Recommendations for Improving Small Business Credit Access and Financial Reform[1]

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Executive Summary

The current recession and co-mingled financial crisis have forced many small businesses to lay off employees, reduce compensation, experience reduced profitability, or shut down entirely. Small businesses were not central to the problems now experienced, but they do suffer from their effects and will pay for their solutions through higher taxes, lower profits, and lower growth. This gives small business a legitimate role in helping to shape a financial system that will be responsive and responsible.

This document outlines a series of policy recommendations that NFIB believes will (a) improve credit access to small businesses and (b) reform the financial system in ways that will help prevent similar financial crises from occurring in the future. Key recommendations include:

- Federal dollars should be made available to assist credit-worthy small businesses who cannot obtain lending in the current environment.

- The "too big to fail" doctrine is no longer acceptable.

- The systemic risk of financial institutions should be reduced by imposing strict limits on the amount of leverage financial institutions can take.

- Capital requirements for financial institutions should account for varying degrees of risk across firms.

- FDIC insurance premiums should rise with the size and complexity of banks.

- Fannie Mae and Freddie Mac should be privatized.

- The Nationally Recognized Statistical Rating Organization designation should be eliminated, and credit rating agencies should adopt an investor-financed model.

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I. Unlocking Credit for Small Businesses

Bank credit plays an important role in small business success. Without access to bank lending, small business owners would have trouble raising the funds they need to operate and grow their businesses. Currently, total small business loan demand is severely depressed due to the recession, with many firms retrenching and cutting back plans to invest and expand. The overall supply of small business credit remains strong, however, and the small business sector generally does not appear to be experiencing credit difficulties any worse than those of previous recessions. This is due in large part to the thousands of small independent banks that did not pursue unsound lending practices and excessive use of leverage in recent years. These banks are financially healthy and have funds available for small business lending.

Despite these realities, some credit-worthy small businesses seeking additional credit have been unable to obtain it in the current economic environment. These businesses are profitable, are run by owners with good credit ratings, and have manageable levels of existing debt. They are good credit risks. However, they have been unable to find a small bank in their area willing to lend to them and have been hurt by cutbacks in lending by large banks, line cuts by credit card companies, and suddenly unavailable home equity lines due to falling real estate prices.

The recent sharp decline of real estate values has also hurt owners by reducing the value of properties owners normally post as collateral to secure loans for their businesses.[2] Most small business owners who own real estate own it for personal or business use. Only a minority own property strictly for investment purposes. Small business owners are therefore long-term owners of real estate who intend to maintain possession of their property for extended periods of time. Yet, they nonetheless have their access to credit hurt whenever real estate markets experience acute, momentary periods of distress, like now. Addressing the credit needs of these owners is important and will help them to keep their doors open, their lights on, and their workers employed.[3]

None of the federal programs announced to date which attempt to increase lending will have a significant impact on small business lending. The Obama Administration's recently unveiled program to unlock credit for small businesses focuses strictly on jumpstarting securitization markets for SBA 7(a) loans and 504 first-lien mortgages. To invigorate securitization markets, the program allows the U.S. Treasury

[2] Small business owners frequently use real estate to finance or collateralize other business assets. According to a 2008 NFIB National Small Business Poll, 76 percent of small business owners have at least one mortgage on real estate they own. Many owners have more than one mortgage. Twenty-two percent of business owners with a mortgage took out at least one mortgage to finance business activities. Sixteen percent use real estate to collateralize other business assets, including 10 percent who use their homes as collateral. See William J. Dennis, Jr., "Access to Credit," NFIB National Small Business Poll, Vol. 8, Issue 7, 2008.

[3] The precise number of small businesses rejected solely because they lacked collateral and the dollars involved have not been quantified, but the increasing number of rejected small business loan applicants and anecdotal evidence suggest reason for concern. According to the afore-mentioned NFIB National Small Business Poll on credit access, about one in 10 small businesses owned at least one upside-down property in late 2008.

