Testimony before the Senate Committee on Banking, Housing, and Urban Affairs
Subcommittee on Economic Policy
Hearing on "Restoring Credit to Main Street:
Proposals to Fix Small Business Borrowing and Lending Problems"

Raj Date
Chairman & Executive Director
Cambridge Winter Center for Financial Institutions Policy

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Thank you, Chairman Brown and Ranking Member DeMint, for inviting me to speak to you about the causes of, and potential solutions to, small business credit contraction.

My name is Raj Date, and I am the Chairman and Executive Director of the Cambridge Winter Center. Cambridge Winter is a non-partisan think tank dedicated exclusively to researching U.S. financial institutions policy issues.[1] Before Cambridge Winter, I had spent virtually my entire career in and around financial services -- in consumer finance, in commercial banking, and on Wall Street. Based on that experience, and on the work of Cambridge Winter, my hope is to provide you with a few practical observations on the state of the marketplace, and to suggest some principles by which you might measure alternative solutions.

This is, as you know, an important issue. Small business credit is tight. FDIC data shows that banks' commercial loan balances, which include small business loans, have already declined by more than $500 billion since the onset of the crisis.[2] I fear that we are at something of a transition point in the marketplace today: the point at which credit contraction becomes less driven by a rational decline in demand for loans, and becomes more driven by a structural shortfall in supply.

Absent structural remedies to that supply problem, the lack of small business credit could become a serious impediment to both the timing and speed of a recovery in the real economy.

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[2] FDIC-insured banks' and thrifts' on-balance sheet commercial loans declined by a cumulative $504 billion over the past five quarters. FDIC, Quarterly Banking Profile Graph Book, page 33 ("FDIC Graph Book") (December 2009).

1. Demand issues

Let me begin by discussing the demand for small business lending. Small business people, in general, are a financially conservative lot. As their own revenue prospects become uncertain, as happens in every recession, they quite prudently tend to shy away from debt financing. Given that natural decline in demand, relatively few small business owners today see the lack of small business credit as their most significant or pressing issue.[3]

The typical recession-driven decline in demand has been accentuated in this downturn by a disconnect on pricing. It is probably not surprising that borrowers, in general, believe that they are more credit-worthy than do their lenders. That is human nature, and in small business lending it is especially true. Prudent lenders should, implicitly or explicitly, consider a number of factors in pricing credit: (1) the small business's cash flow trajectory and resilience; (2) performance history; (3) existing debt load; (4) collateral value and stability; (5) credit quality and character of guarantors; (6) cost of funding; (7) structural interest rate risk; and (8) the asset-liquidity of the loan, once originated. But small business borrowers, which almost definitionally lack professional financial management, typically do not appreciate some of those factors (funding costs, rate risk, and asset liquidity chief among them), and as a result are dissatisfied when those factors drive pricing dramatically higher, as they have in the crisis.

Over the last decade, moreover, small business borrowers' most frequent market signal about their own credit-worthiness came from billions of direct marketing messages from prime credit card issuers. The prime credit card business had come to be dominated by teaser-rate pricing practices, coupled with non-transparent risk mitigation features (e.g. universal default repricing, double-cycle billing, unilateral line decreases). One of the many negative features of teaser-rate marketing is that, when small business owners are, today, confronted with more transparent risk-based pricing, the result is sticker shock. Thankfully, given recent legislation that mandates decidedly more transparent card pricing practices,[4] this pronounced disconnect between borrowers and lenders should reduce over time.

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[3] *See* National Federation of Independent Businesses, "Small Business Credit in a Deep Recession", page 3 ("NFIB Survey") (February 2010).

[4] Credit Card Accountability Responsibility and Disclosure Act of 2009, Pub. L. 111-24, 123 Stat. 1734 (May 22, 2009).

Of course, some apparently credit-worthy small businesses have had a difficult time securing financing over the past year. We have all seen considerable anecdotal evidence to that effect. On balance, though, it is quite likely that the decline in commercial credit *so far* has been more driven by a drop in demand than any other factor.

2. Supply issues

Over the coming quarters, however, the binding constraint on small business lending will shift from a deficit of demand, to a deficit of supply.

