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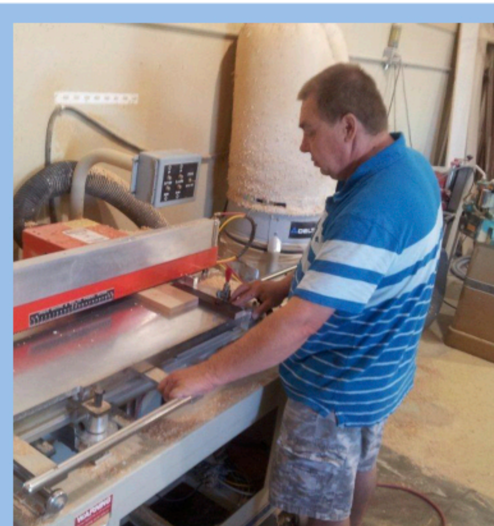

Filling the Small Business Lending Gap:

Lessons from the U.S. Treasury's State Small Business Credit Initiative (SSBCI) Loan Programs

January 2014

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

January 21, 2014

Dear Colleagues:

On September 27, 2010, President Obama signed into law the Small Business Jobs Act of 2010 (the Act), which created the State Small Business Credit Initiative (SSBCI). The Act provided almost $1.5 billion for state programs that support access to credit for small businesses and small manufacturers. SSBCI is expected to spur up to $15 billion in new private capital by requiring states to demonstrate a reasonable expectation that they will leverage $10 in private lending for every $1 in SSBCI funds.

The Act also called on Treasury "to provide technical assistance to States for starting such programs and generally disseminate best practices." Treasury requested the enclosed report— *Filling the Small Business Lending Gap: Lessons from the U.S. Treasury's State Small Business Credit Initiative Loan Programs*—from outside experts for their perspective on the lessons learned from the loan programs. The report is addressed to state policymakers and state program managers. The report covers three areas:

- The context for SSBCI, including the existing federal programs to support small business lending;
- The distribution of SSBCI loan programs by the type of program, the type of implementing agency, and the type of lender;
- The consultants' perspective on the lessons learned and recommendations that could further improve the program's performance.

In addition to reports like this one from industry experts, Treasury also publishes:

- Program Profiles: descriptions of the features of the SSBCI loan and equity products;
- Best Practices from Participating States: peer-to-peer advice on starting and managing SSBCI programs;
- Summaries of States' Annual Reports and Quarterly Reports: statistics and analysis of the states' use of SSBCI funds.

We hope that this report and the other materials available at www.treasury.gov/ssbci will foster greater understanding of state loan programs and their potential to create a more vibrant small business financing market.

Best regards,

Don Graves, Jr.
Deputy Assistant Secretary
Small Business, Community Development
and Affordable Housing Policy

Clifton G. Kellogg
Director
State Small Business Credit Initiative

Filling the Small Business Lending Gap: Lessons from the U.S. Treasury's SSBCI Loan Programs

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1. In North Carolina, Healing with CAARE received funding to expand temporary housing for veterans in Durham County.
2. In Michigan, New Center Stamping received funding for a new line of machinery in inner city Detroit.
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Executive Summary

Section 1: Setting the Context

A. Introduction and Project Background

The State Small Business Credit Initiative (SSBCI) creates an important new catalyst for promoting small business lending and investing. Established by the 2010 Small Business Jobs Act, SSBCI is a collaborative program funded by the U.S. Department of the Treasury (Treasury), managed by the states and their contractors, and implemented through the participation of private sector lenders and investors. The goal of this $1.5 billion program is to use a limited investment of public resources to leverage private sector capital for small businesses.

Several aspects of SSBCI merit special mention:

1. SSBCI creates an innovative funding model: the federal government set outcome parameters – 10:1 private sector leverage within five years—and let states decide how to design and implement the program. State SSBCI programs support private sector lending or investing by sharing in the lender or investor's risk of loss. The private sector bears a significant responsibility for evaluating creditworthiness and program compliance. This federal-to-state-to-private lender-to-small business arrangement is the distinguishing feature of SSBCI's structure. States do not repay the SSBCI funds to Treasury; the state keeps the money as an 'evergreen' fund that recycles into new loans.

