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Administrative Office
c/o Professor George Kaufman
Loyola University of Chicago
820 North Michigan Avenue
Chicago, Illinois 60611
TEL (312) 915-7075
FAX (312) 915-6118

Statement No. 94

For information contact:

Edward J. Kane
(617) 552-3986

Statement of the Shadow Financial Regulatory Committee

on

**The Policy of Authorizing "Minimal
Documentation" Loans**

May 24, 1993

On March 10, 1993, the Clinton Administration outlined a program of regulatory and supervisory changes intended to improve credit availability for small and medium-sized businesses and farms. A central purpose of the program is to boost the speed of macroeconomic recovery by discouraging government examiners from penalizing deposit institutions for expanding their exposure to reasonable credit risks.

Parts of the program dealing with real estate lending and collateral, examination procedures, and appeals of examiner decisions are still unfolding. However, on March 30, federal agencies regulating banks and thrifts issued a joint policy statement aimed at streamlining credit-application procedures for designated business and farm loans at strongly capitalized banks. The interagency statement directs examiners to evaluate these loans solely on the basis of ex post performance. Also, the documentation of the loans that an eligible institution categorizes as qualifying for the program are virtually exempted from examiner criticism.

To be eligible for the documentation exemption, an institution must have received a CAMEL or MACRO rating of at least 2 at its most recent examination and be officially classified as "well" or "adequately" capitalized. The amount of credit for which an eligible bank claims exemption cannot exceed 20 percent of the bank's total capital (i.e., the

total of tier one and tier two capital). Individual loans are limited to the lesser of \$900,000 or 3 percent of a bank's total capital.

The Shadow Financial Regulatory Committee has long endorsed the wisdom of subjecting the risk-taking decisions of soundly capitalized deposit institutions to less intense supervisory attention than parallel decisions made at weaker firms. This would free the agencies to assign supervisory resources to more productive uses. It would also promise a reduced supervisory burden for healthy banks to serve as a reward for managers who strengthen their bank's balance sheet.

For this differential strategy to be pursued safely requires that longstanding weaknesses in supervisory procedures for evaluating the capital adequacy and riskiness of deposit institutions be shored up. The Committee has repeatedly warned that regulators' current approach to measuring bank and thrift capital is unnecessarily slow to recognize important types of deterioration in an insured institution's ability to meet its accumulated liabilities from its own resources. Examination infrequency and difficulties in assessing the adequacy of loss reserves cause CAMEL and MACRO ratings to lag behind changes in a bank's economic strength, while standards used to define adequately capitalized institutions have been far from tight.

The Committee is also concerned that exemptive programs not be used to subvert the objective of bank examination to uncover and remedy excessive risk-taking and weaknesses in internal controls against managerial fraud, carelessness, and incompetence before they spawn sizeable losses. The worrisome aspect of this program is its potential to act as a foot in the door for reducing examiner accountability. Analysis of a business borrower's managerial capacity, capital, collateral, and potential vulnerability to changing economic conditions is an age-old part of credit analysis. Constraining bank examiners from criticizing particular weaknesses in a designated class of loans could expand to block the flow of important information between on-site examiners and other responsible parties. To protect the federal deposit insurance funds, communication channels between federal examiners and bank officers, boards of directors, and top agency officials should be kept as open as possible.