

TARP Junior?

Evaluating the Small Business Lending Fund

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EXECUTIVE SUMMARY

On May 19, the House Financial Services Committee agreed to a \$30 billion program called the Small Business Lending Fund (“SBLF”), which closely follows a proposal made by the Obama Administration in February. Although the proposed bill is intended to help solve what will become a very real problem in the supply of small business credit, its design is likely to fail for the same principal reasons as the Bush Administration’s original TARP Capital Purchase Program.

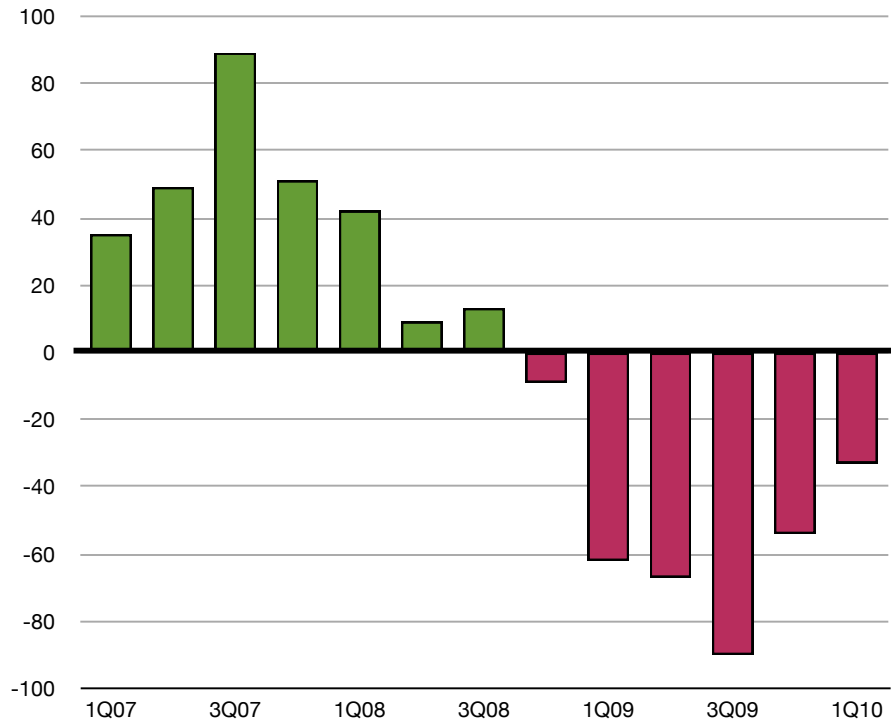
- **Small business credit will become supply-constrained in 2010 and 2011.** To this point, declining small business loan volumes have been mostly driven by a natural reduction in loan demand by credit-worthy small businesses, given the severity of the financial crisis and ensuing recession. As the real economy continues to recover, small business credit demand will recover as well, but the supply of such credit will continue to be impaired. Capital market-funded finance companies are retrenching; high-line consumer products appear uneconomic; small and mid-sized banks remain pressured by commercial real estate credit.
- **The 2008 bank bailout did little to enable small business lending.** For better or worse, the major financial rescue programs (e.g. the CPP, TALF, and TLGP) were focused, in effect, on supporting capital and liquidity at the largest banks and shadow banks. They were not especially suited to aiding the small banks that focus disproportionately on small business credit.
- **Unfortunately, the SBLF will mostly support legacy assets, not new lending.** To its credit, the SBLF creates incentives for small banks to accept capital infusions, and to use that capital to extend prudent small business loans. But as the program is structured in the House bill, most small banks would likely gravitate towards increasing small business lending by only 10%, which would mean that more than 80% of the taxpayer-supplied capital under SBLF would support existing asset portfolios, rather than new small business credit.

The SBLF proposal is meant to address one of the key drivers of small business credit contraction: the capital pressures felt by small and mid-sized banks.

SBLF INTENDED TO ADDRESS SMALL BUSINESS CREDIT CRUNCH

Quarterly Change in Bank Commercial & Industrial Loans, 2007-1Q10

\$ Billions



Key Drivers of Small Business Credit Contraction

- To date: Falling demand for loans by credit-worthy small businesses, in the face of severe real economy recession
- Going forward:
 - Dramatic pull-back by capital-market funded shadow banks (e.g. GE Capital, CIT)
 - Continued shrinking in consumer businesses that were used to fund small business activity: high-line credit cards; cash-out refi's and home equity loans
 - Continued capital pressures at small and mid-sized banks

Focus of SBLF*

* Small Business Lending Fund, as described by the Small Business Fund Lending Fund Act of 2010, H.R. 5297, 111th Cong., 2d Sess. (2010).

