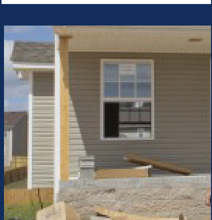
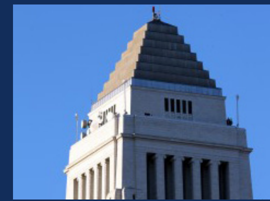
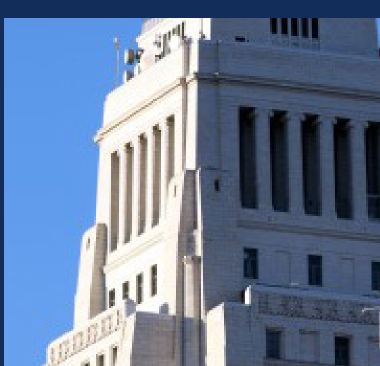





CUSTOMIZING FEDERAL & STATE LOAN GUARANTEE PROGRAMS

JUNE 2012



ACKNOWLEDGEMENT

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ABOUT THE SOUTHERN CALIFORNIA BUSINESS DEVELOPMENT CORPORATION

The SCBDC is a corporation focused on those lending and investing activities that are solely limited to those permitted to be undertaken by Community Development Corporations consistent with the policies established by the Office of the Comptroller of the Currency, the Federal Reserve Board, the California Department of Financial Institutions, and any other relevant regulatory authorities. The SCBDC is a significant investor in the community development finance activities of the Los Angeles LDC, Inc. The shareholders of the SCBDC are regulated financial institutions that serve the low income and distressed communities in California.

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INTRODUCTION

Experts have long recognized that credit risk is largely responsible for the financing problems faced by so many small businesses. In October 2007, the Federal Reserve Board's "Report to Congress on the Availability of Credit to Small Businesses" stated:

> *"The concerns of the Congress and other policy-making bodies about small business financing stem from the perception that small firms have more difficulty gaining access to credit sources than do large businesses or other types of borrowers. The source of this difficulty may be the greater riskiness of small firms and the associated high costs of evaluating and monitoring credit risks, or it may be inefficiencies in markets that hinder pricing of risk or impede the effective pooling of risks. To the extent that private-market impediments or inefficiencies are the source of any difficulties for small business financing, policymakers may focus on changes that reduce these constraints."*

On June 14-15, 2012, the San Francisco Federal Reserve Bank, in cooperation with the Milken Institute, the Los Angeles Local Development Company, Capital Access Group, and Wall Street Without Walls, hosted a two-day meeting to examine an innovative proposal for addressing small-business credit risk. The workshop, "Customizing Federal and State Loan Guarantees," brought together approximately 60 investors, lenders, and public officials to explore the potential of using SBA and other federal guarantees to "wrap" or "enhance" state loan-guarantee and insurance programs. The hybrid strategy would improve publicly sponsored efforts to support credit for small businesses in four important ways:

- First, a hybrid program would combine the credit quality and capacity of federal guarantee programs with the flexibility and simplicity of state initiatives. Thus, it could attract more lenders than state or federal programs alone.

- Second, hybrid programs would allow states to target and tailor federal guarantees more effectively to market needs. This would improve the performance of federal guarantee programs in achieving policy goals.

- Third, state programs generally achieve less leverage per dollar of public cost than federal programs. Thus, hybrids would enable states to use their credit-enhancement dollars more efficiently.

- Finally, hybrid programs are likely to make more types of credit available to more borrowers, thus increasing their value in strengthening state economies and creating jobs.

Under the plan, states would pay any added loan-default costs incurred by the federal government as a result of enhancing or wrapping state programs.

