

# **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](http://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**

### **Contents**

<b>Executive Summary .....</b>	<b>i</b>
<b>Section 1: Setting the Context for SSBCI .....</b>	<b>1</b>
A. Introduction and Project Background.....	1
B. Promoting Small Business Finance in the Wake of the Economic Crisis.....	3
<b>Section 2: SSBCI Product and Portfolio Analysis .....</b>	<b>8</b>
A. SSBCI Loan Products.....	8
B. How SSBCI Assists Small Businesses .....	15
C. Environment in State Government for Loan Programs .....	21
<b>Section 3: Lessons Learned and Recommendations.....</b>	<b>29</b>
A. Lessons Learned .....	29
B. Recommendations for State Policymakers and Program Managers .....	38
<b>Appendix: Advantages and Disadvantages of Three Organizational Structures</b>	<b>44</b>
<b>References .....</b>	<b>46</b>

### **Cover Photos:**

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.
3. In California, a small business owner received funding to expand his custom cabinetry business in Sacramento.

**LIST OF FIGURES**

- Figure 1      SSBCI Loans or Investments for Loan Programs, by Age of Business (Cumulative through 2012)
- Figure 2      Jobs Created and Retained for Loan Programs, by Age of Firm (Cumulative through 2012)
- Figure 3      Number of Loans Made in LMI Areas (Cumulative through 2012)
- Figure 4      Lending Activity and Job Impacts in LMI Areas, by Type of Loan Program (Cumulative through 2012)
- Figure 5      Number of Loans and Amount Loaned or Invested for Loan Programs, by Type of Lending Institution (Cumulative through 2012)
- Figure 6      Top 15 Largest SSBCI Lenders for Loan Programs, by Dollar Amount Loaned (Cumulative through 2012)
- Figure 7      Percent of Lending Activity in LMI Areas, by Lender Type (Cumulative through 2012)
- Figure 8      Jobs Created and Retained for Loan Programs, by Type of Lender (Cumulative through 2012)
- Figure 9      SSBCI Program Activity for Loan Programs, by Type of Managing Organization (Cumulative through 2012)
- Figure 10     Dollars Expended and Number of Loan Transactions per Loan Program, by Type of Managing Organization (Cumulative through 2012)
- Figure 11:    Proportion of SSBCI Funds Expended for Loan Programs, by Agency Type (Cumulative through 2012)
- Figure 12:    Percent of Loan Program Allocation Deployed, by Type of Organization (Cumulative through 2012)
- Figure 13:    Top 15 States in SSBCI Funds Used for Loan Programs Only, Ranked by Percent (Cumulative through 2Q 2013)
- Figure 14:    Jobs Created and Retained for Loan Programs, by Type of Organization (Cumulative through 2012)

## 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 & Schmisser \(February 2013\)](#) 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

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

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):<sup>1</sup>

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<sup>2</sup> 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.

---

<sup>1</sup> A Summary of States' 2012 Annual Reports, available at [www.treasury.gov/ssbbci](http://www.treasury.gov/ssbbci), presents performance data on the SSBCI programs.

<sup>2</sup> 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<sup>3</sup>, 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

---

<sup>3</sup> 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*

- The most attractive SSBCI programs are simple to explain and operate. 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.
- States are most effective in deploying SSBCI funds when the programs fill product niches that can be clearly described. 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.
- 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. 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.
- Lenders are interested in SSBCI programs that solve a clearly identified borrower credit issue. 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.
- Typically, the high-volume lending products subordinate the state's collateral interests to the private lender's interests. 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*

- SSBCI's credibility with state policy leaders and lenders depends on whether the program receives high-level endorsement and visibility. 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](http://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.
- **Summaries of States’ Annual Reports and Quarterly Reports:** Program statistics and analysis of the states’ use of SSBCI funds.

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

### **Section 1: Setting the Context for SSBCI**

#### **A. Introduction and Project Background**

Small businesses generally rely on private investors—friends, families and business colleagues—as well as the commercial lending sector for the capital they need to start up, operate, or expand. The financial crisis of 2008-2009 resulted in much more limited access to capital for small businesses. Some categories of small business traditionally lack access to capital. However, during the deep recession, even businesses with a demonstrated ability to repay credit had difficulty accessing capital. Lending standards tightened considerably, and many small businesses could not meet those standards for reasons beyond their control, such as devaluation in real estate and equipment or a temporary decline in profitability due to the recessionary conditions. Congress sought to address this credit scarcity with the Small Business Jobs Act of 2010. The State Small Business Credit Initiative (SSBCI) was one important component of that legislation. Managed by Treasury, SSBCI provides \$1.5 billion to the states to find ways to draw private sector credit for small companies back into the market. SSBCI provides the states with the ability to customize solutions with programs and products suited to local market needs.

SSBCI is the latest in a series of government-backed efforts to fill gaps in the business financing marketplace. Dating to the 1930s, state industrial revenue bond programs provided the capital companies needed to relocate and expand operations. In the 1950s, Congress created the Small Business Administration (SBA) and its loan programs in recognition of the challenges that small businesses face in the capital markets. Policymakers created these different programs to achieve a common goal: providing businesses with capital they required to increase economic activity in ways that would ultimately lead to more jobs and a larger tax base.

Government guaranteed loan programs stimulate more credit to borrowers through one of three incentives: (1) lowering the cost of credit, (2) providing access to capital for markets the private sector does not fully serve, or (3) mitigating the risk of loss where private lenders perceive an unacceptable level of uncertainty (Hill & Shelly, 1990). Depending on local and national market conditions, the relative importance of these goals may vary. The timing of the government intervention, the state of the business cycle at the time the program was created, as well as state-specific credit needs—all influence the types of programs implemented. At a time of historically low interest rates and a marketplace in which lenders are still wary of financial crisis-induced losses, SSBCI emphasizes the important role that mitigating risk must play in drawing private lenders back in the small business lending market.

In 2011 and 2012, Treasury approved allocations in every state and territory based on a mandated funding formula. All states received at least \$13.2 million, and California received the largest allocation,



\$168.6 million. Each state or territory's application requested SSBCI funds for one or more lending or investment programs. The 57 entities that received SSBCI funds (states, territories, the District of Columbia and municipalities, but referred to more simply as "states" in this report) allotted resources to approximately 150 different programs. As of the end of 2012, there were 110 loan programs approved for about \$1.1 billion (73 percent) of the SSBCI's total funding, while 40 equity capital programs were approved for an estimated \$400 million (27 percent) of the total (U.S. Department of the Treasury State Small Business Credit Initiative, September 25, 2013).

This study focuses exclusively on the 110 loan programs, building on a recent description of SSBCI equity capital programs (Cromwell & Schmisser, February 2013).

The SSBCI-funded loan programs fit into four categories:

1. Loan participation program, including two program sub-types that are economically the same, but entail different staff skills and administrative costs:
  - (a) Direct companion loan (LPP-DCL) in which the state makes loans simultaneously with another lender's loan;
  - (b) Purchased (LPP-P) in which the state purchases a portion of a lender's loan;
2. Loan guarantee program (LGP) in which the state partially guarantees a lender's loan;
3. Collateral support program (CSP) in which the state contributes to the value of available loan collateral by making a deposit held by the lender; and
4. Capital access program (CAP) in which the state contributes to a portfolio reserve account held at each lender.

This paper provides state policymakers and program managers with insights about successful state-lender relationships as well as about the obstacles and barriers that delayed implementation or affected program success. During the course of this research, the Center for Regional Economic Competitiveness (CREC) team interviewed program managers, contractors, and lenders in 42 states. This included telephone interviews with almost every state program manager and with many other economic development policy leaders. CREC visited 13 states to meet with program managers, local lenders, key stakeholders, and in some cases loan recipients. The interviews helped CREC better understand how different SSBCI programs are being implemented at the state level. Finally, CREC also met with program managers during the SSBCI June 2013 conference, examined program performance data integrated into the 2012 SSBCI annual report, and participated in best practice discussions with state program manager working groups focused on the design and implementation of LPPs, CSPs, and LGPs.

