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TESTIMONY OF

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ON

CREDIT AVAILABILITY FOR SMALL BUSINESS

BEFORE THE

COMMITTEE ON SMALL BUSINESS
UNITED STATES HOUSE OF REPRESENTATIVES

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Mr. Chairman and Members of the Committee, I am pleased to have this opportunity to testify on behalf of the Federal Deposit Insurance Corporation (FDIC) on credit availability for small businesses. As we are all well aware, small and medium-sized businesses are the engines of job growth in our economy. Since they generally have very limited or no access to public credit markets, it is critically important that these businesses have adequate access to bank credit on reasonable terms and conditions.

My testimony today will discuss the FDIC's active participation in a program of regulatory and administrative changes to stimulate bank lending to small businesses, the progress of the financial regulatory agencies in identifying possible statutory changes that may be appropriate, and recent trends in lending and investing in government securities by financial institutions.

Credit Availability

The banking industry is well positioned to increase lending to borrowers of all types, including small businesses. At the end of 1992, 11,361 or 95.8 percent of all BIF insured banks qualified as well capitalized. These banks held 87.3 percent of all assets of BIF insured institutions. An analysis by our research staff reveals that these well capitalized banks have sufficient capital to support asset growth approximating $500 billion and still meet the minimum capital requirements for well capitalized institutions. While we would not advocate that banks operate at minimum capital levels and we recognize that any asset growth would include a mix of cash and other liquid assets as well as loans, a figure of that magnitude demonstrates that there is considerable untapped lending capacity in the banking system that is not constrained by regulatory capital requirements. This analysis, moreover, ignores securities holdings of well capitalized banks which could be readily liquidated to further increase lending. In short, the banking industry has ample liquidity and is in a position to lend.

Despite this capacity in the system, lending to businesses has lagged. Data on small loans to businesses, which will represent a reasonable proxy for small business lending, will become available beginning with the June 30, 1993 Call Reports. At present, therefore, we must rely on aggregate commercial and industrial (C&I) lending as reported by banks on their Call Reports.

These data, which may reflect lending predominantly to larger borrowers with lower cost funding alternatives, show that commercial and industrial lending by banks has steadily declined for eleven consecutive quarters, from the second quarter of 1990 through the fourth quarter of 1992. C&I loans to U.S. borrowers, which represent about 86 percent of all C&I loans, declined throughout this period, with the exception of a slight increase in the last quarter of 1992. Over the three-year period 1990 to 1992, C&I loans were down about 14 percent. Most of the decline has occurred in areas of the country where economic conditions have been most adverse, i.e., Northeastern states and California.

We believe this decline is attributable to a number of factors. Much of the decline reflects slack demand resulting from the 1990-91 recession and the slow pace of recovery. The normal reaction of businesses in these times, particularly small businesses, is to shore up their balance sheets by conserving cash and reducing borrowing. Often, they will await an upturn in business or prospects before committing to additional borrowing to finance working capital needs, expansion and capital expenditures.

Call Report data on commitments to make C&I loans[1] support this analysis. These commitments have remained quite stable over the last two years as outstanding loan balances have declined. From the first quarter of 1991 through the fourth quarter of 1992, C&I loans declined $69 billion (11.5 percent), while C&I loan commitments declined less than $3 billion (0.5 percent). This indicates intent and willingness on the part of banks to make C&I loans, but borrowers are opting not to draw down these funds, despite having paid fees to secure the commitments.

In addition, banks generally have strengthened their underwriting standards in the aftermath of the excesses and losses

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[1] C&I loan commitments are reported on Schedule L under "Other Unused Commitments," which for most banks will consist predominantly of C&I loan commitments.

of the 1980s. Many banks are continuing to work off troubled assets and have learned some difficult lessons. Consequently, they are more selective and hesitant to finance new businesses or the expansion of established businesses without a substantial commitment of equity from the borrower and a demonstrated repayment record. Borrowers who cannot meet the more selective criteria are having a particularly difficult time in obtaining bank credit, which may help explain some of the growth in commercial lending by finance companies. Real estate, which has traditionally served as side collateral for many small business loans, has either declined in value in many parts of the country or is not appreciating as rapidly as in the past. Consequently, the equity commitment is more difficult to satisfy for many small businesses.

