The Role of Risk Lending in a Dodd-Frank World

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Key points

Lockhart believes that American society has a strong interest in promoting entrepreneurial activity for the allied benefits of growth and job creation. As the Dodd-Frank Act is implemented, **stronger regulation can and should leave room for risk lending that supports the entrepreneurial sector**. The Federal Reserve is working with both bankers and examiners to get the message out that lending to creditworthy borrowers is good for everyone.

Lockhart thinks that the endgame is smarter, not just tighter, regulation of banks and their lending. **Smart regulation is essential if a significant proportion of risk lending is to remain within the banking system**, which he believes is important. **The credit financing of the entrepreneurial sector should not become a so-called "dark pool,"** where risk lending takes place completely outside of banks.

In Lockhart's opinion, **both banks and nonbanks face challenges** in the current environment. Many banks are repositioning their lending away from concentration in real estate lending. As they enter new lines of business, banks will face the challenges of convincing both regulators and shareholders that their new lending strategies are sound. Meanwhile, nonbanks face substantial market discipline. Clear and convincing explanation of portfolio and funding strategies to capital markets is a continuous requirement for nonbanks.

I appreciate the opportunity to address this group of skilled lenders and investors. I spent a good part of my career working in this industry and view the National Funding Association (NFA) as a group of former colleagues—not actually (most of you are too young), but in spirit at least.

In my 13 years in senior management at Heller and my three years as a director at Capital Source, I learned what it means to design sound yet commercially realistic lending programs, to do rigorous underwriting, to negotiate with borrowers with a risk-reward mentality, and, very importantly, to actively manage exposure on a day-to-day basis.

I also learned a lot about what borrowers expect from deal makers. Heller captured this well, I believe, in a business promotion phrase: "Straight talk, smart deals." I'm proud of my background and experience in the work many of you do. And I think this background adds value in my current role both at the Federal Open Market Committee (FOMC) table and in internal deliberations on regulatory policy implementation.

Today, I want to share some thoughts about what I will call “risk lending.” I will talk about where my notion of risk lending fits in the array of credit providers in our economy and how this set of lending activities aligns with current regulatory direction. And I will try to bring into sharper relief some issues that will be addressed over the coming years as lenders refine business models and regulators seek to achieve the right supervisory balance within a Dodd-Frank construct.

As always, I have to start with the disclaimer that these are my personal views and may not be shared by my colleagues in the Federal Reserve System.

The employment challenge—where jobs come from

To provide a context, I’d like to start with the following proposition: many members of the NFA lend to entrepreneurs, commercial innovators, and risk takers in our economy, and such activity bears on the Fed’s mandate to maximize employment. Put differently, I see a connection between a very important monetary policy objective and your role among providers of credit, especially to early-stage and transitional companies.

So, let me summarize the current employment situation.

The U.S. economy, on net, lost around 8 million jobs in 2008 and 2009. There were three principal sources of job losses. First, firms reduced their workforce in response to lower sales. Second, people lost jobs as many companies went out of business. Finally, the number of jobs created by new firms fell sharply.

Those companies that continued to operate were doing so with a smaller workforce, relying on productivity gains to meet production demand. Recent productivity gains have been substitutes for job creation. This isn’t always the case, but in recent years employment and productivity have involved a trade-off relationship.

In 2010 and through March of this year, the economy added back a net of about 1.5 million jobs. This relatively muted employment growth in part reflects businesses’ continued reliance on higher productivity of existing workers rather than on workforce expansion. Also, there is virtually no net job creation resulting from new business formation in recent quarters.

My current forecast suggests job growth of around 200,000 per month for the rest of the year, including April's numbers, which will come out on Friday. This growth pace implies payroll gains of 1.8 million over that period. At that rate, it may take three years before the size of the nation’s workforce reaches prerecession levels, unless there is a significant downshift in productivity gains and/or much stronger-than-expected economic growth.

The low level of new business formation has been particularly frustrating in this recovery. Research by the Kauffman Foundation shows that between 1977 and 2005, established firms—in other words, existing firms as opposed to new firms—on net eliminated more jobs than they created. This category of firms accounted for destruction on average of one million jobs per year. In contrast, new firms added an average of three million jobs a year.