2. States choose from five basic types of programs (four loan programs or a state-run venture capital program), and they customize the rules to suit local market conditions. To date, community banks and mission-oriented lenders are the major participants in the loan programs, in part because they often specialize in serving small businesses that do not fit a traditional credit profile.

3. States implement the program through state agencies, quasi-public authorities or private contractors. This allows a state to operate its SSBCI program through whatever organizational structure exists in the state with the business lending experience and capacity to execute.

State experimentation with SSBCI credit enhancements offer lessons for policymakers seeking to strengthen their own SSBCI programs as well as other state business financing initiatives.

This document summarizes the results of a year-long study by the Center for Regional Economic Competitiveness (CREC) that focused exclusively on the SSBCI loan programs. Based on data released through the end of 2012, the loan programs comprised 73 percent of the SSBCI funds requested by states, while equity capital programs received the remaining 27 percent of funds requested. Cromwell & Schmisseur (February 2013) analyzed SSBCI equity programs.

This report examines how states are using the SSBCI allocations, what they are learning from the SSBCI experience, and how state policy leaders and program managers can further improve the volume of lending and achieve their individual program goals.

B. Promoting Small Business Finance in the Wake of the Economic Crisis

In early 2010, the nation was in the midst of the most severe financial crisis since the Great Depression. Small businesses were particularly hard-hit when commercial lending standards tightened. Many banks turned away from small business customers, even those with the ability to repay a loan, particularly if the business operated for a short period of time, lacked sufficient borrower equity, possessed devalued real estate or equipment collateral, or had suffered a sudden depletion of cash due to the economic crisis. In response, SSBCI programs seek to help creditworthy small businesses address these weaknesses. With SSBCI assistance, these small businesses can come into compliance with bank underwriting criteria.

SSBCI programs tend not to compete with government-guarantee programs offered by the Small Business Administration and the Department of Agriculture. Instead, SSBCI's flexibility is well-suited to complement those programs by filling gaps created by those programs' limitations on the size or types of loans, the eligibility of certain types of borrowers, the use of loan proceeds, or the type of lender.

SSBCI enlists state economic development agencies because of their insights into local small business capital needs and their capacity to respond to state priorities. SSBCI program rules establish minimum private leveraging standards—per transaction, per program, and overall for each state—that motivate states to experiment and improve on previous state loan programs.

Historic Development of State Loan Programs

States have introduced a range of loan programs that increase access to small business loans

Pre-1970s	States introduce direct loan programs and low-interest rate loans, some of which are funded with tax-exempt bonds.
1970s	Loan guarantee programs begin in states such as California, Maryland, and elsewhere.
1980s	States develop new loan portfolio reserve models, including capital access programs launched in over 20 states.
2008	Michigan creates the first collateral support program.
2011	SSBCI provides funding for these loan programs plus loan participation programs.

New loan program models, such as collateral support and purchased loan participation programs are a potential legacy of the SSBCI program. The federal funding provides states with a source for learning from each other's experience. The result is that states are introduced to new and more sophisticated credit enhancement tools that can engage the private sector to expand the amount of credit available to small business.

Section 2: SSBCI Product and Portfolio Analysis

A. SSBCI Loan Products

SSBCI supports four types of loan programs (listed in order of the SSBCI allocated funding): [1]

1. Loan participation program (LPP), including two sub-types that are economically the same, but entail different staff skills and administrative costs:
   (a) direct companion loan, in which the state makes a direct loan that closes at the same time as a larger private sector loan;
   (b) purchased participation, in which the state purchases a portion of a loan after it has been made by the lender;
2. Loan guarantee program (LGP), in which a state guarantees a portion of the loss on a loan;
3. Collateral support program (CSP), in which a state pledges cash collateral to a lender when the borrower's collateral does not meet the lender's requirements; and
4. Capital access program (CAP), in which the borrower, bank and state contribute to a reserve account held by the lender to cover its losses until the account is depleted.