Credit Availability Program

On March 10, the FDIC joined the Office of the Comptroller of the Currency, Office of Thrift Supervision and Federal Reserve Board in issuing a statement on the problems of credit availability, especially for small and medium-sized businesses and farms. This program, which is set forth in detail in Attachment A, focuses on five areas in which the federal regulatory agencies will act to alleviate the apparent reluctance by banks and thrifts to lend. Those areas are:

- Lending to Small and Medium-Sized Business and Farms
- Real Estate Lending and Appraisals
- Appeals of Examination Decisions and Complaint

Handling

- Examination Processes and Procedures
- Paperwork and Regulatory Burden.

The agencies intend to complete virtually all of the changes proposed in the program within the next few months. Each proposed change will be published individually as the specifics of the change are finalized.

On March 30, the banking agencies announced a joint policy statement on documentation of loans, which is included as Attachment B. Under this new policy, the strongest banks and thrifts, i.e., those which are rated CAMEL or MACRO 1 or 2 and which are at least adequately capitalized, are now able to make and carry some small and medium-sized business and farm loans with only minimal documentation. The total of such loans at an institution will be limited to an amount equal to 20 percent of its total capital. Eligible banks and thrifts will be encouraged to make these based on their own best judgment as to the creditworthiness of the borrowers and necessary documentation. These loans will be evaluated solely on the basis of performance and will be exempt from examiner criticism of documentation.

Agency staff are hard at work devising implementation strategies for the remaining elements of the Administration's program. The next element to be released will likely be a proposed revision of the agencies' appraisal regulations which will be designed to limit the need for formal appraisals prescribed by regulation in a variety of circumstances. This should simplify and facilitate the credit granting process by reducing the cost and delays associated with providing real estate as collateral without compromising essential safety and soundness concerns.

It is impossible to quantify the additional credit that may be extended as a result of the program since we are still rather early in the implementation stage and it would be extremely difficult to isolate the additional lending attributable to the program. We are confident, nevertheless, that the initiatives will prove very helpful in eliminating unwarranted impediments to small business lending and opening new opportunities which both banks and small businesses can reasonably be expected to use to good advantage.

Statutory Changes

As a follow-up to the report on regulatory burden submitted to the Congress last December, the agencies noted that much of the burden imposed on depository institutions derived from statute and consequently there was little the agencies could do on their own to relieve that burden. Consequently, the agencies undertook to identify for Congress possible statutory changes designed to reduce regulatory burden and to report their proposals to Congress by late Spring. Thus far, agency staff have identified for review by senior management at each agency possible statutory changes which the agencies may choose later to recommend to Congress. The review process is still ongoing and the agencies have reached no firm conclusions.

We should point out, however, that the focus of this effort is the reduction of regulatory burden and not increasing credit availability *per se*. The relationship between burden reduction and credit availability is often indirect and difficult to measure. Any cost savings resulting from a reduction in burden may be used in a variety of ways other than funding additional lending. If cost savings are passed on to borrowers by way of lower interest rates and loan fees, loans may become affordable for more borrowers. This would improve credit availability although the result would be very difficult to isolate and measure.

The goal of eliminating unnecessary and burdensome requirements, whether statutory or regulatory, is a worthy one in and of itself and one which must be pursued. Any success in reducing overall burden on banks would serve to reduce their costs and improve their competitive efficiency vis-a-vis other lenders and this will have a positive effect on credit availability, particularly over the longer term.

Government Securities Purchases

Banks have substantially increased their holdings of government securities over the past few years while their total loans have decreased. This shift to government securities reflects both a reduced demand for loans and attractive returns on government securities resulting from an unusually steeply sloping yield curve. The spread between short and longer-term Treasury securities increased steadily since 1990 enabling banks to increase their profits by investing in medium-term instruments, with only moderate interest rate risk and lower costs than loans.

We do not view this investment shift to government securities as a long-term problem but rather as a temporary situation that will change as improving economic conditions bring about increased loan demand. Also, if short-term interest rates rise, the spread between deposits and securities will be closed and banks will no doubt seek higher-yielding investments, such as loans, in order to maintain margins and profits.

