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NEWS RELEASE

FOR IMMEDIATE RELEASE PR-68-72 (10-25-72)

TWO NEW INPUTS FOR THE COMMERCIAL LENDING OFFICER

Remarks

of

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Before the

58th Annual Fall Conference
The Robert Morris Associates

Americana Hotel
Bal Harbour, Florida
October 16, 1972

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The commercial lending officer in today's bank is being pressed on so many sides by new things to consider in the performance of his duties that we in the supervisory ranks are continually impressed by his sophistication and creativity. You are extending credits these days, not only on the basis of your skills in predicting repayment, but with an eye to social consequence, new legislation enacted at the Federal, State or local levels, and more rigorous standards of conduct imposed by administrative agencies and the courts. By and large, you are responding successfully to these unaccustomed variables in your job, and I hesitate even to discuss the two items on my agenda this morning which may only add to the complexities of your day-to-day jobs. The first concerns some new insights, based on research financed by the FDIC, into commercial loan experience with new black businesses and the second is intended to bring to your attention the significant liabilities to which banks may be subject, under some circumstances, when commercial borrowers violate the federal securities laws.

Commercial Lending to Black Businesses

You are well aware of the major effort which has been made over the past decade to encourage lending institutions, especially those operating in or near urban centers which are heavily populated by minorities, to increase their loans to members of minority groups. Banks have responded both by developing their own special programs and by participating in various programs sponsored by the federal government, such as the loan guarantee program of the Small Business Administration. Under this plan a bank and the SBA execute one blanket or master guarantee agreement against which all subsequent loan transactions by the bank are written. The program is based on the conviction that the minority resources seeking to find expression in business would be employed and developed only if bankers accepted the principle of less stringent credit requirements for loans to minorities. To encourage bankers to assume some of the higher risks which it was asking them to undertake, the SBA, under Project OWN, agreed to assume from 90 to 100 percent liability for loans which became delinquent. With the SBA assuming most of the risk on jointly approved loans, banks increased their rate of lending to minority-owned businesses by more than 800 percent during the first seven months of the project.

Viewing the SBA programs solely in terms of the volume of loans made to existing minority-owned businesses and to members of minority groups starting new businesses, they would have to be judged a success. However, the purpose of these programs is to generate a continually increasing flow of funds to minority-owned enterprises. Consequently, the rate at which funds are lost through default is critical to the future development of these programs. On this basis, the SBA guarantee program has not been nearly so successful.

Examination of one sample of loans recorded at the New York, Chicago, and Boston Offices of the SBA indicates that of the 559 loans made by banks to minority businesses between June 1967 and June 1970, 48.8 percent were in default in the summer of 1971. A similar sample of 310 SBA guaranteed loans to white businesses in the same cities made during the same period showed 36.1 percent in default. These figures indicate some success in getting bankers to be less stringent in judging applications for credit through the SBA guarantee programs than they would be in determining credit worthiness without a guarantee. But the high rate of default on all loans and the differential in the default rates between minority borrowers and white borrowers raise a number of questions. Certainly any bank credit screening procedure that leads to default rates of this magnitude is open to criticism. Perhaps even more importantly, however, we must ask whether the higher default rate among loans to minority businesses is due to more liberal credit standards being employed by bank lending officers in evaluating such applications or whether it results from the use of possibly inappropriate credit evaluation criteria which fail too often to identify poor credit risks among minority borrowers.

Some recent research financed by the FDIC under its Dissertation Fellowship Program bears directly on this issue. This program was instituted by the FDIC about four years ago to promote research in banking and related fields and to improve and expand the information available to the bank supervisory agencies, and the banking community. The fellowships give graduate students an opportunity to devote full time to research while writing their dissertations, and have provided financial aid to fifteen graduate students whose dissertations have related to banking, financial markets, and monetary policy.

One of last year's recipients, Timothy M. Bates, studying at the University of Wisconsin, directed his research at an examination and evaluation of the minority loan programs of SBA. His research was directed very specifically at two points of fundamental importance to any lending officer who must establish credit screening techniques to judge loan applications of minority businesses. First, he examined the determinants of profitability among white and black firms that have received loans from the SBA and second, he analyzed alternative criteria to determine the credit worthiness of minority business loan applicants. His results suggest the need for innovation in the credit evaluation procedures employed by commercial banks when dealing with minority business.