In this report, CREC provides insights about the context in which SSBCI was created that will help policymakers better understand why the SSBCI program has been implemented in the way that it has, and the critical role that both states and lenders play in the Initiative's ultimate success. The report then turns to how the SSBCI loan programs operate in practice. This discussion focuses on the nature of the market gaps that small businesses face in accessing loan capital and how SSBCI addresses those gaps.

The study also examines three different organizational structures the states use to implement SSBCI. This is followed by a discussion of the types of loans that states are supporting and which of those loan types are most appropriate for different small business credit needs.

Based on this analysis, the CREC team offers observations about what it sees as important lessons learned from the first full year of program operations. The report concludes with recommendations to state policymakers and program managers about how to enhance SSBCI and its impacts moving forward.

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

### **Why the President and Congress Acted to Help Small Business**

In the midst of the financial crisis of 2008-2009—the most significant since the Great Depression (Bosworth & Flaaen, 2009; Krugman, 2009; Shiller, 2008)—small businesses were particularly hard-hit. Few had sufficient cash reserves on hand, so a slowdown in business created a lack of liquidity to operate or service existing debt. Reluctant customers translated into lower earnings available to fund investments in equipment, real estate, or new employees. Weaker businesses closed their doors, but the stronger ones managed to “right size” to market conditions, shedding workers and shelving plans for long-term investments.

In this economic climate, non-performing commercial loans added to the woes of lenders already dealing with non-performing housing loans. While banks sorted out the worst of the loan portfolios, regulators forced banks to improve their balance sheets by tightening underwriting standards and aggressively addressing problem loans. Accounting for these conditions, it follows that banks would become less risk tolerant than they had been before. Many banks shied away from small business customers that might have the ability to repay a loan, but were hindered by a short track record, devalued real estate and equipment collateral, or a sudden depletion of cash due to the economic crisis.

The economy began its slow healing process in 2010. As the recession and then the early stages of recovery unfolded, many small businesses needed relatively small infusions of credit to make the difference between whether or not the company could make payroll while waiting for cash flow to improve, or to take the chance on purchasing new equipment to upgrade production, or to offer a new service or product. To break this cycle and help regenerate lender interest in these companies, Congress passed the Small Business Jobs Act of 2010.

### **The Context for Federal Support for Business Lending**

For the past several decades, the federal government provided much of its small business lending support through the SBA. The most widely known of these programs, the SBA 7a guarantee and the SBA 504 programs, provide debt financing for a wide range of borrowers. Created in 1953, the 7a guarantee program is the agency’s largest program, providing 44,377 loans to small businesses amounting to more than \$15.2 billion in 2012 (Dilger R. J., 2013). During the same year, SBA approved an additional 7,047 loans totaling \$4.5 billion in additional debt obligations through the SBA 504 program (U.S. Small Business Administration, March 31, 2013).

Other federal agencies also provide loans for small businesses, but these programs often have a particular focus on addressing the unique challenges of lending in disadvantaged or low- and moderate-income (LMI) areas. For example, the U.S. Department of Commerce (Commerce), the U. S. Department of Agriculture (USDA), and the U.S. Department of Housing and Urban Development (HUD) all encourage lending to small businesses to achieve economic development purposes. Commerce's Economic Development Administration (EDA) supports local revolving loan funds managed by local public or nonprofit economic development organizations. HUD's Community Development Block Grant (CDBG) program allows communities to provide loans for economic development purposes. USDA Rural Development Administration provides guaranteed loans to businesses located in rural areas through the agency's Business and Industry (B&I) Guaranteed Loan and the Intermediary Relending Programs (IRP).

EDA and CDBG largely allow public or nonprofit organizations to make direct loans to borrowers. Often, these loans are offered as a companion loan to private financing, but sometimes the borrowers rely exclusively on public or nonprofit agencies for financing. EDA programs target areas with high unemployment or severe economic dislocations, while CDBG focuses on communities with at least 51 percent of households defined as low and moderate-income. Data on these loan programs are reported by the individual entities so the amount of aggregate lending at the national level is difficult to ascertain; however, these intermediary lenders are an important part of the state and local business financing landscape.

USDA underwrites and approves guarantees based on private lender applications in its B&I Program. USDA allocates its guarantee authority state-by-state. A state loan advisory committee reviews the guarantee applications for submittal to the national office for final approval (U.S. Department of the Treasury Office of the Comptroller of the Currency, June 2012). In 2012, B&I approved 401 guarantees totaling \$1.04 billion in new guarantee authority, below the 506 guarantees totaling \$1.24 billion in 2009 (U.S. Rural Development Administration, January 2013). The IRP makes loans to nonprofit intermediaries to operate or replenish local revolving loan funds that are targeted to disadvantaged and remote communities. This included 61 new IRP loans in 2012, obligating about \$17 million in RDA funding.

The EDA, HUD, and USDA programs exemplify how other agencies are involved in lending to address challenges facing certain disadvantaged communities. However, few of these programs are widely known in the lending community because they fill specialized and defined credit niches. Given the challenges of the financial crisis, the President and Congress sought a broader and higher profile approach to expand access to capital.

### **Small Business Jobs Act of 2010**

The 2010 Act recognized SBA's leading role as a source of financing for small businesses. The Act provided SBA with more resources and allowed the agency to temporarily ease the program criteria to broaden eligibility. Congress authorized SBA to provide 90 percent loan guarantees (up from 75 to 85 percent) and to reduce borrower fees, making the program more attractive to lenders that were already familiar with SBA programs. The legislation also increased the maximum loan size under the SBA 7a,

504, and microloan programs. The 7a guarantee and 504 programs could provide loans up to \$5 million (rather than up to \$2 million) and micro-loans as large as \$50,000 (rather than \$35,000) (U.S. Small Business Administration, 2010). In addition, the Act funded an intermediary lender pilot program to encourage nonprofits to provide loans of up to \$200,000, larger than the microloans but smaller than the typical 504 or 7a loan. The Act also temporarily allowed borrowers to use 504 loans to refinance existing loans.

Congress also turned to Treasury to help increase the supply of small business lending from the nation's banking community. The Small Business Jobs Act created two separate Treasury programs: the Small Business Lending Fund (SBLF) to provide capital to qualified community banks and community development loan funds (CDLFs) in order to encourage small business lending and SSBCI to improve the credit quality of small business loan applicants. Through SBLF, Treasury invested approximately \$4 billion in 332 community banks and CDLFs. By making capital available to these institutions, policymakers strengthened these institutions' balance sheets and their ability to increase small business lending. As of September 30, 2013, SBLF participants have increased their small business lending by \$11.2 billion over baseline levels, or an estimated 52,000 additional loans to small businesses.

### **Enter SSBCI as a Small Business Credit Tool**

The Small Business Jobs Act also created SSBCI, a new federal program designed to catalyze small business lending by commercial banks, credit unions, community development financial institutions (CDFIs) and non-bank lenders. Congress created SSBCI to leverage the skills, knowledge, and networks of existing relationships in small business lending between the states and private lenders. State economic development agencies, in particular, were recognized as entities with insights into local small business capital needs that could act on state economic development priorities. In 2010, many states already operated programs to provide capital to small business; SSBCI builds on those existing efforts wherever possible. SSBCI also encouraged state programs to experiment with new models to leverage greater private sector financing for small business. SSBCI cannot be described as a single standardized national program. Instead, SSBCI consists of multiple state programs, each created to provide loan and investment products to meet state-specific small business credit gaps.

Policymakers conceived SSBCI as a public-private partnership with an important private sector role. SSBCI's many program elements have one goal in common: to use federal funds to induce more small business credit by mitigating private sector risks on individual loans and investments. The program design calls for participation from the private sector: banks, credit unions, community development financial institutions, angel investors, and venture capitalists. These lenders supply the targeted \$15 billion of new private capital to be supported by the \$1.5 billion of federal SSBCI funds through 2017.

### **Role of the States in Addressing Business Capital Needs**

States use different approaches to improving the access to capital for small businesses in response to shifting local economic conditions. In 2010, the concomitant fiscal and economic crises left states with few resources to meet these challenges.