We would also note that approximately half of the increase in holdings of U.S. government securities is attributable to increased holding of residential mortgage-backed securities which permit banks to serve as an important indirect source of funding for home loans. Yet other securities holdings serve to finance student and small business loans.

This concludes my formal testimony. I would be pleased to respond to any questions the Members of the Committee may have.

Joint Release

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

(PR-20-93)

Interagency Policy Statement on Credit Availability

March 10, 1993

The four federal regulators of banks and thrifts — the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the Board of Governors of the Federal Reserve System, and the Office of Thrift Supervision — today announced a program directed at dealing with problems of credit availability, especially for small and medium-sized businesses.

The program will focus on the five areas in which the agencies will take action designed to alleviate the apparent reluctance by banks and thrifts to lend. Those areas are:

- Lending to Small- and Medium-sized Businesses
- Real Estate Lending and Appraisals
- Appeals of Examination Decisions and Complaint Handling
- Examination Processes and Procedures
- Paperwork and Regulatory Burden.

The agencies intend to complete virtually all of the changes proposed in the program within the next few months. As the specifics of any change are finalized, that change will be made and published while details of other changes are in the process of being finalized.

A complete statement about the actions the agencies have planned is attached. The statement reaffirms the agencies' belief that it is in the interest of lenders, borrowers and the general public that creditworthy borrowers have access to credit.

This policy statement will be distributed to all federally examined banks and thrifts and to all regulatory agency offices and examiners.

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

Interagency Policy Statement on Credit Availability

March 10, 1993

Problems with the availability of credit over the last few years have been especially significant for small- and medium-sized businesses and farms. This reluctance to lend may be attributed to many factors, including general trends in the economy; a desire by both borrowing and lending institutions to improve their balance sheets; the adoption of more rigorous underwriting standards after the losses associated with some laxities in the 1980s; the relative attractiveness of other types of investments; the impact of higher capital requirements, supervisory policies, and examination practices; and the increase in regulation mandated by recent legislation — specifically, the Financial Institutions Reform Recovery and Enforcement Act (FIRREA) and the Federal Deposit Insurance Corporation Improvement Act (FDICIA).

The four federal regulators of banks and thrifts — the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the Board of Governors of the Federal Reserve System, and the Office of Thrift Supervision — recognize that in the last several years the buildup of certain regulations and practices has become overly burdensome. Indeed, those regulations and practices may have, in some cases, stifled lending, particularly to small- and medium-sized businesses that met prudent underwriting standards.

It is in the interest of lenders, borrowers, and the general public that creditworthy loans be made. Since economic growth, especially job growth, is fueled primarily by small- and medium-sized businesses, credit availability to those borrowers is especially important. Accordingly, the agencies are working on the details of a new program to help ensure that regulatory policies and practices do not needlessly stand in the way of lending. Loans to creditworthy borrowers should be made whenever possible, as long as they are fully consistent with safe and sound banking practices.

Background

The new program is one aspect of an overall effort by the agencies to evaluate carefully and react appropriately to risk in the United States financial services industry. That overall effort envisions substantial oversight, in some cases more than we have now, in areas that pose greater risk to the system. By the same token, regulatory burden will be reduced where risk is low, especially for strong, well-managed banks and thrifts. This program is also part of a broader effort to ensure equal credit opportunity for all Americans and to make credit and other financial services available to low- and moderate-income neighborhoods and disadvantaged rural areas.

The Program

The new program involves a variety of regulatory and other administrative changes which have been agreed to in principle by the agencies. These changes fall into five categories, each of which is discussed below.

Timing. The agencies will work to complete virtually all of the changes outlined below within the next three months. Once the specifics of any of the changes are agreed upon, that change will be made and published, while distribution of other changes remains to be made.

1. Eliminating Impediments to Loans to Small- and Medium-Sized Businesses

Reducing Documentation. Strong and well-managed banks and thrifts will be permitted to make and carry a basket of loans with minimal documentation requirements, consistent with applicable law. To ensure that these loans are made to small- and medium-sized businesses, there will be a ceiling on the size of such loans and limits on the aggregate of such loans a bank may make.