Source: FDIC 1Q10 Quarterly Banking Profile; Cambridge Winter Center analysis

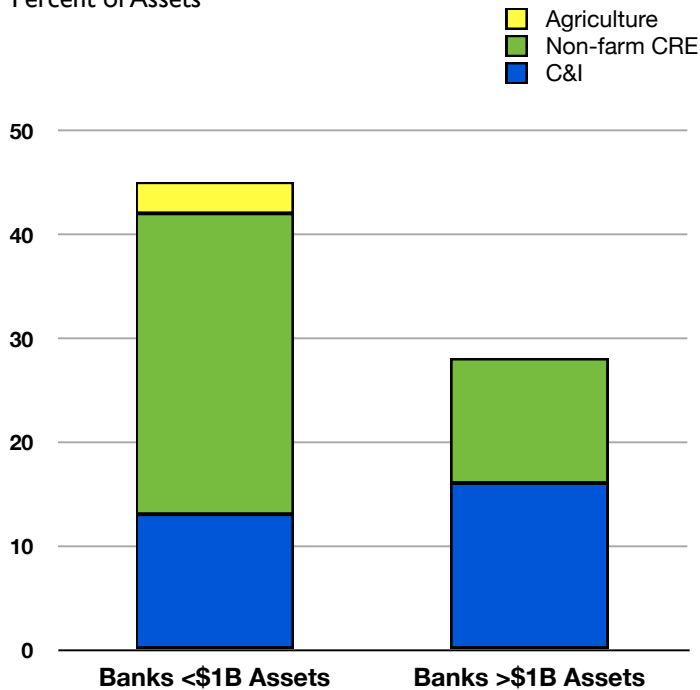
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The first vintage of the bank bailout programs, for better or worse, did not particularly focus on bank-funded small business lending. Small and mid-sized banks are disproportionately concentrated in small business lending; but large banks and shadow banks were disproportionately benefitted by the major taxpayer rescue programs. The SBLF, by contrast, would focus on banks with under \$10 billion in assets, and promises especially attractive terms to banks with under \$1 billion in assets.

MAJOR BAILOUT PROGRAMS MISSED SMALL BUSINESS

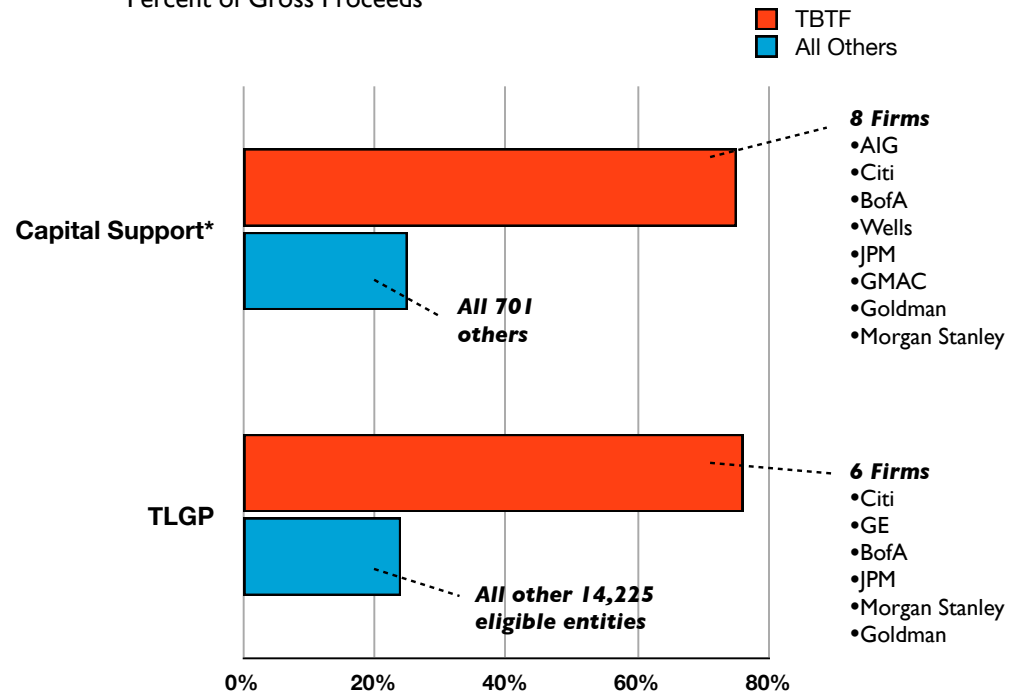
Small-Business Intensive Loans, by Bank Size

