Bauerle's Bank Notes

Whipsawed

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The annual Woodsmen's Show in Galeton, Pennsylvania, draws lumberjacks from around the country to demonstrate their prowess in events bearing names like cross-cut saw, springboard, axe throwing and tree felling. For three days each July, Cherry Springs State Park is alive with the sounds of sawing and the thud of timber landing on the ground. The cross-cut saw competition is a personal favorite, as two men on opposite ends of an eight foot saw take turns pulling it through a tree trunk, seeking to cut the trunk in two in the shortest time.

The event always strikes me as a metaphor for people at work: bound to one another by a shared goal and shared means, but working feverishly at different ends. The image came to mind as I read an Evaluation Report prepared by the Office of Inspector General of the Small Business Administration, titled "The SBA's Portfolio Risk Management Program Can Be Strengthened." The title turned out to be a gross understatement. Sharply critical of the agency for deficient or absent credit risk management practices, the report was a reminder of the problems that have plagued GSE-sponsored lending in the last decade. Said the Inspector General,

> With a focus on lender risk, the SBA did not evaluate its portfolio in terms of other financial and mission risks, such as identifying risky portfolio segments based on default statistics. . . . [W]e determined that the SBA was not regularly assessing the 7(a) loan program and portfolio level risk in terms of the financial and mission risks. Additionally, . . . we also, *sic,* determined that the SBA had not developed a policy for addressing identified portfolio risks.

Any national bank about which the OCC could write those words would be in the hands of that agency's Special Supervision Division within a fortnight.

The details are equally chilling.

> Our limited analysis identified three high-volume franchises [Planet Beach, Petland and Cold Stone Creamery] with historical default rates of at least 46-percent, default values [i.e., share of defaulted SBA-guaranteed loan dollars

> as a percentage of share of loan dollars approved by SBA] over 38-percent and loss rates over 18-percent. . . .
>
> Our analysis also identified five high-volume retail industries with historical default rates of at least 40-percent, default values over 30-percent and loss rates over 16-percent. . . . We determined that over the 2002-2009 period that we reviewed, 10,529 SBA 7(a) loans were disbursed to these five industries, totaling $860 million. Of these loans, 4,415, representing over $300 million in Agency guarantees, defaulted and approximately $150 million in SBA guarantees were charged-off.

Cold Stone Creamery franchisees took home first prize. 321 out of 700 loans made over 6 ½ years defaulted, representing $51 million out of $131 million lent. SBA charge-offs totaled $24 million or nearly ½ of the defaulted debt.

In the aftermath of the Panic of 2008, leading figures have chronicled their and others' actions to stem the crisis. <u>Stress Test</u>, by former Secretary of the Treasury Geithner, is one of the more recent accounts published. In a *New York Review of Books* critique of Geithner's version of events, commentator Paul Krugman credits Geithner and others with swift action to save the nation's biggest banks, but criticizes them for doing too little too late to provide debt relief to beleaguered consumers and small businesses. Krugman's critique has merit. For the programs designed to help consumers recast their debts were plagued by underfunding, delays and bureaucratic tangles. But the SBA Inspector General's report points up a more basic flaw. So much of the GSE-sponsored business and consumer debt was issued based on the premise that losses did not matter because someone else would bear them. Consequently, effective underwriting and risk management did not matter either.

For all its useful insight into the flaws in the way the SBA runs its loan programs, the Inspector General's report fails to take the agency's leadership to task. The problems found are presented as systems issues rather than people failing to do their job. This is reflected in the statement quoted above, "With a focus on lender risk, the SBA did not evaluate its portfolio in terms of other financial and mission risks." In plain English, this means the agency busied itself critiquing banks that made 7(a) program loans, measuring which ones' loans performed better or worse. Meanwhile, the agency ignored the elephant in the living room: its own performance and the default and loss trends revealed by analysis of the entire portfolio. Exhibit A is the high failure rate among Cold Stone Creamery franchisees who took out SBA loans. In the metaphor of the cross-cut saw competition mentioned above, the flaw was not in the saw but in the sawyers. SBA leadership behaved like a woodsman standing on a tree limb 50 feet above the forest floor, making his cut between himself and the tree trunk rather than away from it.

Significant credit contractions are a fact of life. Since the Dow Jones average debuted in 1898, there have been 13 periods when the index declined by more than 30%, or roughly one every decade. The trick is not just to make a better saw blade, but to condition lumberjacks to take pride in their work, respect the risks of their craft, and practice it to balance profit and safety. This is a lesson that the industrial world learned and absorbed

over the last century. Perhaps in the current one, the financial community can too.

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