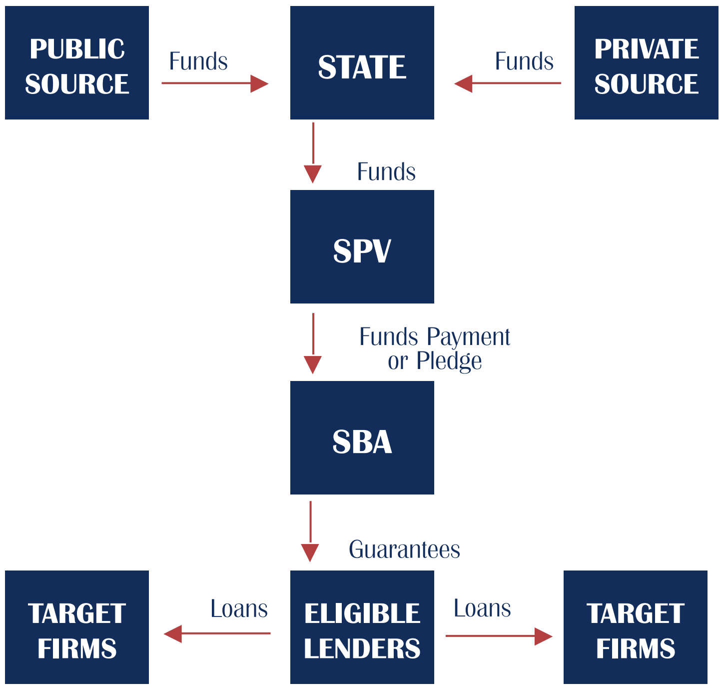
This report on that workshop is divided into four sections.

- **Section 1, Background** looks at the principal differences in federal and state loan guarantees, especially how the costs of these programs are financed.

- **Section 2, Findings** sets forth the business and policy issues that must be addressed if "customization" is to become a practical approach to small-business lending.

- **Section 3, Conclusions** identifies the key elements of a customization strategy capable of responding to these policy and business challenges.

- **Section 4, Recommendations** proposes specific ideas, actions, and initiatives that should be part of a customization program.



BACKGROUND

Every year, the federal government makes or guarantees more than $1 trillion in loans for homeowners, farmers, businesses, and individuals. According to Douglas Eliott of the Brookings Institution, at the end of FY 2010, outstanding federal loans and guarantees, including credit extended by Fannie Mae and Freddie Mac, stood at more than $8 trillion. To put this figure in perspective, the federal government's credit exposure is almost equal to the combined assets of the five largest U.S. banks. Of this $8 trillion, over $2 trillion represented loan guarantees extended to businesses, farms, students, and homeowners.

Until 1990, the federal government used cash accounting to budget the cost of credit programs, a method that produced significant distortions. On the one hand, direct loans appeared to be as expensive as grants, even though most loans would be repaid. On the other hand, loan guarantees appeared to be free even though some guarantees would produce losses.

However, since the passage of the Federal Credit Reform Act (FCRA) in 1990[1], the federal government has used accrual accounting to budget the cost of credit programs. Now, under FCRA, Congress must appropriate an amount equal to the net present value of the expected costs—primarily default losses and interest subsidies—of federal credit programs. This appropriation is called the credit subsidy.

There is no doubt that accrual accounting gives policymakers and managers a more accurate picture of the costs of federal loans and guarantees than cash accounting provides. However, especially for loan-guarantee programs—which appeared to be free under the former accounting method—the need to appropriate money to pay losses that may not materialize for many years appears to have created a bias toward the least-risky loans.

While tighter and more risk-averse underwriting can reduce program costs, it can hinder federal efforts to address market failures and increase investment in underserved markets. This is especially important in view of the fact that most federal credit assistance now takes the form of guarantees rather than direct loans. For example, for FY 2013 only $1.1 billion of the Small Business Administration's $25 billion in credit assistance—about 4 percent—will take the form of direct loans.

One way to make federal small-business guarantees available to more borrowers, especially underserved firms, is to shift credit-subsidy costs to state and local governments—and to the private sector. This approach is, in many ways, simply an extension of current practice. For example, the U.S. Department of Energy operates a loan-guarantee program to encourage funding of innovative energy projects. Similarly, the U.S. Export-Import Bank provides guarantees that protect exporters and their lenders from financial risk. The cost of these programs is paid entirely by fees levied on borrowers and lenders.