As the real economy begins to recover, we should expect demonstrably credit-worthy small business owners to begin to demand credit in greater amounts. As that demand materializes, however, it is quite possible that it will go unmet by the financial system. Indeed, it seems likely that the threat of a shortfall of credit supply will be more pronounced in small business than anywhere else in the credit markets. The reason for this is a structural shift that has been catalyzed by the crisis: the "re-localization" of small business lending.

a. Contraction in national-scale products and firms

Small business finance is, for many firms, tightly intertwined with consumer finance. Because most small businesses are often quite small indeed, their liquidity sources and uses are frequently related to, and even commingled with, the liquidity positions of their owners.[5] As a result, the rapid expansion of consumer financial products in the decade leading up to the crisis -- especially revolving prime credit cards, and cash-out home equity loans -- satisfied an increasing fraction of small business credit needs.[6]

Unfortunately, neither the prime credit card business nor the cash-out home equity business appear to have been particularly suited to withstand an economic downturn. Both businesses, which had become marked by high credit line strategies during the bubble, came under major pressure as unemployment rates climbed. For a lender, high open lines of credit are a recipe for disaster during a recession. In essence, high credit lines tend to be drawn down

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[5] *See* NFIB Survey, *supra* note 3, at page 17.

[6] For example, nearly half of small businesses use personal credit cards for transactions or credit extension. Federal Reserve Board, "Report to the Congress on the Availability of Credit to Small Businesses, pages 29-31 (October 2007); *see also* Charles Ou and Victoria Williams, "Lending to Small Businesses by Financial Institutions in the United States", SBA Office of Advocacy ("SBA Advocacy Finance Report") (July 2009).

disproportionately by borrowers facing adversity, while borrowers in solid financial shape do not draw their lines, and therefore do not add to lenders' net interest margins. Credit losses increase, but net interest margins do not grow. As a result, when faced with climbing unemployment, prudent lenders cut credit lines dramatically.[7] Industry-wide, available home equity and credit card lines have declined by an astonishing $1.6 trillion, or 30%, over the past two years.[8] Massively reduced consumer credit availability, of course, also impacts small businesses.

In addition to the rapid diminution of important lending categories, the past two years have seen the disruption of a wide swath of small business and middle-market commercial finance firms. For decades, much commercial finance activity -- like equipment finance, inventory finance, or receivables finance -- migrated from deposit-funded banks to capital market-funded finance companies. With a benign credit environment, accommodating ABS market investors, and a substantial regulatory capital arbitrage versus banks, many of these firms grew to extraordinary size. The commercial lender CIT, for example, boasted after its crisis-driven conversion into a bank holding company that it was the seventh largest bank in the nation, ranked by commercial and industrial loans. By that metric, CIT was a larger commercial lender than such major regional banks like SunTrust or Regions Financial.[9]

Once the capital market bubble collapsed, unfortunately, these large non-bank finance companies were forced to retreat from the market. GE Capital, for example, apparently plans to shrink its portfolio by some $80 billion over the next few years.[10] Although that down-sizing

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[7] *See* Ed Gilligan, American Express Financial Community Meeting, slides 15-20 (February 3, 2010) (illustrating importance of credit line decreases to credit risk mitigation among high-line prime accounts). Some academics appear to have linked credit line decreases to the reforms enacted by the Credit CARD Act. *See* Todd J. Zywicki, "Testimony Before the U.S. House of Representatives Committee on Financial Services and Committee on Small Business", pages 5-6 (February 26, 2010). In reality, line decreases began well before the legislation was passed, and extended beyond credit card to other asset classes. *See infra* note 8.

[8] FDIC, "Assets and Liabilities of FDIC-Insured Commercial Banks and Savings Institutions", Quarterly Banking Profile (December 2009).

[9] Jeffrey M. Peek, CIT's Presentation at the Credit Suisse Financial Services Conference, slide 14 (February 2009). Despite the conversion of its Utah ILC into a state-chartered bank, the attendant conversion of the CIT parent company into a bank holding company by the Federal Reserve, and the infusion of $2.3 billion in TARP capital by the Treasury, CIT filed for bankruptcy. Taxpayers lost the entirety of their TARP capital investment. *See, e.g.,* Michael J. de la Merced, "Creditors Back CIT's Bankruptcy, *The New York Times* (November 1, 2009).

[10] Jeffrey R. Immelt, "GE Renewal", GE Annual Outlook Investor Meeting, slide 14 (December 15, 2009).

would only represent 15-20% of GE Capital's current size, it implies a reduction in GE's aggregate lending that is roughly equivalent to the entire *combined* commercial and industrial loan books of the large regional banks Fifth Third, Comerica, and KeyCorp.[11]

The credit crisis, then, has simultaneously and dramatically reduced the availability of important nationally marketed lending products, as well as the credit capacity of large national finance companies. Structurally, the market for small business credit would appear to shifting away from national-scale products and firms, and "re-localizing" to regional and community banks.

b. Constraints among regional and community banks

Over the long term, the re-localization of small business lending is good news. The financial system would be more resilient if it relied less on very large non-banks that fund themselves in confidence-sensitive wholesale markets, and instead relied on deposit-funded banks that are not "too big to fail."[12] Regional and community banks are also the most natural underwriters of small business credit risk, given their in-market presence and focus.