Department to purchase up to $15 billion in securities backed by SBA loans, temporarily raises guarantees to 90 percent in the SBA's 7(a) loan program, and temporarily eliminates certain SBA loan fees to reduce the cost of capital to small firms.

While well-intentioned, this program is at best a marginally positive step toward greater access to credit markets for small businesses, since less than 1 percent of small businesses have a government-sponsored loan of any type.[4] Due to complexity and the need for lenders to securitize government-sponsored loans, most SBA-backed loans are made by very large banks which are not the primary source of lending for small businesses. A more productive approach would be to channel available resources through small banks, which are effectively excluded from SBA loan programs. Community banks and other depository institutions serve as a primary source of loans for small businesses, and their inclusion would allow a program to serve a much larger portion of the small business sector.

The Administration has introduced other initiatives aimed at unfreezing credit markets, including the Troubled Asset Relief Program (TARP), the Term Asset Backed Securities Loan Facility (TALF), and the formation of Public-Private Investment Funds (PPIFs). The Federal Reserve has also attempted to lower interest rates by purchasing vast quantities of a wide variety of asset classes. NFIB is hopeful that these initiatives will stabilize the financial system and enhance credit flows throughout the broader economy, but none of them will have a significant impact on lending to small businesses.

TARP, which was originally intended to help troubled banks through the purchase of "toxic" assets, has to date primarily been used for capital injections into large financial institutions and corporations. TALF, which aims to revive the consumer lending business, has the potential to benefit small business owners by encouraging auto lending and invigorating markets for securities backed by credit card receivables and SBA-guaranteed small business loans. However, the response to TALF has so far been tepid, and it is unclear how much the program will help small business owners and entrepreneurs since (a) the SBA loan market makes up only a tiny fraction of the small business loan market, and (b) the provisions to stimulate auto lending and credit card activity are aimed at consumers in general, not small business owners specifically. The PPIFs, meanwhile, are intended strictly for the purchase of troubled "legacy" real estate-related assets. The Federal Reserve's programs to purchase Fannie Mae- and Freddie Mac-sponsored mortgage-backed securities and longer-term Treasury securities may help some small business owners to refinance their homes at lower rates, increasing free cash flow for these owners, but not all business owners have conforming mortgages.

There appears to be an opportunity to expand efforts to encourage lending to healthy small businesses who cannot currently obtain credit. We therefore suggest the following proposal, which should further augment the amount of credit available for credit-worthy small businesses and increase the total amount of small business lending in the economy. The proposal's focus on <u>credit-worthy</u> small businesses should be

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[4] Board of Governors of the Federal Reserve System, "Report to the Congress on the Availability of Credit to Small Businesses," October 2007.

emphasized. Today, the United States faces a financial crisis in large part because of lax lending standards. Making more bad loans may help save some firms in the near term, but doing so will result in greater long-term inefficiencies. Increasing lending for lending's sake, without regard to the credit-worthiness of borrowers, is not the solution to current problems.

Proposal to Enhance Small Business Credit Availability:

1. A government-financed Small Business Job Creation Fund ("The Fund") should be created to purchase shares of small business loans made by participating "well-capitalized" and "adequately-capitalized" banks to credit-worthy small businesses. The Fund would essentially function as a new secondary market for small business loans, and its purchase of loan shares would provide private lenders with access to a greater total amount of loanable funds than would otherwise be available, thereby increasing the amount of credit available to small businesses.

2. The Fund would be seeded by $25 billion supplied by the U.S. Treasury Department. **This money would be provided from a funding source OTHER THAN the Troubled Asset Relief Program (TARP).**

3. To prevent the socialization of existing bank losses, only loans made on or after a future date (to be determined) will be eligible for purchase by The Fund. This will prevent banks from shifting any bad loans they may currently have to taxpayers.