Percent of Assets



Share of Major Bailout Programs

Percent of Gross Proceeds



* Capital Support programs include all of the Bush Administration capital-focused bailouts (AIFP (GMAC); SSIF (AIG); AGP (Citi); TIP (Citi, BofA), and CPP) except for the housing GSEs, Fannie Mae and Freddie Mac, because of their unique *ex ante* implicit taxpayer guarantees.

Source: FDIC; SIGTARP

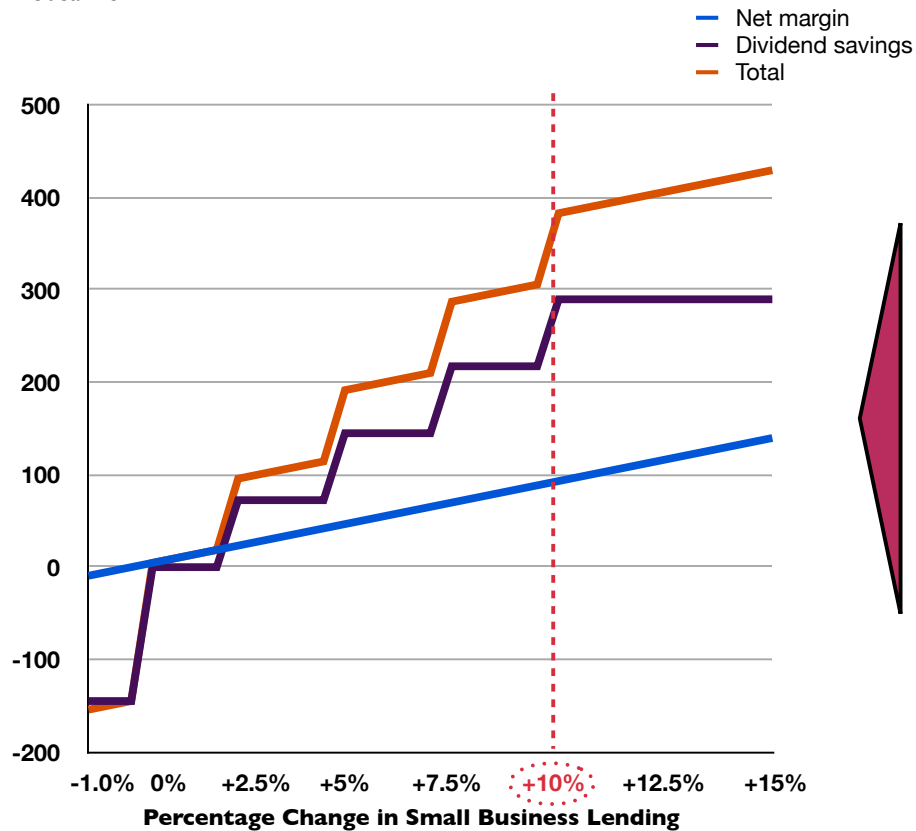
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The first TARP capital program, the CPP, was maligned in part because it created no incentive for recipient firms to extend incremental credit. Between its lack of incentives, and its one-size-fits-all pricing, the CPP became disproportionately valuable to precisely those banks with the most profound challenges. In a right-minded attempt to side-step those problems, the SBLF would create a tiered pricing structure for its preferred tier-1 capital investments in small banks. Analysis of its financial terms demonstrates that banks would have a strong incentive to lend enough -- 10% more small business lending than they had previously -- to qualify for the lowest tier in the pricing structure.