Over the near term, unfortunately, such banks face major challenges. Without intervention, regional and community banks will almost certainly not be able to replace the small business credit capacity that has otherwise disappeared from the market.

There are two problems.

The most serious problem is small banks' capital constraints. Small banks tend to be heavily concentrated in commercial real estate, and those portfolios will continue to be pressured.[13] Notably, small banks tend to lack the capital markets businesses of larger competitors, which have been major profit centers lately. Small bank margins have also been compressed, relative to larger firms, by an exceedingly low rate environment, which tends to disproportionately harm

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[11] "Bank Holding Companies with the Largest U.S. Business Loan Portfolios", *American Banker,* (February 19, 2010).

[12] *See generally* Raj Date and Michael Konczal, "Out of the Shadows: Renewing Glass-Steagall for the 21st Century", *Make Markets Be Markets*, Roosevelt Institute (March 2010).

[13] *See* FDIC Graph Book, *supra* note 2, at pages 5, 21, and 37; Congressional Oversight Panel, "Commercial Real Estate Losses and the Risk to Financial Stability" (February 10, 2010).

banks with high-quality commercial deposit bases.[14] Given this bleak outlook, and the relative difficulty of small banks' accessing new pools of equity capital. it is much more likely that small banks will shrink their lending books over the coming years, not grow them.[15]

There is a second, and less remarked-upon, problem with small banks' small business lending growth: missing capabilities. It is true that the smallest banks (those under $1 billion in assets) are disproportionately concentrated in business lending, as compared to their larger brethren. But most of small banks' concentration in business lending is attributable to their heavy focus on commercial real estate lending.[16] By contrast, the credit capacity that has most dramatically left the market is in *non*-real estate lending -- that is, the lending that had been satisfied, during the bubble, in major part by credit cards, home equity loans, and non-bank finance companies. And it is non-real estate lending that constitutes the majority of small business finance, particularly in certain capital-intensive sectors, like manufacturing.[17]

3. Evaluating alternatives

With this context in mind, and mindful of the track record of past policy efforts, I would suggest three criteria to evaluate alternative policy solutions to the small business credit crunch.

a. Recognize the limits of direct government credit-decisioning.

First, we should recognize the limits on the government's ability, on its own, to quickly and competently direct the flow of commercial credit.[18]

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[14] Commercial deposits typically are not interest-bearing, so a low rate environment does not create lower funding costs (because the interest paid does not become negative). A low rate environment can, however, encourage lower asset yields. The result is a net interest margin squeeze.

[15] It is important to note that although bank capital is pressured, bank funding is not, in general, a constraint for banks today. The FDIC-led measures to backstop a wider range of liabilities have had their intended effect. Banks are holding substantial cash positions, and have invested in steadily growing portfolios of low-risk government and GSE securities, rather than more capital-intensive consumer and commercial loans.

[16] Commercial real estate constitutes fully 29% of of the loan portfolios of banks with under $1 billion in assets; larger banks have only 13% of their portfolios in commercial real estate. FDIC Graph Book, *supra* note 2, at page 21.

[17] *See* SBA Advocacy Finance Report, *supra* note 6, at page 28.

[18] The credit-fueled downfall of Fannie Mae and Freddie Mac is a useful case study on this issue. *See* Raj Date, "The Giants Fall: Eliminating Fannie Mae and Freddie Mac", *Make Markets Be Markets*, Roosevelt Institute (March 2010).

Given the generally negative reaction of both banks and the public to the original TARP capital infusions, it is tempting to imagine that small business credit might be extended by the government directly, without requiring bank intermediation at all. Unlike in education finance, however, there is no existing government apparatus by which to generate, evaluate, negotiate, and close small business loans in the primary market. Even for the SBA, which would be the most relevant existing agency, building and scaling up such an effort would be a massive and complicated undertaking. Given the growing size and urgency of small business credit contraction, working through bank intermediation would appear far more practical. To its credit, this is the approach adopted by Administration's proposed Small Business Lending Fund (the "SBLF").[19]

b. Do not reward the worst banks.

The second principle we should remember is that not all banks are the same; we should not treat them as though they were.

The central conceptual failing of the original TARP capital infusion plan was that it deliberately created a one-size-fits-all investment structure disproportionately valuable to the worst banks. All banks received the same amount of capital; all banks paid the same price. As a result, the TARP investments managed to neither create a credible endorsement that could entice private capital, nor did they provide any competitive benefit to firms that actually had demonstrated an ability to make wise credit risk-return decisions.[20] The Administration's SBLF proposal -- at least as it has been described so far -- risks a similar problem: it would appear the most valuable to those small banks with the most pressing credit-driven capital problems, irrespective of whether those particular banks have any demonstrated capabilities in small business lending. Nor does the proposal calibrate the size of its investments according to any ground-up evaluation of capital needs (through a simplified stress test methodology, for example).