4. To encourage private lenders to participate, loans purchased by The Fund would NOT count against lender capital for regulatory purposes so long as lenders fulfill certain requirements. Specifically, as long as the cumulative amount of loan shares retained by a participating lender remains less than a specified percentage of the lender's capital or assets, regulators would classify those loans as a distinct asset class that would not count toward regulatory capital requirements.

5. Participating lenders would sell to The Fund the rights to not more than 90 percent of eligible small business loans they originate. Lenders must retain at least a 10 percent share in any loan sold to The Fund. The loan shares owned by The Fund would be packaged and sold to private investors as 100 percent guaranteed, non-taxable, inflation-adjusted securities.

    a. By purchasing a percentage of whole loans (and not securities backed by loans), the government effectively includes as potential participants community banks, which rarely securitize the loans they make and instead hold them on their own books. The purchase of loans by The Fund also increases the total amount of credit available to small businesses.

    b. Requiring lenders to hold a share of the loans ensures that lenders share risk and reduces moral hazard.

c. The Fund's sale of securities would provide investors with a new, safe investment and would also replenish The Fund's capital.

6. In acknowledgement of the difficulties that distressed real estate markets are placing on many viable and healthy small businesses, when assessing the eligibility of potential borrowers, lenders and regulators should emphasize the viability of businesses over proposed collateral. Participating borrowers who post real estate as collateral would therefore be subject to relaxed collateral requirements and would not have to meet collateral calls normally invoked by collateral price declines.

7. Excluding real estate collateral requirements, underwriting standards would be lenders' regular standards, subject to the usual requirements of regulatory authorities. *I.e.*, to be eligible for this program, small business owners must have:

    - A track record of good credit (*e.g.*, a FICO score of at least 700).

    - A reasonable amount of equity in the business. Debt-to-equity ratios must remain within a certain band for the duration of the loan.

    - A demonstrated ability to repay. The business must be profitable and follow a business plan with realistic assumptions that forecast future profitability and cash flows sufficient to cover debt obligations.

8. To ensure transparency of lending activity, the number and value of loans retained by lenders would be publicly disclosed.

9. Loans eligible for purchase by The Fund would have terms (par value, maturity length, etc.) modeled after loans eligible through the SBA's 7(a) loan program and would satisfy the use of proceeds requirements outlined in the SBA's 7(a) loan program.

10. Lenders and the government would share repayment of interest and principal (as well as any losses) on a current basis in proportion to their respective ownership shares in the loans.

11. The government would impose no haircuts on assets purchased by the Fund.

12. Lenders would act as both loan originators and servicers and would retain any fees associated with those activities.

13. All "well-capitalized" and "adequately-capitalized" FDIC-insured banks would be eligible to participate in the program on a voluntary basis.

14. A "small business" would be defined by existing SBA regulations for business lending (13CFR§121.301(a)).

15. Program requirements would be enforced by a lender's principal regulatory supervisor. To ensure that requirements are being met and that the program is working effectively, participating lenders would be required to supply a <u>reasonable</u> amount of information to regulators on a regular and timely basis.

16. This program would be temporary and subject to sunset provisions. The sunset date would be tied to an objective measure related to small business borrowing capability and activity. After the sunset date, no new loans could be sold to The Fund.

> **EXAMPLE:** A bank could choose to participate in the program and issue a set of eligible loans to credit-worthy small businesses with cumulative expected nominal future cash flows equaling $1,000,000. The bank would keep any origination fees paid by borrowers. The Fund could purchase the rights to 90 percent of these loans, package them into securities, and sell the securities to private investors. Over time, investors would be entitled to receive $900,000 in borrower payments, while the bank would be entitled to the remaining $100,000. Ninety cents of each dollar repaid by borrowers would go to investors, and 10 cents would go to the bank. The bank would service the loans for their duration and would retain any associated fees.
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> In the event of a default, the borrower's collateral would be possessed by the bank and sold. Ten percent of the sale's proceeds would go to the bank and 90 percent to the government, which would use the funds to make payments to investors over time. The bank would take a loss on its share of the remaining loan balance, and the government would finance any shortfall of funds necessary to make investors whole.