Encouraging Use of Judgment\Borrower's Reputation. The agencies will issue guidance to make it clear that banks and thrifts are encouraged to make loans to small- and medium-sized businesses, particularly loans in the basket discussed above, and to use their judgment in broadly assessing the creditworthy nature of the borrower — general reputation and good character as well as financial condition may be elements in making these judgments. Reliance on a broad range of factors when making a credit determination is especially important.

Other Assets Especially Mentioned. Improper use of the category of Other Assets Especially Mentioned (OAEM) may inhibit lending to small- and medium-sized businesses. Accordingly, the agencies will clarify that examination and rating procedures do not group OAEM loans with classified loans.

2. Reducing Appraisal Burden and Improving the Climate for Real Estate

The experience of the last decade has underscored the importance of sound underwriting standards and effective supervision for commercial real estate loans. Nonetheless, in certain instances regulatory burdens may be adversely affecting loans to sound borrowers. This may be particularly so in the case of loans secured by real estate that are primarily used for non-real estate business purposes. Real estate collateral is often pledged for loans to small- and medium-sized companies that have few other tangible assets.

Using Real Estate Appraisals Prudently. In some cases currently required real estate appraisals may not add to the safety and soundness of the credit decision. Indeed, in some cases, appraisals may prove so expensive that they make a sound small- or medium-sized business loan uneconomical. Accordingly, the agencies will make changes to their rules relating to real estate appraisals along the following lines:

- **Accept Additional Collateral**
  When real estate is offered as additional collateral for a business loan, both the time and expense involved in obtaining an appraisal from a certified or licensed real estate appraiser may discourage a bank or thrift from taking the collateral, may increase the cost of credit significantly, or even may cause the loan not to be made. In some such cases, the real estate appraisal requirement is counterproductive from a safety and soundness perspective. Moreover, the constraint on credit flows to sound businesses may be substantial. Accordingly, the agencies will alter their real estate appraisal rules so as not to require an appraisal by a licensed or certified appraiser for such loans.

- **Reexamine Appraisal Thresholds**
  Appraisals conducted by licensed and certified real estate appraisers, even on real estate of modest value can be quite costly. In the case of a smaller loan, the requirement of an appraisal by a licensed or certified real estate appraiser may make a sound loan uneconomical. Accordingly, the agencies will reexamine their existing rules to make certain that thresholds below which formal appraisals are not needed are reasonable.

- **Limit Periodic Appraisals**
  In some cases real estate appraisals have been required after a loan has been made, and in circumstances where the appraisal did not add to the safety and soundness of the loan. Accordingly, the agencies will work to make certain that real estate appraisals are required after a loan is made only when clearly needed for safety and soundness purposes, provided of course, that all requirements under law have been met.

Changing Rules on Financing of Other Real Estate Owned. Currently, accounting and other rules may discourage banks and thrifts from providing financing to borrowers who wish to purchase real estate classified as Other Real Estate Owned. The agencies will review rules relating to the reporting treatment and classification of such loans and make appropriate changes to facilitate financing to creditworthy borrowers, consistent with safe and sound banking and accounting practices.

Reviewing In Substance Foreclosure Rules. The inappropriate use of in substance foreclosure rules have required foreclosure valuation treatment of loans when borrowers were current on principal and interest payments and could reasonably be expected to repay the loan in a timely fashion. The agencies will work with the appropriate authorities to alter that treatment and to coordinate a change in accounting principles and reporting standards.

Avoiding Liquidation Values on Real Estate Loans. Loans secured by real estate should be evaluated based on the borrower's ability to pay over time, rather than a presumption of immediate liquidation. The agencies will work with their examination staffs to ensure that real estate loans are evaluated in accordance with agency policy.

3. Enhancing and Streamlining Appeals and Complaint Processes

Appeals. It is important for bankers to have an avenue by which they can obtain a review of an examiner's decision when they wish. For that reason, each of the agencies has established an appeals process. To ensure the effectiveness of those processes, each agency will take appropriate steps to ensure that its appeals process is fair and effective.