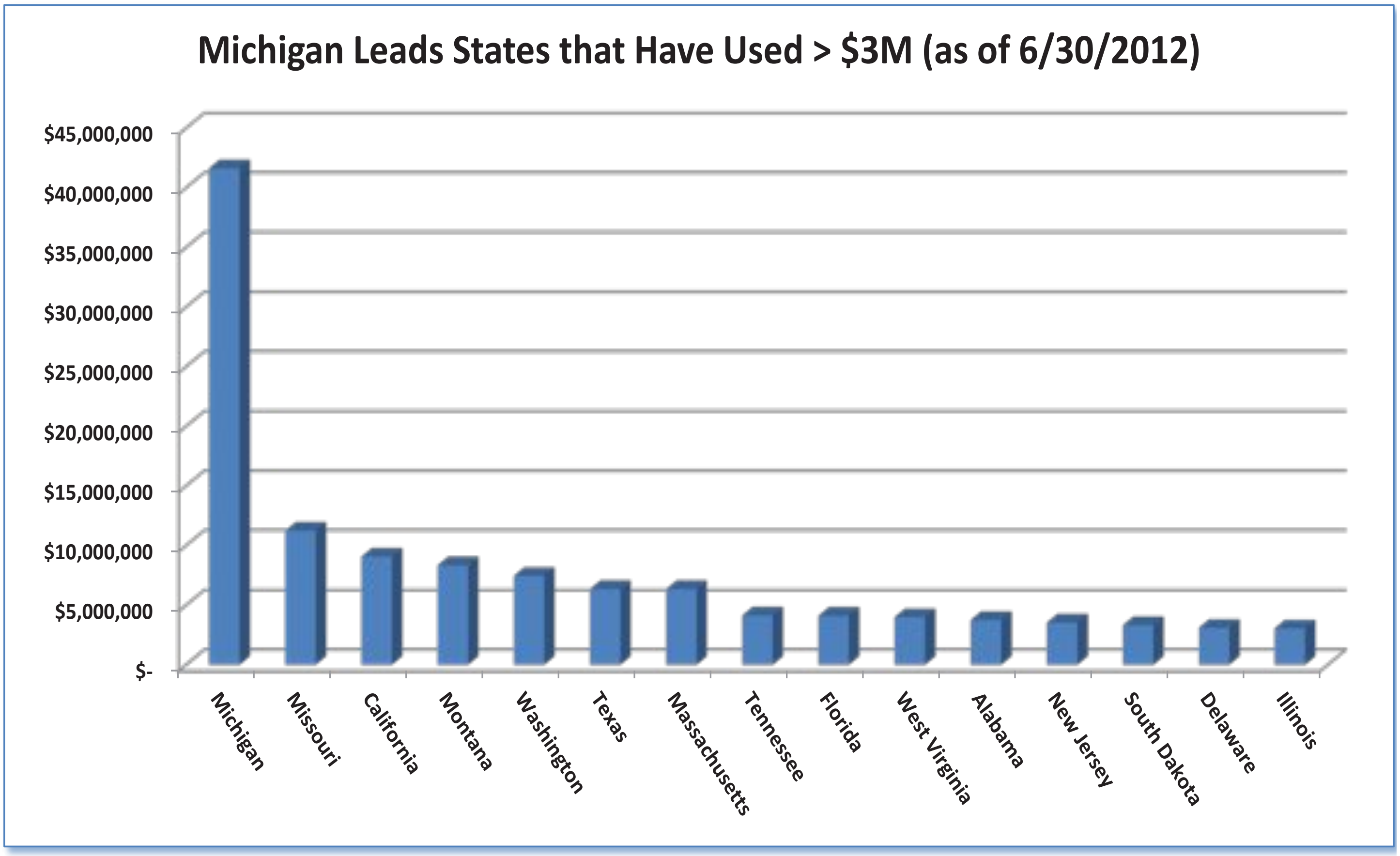
Credit-enhancement programs that make small-business lending safer and more profitable have particular importance today. In California, for example, the number of small-business loans has contracted by 40 percent since 2005. It should be noted that this contraction is not only larger than the national average but concentrated in loans of less than $250,000, the size of loan that many small firms need. In addition, the state ranked sixth in bankruptcies as a percentage of business establishments. Not surprisingly, long-term joblessness (greater than 52 weeks) within California is by far the largest category of unemployment.