Historically, new businesses have been an important catalyst of economic growth in the United States. Research shows that surviving young firms tend to grow very rapidly, and they have a significant effect on overall employment growth. In addition to job growth, new businesses contribute significantly to product and market innovation. For these reasons, the current absence of net growth in the small business segment of the economy is troubling.

Small, early-stage businesses are only part of the spectrum of entrepreneurial activities our economy needs to have a robust net job creation machine. When I think of entrepreneurs, I also think of the people behind middle-market growth companies and turnarounds. More broadly, I think of the many private and public non–blue chip companies that by virtue of smaller scale, competitive position, or operating issues are far from “no brainers” for a lender. In other words, I think of your clientele.

It is difficult to estimate the scale of this segment of business activity and job creation with any precision, but I’ll try. According to the U.S. Small Business Administration, firms of fewer than 500 employees account for 99.7 percent of all employers in the country. They employ around half of all private sector workers, and we estimate they consequently account for roughly half of private sector gross domestic product.

Therefore, I believe we can conclude that the borrower segments you target play a sizeable employment role in the economy and will play a key role in determining the pace at which the nation’s unemployment problem is solved.

Risk lending

So let me define what I mean by risk lending. All lending, of course, involves risk, but I’m not talking about all lending. I’m talking about types of lending represented in this audience. I’m thinking of asset-based lending, especially where repayment relies more on collateral value than the strength of the borrower. I’m thinking of leveraged lending based on the cash flow–derived business value of midsized companies. I’m thinking of subordinated or mezzanine lending where this layer of the debt structure bears most of the real risk. I’m thinking, in many cases, of lending into an operating situation requiring change instead of continuity with past performance. In other words, situations where the path to repayment doesn’t clearly exist at initiation and where the entrepreneur borrower has to implement large-scale change to the business for the loan to perform.

In my experience, some forms of what I’m calling risk lending involve loan structures with flexible and accommodative terms customized for the entrepreneur’s business plan. I’m thinking, for example, of grace periods, bullet and balloon payments, interest reserves, and pay-if-you-can features. This category of lending may also involve reward features for the lender such as spreads that reflect the higher-than-average risk and equity kickers of various kinds.

Industry prior to crisis

Prior to the recent financial crisis and recession, both bank and nonbank financial firms filled the appetite for risk lending in the U.S. economy. The industry included—in addition to banks—independent asset-based lenders and lessors, finance companies, mezzanine debt funds, and hedge funds. Many of these firms were outside the regulatory net and operated quite differently than banks. I think of these nonbank firms as a significant part of the pre-crisis shadow banking system.

In the crisis, funding such firms in the capital markets became very difficult—if not impossible. As a consequence, there’s been substantial alteration of industry structure. There’s been consolidation. Also, some firms that survived and preserved their independence converted to regulated bank status.

Bank status conveys the funding advantage of insured deposits and access to the discount window at the Fed. But with these subsidies, as economists call them, come supervision by regulators in an environment today shaped by reaction to the problems and excesses exposed by the crisis and recession.

It’s fair to say that from a systemwide perspective we are in a period of de-risking. Heightened risk aversion and intensified regulatory supervision are shaping the environment in which you as risk lenders conduct your business.

I perceive something of a dilemma for policymakers, like me, who are involved in both the design of macroeconomic policy aimed at fostering growth and employment and, at the same time, implementation of stronger regulatory policy. Broadly speaking, I believe stronger regulation is justified by recent experience. At the firm level this strengthened regulation translates into higher capital requirements, intensified and improved risk management, redesign of business models, and tighter underwriting standards.

Stronger regulation can and should, however, leave room for lending that supports an active and healthy entrepreneurial sector. I believe it would be unwise to contain and constrain the credit industry to the point that servicing the entrepreneurial sector on commercially reasonable terms becomes quite difficult. I do not believe this is happening. Today, loan demand is weak and origination of good loans is not easy. The Federal Reserve is working with both bankers and examiners to get the message out that lending to creditworthy borrowers is good for everyone.

