Financial & markets regulation

Lessons of mortgage crisis go unheeded in small-business lending market

New breed of nonbank platforms have churned billions of dollars of loans

On Wall Street

A scene from the film 'The Big Short' © AP

46 MINUTES AGO by: **Ben McLannahan**

There's a great scene in *The Big Short*, the movie of Michael Lewis' book about the mortgage crisis, where two shiny-suited brokers (http://www.imdb.com/name/nm2915105/mediaviewer/rm2968510720) brag about how many loans they've been producing — for big commissions — to unsuitable borrowers.

"We call those loans 'Dorothys (http://www.paramountguilds.com/pdf/the-big-short.pdf)' 'cause they're magic," grins the one in black. "No credit, no income, no problem: just tap your shoes together three times and say 'There's nothing like owning a home.'"

But this is no snapshot from some reckless, bygone era. Very similar scenes, featuring very similar characters, have been playing out over the past couple of years in the market for loans to small businesses. Largely out of sight of regulators, a new breed of nonbank platforms such as OnDeck, CAN Capital and Kabbage have churned billions of dollars of loans, many of them originated by industrial banks in Utah, where interest-rate caps do not apply.

Debt investors such as KKR (http://markets.ft.com/data/equities/tearsheet/summary?s=us:KFN) and Victory Park of Chicago have been piling in to buy the loans, while commercial banks such as Wells Fargo (http://markets.ft.com/data/equities/tearsheet/summary?s=us:WFC),Morgan Stanley (http://markets.ft.com/data/equities/tearsheet/summary?s=us:MS) and Credit Suisse (http://markets.ft.com/data/equities/tearsheet/summary?s=ch:CSGN) have supplied funds to the platforms to buy and hold their own. Other investment banks have been eager intermediaries, bundling loans into packages then selling tranches to institutions hungry for yield.

On the front lines, the sales techniques can be near-identical to those employed by the likes of Countrywide or IndyMac a decade ago — teams of people hammering the phones in boiler rooms, supporting brokers (http://commercialloanbrokerinstitute.com/commercial-loan-broker-training/) roaming the streets and knocking on doors. Need a $20,000 loan to upgrade those pizza ovens? No problem. Fancy $5,000 to smarten up that storefront, repayable from daily takings over the next six months?

“There’s a tremendous amount of predatory behaviour around, from people not beholden to the core tenets of fair, affordable and fully transparent and accountable lending,” says Fran Lutz, interim chief executive at Opportunity Finance Network, a Philadelphia-based national group of private lenders directing capital to poorer communities.

He says that many of the newcomers stepped into a void left by crisis-scarred banks such as Citigroup and Bank of America, which pulled back from lending to small businesses under tougher capital standards and heavy pressure from investors to improve profits. In some areas, he notes, the old brick-and-mortar banks have literally shut up shop. “You’ve got ‘banking deserts’ like you have food deserts (http://next.ft.com/content/8e2c0d3c-cddb-11e2-a13e-00144feab7de) — vast areas where you don’t have bank branches or an adequate supply of capital.”

The small-business lending market is much smaller than mortgages: about $250bn, according to the Federal Deposit Insurance Corporation, compared with home loans (http s://www.newyorkfed.org/newsevents/news/research/2016/rp161130) of $8.8tn. On that basis, the damage from a full-blown crisis will be less, but it still hurts when the liquidity dries up. Already, overdue payments on several securitisation deals are so high that they've triggered provisions which divert cash from low-ranked bondholders to protect investors further up the chain.

Meanwhile, some banks have put a stop to funding new business, alarmed by rising defaults. CAN Capital, one of the top three nonbank lenders to small businesses, said it was pausing originations last month as it kicked out (http://next.ft.com/content/80d919d2-b6a2-11e6-ba85-95d1533d9a62) a trio of top managers over wider-than-expected losses.

Doug Naidus, chief executive of World Business Lenders, a Jersey City-based firm that boasts the largest salesforce in the country, likens this credit crunch to the one across the mortgage industry in 2007, when teams of compliance people suddenly appeared to review exposures. (He was co-head of US residential mortgage-backed securities at Deutsche Bank at the time.)

Back then, people thought that house prices would never fall like they did. This time, he says, the delusion was different. An explosion of cheap technology convinced platforms that if they gathered enough data — from cash flows to zip codes to "likes" on Facebook (http://next.ft.com/content/d6daedee-706a-11e5-9b9e-690fdae72044) — they would be able to predict the future. That might be true in, say, insurance, but it's certainly not the case in small-business lending, he says, where tiny shifts in local economies can drive default rates sharply in either direction.

Lenders backing platforms making unsecured loans (unlike WBL, which is secured only) need to brace themselves for big losses, he says.

"The sector credit is defective," says Mr Naidus. "If the underlying credit is broken, you can't structure your way out of it."

The mortgage crisis should have been a better lesson, says Karen Mills, a senior fellow at Harvard Business School who served a five-year stint as the head of the Small Business Administration under president Obama. She recently co-authored a white paper (http://ww w.hbs.edu/faculty/Publication%20Files/17-042_30393d52-3c61-41cb-a78a-ebbe3e040e55.pdf) calling for special charters for nonbank lenders.

If losses keep rising and the funds stop flowing, a generation of small business owners could end up starved of cash — just like young people missed out on home ownership in the years after the crisis.

"We shouldn't make the same mistakes again," she says.

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