Could Small-Business Lending Blitz Backfire?

By Joe Adler, *American Banker*
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WASHINGTON — Though President Obama began a concerted push this week to encourage bankers to boost lending to small businesses, some are wondering if the government will come to regret trying to force the issue.

With the economy still in turmoil, offering economic incentives to increase lending could backfire if small businesses begin defaulting. While few predict a small-business bubble that would equal the one that brought down real estate, many said it is dangerous for the government to advocate specific types of lending.

"One reason we got into the housing crisis was lending standards slipped," said Phillip Swagel, a former assistant Treasury secretary in the Bush administration. "I would just worry the government is encouraging" small-business "lenders to lower lending standards."

The Obama administration has targeted small-business credit as a key driver of economic and job growth, proposing to give $30 billion from the Troubled Asset Relief Program and other incentives to community banks specifically to lend to small firms. Under the plan, banks would receive a percentage point drop in their dividend for every 2.5% increase in lending over a year earlier.

But the proposal comes as the mortgage debacle — which many blame on the government's promotion of housing — is still a recent memory, and both bankers and examiners are now loath to take risks.

"The vast majority of small businesses fail," said Joseph Mason, an associate professor of finance and the LeBow Research Fellow at Drexel University's LeBow College of Business. "Subsidizing small business is similar to subsidizing housing. … It's hard not to believe that housing subsidies skewed the markets in an unhealthy way and should be removed. The problem is anytime you remove a subsidy, that creates a contracting effect for the sector that was the target of the subsidy.

"The administration doesn't see it. The administration only sees the subsidies to be passed out."

Others, while agreeing there is a risk, support the broad principles of a targeted program to promote small-business lending by community banks.

Richard Carnell, a former assistant Treasury secretary, said giving bankers added resources to lend was better than criticizing the agencies for constricting lending through overzealous examinations, which in turn can lend to lax oversight.

"Anytime you allocate credit to a particular economic sector, you may end up with unsound loans that wouldn't otherwise have been made," said Carnell, a law professor at Fordham University. "But I'd rather have a targeted, limited program to help banks make small-business loans than to see politicians browbeating regulators to loosen up on safety and soundness. Better targeted lending than opportunistic browbeating."

While most blame the mortgage mess on poorly underwritten loans and the sharp drop in housing values, many also said that years of policies promoting homeownership — such as the outsized role of Fannie Mae and Freddie Mac, the easing of interest rates and lax bank regulation — resulted in inflated prices and borrowers getting trapped in unaffordable loans.

Critics of the administration's current plan, particularly conservatives who never liked housing subsidies to begin with, say the government is potentially walking down a similar path now with small business.

"We clearly built more housing than we needed," said Mark Calabria, the director of financial regulation studies at the Cato Institute. "If we go along the lines of throwing more money at businesses to create businesses and products that aren't sustainable, then we essentially create more misinvestment."

Mason said the housing debacle turned out to be "an overall lesson that in the long term, subsidies are not a long-term solution for economic growth."

But he and others said the small-business plan might succeed if administered carefully. "In the short term you can sometimes help certain markets develop," Mason said.

Observers said the plan can work only if bankers can feel more comfortable lending to a sector that is reeling from the sluggish economy. "I would take this for what it is right now, which is to make up for the current shortfall in small-business lending," said William Longbrake, an executive in residence at the Robert H. Smith School of Business at the University of Maryland.

"If it's a short-term program I think that is OK, but it needs to address bankers' concern about the risk in lending to more small businesses."

Clearly some regulators are worried, however.

In an interview after Obama announced the small-business lending plan, Comptroller of the Currency John Dugan expressed support mixed with concern.

"The issue we would always have is we fully understand the importance of banks making loans to creditworthy borrowers but we don't want them to make loans to noncreditworthy borrowers," Dugan said.

But Robert Clarke, a former comptroller who was once dubbed the "regulator from hell" for being tough on banks, said that regulators and bankers are sufficiently vigilant following the financial crisis to ensure the plan did not result in a build-up of faulty loans.

"There is the possibility that government trying to shove banks into doing particular kinds of lending creates potential for their making poorly underwritten loans, but the community banks are so wary today of making a bad loan that it would be highly unusual for them in response to the pressure from the government to go out and make poorly underwritten loans," said Clarke, a senior partner at Bracewell & Giuliani. "Of all the programs that have come down so far, I think this one, if it is properly structured and administered, has the potential to provide some real help."

Others said the housing and small-business sectors are too different from each other for there to be an identical result from subsidizing credit to the two industries.

Jim Vogel, the head of fixed-income research at First Horizon National Corp.'s First Financial Capital Markets Corp., said problems that originated with subprime lending spread because other lenders pushed to earned the same kind of profit margins, and lowered their underwriting standards. "It carried over to other sectors," he said. "I don't think you have that same homogeneity and tight pipeline channels in small-business lending."

1 | 2 | Next View on single page Page 1 of 2.

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