The data for this study consisted of information gathered from the New York, Chicago and Boston offices of the Small Business Administration. Selected balance sheet data, income figures, and personnel profile information were secured for samples of 559 black business loan applicants and 310 white applicants.

Since the ability of a firm to generate net profits is of obvious and foremost concern to anyone who considers lending to that firm, the first major portion of the study concentrated on the relative importance of the factors which determine profitability among the white and black sample firms, respectively. Certain of these profitability factors were surprisingly similar for each group of firms. Thus, the return to net worth for the black firms was found to be 14.43 percent while for the white owned business the figure was 15.30 percent. For both groups of firms it was found that there is a very high penalty for being illiquid though the actual incidence of illiquidity was most common among the black enterprises. It was also found that if the owner of the business enterprise holds another job, profits will be reduced on average by about $2,000. That figure was almost identical for both groups.

The areas in which factors bearing on profitability were found to have different impacts between black and white firms involved entrepeneural experience and staff size. While the results on these points are uncertain and subject to further research, it would appear that prior managerial experience on the part of the owner has very little impact upon the level of profitability of a small business enterprise. Hence, it is possible that very little importance should be attached to this factor in evaluating the potential success of the enterprise. Concerning staff size, the results suggest that black firms tend to overhire. It appears that while white firms can increase profitability by expanding employment, black firms have an overly large number of employees relative to current operations. This finding is difficult to interpret. It may mean that black firms have in fact overhired both for their current size and for their near term prospective size. On the other hand, it could mean that black firms are legitimately preparing for future growth and that a policy of overhiring relative to present volume is actually optimal for prospective near-term growth.

It must be noted, of course, that the black firms were being compared with a particular type of white firm. The white firms were probably of less than average profitability compared to the total business population. In addition, the fact that they were borrowing under the SBA's loan guarantee program would indicate further that they probably did not have the alternative of seeking funds directly from the private sector. Thus, when we note the strong similarity between the black firms and the white firms being sampled as to the factors that determine profitability, it is with this group of white firms that the comparison is being made.

One additional observation based on the first part of this study should be noted. It is clear from a profile of the businesses represented that the newer black owned firms that have been provided access to capital through programs such as Project OWN are entering fields not previously occupied by blacks. Tests performed in this study suggest that the primary reason that blacks concentrated their efforts for such a long time in narrowly circumscribed fields like laundries, grocery stores, funeral parlors and so on in minority areas was not only that these kinds of businesses were generally left to them by white businessmen but perhaps, more importantly, because these were fields in which one could begin and continue operations with very little capital -- access to which might then not have been generally available to blacks. Now that capital is being made more generally available to blacks, we find blacks successfully entering more capital-intensive fields and concentrating less on the previously "protected" fields. The implications for the loan officer are important. Black business loan applications can be expected in all areas of commerce and they should be accepted on an equal basis. It was primarily lack of access to the capital markets which previously prevented blacks from operating outside these narrow areas.

The second major portion of Mr. Bates' work involved an examination of alternative loan evaluation criteria to ration available funds among minority business loan applicants. I mentioned previously that the default rates for the SBA guaranteed loans have at times exceeded 36 percent for loans to white firms and 48 percent for loans to black firms. These figures suggest that lending institutions have been employing less than adequate criteria to judge the relative credit worthiness of their loan applicants. Moreover, the differences in the rates imply that it may be appropriate to use a different set of criteria for screening minority applicants than those usually employed. In this study, an attempt was made to develop more effective credit screening procedures. The black and white loan samples were first divided into two groups consisting of good loans whose payments were current, and bad loans that were over 60 days delinquent. A statistical technique known as discriminant analysis was then used to construct separate sets of weights to be applied to those characteristics of the white and black applicants which best distinguished the good and bad credit risks. If appropriately constructed, these weights might then be used to predict more accurately potential delinquencies among new applicants. To determine whether the same or different criteria should be applied to black as well as white applicants, the set of weights developed for the white loans was applied to the sample of black loans. This exercise is interpreted as being equivalent to a white banker applying his traditional set of loan evaluation criteria to black loan applicants. The results indicate that not only would more loans to blacks have been granted using the weights for the white sample as opposed to those for the black sample but also that a third more black loans would have become delinquent using the weights for the white sample rather than the weights developed specifically for the black sample. This suggests that different criteria should be applied in evaluating minority applications and white applications, and this conclusion gains additional support from a detailed analysis of the characteristics and the associated weights used to separate good and bad credit risks.