In particular, each agency will ensure that its process provides a fair and speedy review of examination complaints and that there is no retribution against either the bank or the examiner as the result of an appeal.

Complaints. Each of the agencies has a process to handle more general complaints from the institutions they regulate and from the general public. Although the volume of such complaints can be high, each agency recognizes that reviewing and responding to these complaints is an important element of proper supervision. The agencies are particularly concerned that complaints of discriminatory lending practices be handled with the utmost seriousness and on an expedited basis.

Accordingly, the agencies will review their complaint processes to improve both the care with which complaints are scrutinized and the timeliness of responses.

4. Improving Examination Process and Procedures

Reducing the Burden of the Examination Process. A proper examination of a bank or thrift by its very nature involves some disruption to the examined institution. Such disruptions, however, are costly to the institution and can interfere with its credit functions. It is highly desirable that examination disruptions be minimized.

Accordingly, the agencies have agreed to intensify efforts to minimize such disruptions and, in particular, to take the following steps: (i) eliminate duplication in examinations by multiple agencies, unless clearly required by law, (ii) increase coordination of examinations among the agencies when duplication is required, and (iii) establish procedures to centralize and streamline examination in multibank organizations.

Refocusing the Examination Process. If examinations are to fulfill their functions both in the areas of safety and soundness, fair lending, and consumer protection compliance, it is important constantly to reexamine the elements of the examination to determine whether the process is effective. Similarly, regulations and interpretations must continually be assessed to determine whether they are fulfilling these functions.

To improve the regulatory process, the agencies have agreed to heighten their emphasis in examinations on risk to the institution and to issues involving fair lending in place of areas that have become less productive over time. Agency policies and procedures will be reviewed with this focus in mind.

Reducing Regulatory Uncertainty. Uncertainty is part of the regulatory burden that banks and thrifts face and that contributes to their reluctance to make some credits available. This uncertainty can stem from ambiguous language in regulations and interpretations, from delays in publishing regulations and interpretations, and from failures to follow uniform examination standards that clearly reflect agency policies.

Accordingly, the agencies will review their regulations and interpretations to minimize ambiguity wherever possible and will step up efforts to publish regulations and interpretations required by law or sound regulatory practice. In addition, the agencies will reemphasize to their examiners to follow agency policies and guidelines carefully and accurately in carrying out examinations and reviewing applications. The agencies will make every effort to ensure that examination and application processing is performed uniformly across the country.

5. Continuing Further Efforts and Reducing Burden

Further Efforts. Additional items will be reviewed for possible change. One item that will be reviewed relates to the treatment of partially charged-off loans. Under current practice delinquent loans that have been partially charged off cannot be returned to performing status even when the borrower is able to, and fully intends to, pay the remaining interest and principal to the bank in a timely fashion. The agencies will work to develop common standards for determining when a loan may be returned to accrual status.

Paperwork Burden. No good is served by forcing banks to bear an excessive regulatory paperwork burden. Accordingly, the agencies have begun and will continue to review *all* paperwork requirements to eliminate duplication and other excesses that do not contribute substantially to safety and soundness.

Regulatory Burden. It is not paperwork alone that unnecessarily burdens banks and thrifts. Regulations and interpretations also may be unnecessarily burdensome. In some cases the passage of time has made regulations outmoded. In other cases the regulations may not have fulfilled their goals.

Accordingly, the agencies also have begun and will continue to review *all* regulations and interpretations to minimize burden while maintaining safety and soundness standards.

Distribution: FDIC-supervised banks (Commercial and Savings)

Joint Release

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

(PR-26-93)

Interagency Policy Statement on Documentation of Loans

March 30, 1993

The four federal regulators of banks and thrifts — the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the Board of Governors of the Federal Reserve System, and the Office of Thrift Supervision — today announced further details on the implementation of their March 10 program to increase credit availability. Today's policy statement outlines changes in the area of loan documentation.

The strongest banks and thrifts, those with regulatory ratings of 1 or 2 and with adequate capital, will now be able to make and carry some loans to small- and medium-sized businesses and farms with only minimal documentation. The total of such loans at an institution will be limited to an amount equal to 20 percent of its total capital. Eligible banks and thrifts will be encouraged to make these based on their own best judgment as to the creditworthiness of the loans and the necessary documentation. These loans will be evaluated solely on the basis of performance and will be exempt from examiner criticism of documentation.