B. How SSBCI Assists Small Businesses

Through 2012, states[2] expended slightly more than $190 million in SSBCI funds through the loan programs, drawing into the market over $1.4 billion in new private loan capital. This performance represents approximately $7 private lending for each dollar of SSBCI funds. Based on data reported by the states, these 4,439 loans resulted in an estimated 14,500 new jobs created and nearly 33,900 existing jobs retained that were at risk of loss. (These figures do not include the results from the SSBCI equity programs.)

Notably, lenders made a significant number of SSBCI-supported loans to underserved sectors:
- Companies five years old or younger received half the SSBCI dollar loan volume.
- Small companies with fewer than 50 employees received 96 percent of SSBCI loans, and 80 percent of the borrowers employed 10 or fewer employees.
- Companies in low- and moderate-income areas received 42 percent of the SSBCI loans.

The average size of SSBCI loans was about $319,000, and two-thirds of the loans were below $100,000.

Community banks made nearly 60 percent of the dollar volume of SSBCI-supported loans. Community banks and Community Development Financial Institutions (CDFIs) together accounted for 87 percent of the number of those loans.

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[1] A Summary of States' 2012 Annual Reports, available at www.treasury.gov/ssbbci, presents performance data on the SSBCI programs.

[2] Treasury awarded allocations to 47 states, the District of Columbia, five territories, and municipalities in the three states that either did not apply or withdrew their application. For convenience, this report refers to all the entities that received allocations as "states." The amount of each state's allocation was determined by a funding formula in the legislation.

C. Organizational Structures that Deliver State Business Loan programs

CREC examined the track record of the different organizational structures deploying SSBCI capital. An appendix lists the advantages and disadvantages of the three structures.

- State economic development agencies (35 states[3], 63 programs). These agencies are traditional government bodies led by a member of a governor's cabinet. The agencies follow state personnel, procurement, and information transparency rules and regulations. These agencies function under the normal state budgeting system and require state legislative authority to spend dollars. For the most part, state agencies operate the SSBCI programs within an existing government bureaucracy that manages loan programs under the same pre-existing rules and regulations that must be followed for other state business assistance programs.

- Quasi-public, state-chartered authorities (15 states, 31 programs). These quasi-public authorities are created by state legislation to achieve a specified mandate and are typically governed by boards consisting of gubernatorial or legislative appointees with business or banking expertise. Typically, the chief executive officer is selected by the governor in consultation with an advisory board or by the authority's board with the consent of the governor. Staff members of these authorities are often experts in their field. Quasi-public authorities operate as hybrids of state agencies and private contractors: while they can operate outside of state agency legal frameworks to some extent, they also have many of the characteristics of a state agency. The state government can often delegate authority and transfer funds to state-chartered authorities more expeditiously than to private contractors.

- Private contractors, either non-profit or for-profit entities (9 states, 16 programs). In some states, private entities oversee the use of SSBCI funds; manage lender relationships; handle compliance activities; and report on results. The state maintains responsibility for performance and compliance. Examples of these private contractors include statewide not-for-profit economic development agencies, SBA certified development companies, CDFIs, and for-profit business development companies.

Through 2012, private contractors expended \$2.6 million per loan program and quasi-public authorities expended \$2.4 million per loan program, more than double the \$1.2 million expended by state agencies.

States that used SSBCI funds more slowly encountered headwinds that impeded progress:

- Half of the state programs did not exist prior to the availability of SSBCI funds. These states needed to hire new staff, write new program rules and build new lender relationships.

- States allocated a significant share of the SSBCI funds to CAPs, a type of program that lenders used extensively in the 1990s and 2000s. The CAP model depends on lenders originating

[3] Some states deploy SSBCI funds through multiple organizational structures, so a state may be listed in more than one category.

enough loans to build up a reserve account to absorb losses. This feature deterred smaller volume lenders. National banks said CAPs did not provide sufficient credit support to overcome the perceived risk of lending in the post-recession environment. As a result, many states later reallocated the SSBCI funds out of CAPs and into other eligible programs.

- From 2010-2013, the economic development efforts of at least 13 states were significantly restructured through the creation of new state agencies or quasi-public authorities. Other states experienced turnover of leaders or crucial staff, which inevitably slowed ramp-up.