Summary of Program Benefits:

- **Small business owners** will benefit from increased credit availability, which should reduce any unmet loan demand by credit-worthy small businesses. Owners with financially healthy businesses, but whose real estate collateral has fallen in value due to distressed market conditions, will especially benefit.

- **Lenders** will benefit from having the ability to make more small business loans and earn more profits than they otherwise would. By sharing credit risk with the government, lenders should be willing to lend to some businesses that they otherwise would not have in the absence of a public-private risk-sharing agreement.

- **The federal government** would take on some additional risk by guaranteeing securities backed by small business loans, but losses would be limited since the underlying loans should be performing. The government would forego some potential revenue due to inflation adjustments and the tax-exempt status of the securities, but it would accomplish its objective of getting more money into the hands of small business owners who will use their loans productively, helping to create jobs and stimulate economic growth.

- **Investors** will benefit from having a new, safe investment that pays a higher return than the risk-free rate. Investors would be protected against inflation and would benefit from the tax-exempt status of the securities.

II. Ensuring the Competitiveness of Small Community Banks

The Administration's initiatives and our supplementary proposal are only part of the solution to enhance credit availability. Functioning credit markets also require a healthy financial system and stable and sound financial institutions, without which commercial lending would not occur and capital markets would not function.

The U.S. financial system is the world's most dynamic and complex, and it consists of a multitude of different institutions including commercial banks, investment banks, hedge funds, private equity funds, credit unions, and many others. For small businesses, small community banks are the most important financial institutions. While many owners do patronize larger banks, small banks and other depository institutions serve as a primary source of loan debt for small businesses. For these institutions to thrive, the banking system must be (a) competitive and (b) uniformly regulated, so that large banks do not have advantages in attracting capital or complying with regulations. Going forward, lawmakers must be cautious that actions taken to centrally monitor and regulate systemic risk and to reform and "streamline" the financial regulatory system do not harm the ability of small banks to compete.

NFIB believes that when considering proposals for financial reform, lawmakers should ensure that:

- **The current dual banking system of federal and state charters is maintained.** Newly chartered state banks are an important source of funding for small firms and provide an important alternative to large, federally-chartered banks.

- **No additional burdens are placed on states that would inhibit the chartering of new banks.** Competition is critical to the health of the banking system, and entry into the banking business must not be unreasonably restricted. Many recently formed banks have gone into business specifically targeting the small business market.

- **Any restructuring of the Federal Home Loan Banks takes into account the importance of these institutions in providing liquidity to small banks.** One of the reasons small banks have been able to continue funding small firm loans has been their access to Federal Home Loan Bank advances.

- **Reform should include steps to increase the consistency of bank supervision.** While economic conditions and human behavior prohibit absolute consistency, there have been too many reports of arbitrary and differing standards applied to similar banking activities.

Equally important to the health of small banks is the depositor confidence generated by the Federal Deposit Insurance Corporation's (FDIC) guarantee of deposits, up to a maximum of $250,000 per deposit,[5] and the FDIC's ability to thoroughly monitor, regulate, and, if necessary, take over troubled institutions. Such confidence does not come cheaply, and FDIC-insured institutions are required to pay annual premiums to the FDIC for deposit insurance. While the FDIC's insurance pool is obligated to cover deposits at any failed bank, small banks have historically been treated unfairly relative to large banks when it comes to funding obligations. For example, large banks are able to finance their loans with foreign deposits and debt securities on which they pay no FDIC insurance premiums, but small banks are not.