In response to perceived gaps or deficiencies in federal programs, almost every state and many localities have instituted their own loan-guarantee and insurance programs to benefit small businesses. However, unlike the federal government, states are generally prohibited from pledging their credit on behalf of private interests. This means that a state loan-guarantee program is backed solely by funds contributed to a reserve account. The state is not legally responsible for the obligations of its loan-guarantee programs. Because lenders have no recourse to the state itself, state programs are often overcapitalized, holding large enough reserves to withstand even catastrophic losses. For example, in California, the Small Business Loan Guarantee Program[2] holds $1 in reserves for each $5 in credit exposure. For the same $1, SBA can provide about $65 in guaranteed lending.

It appears that using state funds to pay SBA's subsidy costs rather than for deposits to the state's reserve account could yield two important benefits. First, it would enable states to offer stronger guarantees while using fewer dollars. Second, it would improve the extent to which federal guarantee programs increase capital flows to underserved firms without increased federal cost. The impact of this small change should be significant.

Last year, under the State Small Business Credit Initiative (SSBCI)[3], the Treasury Department awarded $1.4 billion to 54 states and territories to strengthen small-business guarantee and insurance programs. Nationally, about $1 billion remains unused. As of December 2011, California had employed less than $10 million of its $168 million allocation. Many other states have also found SSBCI funds difficult to deploy. Using them to finance the credit-subsidy costs of SBA or other federal guarantors could potentially produce almost $65 billion in financing for small businesses and create or save more than 2 million jobs.

STATES THAT HAVE EXPENDED OR OBLIGATED > $3M
(AS OF 6/30/2012)



FINDINGS

1. **SBA is, by far, the largest and most important source of credit support for small businesses.**

   a. In 2013, SBA is expected to provide almost $25 billion in credit support through multiple programs.

   b. Together, the Export-Import Bank and U.S. Department of Agriculture provide only about 10 percent of SBA's volume.

2. **SBA programs, especially its flagship 7(a) guaranteed loan program,[4] can be difficult for small lenders to employ successfully.**

   a. SBA can refuse to honor its guarantee if a lender breaches the agency's rules regarding loan and borrower eligibility, documentation, and servicing. Although SBA reports that recent changes have increased the percentage of approved requests to 95 percent, the program nevertheless involves "claims" risk or costs that some smaller lenders find unacceptable.

   b. To fulfill SBA's extensive compliance requirements, larger lenders typically establish dedicated SBA lending divisions. However, because smaller banks can rarely afford such specialized business units, they are less likely to make frequent use of SBA guarantees.

3. **A significant number of lenders use SBA guarantees to improve the profitability rather than the availability of small-business loans. Risk aversion on the part of the federal government and lenders appears at least partly responsible.**

   a. Using SBA guarantees for comparatively safe loans allows lenders to benefit from the liquidity and capital efficiency of SBA loans while minimizing the danger that high delinquency, default, and loss rates will jeopardize their status in the Preferred Lenders Program.[5]

   b. SBA can minimize its cost to taxpayers by limiting eligibility for guarantees to lenders, borrowers, and loans that pose limited default risks. Some past efforts to expand credit to risky borrowers, such as Community Express, have resulted in dramatically increased costs.

   c. According to many lenders, SBA-guaranteed subordinate debt would meet an important

market need. However, OMB circular A-129, "Policies for Federal Credit Programs and Non-Tax Receivables," specifically discourages loans in which the federal government assumes a subordinate position. Agencies do not, however, always follow OMB's guidance. For example, under the SBA's Certified Development Company or 504 Program, the federal government guarantees subordinate debentures issued to provide fixed-asset financing to eligible firms.

4. **The Treasury Department's State Small Business Credit Initiative gave states $1.4 billion for innovative credit-support programs. While the program allows states to finance alternatives to SBA programs, the slow rate at which SSBCI funds have been deployed creates the risk that undisbursed funds will be forfeited.**

   a. By law, Treasury may withhold any SSBCI funds not disbursed within two years after the signing of a state's allocation agreements.

   b. California's amended allocation agreement, signed in May 2011, divided the states $168 million in SSBCI funds equally between CalCAP, the state's portfolio-insurance program, and the State Small Business Loan Guarantee Program (SBLGP).

   c. As of June 2012, the state is estimated to have used $10 million of its allocation. If CalCAP and the SBLGP are unable to use an additional $37 million in SSBCI funds by the end of May 2013, California may lose up to $112 million in SSBCI funds.