- Some states divided the allocation into multiple SSBCI loan programs with multiple contractors to implement them, creating management challenges.

- Some territories and municipalities comprise a small market area with little banking activity and therefore present a challenging environment in which to deploy SSBCI funds.

Section 3: Lessons Learned and Recommendations

A. Lessons Learned

By the spring of 2013, each state had operated its SSBCI programs for at least one full year. Based on the early program performance, as well as CREC's experience with commercial lending and economic development programs, the following lessons learned may assist state policy makers and state program managers:

Program Priorities

- Strong state leadership facilitates SSBCI execution and impact. States execute SSBCI programs rapidly when they enjoy a long-standing consensus about the importance of small business lending to the state's economic development.

- Some states integrate SSBCI into multi-faceted economic development strategies. By engaging the governor's office in developing solutions to the state's lending needs, SSBCI encourages collaborations across state agencies and with private lenders. SSBCI program rules give states the flexibility to fill gaps in their economic development strategies.

- States seek to harmonize two priorities— using SSBCI to promote small business lending as quickly as possible, while also targeting the types of businesses that create long-term economic benefits. What ultimately constitutes "success" differs among the states, but the early emphasis on deploying the SSBCI funds rapidly encouraged states to broaden their lending targets. After SSBCI funds have been fully drawn, some states may re-focus on narrower development goals.

- Some states choose to monitor SSBCI impacts beyond the initial focus on loan deployment. Treasury requires certain loan-by-loan data to be reported annually. A few states gather additional information from the outset, or they re-survey borrowers after the loan is made.

Program Design

- <u>The most attractive SSBCI programs are simple to explain and operate.</u> These programs create a process that is easy to use, is responsive to lender needs, and reduces potential burdens on lenders or borrowers wherever possible. Successful states also seek to develop lender-friendly loan management processes. Lenders do not want to participate in programs that create delays or uncertainty. The most pro-active states create expedited processing systems that become part of the program's marketing to lenders.

- <u>States are most effective in deploying SSBCI funds when the programs fill product niches that can be clearly described.</u> The most frequently heard credit gaps were for loans that:
  - Do not meet the guidelines for SBA or USDA loan guarantee programs;
  - Require some credit support, but do not justify the cost and paperwork of a typical government-guarantee program;
  - Help nonprofit organizations; and
  - Provide short-term working capital and bridge financing. One emerging use of SSBCI loan programs is to support construction loans prior to the closing of permanent financing from the SBA 504 program.

- <u>All four types of SSBCI loan programs have succeeded in at least a few states, but certain program types are initially more appealing to lenders.</u> Subordinated LPPs and CSPs are two relatively new program models that SSBCI introduced in many states. Lenders are initially more comfortable with programs that reflect standard banking practices (like LPPs or LGPs). On the other hand, CSPs and CAPs have economic benefits for lenders who understand them.

- <u>Lenders are interested in SSBCI programs that solve a clearly identified borrower credit issue.</u> Lenders do not want to make 'risky' loans. Instead, lenders use SSBCI loan programs to address an identified credit weakness that brings otherwise creditworthy loan requests into conformance with the lender's credit standards.

- <u>Typically, the high-volume lending products subordinate the state's collateral interests to the private lender's interests.</u> These states balance the lender's interest in mitigating its risk of loss with the state's desire to leverage its limited resources to the greatest extent. In all SSBCI programs, lenders must have meaningful capital at risk, which reduces the possibility of adverse selection of loans that are unlikely to repay. States determine whether to re-evaluate the lender's credit underwriting of the loan.

Program Marketing

- <u>SSBCI's credibility with state policy leaders and lenders depends on whether the program receives high-level endorsement and visibility.</u> SSBCI is a program designed for states and lenders. Successful programs generate attention and buy-in from state policy leaders. And when policy makers embrace the SSBCI program, it results in positive attention and improved outcomes in the lender community.