Small banks have also been treated inequitably during the FDIC's recent attempt to replenish its insurance pool. The recent spike in bank failures has depleted the FDIC's funds, and even though large bank failures account for a disproportionate amount of the FDIC's costs, the FDIC has proposed raising insurance premiums for <u>all</u> banks to replenish its insurance pool. This is a patently unfair outcome in which small banks are forced to cover the risks and losses of larger, more systemically important banks.

NFIB supports changes that do not penalize smaller financial institutions and improves the competitive balance between small and large banks:

- **FDIC insurance should be progressive. The cost of insurance should rise with the size of deposits, liabilities, and risks taken.** As banks grow in size and scope, they produce increasing systemic and idiosyncratic risks. Banks should pay higher premiums for disproportionately larger risks (attributable to both on- and off-balance-sheet exposures).

- **Larger banks should be required to pay insurance premiums on all of their funding sources (not just deposits) or all of their assets.**

III. Recommendations for Financial System Reform

Reforming the financial system is also important to small business owners, who have been severely harmed by the current recession caused primarily by excessive risk-taking and poor decision-making by financial institutions. The recession has hurt profits and forced owners to make tough choices such as letting go of employees, reducing compensation for workers, or shutting down entirely. As lawmakers continue to introduce more bailout and stimulus packages to pull the economy out of recession, it is important to remember that:

[5] On October 3, 2008, the FDIC temporarily increased the limit on depositor insurance coverage from $100,000 to $250,000 per deposit. The limit is currently set to revert to $100,000 on January 1, 2010. See http://www.fdic.gov/deposit/deposits/insuringdeposits/.

Main Street and small business owners did not create this mess, but they are undeniably hurt by it and are being asked to help pay for the solution.

As part of the solution but not part of the problem, small business owners therefore have every right to expect that their views and interests will be taken into account when policies aimed at repairing the nation's financial system are crafted. It is important that the financial system be reformed so that similar financial meltdowns are prevented from happening again. We provide some recommendations for reform below which, if adopted, will help create a financial system marked by increased stability and more prudent oversight without overly discouraging risk-taking.

Reduce Systemic Risk in the Financial System

To date, the federal government has allocated over $12 trillion in financial assistance or guarantees to help right the economy.[6] Much of this money has gone to large, troubled financial institutions that, in the judgment of federal officials, are "systemically important" with assets sizeable enough and contractual obligations numerous and consequential enough that their failures pose a risk to the nation's entire financial system.

Advocates for these institutions sometimes claim the financial services industry is fiercely competitive and firms need to operate on a large scale and include numerous business lines to compete in a tough, global marketplace. While scale and scope can confer benefits, the size and complexity of these institutions are disadvantages and make them difficult to manage. Increased bank complexity is also disadvantageous for serving smaller, idiosyncratic firms whose sizes make them less economic for a very large bank to serve. Current economic realities also contradict claims that size is a necessary condition for financial institutions to succeed. Whereas many large firms face billions of dollars of additional write downs and continue to see their share prices punished, deposits are up at a majority of community banks, which are acquiring new customers at a faster rate than in the past. Loan originations at community banks are also strong.[7]

Banks that grow large and produce systemic risk without delivering commensurate benefits attributable to scale and scope should not be allowed to grow for growth's sake. In place of mega banks, the economy and society might be better served by having a larger number of stronger regional banks that are more knowledgeable about business and economic conditions in the markets they serve and, consequently, are better able to assess and manage risk.

In addition to the systemic risks they pose, systemically important financial institutions (SIFIs) also have damaging and anticompetitive effects that can hurt market efficiency.

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[6] Mark Pittman and Bob Ivry, "Financial Rescue Nears GDP as Pledges Top $12.8 Trillion," Bloomberg, March 31, 2009.

[7] See the Independent Community Bankers of America and Aite Group, LLC's recent report, The Impact of the Financial Crisis on U.S. Community Banks: New Opportunities in Difficult Times.