5. **The underuse of SSBCI funds may be partly caused by structural features of approved programs.**

   a. Capital access programs (CAPs)[6] are unattractive to many low-volume lenders because accumulated loan-loss reserves may not be sufficient to cover losses. Larger, high-volume lenders have not yet become major users of CAPs, in part because the SBA Express Program offers a more attractive alternative. For this reason, CalCAP and other CAPs across the country have used only a small part of their SSBCI allocations.

   b. Loan-guarantee programs, such as SBLGP, do not offer the same benefits as SBA guarantees. For example, unlike SBA guarantees, state guarantees cannot easily be sold in the secondary market. Moreover, regulators require lenders to hold more capital against state-guaranteed loans than against SBA loans.

   c. While state programs typically entail less compliance complexity than SBA programs, some lenders have experienced difficulty in securing full payment of losses on defaulted loans. Along with the limited capital backing, this makes state programs less attractive as a source of risk mitigation.

6. **Customization may help states create hybrid credit-enhancement platforms that offer lenders the best features of SBA and state programs. However, such programs will probably need the approval of the OMB, SBA, and Treasury Department.**

   a. OMB Circular 129 stresses the importance of contracts that protect the government's interest. Any expansion of the risks assumed by federal credit programs may require OMB review.

   b. SBA often tests innovative uses of its guarantees through pilot programs. State customization of those guarantees may require SBA approval.

   c. The SSBCI statute and policy guidance are silent on the use of SSBCI funds to finance costs associated with using federal guarantees to enhance state programs. Explicit Treasury approval for such a use may therefore be required

7. **Some states may find customization unattractive if it imposes additional costs on state agencies or undermines existing efforts.**

   a. Developing a customization program may strain state budgets. For example, securing federal approval to use SSBCI funds to pay federal credit-subsidy costs may place an additional burden on limited SSBCI administrative funds.

   b. Customization may divert resources from established state credit enhancement, thus risking limited state resources on an unproven strategy.

CONCLUSIONS

1. **Customization can increase the capacity and appeal of state credit-enhancement programs. In addition, using SSBCI money to fund customization programs may help reduce the risk of losing undisbursed funds.**

   a. As of December 2011, CalCAP and SBLGP had used about $5.6 million in SSBCI funds to support about $57 million in loans to small businesses. Given current reserving policies and practices, lending under the two programs will have to reach over $1 billion by May 2013 in order to avoid the potential loss of California's remaining allocation.

   b. In many other states and localities, significant alterations to SSBCI-financed programs may be needed to avoid the risk of adverse action by Treasury. Customization is among the options that states should consider.

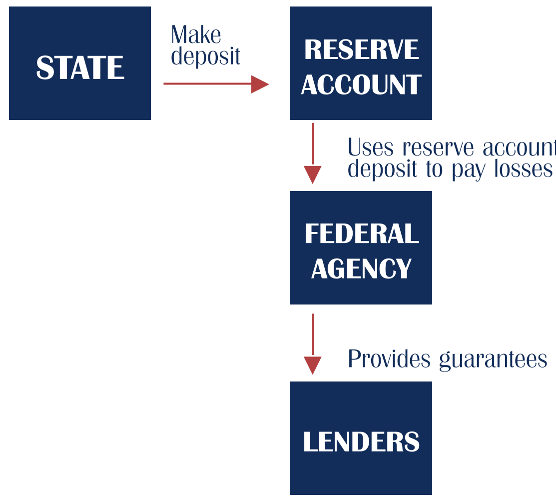
2. **Federal agencies may be able to use their authority to conduct pilot programs to organize efforts to customize loan guarantees.**

   a. Pilot programs typically permit the testing of innovative or novel forms of small-business financing that are statutorily permissible but not allowable under current policy and regulations.

   b. SBA has used this authority to test programs, including Community Advantage and Express Loan Programs.

3. **The credit-subsidy costs associated with customization can be covered through direct or indirect financing.**

   a. Direct financing would involve the use of state or private funds to deposit money in the appropriate account of the federal credit agency.