- SSBCI is well-suited to lenders that "hand craft" loan terms to a customer, which is a business model characteristic of community banks and CDFIs. SSBCI programs enroll loans from all approved lenders. Some large-volume lenders are less interested in loans with non-standard terms or collateral, or loans with complex multi-layered financing. These "hand crafted" loans can be readily processed through state SSBCI programs.

- Successful marketing campaigns initially target a specific group of small business lenders. To get started, states target the small business lenders who are well-known in the local market. Successful states find a "champion" who is willing to learn the SSBCI program rules and then offer testimonials to other lenders. State programs typically build the base of participating lenders one-by-one based on in-person sales calls.

- State managers must demonstrate the value of the SSBCI program to lenders' key executives as well as to loan officers. A multiple-touch, in-person marketing approach is necessary to attract financial institutions. Buy-in must occur among both senior executives and lending officers.

Program Implementation

- While states can be effective in managing SSBCI programs through any of three different organizational structures, quasi-public authorities and private contractors deployed SSBCI funds most rapidly so far. Where existing financing organizations or programs have the confidence of state leaders, states often allocate SSBCI funds to them. Often, quasi-public authorities and private contractors have program staff with commercial lending experience and pre-existing lender relationships that enable them to launch new loan programs quickly.

- Successful states use three strategies to achieve the overall 10:1 private leverage targets: recycling of funds, participating in transactions with multiple loans, and reducing the amount of SSBCI support per loan. To approve an SSBCI application, Treasury requires each state to demonstrate a "reasonable expectation" that its combined programs will achieve $10 in private leverage for every $1 in federal contribution. Most states find that providing less than 10 percent credit support for each loan is insufficient to attract lenders' interest. Therefore, states employ three strategies: (1) recycle funds quickly through shorter-term loans such as working capital loans and construction and bridge financing, (2) combine SSBCI-supported loans as part of a larger financing package with other loans, and (3) reduce the percentage of SSBCI support per loan, once a program becomes widely accepted in a state.

- States build success based on relationships of trust and dependability between the state's SSBCI program and participating lenders. The relationship begins with staff knowledge about commercial lending. These relationships also depend on strong communication and follow-through on any promises made during the loan approval, closing, and servicing process.

- Early evidence suggests that states working through mission-oriented lenders have the greatest success in reaching underserved borrowers. Several states use CDFIs and revolving loan funds to reach underserved groups (including California, Georgia, Montana, Pennsylvania and

Washington). These specialized lenders help states reach underserved populations, including young companies, small companies, and companies located in LMI areas.

- By paying close attention to compliance with federal rules, many states avoid potential missteps that could slow progress. SSBCI represents a classic problem for stimulus programs designed to affect the economy quickly. The program funds must be deployed rapidly and with proper stewardship. Achieving results requires all due speed. Protecting taxpayer interests also requires continued diligence, including documenting program compliance.

Program Sustainability

- To date, only a few states have focused on what will happen to their SSBCI programs after the program ends in 2017. In some states, the programs will continue after 2017 because the quasi-public authorities or private contractors that operate the program will retain the funds permanently.

B. Recommendations for State Policymakers and Program Managers

Based on the observations made throughout this report, CREC offers the following recommendations to state policy makers and state program managers:

(1) Expand the SSBCI program's outreach.

A. Focus marketing and outreach efforts on lenders that can be converted to SSBCI "power users."

State program managers should analyze the state's banking sector and target institutions that seem most aligned with the mission of SSBCI. Sometimes these are smaller community banks. States should focus the outreach on institutions that the state expects to provide the bulk of SSBCI loans.

B. Define SSBCI lending niches clearly, and in ways that complement other government loan guarantee programs.

States should develop clear messages about how the SSBCI programs address lender needs and complement available SBA and USDA loan guarantee programs.

C. Develop marketing materials that leverage public relations and free media.

States should consider creating a marketing toolkit—working collaboratively if they wish— with the most persuasive program and/or product messages. The toolkit could also provide templates of success stories that explain how the program addresses a specific credit weakness. This toolkit would include a strategy for using the marketing materials.

(2) Consider hiring staff with prior lending and compliance experience.