SBLF WOULD CREATE INCENTIVE TO INCREASE LENDING 10%

Marginal Annual Net Income for Average Small Bank Participant in SBLF

\$ Thousands



Key Assumptions

- Assumes average bank with under \$1 billion in assets
 - \$207 million in assets
 - \$145 million in risk-weighted assets
 - \$93 million in benchmark "small business" loans
 - C&I
 - Non-farm owner-occupied CRE
 - Agriculture loans
- Assumes bank accepts full extent of SBLF capital (5% of risk-weighted assets for bank under \$1 billion in assets)
- Assumes incremental lending at 1% ROA (net of origination and associated operating expense, after tax) and that SBLF dividends are not tax-deductible
- Does not assume any ancillary revenue streams (e.g. deposit balances captured through incremental lending)

Source: H.R. 5297 section 4(d)(4)(A); FDIC; SNL; Cambridge Winter Center analysis

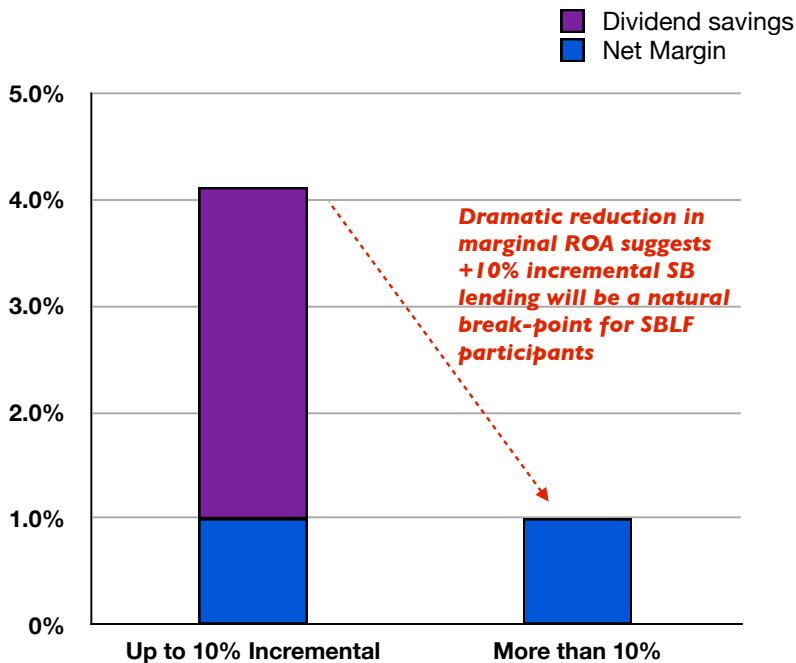
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Unfortunately, it seems rather less likely that small banks would increase small business lending any *more* than 10% by virtue of SBLF's provisions. And, if that is the case, the vast majority of taxpayer capital committed under the SBLF would support other bank activities, or legacy credit problems, rather than new small business lending.

SBLF CAPITAL WOULD, MOSTLY, NOT SUPPORT NEW LENDING

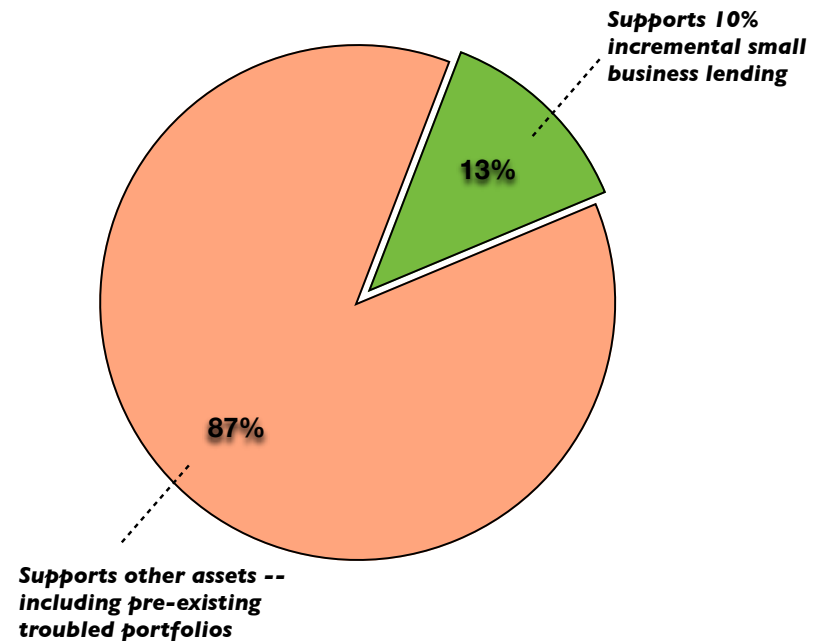
Return on Assets for SBLF-Qualifying Lending Up to 10% Incremental, and Beyond 10% Incremental

Percent



SBLF Capital Use, Assuming +10% SB Lending

Percent



Note: See key assumptions on slide 5
Source: Cambridge Winter Center analysis

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