### *Why are State Economic Development Policies Important to Small Business Lending?*

When Congress put the final touches on the Small Business Jobs Act, the states operated more than 400 different state-funded lending, loan guarantee, and bonding programs designed to help small businesses access capital (Council for Community and Economic Research, 2013). These programs ranged from an Alabama linked deposit program to a micro-lending program for Wyoming women-owned businesses.

In the past, states typically used lower cost, easier-to-access credit as an inducement to attract private sector investment. After the 1981-1982 recession, high interest rates made credit less affordable to small businesses. In response, the states created a number of interest subsidy and grant programs. The recession of 2008-09 differed from the early 1980s because the cost of credit remained low when monetary policies successfully kept interest rates low. As a result, the pre-existing state programs that featured low interest rates were not adequate to address the credit market challenges.

The singular impacts of the 2008-2009 recession on the small business sector required new solutions. Unfortunately, budgets for legacy state-funded economic development financing programs were cut in half between 2007 and 2010, at the time when stimulating small business job creation activity was most needed (Council for Community and Economic Research, 2013). The states were simply in no fiscal condition to step up and fill the gaps in credit markets as they had during the 1980s.

The creation of SSBCI represented a vital lifeline to the states as they explored state-based solutions to local credit challenges. The SSBCI program included an unprecedented goal of leveraging significant private lending and investment—\$10 of private financing for every federal dollar invested. This leveraging goal meant that many traditional state programs such as direct companion loans and fully funded guarantee programs would not suffice. This federal requirement pushed states to experiment with new programs, leaving a potential legacy for future state financing programs.

### *How Has SSBCI Affected the Pre-Existing State Programs?*

States are the delivery channel for SSBCI small business loan programs. SSBCI presented states with an opportunity in the form of new funding. But SSBCI also presented states with a challenge through its private leverage rules and its call for rapid deployment of funds.

SSBCI allows the states to use their own judgment about which programs to employ and how to implement them as long as the programs meets three private leverage requirements:

- In every transaction supported by SSBCI, the financial institution lender must have a “meaningful amount of its own capital resources at risk” in the loan;
- Taking all the transactions together in one of a state’s SSBCI programs, at least one dollar of private capital must be loaned or invested for every federal dollar of credit support; and

- Taking all of the programs together for a given state, the overall SSBCI portfolio must demonstrate a “reasonable expectation” that it can leverage \$10 of private capital for every federal dollar of credit support.

At the same time that states must comply with these federal leverage requirements, states also have economic development priorities that may not coincide with the interests of private lenders that provide the loan capital for SSBCI-supported transactions. State economic development agencies are primarily tasked with increasing economic activity, creating jobs and increasing tax revenues. States accomplish this goal using a number of tools available in the state economic development toolbox—financing programs being just one of them. For many states, SSBCI introduced a new set of tools. Several states did not have significant business financing programs before SSBCI. Those states that did have historical programs largely used them to make a handful of targeted loans that were viewed as important to achieving broader economic development goals.

In summary, the rollout of SSBCI proceeded state-by-state, not as a standardized or uniform product. As they introduced their specific programs to the marketplace, states encountered and addressed local market conditions, learning from their own experience and their peers’.

## Section 2: SSBCI Product and Portfolio Analysis

### A. SSBCI Loan Products

Treasury allocated SSBCI funding to the states to support four types of loan programs. The programs described below are organized in the order of largest to smallest SSBCI allocation. Over the last few decades, states have introduced direct loan programs, loan guarantees and capital access programs. Policymakers may be less familiar with loan participation programs and collateral support programs, but states have adopted these new programs quickly.

1. A **loan participation program** (LPP) includes two program sub-types: direct companion loans and purchased participations. Treasury combines these two program types because they are economically identical in mitigating lenders' risk of loss. States have long used direct companion loans in revolving loan funds. Purchased participation programs are a common private sector alternative that states have recently embraced under SSBCI.
  - (a) A **loan participation program – direct companion loan** (LPP-DCL) offers financing to a borrower at the same time a primary private sector lender makes another typically larger loan to the same borrower. The state may or may not subordinate its collateral position to the primary lender. While direct companion loans have been popular as a strategy for state revolving loan funds, LPP-DCLs comprised only 6 percent of the initial SSBCI allocation for loan programs. Seven states allocated \$62 million to eight LPP-DCLs, including four new programs. After some program modifications, close to \$60 million remains allocated to LPP-DCLs as of June 30, 2013.
  - (b) A **loan participation program – purchased** (LPP-P) reduces a lender's risk of loss by purchasing a portion of a loan after it has closed. The state may or may not subordinate its collateral position to the primary lender, but lenders clearly prefer the state to do so. Purchased participations have been much more popular as an emerging financing model under SSBCI. As of June 30, 2013, 35 states had received allocations for their LPPs, totaling \$407 million, or 37 percent of the SSBCI funds for loan programs.
2. A **loan guarantee program** (LGP) provides a lender with a partial guarantee in the event of a loss. States set aside funds to cover potential losses in a dedicated cash reserve or trust account. Most set aside 100 percent of the value of the guarantee, but some may set aside less based on their track record with similar guarantees. Some set aside as little as 20 percent in cash with a promise, in the case of default, to pay any deficiency remaining up to the guarantee amount after the borrower's collateral has been liquidated. As of December 31, 2012, 19 states allocated SSBCI funds to LGPs. Of those, 10 were newly established programs under SSBCI. About \$220 million was initially allocated to LGPs, and \$218 million remained allocated to these programs as of June 30, 2013.



3. A **collateral support program** (CSP) pledges cash collateral to lenders in cases where a borrower's collateral does not meet the lender's requirements. In recent years, banks increased collateral requirements while asset values have generally declined. CSPs pledge cash collateral to enhance the total collateral coverage for individual loans as long as the borrower can demonstrate sufficient cash flow to repay the loan. Only Michigan had a CSP before SSBCI. By 2012, fourteen states had created new CSPs. As of June 30, 2013, States had allotted about \$213 million in SSBCI funds to CSPs. This represents a significant increase from the \$166 million originally allocated to CSP.
4. A **capital access program** (CAP) creates a reserve account at each lender to cover losses on enrolled loans until the account is depleted. Both the lender and borrower contribute a percentage of an individual loan or line of credit to the reserve fund (a total of 2 to 7 percent of the loan amount). The state then matches these contributions to the reserve account dollar-for-dollar. Once the reserve is built up, it can be used to cover losses on the lender's future CAP loans. Due to the small contribution per loan, CAPs generate large leverage ratios, above 20 to 1 in many cases. CAP programs existed in many states before SSBCI. Initially, 27 states allocated \$291 million to CAPs, but states struggled to attract as much interest as they originally expected. As of June 2013, about 55 percent of that allocation had been shifted to other SSBCI programs, leaving \$133 million allocated to CAPs.

Each of these lending products requires different staff capabilities and lending infrastructure. Some programs require more program involvement in underwriting, credit analysis and documentation, while others require minimal lending expertise. States with limited administrative capacity may opt for loan products in which the lender bears primary responsibility for loan originating and servicing. States that desire greater control over the entire process need more in-house expertise. The following sections examine the four different types of programs to help policymakers better understand how each works for states and lenders.

## **1(a). Loan Participation Program - Direct Companion Loan (LPP-DCL)**

### ***Why LPP-DCLs Work***

- Companion loans reduce the lender's loss exposure because the direct loan reduces the lender's loan amount.
- If subordinated, direct companion loans can address a collateral gap and eliminate the lender's "first loss" risk.
- If the state offers a lower interest rate or a longer amortization period, companion loans can improve the borrower's cash flow and debt service coverage ratio.
- In a LPP-DCL, the borrower receives two loans, one from the lender and one from the state. Therefore, the total transaction may be larger than the lender's typical lending limit.

### ***When LPP-DCLs May Not Work***

- LPP-DCLs require the greatest degree of credit administration and staff expense because the state's loan is separately underwritten and closed. LPP-DCLs require the state to manage the customer relationship directly, including loan collections and workouts of any troubled loans.
- LPP-DCLs require staff with commercial underwriting and collections experience.
- Because underwriting and closing costs are higher, the program is often not a good fit for small transactions.
- If the companion loan is not subordinated, the participating lender shares pro rata in losses, and the state's efforts to mitigate risk may not seem significant to the senior lender.