Each minimal documentation loan is subject to a maximum loan size of $900,000 or 3 percent of the lending institution's total capital, whichever is less. If a borrower has multiple loans in the exempt portion of the portfolio, those loans must be aggregated before the maximum is applied. Loans to institution insiders — executive officers, directors, and principal shareholders — are ineligible for inclusion, as are loans that are already delinquent.

The package also offers some relief for banks that do not qualify for the program, and for loans that are not in the exempt portion of a bank's portfolio. The policy statement also includes guidelines which provide institutions some additional flexibility in applying their documentation policies for small- and medium-sized business and farm loans without examiner criticism.

Today's initiatives are directed at eliminating unnecessary documentation and reducing costs to lending institutions and the time it takes to respond to credit applications. OTS will soon issue a regulation to amend its current loan documentation requirements to comply with the statement. For banks, the program requires no change in existing regulations and is effective with today's release.

The complete program is being mailed to all regulated institutions and all examiners, and additional copies are available from the agencies.

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

Interagency Policy Statement on Documentation for Loans to Small- and Medium-sized Businesses and Farms

March 30, 1993

Introduction

Problems with the availability of credit over the last few years have been especially significant in the area of small- and medium-sized business and farm lending. This reluctance to lend may be attributed to many factors, including general trends in the economy; a desire by both borrowing and lending institutions to improve their balance sheets; the adoption of more rigorous underwriting standards after the losses associated with some laxities in the 1980s; the relative attractiveness of other types of investments; the impact of higher capital requirements, supervisory policies, and examination practices; and the increase in regulation mandated by recent legislation — specifically, the Financial Institutions Reform, Recovery, and Enforcement Act and the Federal Deposit Insurance Corporation Improvement Act.

The four federal banking agencies — the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the Board of Governors of the Federal Reserve System, and the Office of Thrift Supervision — expect small- and medium-sized business and farm loans, like all credits, to be made consistent with sound underwriting policies and loan administration procedures. The agencies are concerned, however, that institutions may perceive that the agencies are requiring a level of documentation to support sound small- and medium-sized business and farm loans that is in excess of what is necessary to making a sound credit decision. Unnecessary documentation raises the cost of lending to small- and medium-sized businesses and farms, results in delays in bank lending decisions, and may discourage good borrowers from applying. The agencies believe that the elimination of unnecessary documentation for loans to small- and medium-sized businesses and farms will reduce costs to the institution and the time it takes to respond to credit applications from small- and medium-sized businesses and farms without adversely affecting the institution's safety and soundness.

The federal banking agencies expect financial institutions to maintain documentation standards that are consistent with prudent banking policies. However, the maintenance of documentation beyond that necessary for a credit officer to make a sound credit decision and to justify that decision to the institution's management adds to loan administration costs without improving the credit quality of the institution. Unnecessary documentation impedes the institution from responding in a timely and prudent manner to the legitimate credit needs of small- and medium-sized businesses and farms in its community. Accordingly, the agencies are taking steps to correct any misunderstanding of regulatory requirements and to reduce regulatory impediments to lending to creditworthy small- and medium-sized businesses and farms.

Documentation Exemption for Small- and Medium-sized Business and Farm Loans

Well- or adequately capitalized institutions with a satisfactory supervisory rating will be permitted to identify a portion of their portfolio of small- and medium-sized business and farm loans that will be evaluated solely on performance and will be exempt from examiner criticism of documentation. While bank and thrift management will retain responsibility for the credit quality assessment and loan loss allowance for these loans, the lending institution will not be subject to criticism for the documentation of these loans.

This exemption will be available only to institutions that are well- or adequately capitalized institutions under each agency's regulations implementing section 38 of the Federal Deposit Insurance Act and that are rated CAMEL or MACRO 1 or 2. These institutions are by definition those that have demonstrated sound judgment and good underwriting skills; moreover, their strong capital position insulates the deposit insurance funds from potential losses that may be incurred through small- and medium-sized business and farm lending.