- **First, SIFIs do not have to pass a market test.** By bailing out troubled firms, the government reduces incentives for poor performers to learn from their mistakes and make adjustments to improve future performance. A "too big to fail" policy erodes the market discipline necessary to ensure that winners win, losers lose, and bad practices and ideas are retired.

- **Second, SIFIs are especially susceptible to moral hazard problems.** Institutions which know the government will bail them out will be more inclined to chase higher returns by pursuing riskier business activities. Any profits from these activities will be privatized, while losses will be subsidized by taxpayers.

- **Third, SIFIs benefit unfairly from artificial competitive advantages that their non-systemically important peers do not enjoy.** Creditors and investors are willing to provide lending and capital to SIFIs on more favorable terms than they do to non-SIFIs, since they know that the downside risk of providing financing to SIFIs is limited. This favorable treatment provides SIFIs with artificial competitive advantages that reduce competition and reinforce the systemic importance and risks posed by SIFIs.

- **These advantages mean that there is an incentive for non-systemically important firms to grow in scale and scope to become systemically important.**

At present, it appears that taxpayers have little recourse but to help pay to correct the mistakes made by SIFIs. Saving these troubled firms may or may not ultimately prove the right decision, but the anticompetitive effects of SIFIs and the enormous cost to taxpayers of bailing out SIFIs undermine the arguments that support the existence of such large institutions. The damage SIFIs have caused makes it clear that policies designed to limit systemic risk should be vigorously pursued by lawmakers.

The first priority of politicians and regulators should be to (a) identify which existing firms are systemically important, (b) determine whether these firms produce social benefits or meet public needs that smaller, non-systemically important firms cannot, and (c) evaluate whether these social benefits and public goods outweigh the systemic risks created by the firms' scale and scope.

- **A compelling argument needs to be made as to why systemically important firms should be allowed to continue in their current forms. Barring a persuasive argument, these firms should be required to reduce their operations to a point where they no longer pose systemic risks.**

- **Those SIFIs judged to produce net positive social benefits and are permitted to continue in their current forms should face tighter oversight of their business activities, and new regulations designed to limit their risk of failure should be implemented.**

- **Systemically important banks should be required to contribute disproportionately to the FDIC insurance fund.**

- **A reasonable way to prevent systemic risk among commercial banks is to limit the maximum share of U.S. deposits allowed at any particular institution. The current limit of 10 percent of total U.S. deposits is too high and should be lowered.**

- **Commercial banks should also be required to fund a larger share of bank assets from core deposits.**

<u>**Privatize Government-Sponsored Enterprises (GSEs)**</u>

The government-sponsored enterprises Fannie Mae and Freddie Mac present a unique case of the perils created by systemic risk. These two institutions have long played an important role in supporting the U.S. housing market and operate under congressional charters requiring them to, among other things, promote access to mortgage credit throughout the country and support a secondary market for residential mortgages. For most of their history, Fannie and Freddie executed their missions with great success and dominated the market for residential mortgages. As recently as six years ago, these two institutions alone held over half of the nation's outstanding mortgage debt.[8]

Although Fannie and Freddie were recently placed under government conservatorships, just one year ago they were still privately-owned entities that distributed profits to private shareholders. Unlike the vast majority of private institutions, however, Fannie and Freddie enjoyed special relationships with the federal government including exemptions from state and local taxes and what was effectively a credit line with the U.S. Treasury Department. Many investors believed that these special relationships and Fannie and Freddie's importance to the housing market implied the existence of an implicit government guarantee of Fannie and Freddie's liabilities. That is, investors believed Fannie and Freddie were "too big (or important) to fail" and that the government would absorb their obligations should either of them prove unable to meet them.