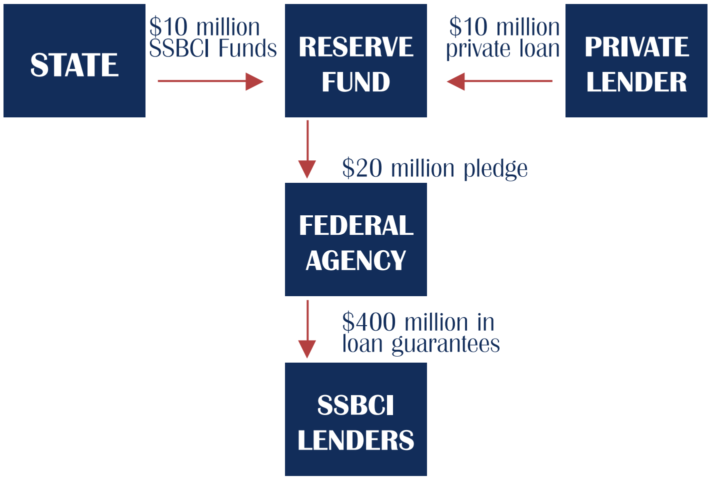


   b. Indirect financing entails the use of public or private assets to collateralize federal guarantees. For example, loan-loss reserves established under state-sponsored capital access programs might be used to collateralize SBA loan guarantees.

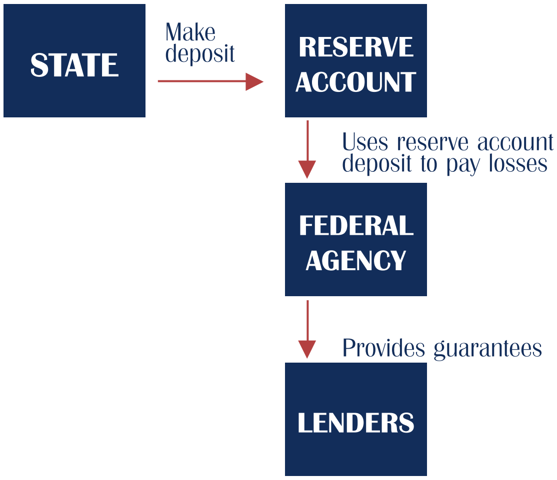
4. **Policymakers should consider a variety of options for financing direct payments and collateral accounts.**

   a. Risk-based interest rates and fees. Cash flows from loans can be used to make credit-subsidy payments or deposited in collateral accounts.

   b. Unused SSBCI funds. With Treasury approval, states may draw down unused SSBCI funds to collateralize private financing if the proceeds are employed for an approved CAP or other credit-support programs. For example, SSBCI funds might be used as security for a private loan to a loan-loss account that, in turn, would use the proceeds to collateralize a federal loan guarantee for a small business. To illustrate, a state might transfer $10 million in SSBCI funds to a loan-guarantee program's reserve fund. The state could then borrow an additional $10 million in private funds, bringing the total assets of the reserve fund to $20 million. The $10 million in private borrowing would be secured by the $20 million in reserve fund assets. Assuming that each $1 of reserve fund capital could back $20 in federal guarantees, (about 30% of SBA's leverage) the entire $20 million would then be used to back small-business loan guarantees totaling $400 million.



c. Program-related and impact investments. Instead of SSBCI funds, financing from foundations and institutional investors may be employed to collateralize federal guarantees or to make credit-subsidy payments. Under certain conditions, foundations may be able to use their endowment funds to buy market-rate debt issued to finance collateral accounts or to make credit-subsidy payments to federal agencies.



d. Private debt. Special-purpose companies (SPCs) could be established to collateralize federal guarantees or to make credit-subsidy payments. These SPCs might be financed through the issuance of a collateralized loan obligation (CLO) backed by the cash flows from federally guaranteed or insured loans. In most cases, a small interest surcharge on the guaranteed loans should be sufficient to make required interest and principal payments on the CLO.

e. Foreign investment. Policymakers should consider use of EB-5 (Employment-Based Immigration) investments to finance federal subsidy costs or to provide collateral for federal guarantees. The EB-5 program provides temporary visas for immigrants who invest a minimum of $500,000 in a business that directly or indirectly creates 10 U.S. jobs.

f. Tax credits. California's 20 percent tax credit through Treasury's Community Development Financial Institutions program is a potential source of financing for credit-subsidy payments or accounts that collateralize federal guarantees.

