrower at least, are entirely sound.

In this connection, Congress in 1942 enacted a law exempting from the 10 per cent limitation on national bank loans to one borrower obligations guaranteed by the United States or by a Federal Reserve Bank, and a similar statute has been passed in nearly all of the States with respect to State banks. This has been of assistance in connection with the guaranteed V-loan program under which the War and Navy Departments and the Maritime Commission guarantee loans for war production purposes through the agency of the Federal Reserve Banks. This legislation, however, affects primarily larger loans rather than loans to small business.

As a matter of interest in this connection, it may be mentioned that in November 1942 the Federal bank supervisory agencies announced a joint policy with reference to investments in and loans upon United States Government securities. This provided that there would be no deterrents, in examination or supervisory policy, to investments by banks in Government securities, nor to short term loans by banks to finance the purchase of such securities.

While a close coordination of bank examination policy among the Federal supervisory agencies and frequent consultation among such agencies is, of course, most desirable, such consultations are constantly taking place on questions which are arising from day to day. It seems unlikely that there is any considerable field of latitude in which any revision of bank examination policy as it presently exists could, through meetings of the supervisory agencies or otherwise, bring any substantial increase in volume of business loans made by the private banking system.

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