Regrettably, this implicit guarantee has now become explicit, as taxpayers are being forced to cover enormous losses piled up at Fannie and Freddie. That taxpayers must share the losses of these institutions when they did not also share in the profits is a fundamentally unfair outcome, and NFIB believes that reforming Fannie and Freddie should be a top priority for lawmakers going forward. Lawmakers should introduce reforms which ensure that Fannie and Freddie do not pose such risks to taxpayers in the future. Achieving this outcome requires lawmakers to address two key issues: (1) the unfair, "hybrid" structure of Fannie and Freddie which privatizes profits but socializes losses, and (2) the systemic risk posed by Fannie and Freddie's size. To address these issues, NFIB recommends that lawmakers:

[8] Arnold Kling, "Freddie Mac and Fannie Mae: An Exit Strategy for the Taxpayer," Cato Institute Briefing Paper No. 106, Cato Institute, September 8, 2008.

- **Privatize Fannie and Freddie by abolishing their government charters and eliminating their tax exemptions and other special privileges.**

- **The bulk of Fannie and Freddie should be sold off to private investors as separate components. The components should be small enough that none of them are systemically important or dominate existing private market participants. Ensuring robust competition and the existence of numerous players in the residential mortgage business is important to reducing systemic risk.**

<u>Prevent Excessive Risk-Taking and Make Capital Requirements Sensitive to Systemic Risk</u>

Another factor that contributed heavily to the present financial crisis is excessive risk-taking among financial institutions. While commercial banks cannot leverage their equity more than 15 to 1, some non-commercial bank financial institutions that incurred the biggest losses had leverage of more than 30 to 1 prior to the collapse of the stock market.[9] In recent years, Fannie Mae's debt-to-equity ratio reached levels of approximately 60 to 1, levels far too risky for an institution that big and important.[10]

Lawmakers and regulators need to take steps to limit the amount of risk that financial institutions can take and to ensure that firms have enough capital to cover potential losses. The numerous taxpayer bailouts of financial institutions and the hundreds of billions of dollars in asset guarantees made by the Federal Reserve make it clear that existing rules are flawed or insufficient. NFIB believes that:

1. **Strict limits should be imposed on the amount of leverage that financial institutions can adopt. Whatever cap is adopted should acknowledge both on- and off-balance-sheet exposures.**

    a. Higher levels of leverage allow for higher returns on equity when businesses are profitable, but they can also magnify losses.

    b. Reducing the amount of leverage in the economy reduces the chance that damaging amounts of deleveraging will occur during busts, mitigating the procyclical effects of leverage.

    c. Because of the risks SIFIs pose, they should be managed more conservatively than non-SIFIs. **<u>Limits on leverage for SIFIs should therefore be stricter than limits for non-SIFIs.</u>**

2. **Capital requirements should be tailored to account for varying degrees of systemic importance across firms. SIFIs should face stricter capital**

[9] Oral testimony of Luigi Zingales on "Causes and Effects of Lehman Brothers Bankruptcy" before the House Committee on Oversight and Government Reform, October 6, 2008.
[10] The Wall Street Journal, "Fannie Mae Enron?", February 20, 2002.

requirements than non-SIFIs, given the greater harm a SIFI's failure would produce than a non-SIFI's.

3. **Going forward, regulators should place more emphasis on leverage and liquidity risks when examining financial institutions.**

Reform the Credit Rating Industry

The current crisis has also revealed shortcomings in the ability of major credit rating agencies to rate complex financial securities in an accurate and timely fashion. The three major rating agencies, Moody's, S&P, and Fitch, were at fault for their poor evaluation of subprime residential mortgage-backed securities and other structured financial products. Their blatant disregard for the intrinsic riskiness of many securities (which they rated as among the safest) contributed to a massive misallocation of capital, higher than desired levels of risk-taking, and a major asset price bubble.