### **SSBCI in Action: Direct Loan Program in New Jersey**

New Jersey Economic Development Authority (NJEDA) found a variety of successful implementation methods for its Direct Loan Program. The state aligned this program with other existing economic development initiatives to meet the credit needs of small businesses.

- New Jersey's Main Street Business Assistance Program focuses on small and mid-sized businesses and non-profit borrowers.
- New Jersey's long-term loans target CDFIs, micro-lenders and other intermediary finance organizations.
- New Jersey also makes fixed-rate direct loans to small businesses in LMI communities that do not meet bank underwriting criteria using other state programs.

The New Jersey programs exemplify how one loan program type can be adapted to meet a diversity of needs. .

## **1(b). Loan Participation Program – Purchased (LPP-P)**

### ***Why LPP-Ps Work***

- Banks frequently sell and service loan participations in the private market, which aligns the LPP-P with familiar banking practices.
- The lender maintains the primary relationship with the borrower, reducing transaction costs.
- If subordinated, participations can address a collateral shortfall by absorbing loan losses before the lender must record a loss.
- The lender sets the loan terms, interest rates, maturity, and use of funds (except for ineligible SSBCI uses such as passive real estate investment).
- States earn interest revenue from their portion of the loan.
- The lender closes the loan using its own documents.
- The lender can originate loans larger than its legal lending limit because the portion sold to the state does not count toward this limit.

### ***When LPP-Ps May Not Work***

- If the participation is not subordinated, the risk mitigation provided by the state's LPP-P may not be significant.
- When a lender sells a participation in a loan, that portion is subtracted from the loans outstanding on its balance sheet. Therefore, the lender holds a lower level of loans outstanding which reduces the profitability of the borrower relationship.

### **SSBCI in Action: Loan Participation Program-Purchased in South Carolina**

South Carolina's LPP-P targets businesses in all industries, including manufacturers, professionals and retailers, with an emphasis on loans in LMI areas. Not-for-profit entities are also eligible. The maximum participation is generally \$1 million. Typical participations range around 25 percent of the loan amount. Loan participations to date have all been subordinated to the lenders' collateral interests. The lender is responsible for all servicing, collections and liquidation.

South Carolina's LPP-P addresses the collateral gap that small business borrowers often encounter. Loans are not automatically rejected because they have insufficient collateral. Financial institution lenders enjoy the flexibility of setting loan rates, terms and conditions, subject to meeting SSBCI policy guidelines and concurrence by South Carolina's program administrators.

By September 30, 2013, South Carolina had disbursed or committed \$15 million to 67 loan participations and supported a total loan volume of almost \$63 million through the program.

## 2. Loan Guarantee Program (LGP)

### *Why LGPs Work*

- Lenders are familiar with LGPs based on experience with the SBA 7a program and similar programs.
- LGPs do not affect the lender's loans outstanding on its balance sheet, which maximizes its profit potential from the borrower relationship.
- If a state has confidence about its expected losses on the LGP, the program can set aside less than 100 percent of the total loan guarantee exposure. This allows a state to leverage its guarantee funds to make more loans.
- The state may allow the lender to set the loan terms, including interest rates, maturity, collateral, and use of funds (except ineligible SSBCI uses such as passive real estate investment).
- The lender uses its own documents and maintains the primary relationship with the borrower.
- Pricing to borrowers can be more favorable than comparable federal loan guarantee programs.

### *When LGPs May Not Work*

- LGPs require the state to have skilled credit underwriting expertise to evaluate credit quality and size loan guarantees appropriately, especially when the state chooses to set aside less than the full amount of the guarantee.
- If the state's program is new and does not have a history of payouts, lenders and regulators may discount the value of the guarantee or require the state to maintain a cash deposit to demonstrate good faith in fulfilling the guarantee promise.
- Many banks use the established SBA loan programs and want to avoid the costs of learning and managing a new guarantee program.
- The program does not provide lenders with the benefit of a well-established secondary market as is available for SBA guaranteed loans.
- Typically, the lender shares pro rata in all losses, based on the percentage of the state's guarantee.

### **SSBCI in Action: Loan Guarantee Program in Florida**

Florida created a successful LGP that guarantees up to 50 percent of the loan amount. As of September 30, 2013, Florida guaranteed 19 loans totaling \$36 million by using \$9.5 million of its SSBCI allocation. Nearly 30 percent of the guaranteed loans are to charter schools and other nonprofit entities.

Lenders noted the following strengths:

- Program procedures are simple and the state responds in a timely manner.
- The guarantee is paid after 120 days of nonpayment by the borrower so financial institutions enjoy a level of security.

### 3. Collateral Support Program (CSP)

#### *Why CSPs Work*

- CSPs fill the gap between the collateral's appraised value and the lender's minimum loan-to-value requirement.
- Because the full amount of the loan remains on the lender's balance sheet, CSPs maximize the lender's loans outstanding and its potential profit from the borrower relationship.
- The state's deposit increases the lender's deposit base at the same time that it provides collateral for a portion of the enrolled loan.
- The required additional underwriting documentation is minimal, as a majority of states use lender-prepared analyses to assess the extent of the collateral shortfall.
- The state funds the collateral support deposit upfront, which reduces the lender's uncertainty of collecting on payouts.
- States may allow the bank to set terms including interest rates, maturity, and use of funds (except ineligible SSBCI uses such as passive real estate investment).

#### *When CSPs May Not Work*

- Bankers may not be familiar with this form of credit enhancement. CSPs require extensive marketing and outreach to educate lenders.

#### **SSBCI in Action: Collateral Support Program in Idaho**

Idaho created a CSP that allowed the state to provide collateral coverage of up to 20 percent of the loan amount. The state deposits cash at participating financial institutions to cover the amount of collateral shortfall. As of September 30, 2013, Idaho had disbursed or committed \$14 million in CSP funds, enabling participating lenders to approve 136 loans totaling over \$89 million.

Idaho's success can be attributed to at least two factors:

- ***Significant 'buy-in' from banks***

Idaho held roundtables to understand what financial institutions identified as impediments to lending to small businesses and what type of program could address the issues. Additionally, the program manager undertook numerous tours of the state, meeting with most Idaho lenders.

- ***Ease of program***

Streamlined to be simple for financial institutions, the state only requires the lender's underwriting analysis and, in a few cases, additional one to two page documentation of the loan's collateral coverage.

Due to continued demand among lenders, Idaho's CSP borrowed an additional \$3.0 million from a sister state agency to expand the program.

## 4. Capital Access Program (CAP)

### *Why CAPs Work*

- CAPs provide an easy-to-use financing mechanism for the smallest businesses historically underserved by financial institutions.
- CAPs require a small subsidy (2 to 7 percent of the loan) relative to the loan amount, so CAP loans generate high leverage ratios. Private leverage ratios will be 20 to 1 or higher.
- Use of the CAP is time-efficient for the lender, since the state is not involved in loan underwriting or loan approval. CAP loan enrollment is a simple process.
- Low transaction costs mean that CAPs can support loans of a few hundred dollars.
- As long as a CAP lender remains active in the program, the lender substantially reduces the risk of loss on its CAP portfolio.
- The lender closes on its own documents.
- Once participating lenders enroll in the program, the program is easy and not labor-intensive to implement or monitor.

### *When CAPs May Not Work*

- Lenders need to enroll numerous loans to build sufficient reserves to cover anticipated losses.
- CAP fees range from 2 to 7 percent of the loan, which lenders and borrowers generally view as high.
- Once reserve funds are exhausted, the lender absorbs 100 percent of enrolled loan losses.
- Some lenders initially find CAP difficult to understand. States typically need extensive marketing to publicize the program and to gain lenders' trust that funds will be available in the future, especially in states where legacy CAP programs were suspended due to lack of funds.

### **SSBCI in Action: Capital Access Program in California**

California Capital Access Program (CalCAP) is a long-standing, successful state program used primarily by community banks and nonbank CDFIs. SSBCI builds on the state program and as of September 30, 2013, California has used \$4.6 million of its allocation to support over 3,000 loans totaling over \$104 million. Cal-CAP has generated \$22 in new lending for each \$1 in federal support.