A total of nine characteristics were originally employed as potentially important factors. These included measures of total assets, the use to be made of the loan proceeds, credit rating of the applicant, business net worth, liquidity, repayment ability, outside net worth, outside income of the owner and previous managerial experience. Unfortunately, the techniques used do not permit us to identify the precise degree to which one or more of the above characteristics may be more important in judging black applications than in judging white applications or the precise weight to be given the factors that are important in evaluating either type of application. The results do, however, allow us to make some rough approximations. For example, one variable which appeared to be relatively important in distinguishing between good and bad credit risks among white loan applicants was business net worth. However, it seemed to have virtually no importance in distinguishing between good and bad credit risks among black loan applicants. For this reason, it was excluded from the black criteria. In fact, neither business net worth nor any other leverage measure seemed to be important in distinguishing between those black firms which met their loan payments and those which did not. It also appeared that different measures of liquidity should be applied to black loan applicants than to white applicants.

Even as to those characteristics that appeared important in evaluating both groups, it appears that different weights may be appropriate for black loan applicants than white loan applicants. In particular, the historical credit experience of the owner and the firm as measured by the credit rating factor appeared to be much more important in judging white applicants than blacks. The same was true for the factor reflecting repayment ability. Similarly, different weights were also given to management experience, liquidity, and firm size.

The results of this research imply the following conclusions. First, the most important determinations of the profitability of minority enterprises are very similar to the factors explaining the profitability of nonminority firms. Second, improved access to credit and capital markets is likely to cause the pattern of development of black businesses to be very different in the future from what it was when blacks concentrated their efforts in a few traditional lines of commerce. Third, the criteria by which the credit worthiness of black business loan applicants should be judged is probably different from the criteria which should be employed with white business loan applicants. In other words, different standards should probably be developed specifically for black businesses if more accurate predications are to be made as to their credit worthiness.

Possible Bank Liability under the Federal Securities Laws for Violations by Borrowers

The commercial lending officer these days also needs to know more about the growing reach of our federal securities laws, not so much brought about by new legislation or SEC regulations as by court decisions. Increasingly, persons and institutions only peripherally involved in the unlawful conduct of others are being held to full liability themselves, and the damages and penalties prescribed can be extraordinarily severe.

The legal doctrine of "aiding and abetting" the violations of another is still evolving, but the essential elements are actual or constructive knowledge of another's violation, coupled with conduct which substantially assists or encourages the wrongdoer. The doctrine resembles the concept of conspiracy, but is generally satisfied by a lesser degree of involvement than would be required to establish conspiracy in any criminal sense. Indeed, one United States Court of Appeals has stated that under the anti-fraud provisions of the federal securities laws, "liability predicated on aiding and abetting may be founded on less than actual knowledge and participation in the activity proscribed." Even if the limits of the doctrine are not settled, one thing is perfectly clear: where liability does apply, it is as complete as that of the principal violator. Thus, it is conceivable that a bank which is found to have aided and abetted a violation of the disclosure requirements governing a distribution of securities, could be liable -- where the company had become insolvent -- for the entire amount of the offering. And, in certain circumstances where trading in the after-market has been effected on the basis of the inadequate disclosures, the bank could be liable not only for the amount of the offering but for losses experienced by persons trading in the stock in the after-market. What is more, the bank and the bank's officers most involved could also be subject to criminal and injunctive sanctions.