A. Hire staff with commercial lending experience and/or train SSBCI staff in the sales process.

Programs staffed by experienced lenders understand the loan underwriting process and constraints under which lenders operate. States should consider independent training sources to equip state program staff with improved selling and loan servicing skills.

B. Employ dedicated compliance officers.

Employing a compliance officer—even on a contract basis—can help avoid inadvertent problems that can result in significant compliance issues and/or costs.

(3) Encourage continued program review and innovation.

A. Host or participate in on-site peer-to-peer program panel reviews.

States should consider organizing three-person panels composed of other states' program managers to provide an outside peer assessment of the state's programs and lending environment.

B. Conduct structured product and process innovation working sessions to refine SSBCI operations and respond to on-going market changes.

States should conduct periodic working sessions with stakeholders (internal staff, lenders, in-state experts, and other key partners) to adapt product offerings as market conditions change.

(4) Enhance understanding of SSBCI's impacts.

A. Consider expanding future state loan tracking systems to gather data on race/ethnicity, gender, and veteran status of borrowers to the extent the law allows.

As states continue to originate more SSBCI loans, they should consider collecting additional data that can tell a compelling story about how SSBCI addresses underserved credit markets.

B. Consider how to validate program impacts on small businesses.

States should consider developing a process for validating data on employment, jobs created/retained, and total borrower revenues after the loan has closed and the business invests the capital that SSBCI has made available.

C. Consider upgrading processes and information management tools to monitor loan performance.

As the size of the loan portfolio increases, the state managers' workload will shift to portfolio monitoring, which requires adequate management skills and computerized systems. States with sufficient loan volume should consider developing a real-time tracking system to manage transactions from application to loan payoff. An accurate loan tracking system can provide "real-time" insights about the small business credit markets, SSBCI's progress in improving those markets, and the quality of the SSBCI loan portfolio.

(5) Foster increased use of SSBCI funds to reach underserved populations.

A. Adopt best practices from states that reach underserved populations by engaging CDFIs or other specialized lenders.

States should consider expanding relationships with these specialized lenders. States may need to provide CDFIs and other lenders with administrative funding necessary to originate and service loans to underserved populations.

B. Develop strategies to engage younger companies and the financial institutions with track records in lending to them.

Research indicates that young companies are more likely to be job creators than more mature companies. States should consider special outreach to young companies and the lenders that serve them. States may consider lower borrower fees or subsidized interest rates for "young" job-creating companies.

C. Experiment with credit support program models to encourage greater usage of SSBCI in low- and moderate-income areas.

States should experiment with methods to sustain and enhance lending in LMI areas by lowering the private leverage expectation for loans in LMI areas. Some states lower fees for borrowers in underserved groups or businesses located in LMI areas. CAPs are notably successful in California, New York, and Michigan in reaching companies that are smaller, younger and located in LMI areas. Although lenders have not used CAPs widely in other states, in the future, states should consider testing whether higher match rates or providing start-up funds for each lender's reserve account might increase lender interest in CAPs.

(6) Plan for long-term program sustainability.

A. Analyze the revenue and costs associated with managing SSBCI loan programs.

Purchased LPPs may provide the greatest net earnings potential of all the different SSBCI loan programs. States need to better understand the administrative costs as well as the net costs of servicing the various credit enhancement programs.

B. Develop a clear plan for maintaining the state's program beyond 2017.

States have an opportunity to maintain the SSBCI institutional infrastructure and lending relationships into the future. To do so, states must address two important questions:

- Where will the states find additional capital to continue the credit enhancement programs in 2017 and beyond?
- How will the states fund the administrative costs of the programs after federal SSBCI administrative support ends in 2017?

The states should capitalize on their investment of time and money to continue SSBCI programs into the future. A key element of this plan should be determining how best to manage the revolving federal funds when all of the funds have been deployed and then again when SSBCI allocations lose their federal character after 2017.

Treasury publishes a variety of reports on SSBCI available at www.treasury.gov/ssbci, including:

- **Program Profiles**: Descriptions of the features of the SSBCI loan and equity products.
- **Best Practices from Participating States**: Peer-to-peer advice on starting and managing SSBCI programs.
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