To qualify for the exemption, each loan may not exceed the lesser of $900,000 or three percent of the institution's total capital, and the aggregate value of the loans may not exceed 20 percent of its total capital. In addition, loans selected for this exemption by an institution must not be delinquent as of the selection date, and each institution must comply with applicable lending limits and other laws and regulations in making these loans. Furthermore, such loans may not be made to an insider.

Small- and medium-sized business and farm loans that do not meet the criteria for exemption set forth in this policy statement would continue to be reviewed and classified in accordance with the agencies' existing policies.

The details of the exemption are as follows:

- **Documentation exemption.** Each institution eligible for the exemption provided in this policy statement may assign eligible loans, subject to the aggregate limit on such eligible loans, to an exempt portion of the portfolio. Loans assigned to this exempt portion will not be reviewed for the completeness of their documentation during the examination of the institution. 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.

- **Restrictions on loans in the exempted portion of the portfolio.** The institution must fully evaluate the collectibility of these loans in determining the adequacy of its allowance for loan and lease losses (ALLL) or general valuation allowance (GVA) attributable to such loans and include this evaluation in its internal records of its assessment of the adequacy of its ALLL or GVA. Once a loan in the exempt portion of the portfolio becomes more than 60 days past due, the loan may be reviewed and classified by an examiner; however, any decision to classify would be based on credit quality and not on the level of documentation.

- **Eligible institutions.** An institution is eligible for the documentation exemption if (1) pursuant to the regulations adopted by the appropriate federal banking agency under section 38 of the FDI Act, the institution qualifies as well- or adequately capitalized, and (2) during its most recent report of examination, the institution was assigned a composite CAMEL or MACRO rating of 1 or 2.

- **Ineligible loans.** Loans to any executive officer, director, or principal shareholder of the institution, or any related interest of that person, may not be included in the basket of loans.

- **Aggregate limit on loans.** The aggregate value of all loans assigned to the basket of loans provided for in the exemption may not exceed 20 percent of the institution's total capital (as defined in the capital adequacy standards of the appropriate agency).

- **Limit on value of individual loan.** A loan, or group of loans to one borrower, assigned to the basket of loans provided for in the exemption may not exceed $900,000 or 3 percent of the institution's total capital (as defined in the capital adequacy standards of the appropriate agency), whichever is the smaller amount.

- **Transition from eligibility to ineligibility.** An institution that has properly assigned loans to the exempt portion of its portfolio pursuant to this statement but subsequently fails to qualify as an eligible institution may not add new loans (including renewals) to this category.

Treatment of Small- and Medium-sized Business and Farm Loans Not Qualifying for Exemption

The agencies will continue current examination practices with regard to documentation of small- and medium-sized business and farm loans at institutions not qualifying for the exemption and loans at qualifying institutions that are not assigned to the exempt basket. The guiding principle of agency review will continue to be that each insured depository institution should maintain documentation that provides its management with the ability to:

(a) make an informed lending decision and to assess risk as necessary on an ongoing basis;

(b) identify the purpose of the loan and the source of repayment;

(c) assess the ability of the borrower to repay the indebtedness in a timely manner;

(d) ensure that a claim against the borrower is legally enforceable; and

(e) demonstrate appropriate administration and monitoring of a loan.

In prescribing the documentation necessary to support a loan, an institution's policies should take into account the size and complexity of the loan, legal requirements, and the needs of management and other relevant parties (such as loan guarantors).

In applying these standards, the agencies will continue to recognize the difficulty and cost of obtaining some documents from small- and medium-sized businesses and farms. These difficulties and costs could result in some deviations from an institution's own loan documentation policy for small- and medium-sized business and farm lending. Such deviations are frequently based on past experience with the customer. In such cases, the loan will not be criticized if the examiner concurs that sufficient information exists to serve as a basis for an informed credit decision.

Implementation

This policy statement will take effect immediately upon issuance. However, the agencies will monitor how qualifying institutions implement its provisions and how those institutions and the loans they designate for inclusion in the exempt basket perform. Changes to this policy statement may be made based on the agencies' experience.

Distribution: FDIC-supervised banks (Commercial and Savings)