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Commentary » RONALD D. PAUL

In search of liquidity

Community banks need more cash on hand to fund small businesses

The federal government has introduced a welcomed program to help community banks increase the amount of money they are qualified to lend to small businesses, something that potentially could become a major contributor to the economic recovery. But for community banks to take full advantage of the higher lending amounts, the federal government needs to introduce new policies aimed at helping them generate more sources of funding loans.

A bank's formula for the total amount of money it can lend is based on its capital — the sum of the institution's assets contributed by shareholders and the profit it has earned and retained. But it is the cash on hand that enables a bank to make those new loans at the permitted amount.

The Small Business Lending Fund will be an effective source of capital to make new loans to small businesses. Congress has made $30 billion available to community banks for this purpose. This very inexpensive source of capital could provide EagleBank about $56 million and qualify it to make several hundred million dollars of new loans in the next few years to small businesses in the Washington metropolitan area.

But the catch is that the bank may not have the cash on hand to make those loans. EagleBank, a well-capitalized bank, can leverage its capital 8 1/2 -fold. So $56 million of capital, for example, means you can lend $475 million. But, and it's a big but, you need to have the other $420 million in funds available.

It's going to be the strong markets and the strong banks that start pulling the country out of this economy, and strong banks need liquidity to make new loans to small businesses. When a small business, say a hardware store or a restaurant, comes to EagleBank and asks for a bigger loan because it is experiencing an increase in its inventory or volume of business — which is a good thing — the bank doesn't want to be in the position of having to say, "Sorry, we don't have the funds available."

Obviously, increasing our deposits is the best way to expand the number of sources for new loans. Community banks have less funding — less liquidity — now in part because some customers during the financial crisis fled to larger banks, believing their deposits would be safer there. Certain customers may still carry the perception that community banks are not as safe as the big banks, right or wrong.

The government can help by lifting the $250,000 limit on the amount of deposits the FDIC insures. If the FDIC insured all deposits, the perception issue would be satisfied and community banks would no longer be at a disadvantage.

Community banks have suffered from the government's decision some years ago to allow investment houses to create bank holding companies that attract money market customers away from community banks. That policy should be reversed. I also urge local businesses, state governments and local municipalities to support local community banks.

We must also re-examine alternative sources of funding for well capitalized and well managed banks. Our regulators annually examine and rate banks, but it often seems the results are not recognized. One source of funds for banks is borrowing from the government. We should look at allowing highly rated banks to have differentiated credit and collateral standards for borrowing from the Federal Home Loan Banks. Similarly, for highly rated institutions, the Federal Reserve should be able to provide borrowing that is not limited to being paid back over very short time frames, as is now the case.

The creation of the Small Business Lending Fund is a great first step in making funds available to small businesses. Now we have to tackle the next step of liquidity so we can fuel the economy.

Ronald D. Paul is chairman and chief executive of EagleBank.