The flexibility of the CAP is demonstrated in the profiles of two lenders participating in CalCAP:

Pacific Enterprise Bank, the top CAP lender in the nation by dollar volume, has enrolled over 130 loans for more than \$47 million. The Bank's largest loan is \$2,500,000, and its smallest loan is \$4,230.

Opportunity Fund, a non-profit CDFI micro-lender, is the largest CAP lender in the nation by loan volume, having enrolled over 2,000 loans as of September 30, 2013. Making loans as small as \$500, Opportunity Fund has loaned over \$22 million.

## B. How SSBCI Assists Small Businesses

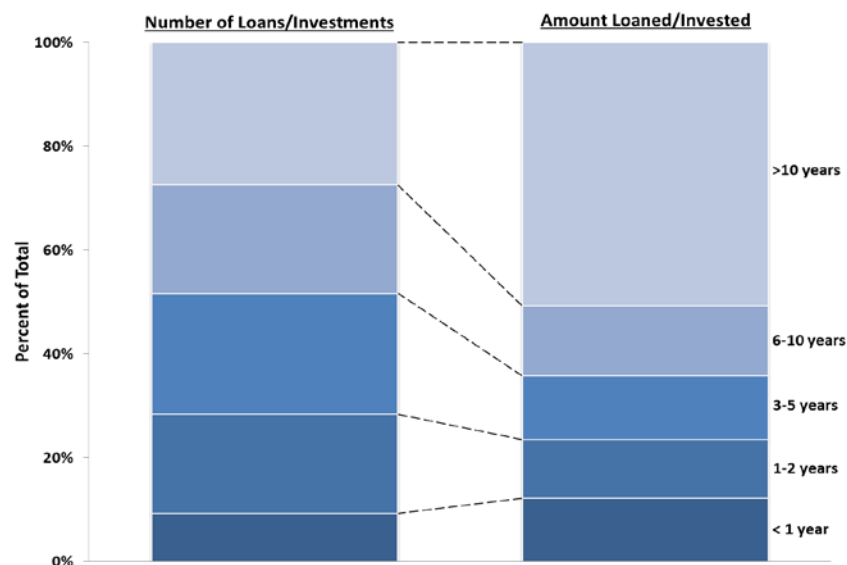
During SSBCI's first two years of operation, states' loan programs expended slightly more than \$190 million that leveraged \$1.4 billion in 4,439 new loans. That performance represents a ratio of approximately \$7 in private lending for every \$1 that the states have expended through SSBCI loan programs. While the data represents less than two full years of activity, some early trends emerged. It is too early to say if these trends will last throughout the program period.

### How SSBCI Is Helping Young Companies

Young companies are important to the nation's vitality. Recent Kauffman Foundation reports indicate that younger companies are more likely to create jobs than older companies (Stangler & Kedrosky, September 2010; Haltiwanger, Hyatt, McEntarfer, & Sousa, November 2012). However, in today's market, access to credit appears disproportionately difficult for companies with a short financial history. A recent Federal Reserve Bank of Atlanta survey found that among young companies five years old or less, lenders turned down 54 percent of loan applications, as compared with 27 percent of applications from more mature companies. Furthermore, only 13 percent of young companies receive the amount of credit for which they applied, as compared with 30 percent of more mature companies.

SSBCI successfully helps young companies gain access to private capital. As Figure 1 illustrates, about half of the loans made through SSBCI loan programs are to companies in existence five years or less. Because these companies lack an extensive credit history, credit enhancements like SSBCI can be particularly important to mitigate perceived risks. The loans provided to younger companies are smaller in size than the overall average for SSBCI, but more than one-third of the total SSBCI lending volume is made to these young companies.

**Figure 1: SSBCI Loans or Investments for Loan Programs, by Age of Business (Cumulative through 2012)**





**Figure 2: Jobs Created and Retained for Loan Programs, by Age of Firm (Cumulative through 2012)**

Age of Firm	Jobs Created	Jobs Retained	Jobs Created or Retained	Jobs Percent of Total	Number of Loans Percent of Total	Amount Loaned or Invested Percent of Total
<1 Year	2,314	1,476	3,790	8%	12%	9%
1-2 Years	2,210	4,331	6,541	13%	11%	19%
3-5 Years	2,008	4,650	6,658	14%	12%	23%
<i>Less than 5 years</i>	<i>6,532</i>	<i>10,457</i>	<i>16,989</i>	<i>35%</i>	<i>36%</i>	<i>52%</i>
6-10 Years	2,768	6,929	9,697	20%	14%	21%
>10 Years	5,240	16,503	21,743	45%	51%	27%
<i>More than 5 years</i>	<i>8,008</i>	<i>23,432</i>	<i>31,440</i>	<i>65%</i>	<i>64%</i>	<i>48%</i>
<b>Totals</b>	<b>14,540</b>	<b>33,889</b>	<b>48,429</b>			

Figure 2 illustrates that companies in existence for 5 years or less account for 45 percent of the new job creation activity. Among companies in existence more than 5 years, the SSBCI loans tend to help companies retain jobs; 49 percent of all job retention results were reported by companies aged 10 years or older.

### How SSBCI Is Helping Smaller Companies

States use SSBCI largely to help relatively smaller companies—companies with 50 or fewer employees. Nearly 96 percent of the loans, two-thirds of the loaned amount, and nearly two-thirds of the jobs created or retained have all occurred in companies with 50 or fewer employees. Micro-firms (those with 10 people or less) have especially benefited, receiving 80 percent of all SSBCI loans originated. More than 30 percent of the new jobs created through SSBCI loans have been in these smaller companies.

CAPs also seem particularly useful in meeting these needs of the smallest businesses, especially those located in LMI areas. About two-thirds of SSBCI loans by number of transactions were made to companies with revenues less than \$500,000. About 75 percent of the loans in LMI areas were to these smallest businesses. About 81 percent of CAP loans by number of transactions made in LMI areas were made to companies with less than \$500,000 in revenues. Nearly 30 percent of the jobs created or retained in LMI areas were in these smallest of businesses.

### How SSBCI Is Helping Companies in Low and Moderate Income Areas

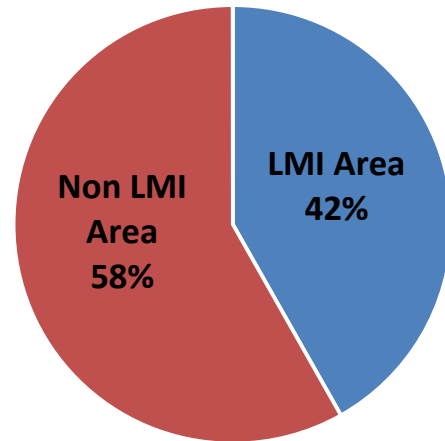
LMI areas are relatively well represented in the SSBCI-supported loan volume through 2012.<sup>4</sup> Figure 3 shows that about 42 percent of the loans were made in LMI areas. Not surprisingly, the loans made in low-income areas were significantly smaller than those made elsewhere. The average size of SSBCI funds expended per loan was an estimated \$43,600 for all loans, but it was \$17,900 in low-income areas

<sup>4</sup> For SSBCI, a “low-income” area is one in which the median household income is 50 percent or less of the area median. A “moderate-income” area is one in which the median household income is 50 to 80 percent of the area median. This definition draws on the Census Bureau’s American Community Survey (ACS) to provide median household income data.

and about \$42,000 in moderate-income areas. Overall, 35 percent or 17,252 of the jobs created or retained by the SSBCI loans were in LMI areas.