Among the many and varied situations in which liability can arise under the "aiding and abetting" doctrine are several which should concern the commercial lending officer. One such matter of present interest to the Securities and Exchange Commission, as Chairman Casey told the American Bankers Association six months ago, is the use of bank loans as artificial "window dressing" for a company's financial statements. An illustrative case is the SEC's 1970 action against Liberty Equities Corporation, wherein it was alleged that a bank participated in a fraudulent scheme to bolster the company's financial position by engaging in a transaction where a loan was coupled with the immediate purchase of intermediate-term, non-negotiable, non-interest bearing certificates of deposit as collateral. This transaction, according to the SEC's complaint, served no legitimate business purpose and was not disclosed by the company in its various filings with the SEC and its reports to stockholders. The company then artifically improved its working capital position by further misrepresenting the terms of the certificates of deposit. The bank consented to the injunctive relief requested without admitting or denying the allegations. Similarly, the SEC has been calling for full disclosure of compensating balance arrangements where in fact such arrangements are part of the terms of a loan. Accountants' requests to banks for loan confirmations now often include pointed questions concerning such compensating balances or other arrangements between the bank and its customer which in economic reality affect the overall cost of the borrowing. Although the primary responsibility for such disclosure rests with the company, the bank must truthfully reply to such inquiries at the risk of incurring liability if the company is later found to have violated the securities laws by a misdescription of its loan arrangements.

Attorneys in the Legal Division at FDIC recently were confronted with a similar problem. A State nonmember bank had made a substantial loan to a fledgling company which then made a public distribution of its stock. In its offering material, the company misdescribed the loan proceeds as merely representing a non-interest bearing advance from a shareholder. While the stock distribution was in progress, the loan reached maturity and the company's officers approached the bank for an extension. In doing so they requested that the loan be recast with the shareholder as the maker of the note, so that the transaction would more closely approach the one described in the company's offering circular. It was apparently agreed that after completion of the stock offering, the loan would be reconverted as once again the primary obligation of the company. After discussions between FDIC's staff and the bank's management and counsel, the bank determined that its potential liability as aider and abetter in the situation warranted a discussion with the company concerning what steps could be taken to absolve the bank of any liability that may have been created by the misrepresentation. The company shortly thereafter reported the matter to the SEC and is preparing to make a voluntary rescission offer covering the stock issued in the distribution.

The SEC staff has also suggested that where loans to corporate officers and directors are based in part upon compensating balance deposits by the corporation, such arrangements may constitute an item of indirect remuneration by the corporation to the executives involved. As such, it may have to be reflected in proxy, registration statements, prospectuses and other documents filed with the SEC. Banks should not be surprised if legal counsel preparing such SEC filings inquire about the arrangement and should know that the failure to disclose the true situation could render the bank vicariously liable for any violations of the securities laws by the corporation.

Another area in which commercial lending officers must be wary of aiding and abetting liability concerns the bank's relations with investment companies and their affiliates. The Investment Company Act of 1940, recognizing the delicate and vulnerable nature of investment companies, generally prohibits transactions between such companies and their affiliates without prior SEC approval. Investment companies, of course, may have a great deal of cash and other liquid assets which could be deposited with banks at the direction of controlling affiliates, on disadvantageous terms to the investment company, in order to obtain special treatment for its affiliates from the bank. In a current SEC proceeding involving an investment company and several banks, it is alleged that the banks knowingly participated in a violation of the affiliate transaction provisions of the Investment Company Act where funds of an investment company were unlawfully utilized to purchase certificates of deposit to support loans made to an affiliate. The moral of this proceeding is that a bank which acts as depository for an investment company must be very careful in its dealings with an affiliate of the investment company to insure that the nature and terms of the transaction cannot credibly support changes of improper favoritism.

Another important area where bank's lending activities can lead to potential aider and abetter liability is in the financing of tender offers. Under the governing SEC regulations, the acquiring company's financing arrangements must be disclosed in detail, although the identity of the lending bank may be treated confidentially upon request. While it is, of course, the primary responsibility of the company to describe its financing arrangements adequately, a lending bank could become liable as an aider and abetter where the bank knew or should have known of a company's misdescription of the arrangements.

These examples of potential aider and abetter liability will suffice to point up the substantial dangers in this area, but I would caution you that the list is by no means exhaustive. Moreover, with such rich targets as banks, lawsuits brought by disgruntled shareholders can be expected to proliferate and many will be urging significant extensions of the doctrine.

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