5. **Technical assistance can help to reduce borrower defaults. As such, the funding of technical assistance should be considered a legitimate strategy for reducing credit-subsidy costs.**

   a. Consideration should be given to financing "post-closing" technical assistance through transaction fees. These fees could be included in loan proceeds and repaid by the borrower over time.

   b. Borrowers who agree to post-closing technical assistance should have part of the cost rebated or offset in the form of reduced interest rates or easier repayment terms. Loans that allow borrowers to defer the repayment of principal are an example.

6. **Best-of-breed technology is important to the success of customization.**

   a. Using electronic technology to collect, store, and analyze loan and lender data will permit accurate analysis and pricing of risk. This will ensure that credit-subsidy and collateral requirements are established at appropriate levels.

   b. Technology will also lower costs and facilitate the standardized underwriting, servicing, and documentation that will permit lenders to meet the requirements of regulators and investors for securitization programs.

SUGGESTIONS

1. **Organize a pilot program in three to five states, including California, to test the customization of SBA and other federal guarantees.**

    a. The pilot programs should be designed to provide forms of financing not generally available or affordable to small businesses and produce at least $100 million in financing for underserved borrowers over five years.

    b. Sponsoring states should be required to demonstrate the capacity to provide the credit-subsidy payments or collateral required for five years of guaranteed lending.

    c. Within sponsoring states, the program should initially be limited to a relatively small group of CDFIs and banks with a history of successful small-business lending.

    d. Guaranteed lending under the program should be restricted to borrowers and loans meeting eligibility criteria proposed by each lender and approved by SBA.

2. **Require lenders in pilot programs to employ a common technology-based platform for originating and administering loans.**

    a. A common platform will also allow lending costs to be distributed among lenders, facilitate compliance with SBA rules, and allow program modifications and enhancements to be made quickly and uniformly.

    b. A common platform will also ensure the standardization required for accurate pricing of loans and credit subsidies as well as for securitization.

3. **Establish a special-purpose company (SPC) as the financing vehicle for the customization program.**

    a. The SPC could take a number of forms but would have the authority to issue notes and bonds and to serve as the repository for cash and other assets required to collateralize SBA guarantees or to make credit-subsidy payments.

    b. SPC assets, whether collateralizing SBA guarantees or deposited in an SBA account, would be used to buy all defaulted loans under the pilot program. Only after the depletion of SPC assets would SBA funds be used to purchase defaulted guarantees.

    c. A firm selected by participating lenders and approved by the sponsoring state agency should manage the SPC. Ideally, the management firm should have a financial interest in the SPC.

4. **If permitted by Treasury, employ unused SSBCI funds to finance the SPC.**

    a. Nationally, about $1 billion of the $1.4 billion in SSBCI funds allocated to states remains unused. The use of some of these funds to support the pilot program appears to be consistent with the SSBCI statute and Treasury policy guidance.

    a. Use the “qualifying loan or swap funding facility” provision of the SSBCI statute to leverage private financing. Under current rules, states can draw down SSBCI funds to collateralize private financing if the proceeds of the transaction are used to support an approved program.

ENDNOTES

[1] *The Federal Credit Reform Act of 1990 (FCRA) was enacted as part of the Omnibus Budget Reconciliation Act of 1990 and was intended to improve the measurement of the budgetary costs of federal credit programs.*

[2] *The California Small Business Loan Guarantee Program resembles the Small Business Administration's Guaranteed Loan Program. It provides a partial guarantee of small-business loans made by banks and other eligible lenders.*

[3] *The State Small Business Credit Initiative (SSBCI) was part of the Small Business Jobs Act of 2010. It provides states with $1.5 billion to strengthen programs that support lending to small businesses and small manufacturers. SSBCI was designed to spur up to $15 billion in lending to small businesses. Participating states use SSBCI funds for programs that leverage private lending to help finance small businesses and manufacturers that are creditworthy, but are not getting the loans they need to expand and create jobs.*