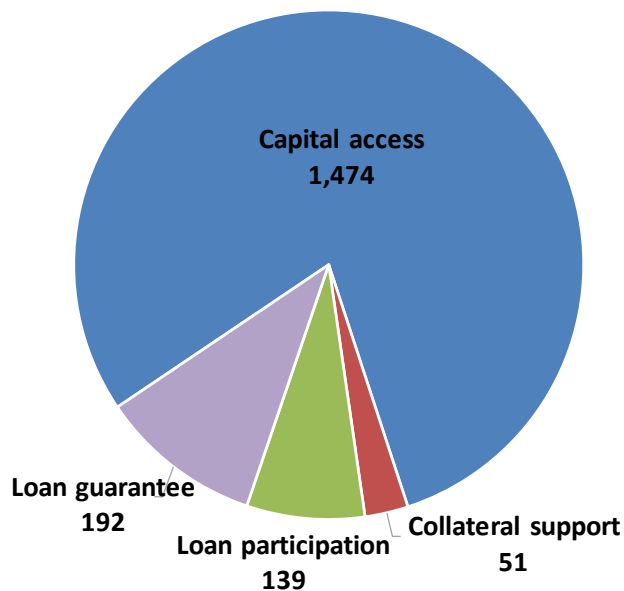
CAP lending is better represented in LMI areas than other types of loan programs. Eight of ten loans originated in LMI areas were CAP loans (See Figure 4). CAP also has had the greatest effect on job creation and retention in LMI areas, providing nearly half (45 percent) of the reported impacts. This is higher than in non-LMI areas where CAP accounts for only 70 percent of originated loans, but CAP represents 54 percent of all job creation and retention in non-LMI areas. At the same time, LPPs and LGPs represent a much smaller share of loans made in LMI areas. They combine for only about 18 percent of the total loans originated in LMI areas, but generate nearly half (49 percent) of the job creation and retention activity.

**Figure 3: Number of Loans Made in LMI Areas (Cumulative through 2012)**

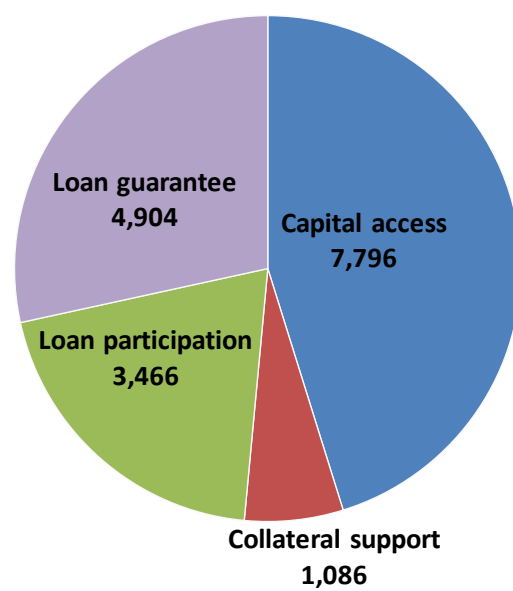


**Figure 4: Lending Activity and Job Impacts in LMI Areas, by Type of Loan Program (Cumulative through 2012)**

**Number of Loans Originated in LMI Areas**



**Number of Jobs Created/Retained in LMI Areas**



## Types of Lenders Participating in SSBCI Programs

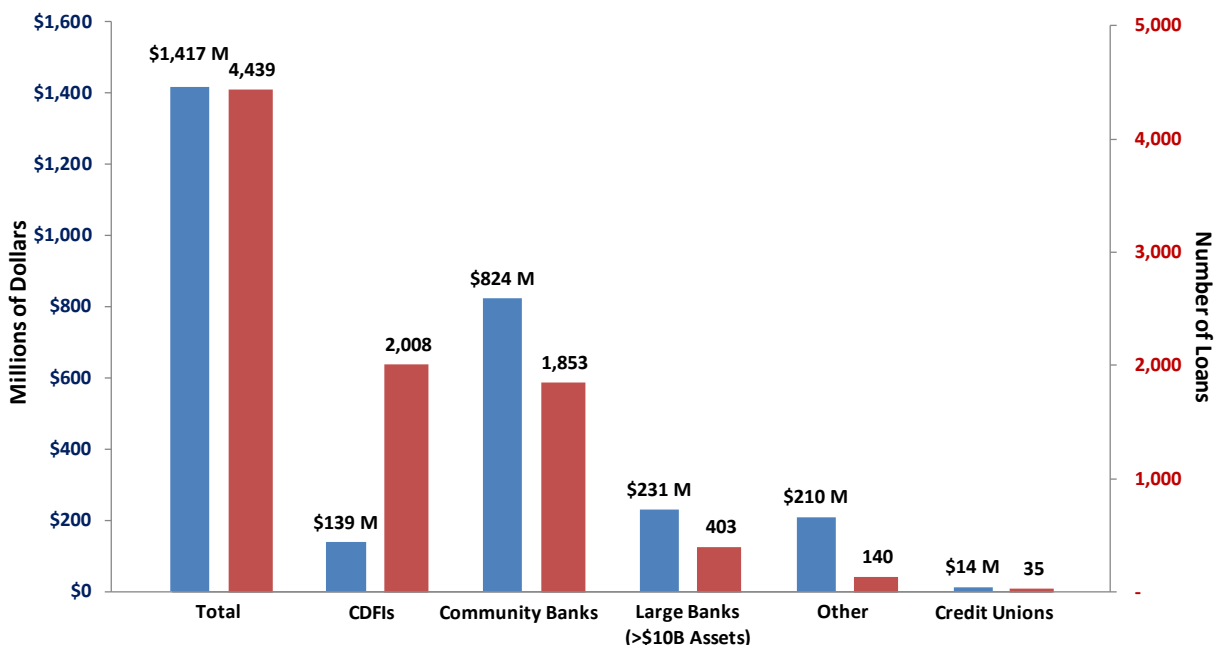
Thus far, the discussion has focused on the role of the state as a key partner for SSBCI. Yet the program's success also depends on private lenders' participation. To date, lender participation has been uneven, varying by state and also by type of lender.

Aggregating the state programs to a national level reveals some important trends about financial institution participation in SSBCI. SSBCI has attracted a diverse group of financial institutions, ranging from some of the largest national banks to smaller nonprofit organizations. So far, community banks (i.e., those with less than \$10 billion in assets) are most active in the SSBCI program. Data through 2012 show that nearly 60 percent of the loan *dollar* volume originated with SSBCI support can be attributed to community bank lenders as illustrated in Figure 5. Community banks originated a large number of loans *by number* as well. Community banks (with 1,853 loans) originated nearly as many loans as CDFIs (with 2,008). Most of the activity by CDFIs was for very small loans.

One significant group of lenders, classified as "other" in Figure 5, includes nonprofit business financing entities such as SBA certified development companies, state or local economic development agencies, and similar non-depository intermediary relending organizations. That group originated about 14 percent of the dollar loan volume with only 3 percent of the number of loans.

Looking more closely at specific lenders provides additional insights. Figure 6 lists the 15 most active lenders in terms of dollar volume of lending. These institutions originated 22 percent of the total loan volume through SSBCI in 2011 and 2012. The four large banks (>\$25 billion in assets) in the top 15 had

**Figure 5: Number of Loans and Amount Loaned or Invested for Loan Programs, by Type of Lending Institution (Cumulative through 2012)**



multi-state footprints. Three of the large banks were active in multiple state SSBCI programs. The most active lender by dollar amount was Huntington National Bank, a large regional bank that has employed SSBCI credit enhancements in loans valued at \$46 million across three states.

- Four of the fifteen most active SSBCI lenders *by dollar amount* were small community banks with less than \$1 billion in assets and three others were large community banks with between \$1 and \$5 billion in assets.
- One of the fifteen most active SSBCI lenders *by dollar amount* was a non-depository CDFI.

**Figure 6: Top 15 Largest SSBCI Lenders for Loan Programs, by Dollar Amount Loaned (Cumulative through 2012)**

Rank	Lender	Number of Loans	Amount Loaned	Average Amount Loaned
1	Huntington National Bank (OH, IN, & MI)	196	\$46,445,920	\$236,969
2	Pacific Enterprise Bank (CA)	102	\$33,359,061	\$327,050
3	Amarillo National Bank (KS)**	3	\$30,685,569	\$10,228,523
4	NewBridge Bank (NC)	44	\$29,008,154	\$659,276
5	Citizens Bank (MI)	4	\$21,293,000	\$5,323,250
6	NBT Bank, N.A. (VT)	3	\$21,083,720	\$7,027,907
7	M B Financial Bank N A (IL)	3	\$20,500,000	\$6,833,333
8	Fifth Third Bank (MI)	19	\$18,594,250	\$978,645
9	mBank (MI)	4	\$16,476,237	\$4,119,059
10	Wells Fargo Bank, NA (NM, SD)	3	\$16,328,658	\$5,442,886
11	Village Bank and Trust (IL)	4	\$12,855,713	\$3,213,928
12	The Palmetto Bank (SC)	19	\$12,100,117	\$636,848
13	People's United Bank (VT, NH)	20	\$11,594,133	\$579,707
14	Plaza Bank (CA)	26	\$11,165,590	\$429,446
15	Opportunity Fund (CA)	1,316	\$10,960,236	\$8,328
	TOP LENDERS TOTAL	1,766	\$312,450,358	\$176,925
	Percent of Total	40%	22%	
	SSBCI TOTAL	4,439	\$1,416,876,820	\$319,188

\*\* The loan proceeds from Amarillo National Bank were used in Kansas, although the bank's headquarters are in Texas.