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[19] Fact Sheet titled "Administration Announces New $30 Billion Small Business Lending Fund" ("Fact Sheet") (February 2, 2010).

[20] Not until the "stress tests" on the largest banks were these fundamental problems addressed. *See* Raj Date, "Stress Relief", Cambridge Winter Center, pages 1-2 (April 20, 2009) ("Although the Administration does not describe the stress tests in this way, the initiative has the potential to help undo the most profoundly damaging strategic errors of the original Paulson capital purchase plan").

c. Create an explicit link to desired behavior.

Third, we should be careful and explicit with incentives.

Many policy-makers and citizens who supported the original TARP capital infusions, and who believed at the time that credit would, as a result, be stabilized, are unsurprisingly irritated by continued declines in bank lending volumes. The lesson is straightforward: if taxpayers are asked to supply subsidies to support any given activity, those subsidies should be narrowly tailored to achieve that end, and, if possible, be made contingent upon it. Of course, when the desired activity is lending, policy-makers should simultaneously be careful not to create such strong incentives that they inadvertently goad banks into irresponsible credit decisions, which ultimately do more harm than good.

On its face, the SBLF proposal tries to strike this balance this by varying a bank's cost of government-supplied capital according to its percentage increase in small business lending off a 2009 baseline, but to keep the percentage increase modest enough as to not encourage cavalier decision-making. But the percentage amount of increased small business lending appears so modest -- at least in the initial proposal -- that it appears likely that most of the government-supplied capital could be used to bolster pre-existing weakness in a firm's capital, rather than to support incremental credit.

Indeed, the example provided in the initial description of the SBLF entails a bank with $500 in assets, $250 million of which are small business loans. The bank, after receiving a $25 million capital infusion from the SBLF, manages to increase its small business lending 10%, to $275 million, and thereby receives a full 400 basis point annual reduction in the cost of the government's capital stake.[21] But regulatory capital required to support that incremental $25 million in loans is probably something close to $2.5 million. So the bank has received, net of the $2.5 million capital support required for the $25 million in new lending, an excess $22.5 million in capital from the government, which presumably is being used, in the Administration's example, to plug holes in the bank's existing capital position.

The SBLF proposal, then, will require some refinement before it is ready to implement. And it will take time to implement well.

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[21] Fact Sheet, *supra* note 19, at page 2.

4. <u>An interim approach</u>

Given the urgency of this issue, though, Congress may want to consider, in parallel, an interim measure that might be rather simpler to implement.

Rather than investing taxpayer capital directly into banks, we could reduce the regulatory risk weighting on some finite quantum of incremental small business lending. For those banks that find regulatory capital their binding constraint,[22] but who do see economically attractive lending opportunities in the marketplace, a temporary reduction in regulatory capital requirements related to that lending would spur counter-cyclical credit extension.[23] In essence, we would enable otherwise economically attractive loans that are today held back by the legacy of poorly performing, capital-intensive assets on bank balance sheets.[24] By limiting the percentage increase in small business loans eligible for this risk weight-reduction, we could prevent small banks from abusing this program by taking on outsized small business portfolios.

By reducing regulatory capital requirements on new lending, of course, we would be increasing the "tail risk" of loss borne by the FDIC's Deposit Insurance Fund, and, indirectly, increasing risk to the taxpayer.[25] But that incremental risk would at least be tied specifically to the outcome we desire -- incremental small business credit.

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I hope this statement helps you as you consider these critical issues. I look forward to your questions.

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[22] For some institutions carrying low risk weightings on their existing assets, it is possible that reductions in leverage ratio requirements might be required in addition to a reduction in risk weightings. In other words, incremental credit can only be encouraged if the *binding* regulatory capital constraint is relaxed.

[23] Static minimum regulatory capital ratios are frequently criticized because they encourage pro-cyclical lending volumes. Providing regulatory capital relief for small business credit at this point in the cycle would help mitigate that problem, albeit in an admittedly *ad hoc* manner.

[24] Changing regulatory capital requirements does not, strictly speaking, itself transform economically unattractive loans into economically attractive ones. It simply relaxes regulatory capital constraints on otherwise attractive loans. Conceivably, an interim reduction in risk weightings could be coupled with an interim government or public/private guaranty on the credit losses associated with incremental small business lending. That *would* transform, on the margin, economically unattractive loans into attractive ones; but it would also be every bit as complicated as the Administration's proposal itself.

[25] The Deposit Insurance Fund (the "DIF") is protected, in part, by a bank's capital cushion. So in the event of a bank failure, the DIF would be more exposed to losses by the magnitude of the capital relief provided under this proposal. Of course, Congress could choose to compensate the DIF in that amount.