[4] *Under the 7(a) program, SBA typically guarantees 50 percent to 85 percent of loans to eligible small businesses. Upon loan default, SBA will buy the guaranteed portion of the loan from the lender.*

[5] *Under the Preferred Lenders Program (PLP), SBA delegates the final credit decision, liquidation authority, and most responsibility for servicing to carefully selected lenders.*

[6] *A CAP is a loan portfolio insurance program. Under CAPs, when a lender originates a loan, the lender and borrower contribute a portion of the loan or line of credit, from 2 percent to 7 percent, to a reserve fund in the lender's name. The state matches the combined lender/borrower contribution, and sends the state contribution to the lender-held reserve fund. Each lender's total CAP reserve fund is available as cash collateral to cover losses on all loans in the lender's CAP portfolio. Loans are originated and serviced by the lender, and the lender may make claims to withdraw from the reserve for losses incurred through default.*

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Paul Pryde is a public policy and finance consultant specializing in market-based solutions to the capital access problems of underserved businesses and communities. He was responsible for organizing one of the first securitized sales of small business loans financed with Community Development Block Grant funds and subsequently advised states and localities on the valuation and/or sale of over $100 million in economic and community development loans. More recently, he was principal author of a feasibility report, for the U.S. Treasury's CDFI Fund, on the securitization of community development loans and served as chief policy consultant for the U.S. Treasury Department's $1.5 billion State Small Business Credit Initiative.

Mr. Pryde has also been a consultant to, and board member of, a number of national policy development organizations, including Wall Street Without Walls, the Capital Access Task Force of the Minority Business Development Agency, the Northeast-Midwest Institute, the National Center for Neighborhood Enterprise, the Finance Project and the Corporation for Enterprise Development where he served a four-year term as chairperson. He is also the author and co-author of several publications on markets, economic development and entrepreneurship, including Black Entrepreneurship in America, an examination of enterprise formation and economic progress in the African-American community. Mr. Pryde is a graduate of Howard University and has conducted graduate work in business and public administration at George Washington University.

SUPPORTERS

Southern California Business Development Corporation - a for profit community development corporation with a mission to establish and build an investment fund to foster and stimulate community development and job creation in Southern California, and particularly in the City of Los Angeles, by making debt and/or equity investments in small businesses which have growth opportunities and do not qualify for conventional financing.

Main Street Capital BIDCO – a for profit corporation, in formation, with a mission to promote community development in distressed and underserved communities throughout the state of California by making, either directly or through local development corporations, debt and/or equity investments in small businesses that have growth opportunities but may not qualify for conventional financing.

Community Reinvestment Fund USA – a national non-profit organization that helps to improve the lives of disadvantaged people and strengthen distressed communities through innovative finance.

CONVENERS

Federal Reserve Bank of San Francisco – The Federal Reserve System conducts monetary policy in the pursuit of maximum employment, stable prices, and moderate long term interest rates. The twelve Reserve Banks supervise and regulate banks and the financial system, protecting consumer credit rights, maintaining stability in the financial markets, managing payments systems, and providing financial services to banks, government, and foreign financial institutions. Locally, the "Fed" convenes on community economic development issues; reporting on research analysis that explains policy implications.

The Milken Institute - is an independent economic think tank whose mission is to improve the lives and economic conditions of diverse populations in the United States and around the world by helping business and public policy leaders identify and implement innovative ideas for creating broad-based prosperity. We put research to work with the goal of revitalizing regions and finding new ways to generate capital for people with original ideas.

Wall Street Without Walls - connects capital market institutions and financial products with organizations engaged in community economic development in low and moderate-income communities, both urban and rural.

Capital Access Group, LLC is a minority-owned consulting and financial advisory firm specializing in financial innovation for the community development and economic development finance industries. It has particular expertise in the creative use of public policy and structured finance to reduce the risk and costs of loans to emerging domestic market firms.

Los Angeles LDC, Inc. – is an independent non-profit community development financial institution with a mission to provide capital and advisory services to foster positive community development impacts in distressed neighborhoods by aligning the needs of our borrowers and investors.

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