The 15 most active lenders by number of loans were responsible for 40 percent of the total number of SSBCI loans in 2011 and 2012. Opportunity Fund was the most active among all the lenders with nearly 30 percent of all SSBCI transactions nationwide. Opportunity Fund is a non-depository, CDFI micro-lender with \$45 million in total assets. Meanwhile, no credit unions were among the most active participants.

**Figure 7: Percent of Lending Activity in LMI Areas, by Lender Type (Cumulative through 2012)**

Type of Lender	Percent of Loans in LMI Areas	Percent of SSBCI Funds Expended in LMI Areas
CDFI	57%	66%
Community Bank	31%	31%
Credit Union	37%	15%
Large Bank (>\$10B Assets)	20%	34%
Other	26%	26%
All LMI Area Lending	42%	34%

Nonetheless, an analysis of lending activity reinforces the importance of CDFIs and credit unions as vehicles for reaching businesses in LMI areas. As illustrated in Figure 7, CDFIs do most of their SSBCI-related lending in LMI areas: 57 percent of their loans by number of transactions and 66 percent of their loans by dollar amount. Credit unions make more than one-third of their SSBCI loans in LMI areas, but these represent only 15 percent of their loans by dollar amount, meaning that credit unions tend to make much smaller loans in LMI areas than they do in non-LMI areas.

In 2011 and 2012, community banks offered the same size loans in LMI and non-LMI areas. Nearly one-third (31 percent) of community banks' loan activity and loan dollar volume occurred in LMI areas. Large banks make about 20 percent of their transactions in LMI areas, but those tend to be relatively larger transactions, representing 34 percent of their total SSBCI loan volume.

In summary, SSBCI lending activity and the reach to small businesses differ widely based on the type of lenders. CDFIs and community banks originated 87 percent of the SSBCI loans, and they account for 76

**Figure 8: Jobs Created and Retained for Loan Programs, by Type of Lender (Cumulative through 2012)**

Type of Lender	Jobs Created	Jobs Retained	Jobs Created or Retained	Jobs Percent of Total	Number of Loans Percent of Total	Amount Loaned or Invested Percent of Total
CDFI	1,987	7,271	9,258	19%	45%	8%
Community Bank	8,098	19,665	27,763	57%	42%	60%
Credit Union	278	74	352	1%	1%	1%
Large Bank (>\$10B Assets)	3,071	4,796	7,867	16%	9%	17%
Other	1,106	2,083	3,189	7%	3%	14%
Totals	14,540	33,889	48,429			

percent of the job creation and retention activity. As Figure 8 illustrates, community banks, in particular, have been critical sources for financing that resulted in 27,763 or 57 percent of the new and retained jobs while CDFIs accounted for 19 percent of the new and retained job activity.

## **C. Environment in State Government for Loan Programs**

When Congress passed the Small Business Jobs Act in 2010, states were undergoing a transition in economic and business development policymaking. With 29 new governors inaugurated in recent elections, 2011 represented a watershed year in terms of new state job creation initiatives. Just as SSBCI resources became available, states were seeking ways to combat unemployment and jump-start their economies.

As SSBCI rolled out across the country, some states deployed the funds more quickly than others. States had to overcome various challenges as they engaged local lenders as participants. First, only about half of the state programs existed prior to the availability of federal funds, so many programs had to be launched from scratch. Second, many of the existing programs experienced major budget cuts prior to SSBCI's creation as a result of state fiscal crises that paralleled the national financial crisis. Third, many existing programs had different rules that needed to be adapted to accommodate this new federal investment. Finally, states allocated a significant share of the SSBCI funds to CAPs, a program type that did not meet lender needs in terms of risk mitigation in the post-recessionary lending environment.

### **Leadership and Organization of State Economic Development Agencies**

During 2010 and 2011 the economic development efforts of at least 13 states underwent significant restructuring (Feser & Poole, October 31, 2011). These reorganizations affected which agency would manage the SSBCI program and whether states applied for loan programs or state-run venture capital programs. In short, significant economic development policy churn in several states affected economic development and business loan programs just as Treasury was trying to engage the states in organizing and implementing the new SSBCI programs.

This churn has continued beyond SSBCI's first year. States continue to examine their policies, altering the way they make, organize, and implement economic development strategies. This continuous change explains why certain state economic development policy leaders are more engaged with SSBCI than others. Furthermore, every few months another state begins a new cycle of economic development policy reformulation. For instance, states underwent significant shifts in 2013. North Carolina began the process of bolstering its Department of Commerce with programs previously administered by the Rural Economic Development Center. California created a new Governor's Office of Business and Economic Development in 2013 which now manages that state's LGP. These types of organizational changes always create uncertainty about whether a program will continue to operate.

Continuing changes in state leadership and how states organize the economic and business development programs represent an important part of the back-story as states decide how best to design, manage, and implement the SSBCI loan and venture capital programs.

## Organizational Structures: State Agencies, Quasi-Public Authorities and Private Contractors

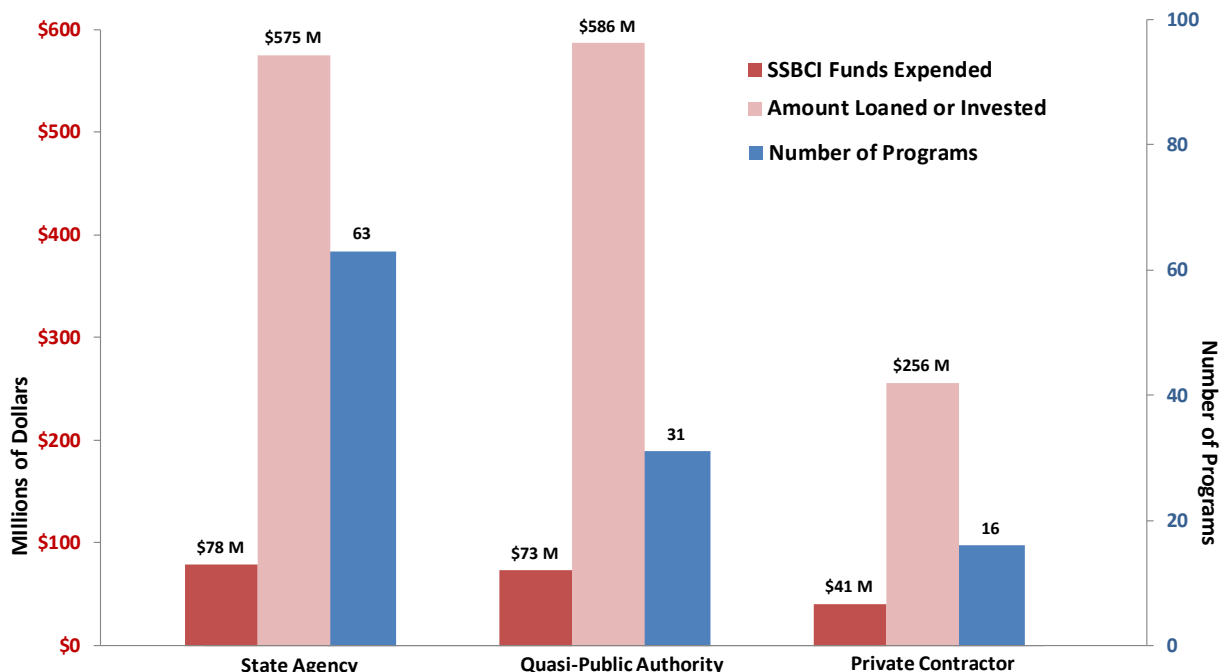
To better understand the current situation, CREC examined the track record of the different types of organizational structures in deploying SSBCI capital. This section examines three distinct program delivery models:

- State economic development agencies;
- Quasi-public state-chartered authorities; and
- Private contractors, either nonprofit or for-profit entities.

