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Dodd-Frank's small business lending time bomb

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After two years of the *Dodd-Frank Wall Street Reform and Consumer Protection Act*, a few of the landmines hidden in its hundreds of pages are starting to come to the surface.

Under Section 1071, Subtitle G, labeled "Regulatory Improvements" (who says Congress doesn't have a sense of humor?), the act establishes a system of small business loan data collection. The claimed purpose is to "facilitate enforcement of fair lending laws and enable communities, governmental entities and creditors to identify business and community development needs and opportunities of women-owned, minority-owned, and small business." Translation: Push affirmative action in small-business lending.

Recall that the same scheme of statutory social engineering contributed to the boom in subprime lending that eventually imploded the mortgage market. It appears Dodd-Frank is determined to drive small business lending down the same path.

The financial crisis demonstrated the government's ability to take what should be a relatively safe activity — mortgage lending — and turn it into a disaster. Small-business lending, however, is already far from safe. The annual failure rate for firms with fewer than five employees averages around 20 percent — 1 in 5. That's true even in the best of times: In 2005, 19 percent of small businesses failed. Small-business failures, however, are not random. Younger firms fail at a higher rate, of course. Another big factor is the type of firm — a factor that tends to be heavily influenced by the race and gender of its ownership.

For example, 16 percent of female-owned firms operate in health care and social assistance, a sector with the comparatively low failure rate of 18 percent. Meanwhile, only 10 percent of Hispanic-owned businesses operate in those industries, while Hispanics own a disproportionately high number of construction firms. In 2009, construction businesses in operation for less than 10 years failed at a rate of 30 percent.

Varying industries have both different success rates and different capital needs, and their demand for loans and their creditworthiness also differ. Since race and sex of ownership is a demonstrable factor in industries with different failure rates, loan pricing and denial will differ across race and sex even in the total absence of discrimination. "Equalizing" denial and pricing in the way Dodd-Frank seeks to do necessarily means extending credit to riskier firms.

Firm failure rates also differ significantly across geographic areas. To the extent that some demographic groups are concentrated in specific areas — say, Hispanics in the Southwest — differences in local economic conditions will also drive differences across race.

One would hope these variables would be taken into account. But the Justice Department proved that's not the case in its recent shakedown of Wells Fargo for mortgage-lending practices that supposedly discriminated against blacks and Hispanics. That action was based upon an analysis that would garner an "F" in an undergraduate statistics class. If the Justice Department had made even a minimal attempt at controlling for factors such as credit risk or loan-to-value, its own data would have revealed that differences in mortgage rates are driven by credit scores and loan features, not race. This strongly suggests that politics, not reason, will drive the use of data collected under Dodd-Frank.

The Wells Fargo incident could also be an ominous sign of where government policy is headed. Unlike the mortgage market, only a portion of small-business lending (thankfully) is now guaranteed by the government. The Small Business Administration's own lending practices appear questionable under the standards embraced by Dodd-Frank: in fiscal 2011, 3 percent of the agency's Section 7(a) loans went to blacks, while 6 percent went to Hispanic business owners and 17 percent to female-owned businesses.

Despite its risk, small-business lending has rarely been the cause of financial crises. The reason is that banks, knowing such lending is risky, take precautions and maintain conservative underwriting standards. Once government collected and published data on mortgage lending by race and gender, the first thing to come under attack was those previously conservative underwriting standards. What happens when the administration or members of Congress start to complain that women and minorities are being victimized in small-business lending?

Given that small-business underwriting is even more subjective than mortgage lending, erosions in underwriting standards could easily result as community groups and politicians pressure banks to extend small-business loans to favored constituents. We are fortunate that losses on small-business loans played a relatively minor role in the recent financial crisis. If we want to avoid them playing a larger role in the next conflagration, then repeal of Dodd-Frank's Section 1071 should be a high priority for the next Congress.

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