Regulatory posture post-crisis

Underpinning financial and banking reform efforts is a bedrock principle, the soundness of which I think is hard to deny. Society (taxpayers) should not bear the downside risk while private parties (managers, shareholders, and private creditors) enjoy all the upside. The Volcker rule in the Dodd-Frank Act is based on the related idea that a financial institution that enjoys a government safety net shouldn’t engage in highly risky proprietary activities.

Dodd-Frank is now the legal framework in which regulators are currently writing rules and implementing new policy. The Dodd-Frank era calls for new supervisory methodologies and the upgrading of practices. Those most relevant to bankers in this audience are the following:

- Strengthened capital standards and—pursuant to Basel III—enhanced risk-based capital allocation;
- Horizontal systemwide monitoring of concentrations, evolving lending practices, and risks;
- Intensified scrutiny of risk management systems and lending practices, including underwriting standards; and
- Greater attention to liquidity management of individual firms.

But in my view, the endgame is smarter and not just tighter regulation. I believe we regulators must continue to raise our game. Our examiners have to be able on a consistent basis to evaluate loans in terms of associated risk controls and systems. Examiners must be able to distinguish between calculated risk taking and poor underwriting. And examiners need to validate the risk-reward calculus that goes into the pricing of levels of risk in loan structures.

Smart regulation is essential if a significant proportion of risk lending is to remain within the banking system. I believe it’s important that this be the case. As a result of Dodd-Frank, the Federal Reserve now has more explicit responsibility for financial system stability and the monitoring of systemic risk. To carry out this responsibility, we need visibility into major areas of activity, and in my view the lending businesses falling within my definition of risk lending qualify. The credit financing of the entrepreneurial sector should not become a so-called “dark pool.”

That said, the social usefulness of commercial credit organizations outside the regulatory net should be acknowledged. Some types of deals—particularly those with novel or speculative sources of repayment—will just be hard for many banks to do at any scale.

The historic solution to the too-risky-for-the-bank problem has been to concentrate certain lending activities in a finance company under a bank holding company remote from the bank and government-guaranteed deposits. In my mind, this approach still requires that the activity does not pose undue risk to the total organization. The activity should also conform to what the top leadership of the institution can understand and supervisors can effectively evaluate.

Challenges for banks and nonbanks

Both banks and nonbanks (that is, finance companies and funds) face challenges in the current environment. Let me emphasize two areas of challenge, one most relevant to banks and one for nonbanks.

First, for banks, higher risk loans ought to be booked on balance sheets that can afford the exposure. At the moment this is a constraint for a number of bank lenders who are working down excessive concentrations in distressed or problematic asset classes.

Over the past few decades many banks of all sizes gravitated to real estate lending in various forms and allowed their commercial and industrial lending capability to atrophy.

Many banks are now repositioning their lending away from concentration in real estate lending. Banks entering new lines of business will face the challenge of convincing both regulators and shareholders that their new lending strategies are sound. That means having human capital with the necessary skill sets and adequate infrastructure to manage the risks.

As banks diversify lending activities, I think we regulators will have to continue to refine our ability to assess the soundness of a variety of forms of lending. Over my banking career, I had experience at both ends of the spectrum of lending strategies—that is, unsecured lending to very strong credits as well as collateral-secured and tightly controlled lending to weaker credits with good collateral. In my view there are legitimate bank lending businesses all along this spectrum.

Some of my personal experience was in an independent, nonbank finance company. The second challenge I see relates to this business model. Nondepositories face substantial market discipline. In nonbanks, to satisfy funding markets, asset strategies and liability strategies have to fit together in a congruent structure. Clear and convincing explanation of portfolio and funding strategies to the capital markets is a continuous requirement, especially in a period with "black swans" still fresh in memory.

Importance of risk lending

The financial crisis of 2008 and the resulting deep recession have brought profound financial reform. The Dodd-Frank Act defines the lending landscape for much of the credit industry. As necessary reforms are implemented, I think all concerned must take into account the importance of risk lending to the nation's economic fortunes. American society has a strong interest in promoting entrepreneurial activity for the allied benefits of growth and job creation. As a class, the borrowers you finance—the entrepreneurs, the risk takers, the value creators—are quite likely to be a key element of the country's long-term economic revitalization.

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