How rating agencies failed so dramatically and how well they improve their performance in the future largely depend on the industry's structure. The industry's current form divides rating agencies into two groups: (1) SEC-designated Nationally Recognized Statistical Ratings Organizations (NRSROs), which include Moody's, S&P, and Fitch, and (2) non-NRSROs. This structure does not produce the competition necessary to incentivize existing NRSROs to reform and improve, since NRSROs enjoy a number of artificial benefits over non-NRSROs. These benefits stem primarily from regulations linking capital requirements for banks and insurers to NRSRO ratings of their assets and the Employee Retirement Income Security Act (ERISA), which stipulates that pension funds can only invest in securities rated "investment grade" by NRSROs.

Although well-intentioned, the practical effect of these regulations is to create an artificial barrier to entry for newcomers to the credit rating industry. The enormous purchasing power of banks, insurers, and pension funds means that issuers have a huge incentive to obtain ratings from NRSROs, but very little incentive to obtain ratings from non-NRSROs. Non-NRSROs therefore face an immensely difficult challenge in acquiring clients and growing market share regardless of whether they perform better, are more efficient, or utilize a superior methodology than established NRSROs. Moreover, the dominance of the three major rating agencies means that under the current framework, these firms do not have to pass a market test and are not penalized for poor performance.[11] Even if Moody's, S&P, and Fitch perform poorly, issuers have no real alternative but to continue obtaining ratings from these agencies if they want access to capital markets.

[11] According to Moody's, they, S&P, and Fitch collectively account for 95 percent of global ratings. While total revenues for the credit rating industry were approximately $5 billion in 2007, revenues for rating agencies other than Moody's, S&P, and Fitch totaled just $25 million (approximately). See *How to Improve the Credit Rating Agency Sector*, Egan-Jones Ratings Co. American Enterprise Institute Presentation, June 24, 2008.

Finally, the business model followed by credit rating agencies introduces conflicts of interest that can lead to inflated ratings. Right now, most rating agencies are paid by the issuers that obtain ratings for their securities. In this system, issuers of structured financial products are able to "shop" among NRSROs for the best available rating. Rating agencies therefore have an incentive to provide better ratings than their peers might (to attract business), potentially leading to overly optimistic ratings.

NFIB believes that reforming the credit rating industry is a desirable step that can help discourage asset bubbles from forming and provide more accurate information for investors. Done correctly, reform can help to avoid gross misjudgments of the risks of structured financial instruments, as happened in the run-up to the present crisis. NFIB recommends that:

1. **The NRSRO designation be eliminated to increase competition and innovation in the credit rating industry. Rating agencies should compete on an equal basis and be subject to market discipline, without which they have little incentive to improve and perform well.**

2. **Rating agencies return to an investor-financed business model. Such a model would reduce conflicts of interest that can lead to inflated ratings and would push rating agencies to perform better and provide more accurate ratings.**

Improve Regulation of Off-Balance-Sheet Activities

Lawmakers and regulators should also limit the use of off-balance-sheet accounting and entities, especially when leverage in excess of a parent firm's ratios is employed. Time after time, regardless of how much or where information was disclosed in footnotes, off-balance-sheet activities have confused investors and inhibited clear understanding of the true risks and liabilities of firms. Transparency is best supported when everything is on the balance sheet. In those future instances where firms do engage in approved off-balance-sheet activities:

1. **Off-balance-sheet exposures should be acknowledged when determining if a firm is in compliance with restrictions on leverage.**

2. **Firms should be required to hold capital against off-balance-sheet exposures.**

IV. Recommendations for Collecting Small Business Finance Data

Private interests and policymakers have recently encountered an embarrassing lack of small business-specific, empirical data to inform them of the status of small business credit access. They have been forced to rely on privately generated data and anecdote, both of which have been helpful but not satisfying. The Federal Reserve not long ago declared its intent to no longer conduct the Survey of Small Business Finances. Given difficult issues, cost, and delay in publication, this step is not unreasonable. A more helpful initiative would be a contemporaneous data set designed specifically to ascertain the availability of credit to small businesses. The set should elicit the necessary information with a modest response burden on smaller firms and at reasonable expense to the Federal Reserve.