As illustrated in Figure 9, states are implementing 110 loan programs through SSBCI. State agencies manage 57 percent of the loan programs, followed by quasi-public authorities and private contractors at 28 percent and 15 percent respectively. State agencies expended the greatest amount in aggregate given the large number of programs they operate. However, as shown in Figure 10, private contractors expended \$2.5 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. Private contractors closed 40 transactions per loan program and state agencies closed 49 transactions per loan program, more than double the 24 transactions closed by quasi-public authorities. The high number of loans per program for state agencies is affected by the large number of CAP loans in California.

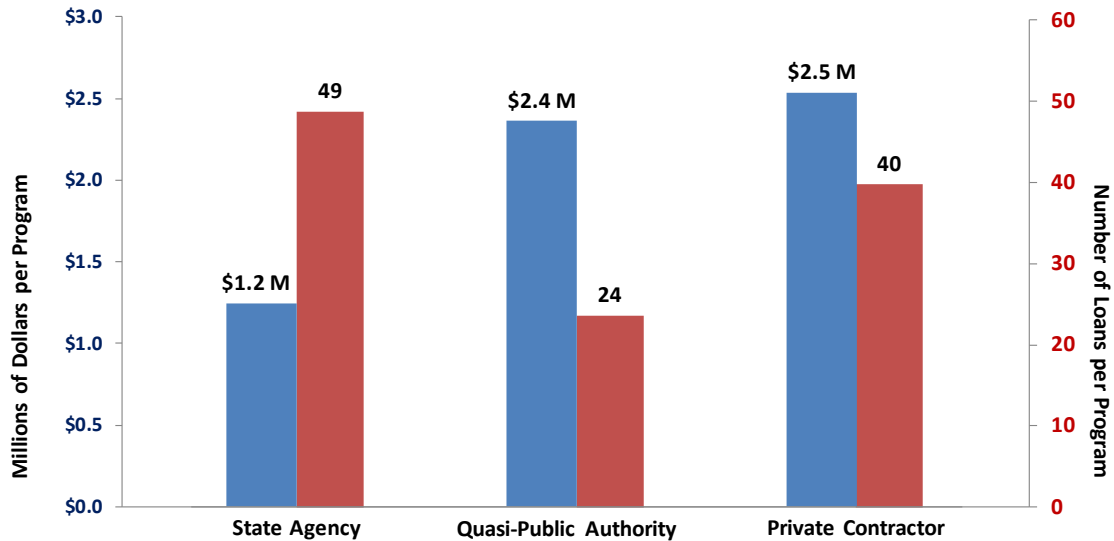
Each of these organizational models offers advantages and disadvantages in deploying capital and

**Figure 9: SSBCI Program Activity for Loan Programs, by Type of Managing Organization (Cumulative through 2012)**





**Figure 10: Dollars Expended and Number of Loan Transactions per Loan Program, by Type of Managing Organization (Cumulative through 2012)**



achieving the Congressional goals for assisting small businesses. (See Appendix.)

### Managing SSBCI through State Agencies

Thirty-five states operate some or all of their SSBCI loan programs through a state agency. These agencies are traditional government bodies often led by a member of the Governor’s cabinet. In California and Maryland, the state relies on two different agencies to manage SSBCI programs. These state agencies operate business loan programs with an eye toward transparency and public mission. The programs adhere to 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. Sometimes, state legislative authority is required to spend federal awards such as SSBCI.

For the most part, state agencies must operate their legacy and SSBCI loan programs within an existing government bureaucracy that manages business loan programs using many pre-existing rules and regulations. These agencies also usually provide a broad array of other assistance programs beyond business lending.

### Managing SSBCI through Quasi-Public Authorities

Fifteen states operate some or all of their SSBCI programs through quasi-public authorities. These authorities are state-controlled, but often operate somewhat differently than economic development

state agencies.<sup>5</sup> Quasi-public authorities are created by legislative charter to achieve a specified mandate. Unlike non-profit organizations, a quasi-public authority's board cannot change that mandate. Changes in mission and even certain changes in operating procedures must be approved by legislation. Often, the board for such an authority consists of gubernatorial and/or legislative appointees, with business or banking representatives intended or required as part of the organization's charter. Many quasi-public authorities were created in the 1970s or 1980s to issue revenue bonds for economic development purposes or to provide access to capital for businesses. This kind of organization has some degree of independence from day-to-day executive and legislative governance because elected officials appoint board members for a term that may not align with the gubernatorial election cycles.

In general, quasi-public authorities have a chief executive officer (CEO) selected by the governor in consultation with an advisory board or by the authority's board with the consent of the governor. The CEO reports to the board, but frequently serves at the will of the governor. Quite often, staff members are highly expert in the field because the organization has some freedom to hire outside the state personnel system. This means that staff in these authorities may be paid at slightly higher rates than state personnel. Of course, not every authority operates this way, and some authorities are subject to state civil service requirements even when the authority has the independence to hire separately from the state personnel office.

States with these quasi-public authorities in place tend to turn to them as the most capable entity to implement SSBCI. In most cases, the quasi-public authorities have the ability to operate independently of annual state appropriations cycles because they generate revenue from the interest and repayment proceeds associated with past projects. For example, the New Jersey Economic Development Authority, the Finance Authority of Maine, and the Arkansas Development Finance Authority were all chartered by their respective state legislatures and provided statutory authority to operate independently. In many cases, the authority receives periodic appropriations that "endow" its programs.

These state-chartered quasi-public authorities operate as hybrids of state agencies and private contractors. The state government can typically delegate authority and transfer funds to state-chartered agencies under more relaxed rules than are required when states work with private non-profit or for-profit contractors. Nonetheless, some authorities operate like a private enterprise with their own purchasing rules while others must abide by state requirements including procurement and open meeting rules.

### **Managing SSBCI through Private Contractors**

Nine states operate their SSBCI loan programs through private contractors – either nonprofit or for-profit enterprises. In these states, the private contractors may manage lender relationships, oversee the

---

<sup>5</sup> In a few cases, a state may technically have a separate quasi-public authority, but the quasi-public operates de facto as an office or department of the state agency in which the organization is housed. For the purposes of this analysis, these organizations are treated as state agencies.

loan fund (even before the funds have been dedicated to any individual borrower), manage compliance activities, and report on results. Examples of these private entities include statewide not-for-profit economic development agencies, SBA certified development companies, revolving loan funds, and CDFIs.

States tasked private nonprofit entities such as Enterprise Florida, Inc., and the North Carolina Rural Economic Development Center with a broad array of economic development responsibilities, not just management of SSBCI programs. Enterprise Florida operates that state's LGP and LPP-P under an agreement with the state Department of Economic Opportunity (DEO), while DEO manages the state's CAP. In North Carolina, the Rural Center operates all of the state's SSBCI programs under an arrangement with the state's Department of Commerce.

Other states tapped the SBA 504 intermediary network to help manage SSBCI programs. In South Carolina, a state-chartered, SBA-certified business development corporation (BDC) manages all of the state's SSBCI programs. Wisconsin contracted management of the state's CAP to a local BDC. In California, the Governor's Office of Business and Economic Development contracts with nonprofit regional nonprofit corporations, most of which participate in SBA-guaranteed programs, to source and underwrite state loan guarantees.

In several states, CDFIs play an active role not only as lenders but also as managers of certain SSBCI programs. For instance, the state of Washington placed Craft3, a local CDFI, in the role as manager of that state's LPP. Likewise, Georgia implements one of its loan programs through CDFIs that source, underwrite, close, and service loans on the state's behalf. Montana contracted with several CDFIs and nonprofit contractors to source and service transactions for the state.

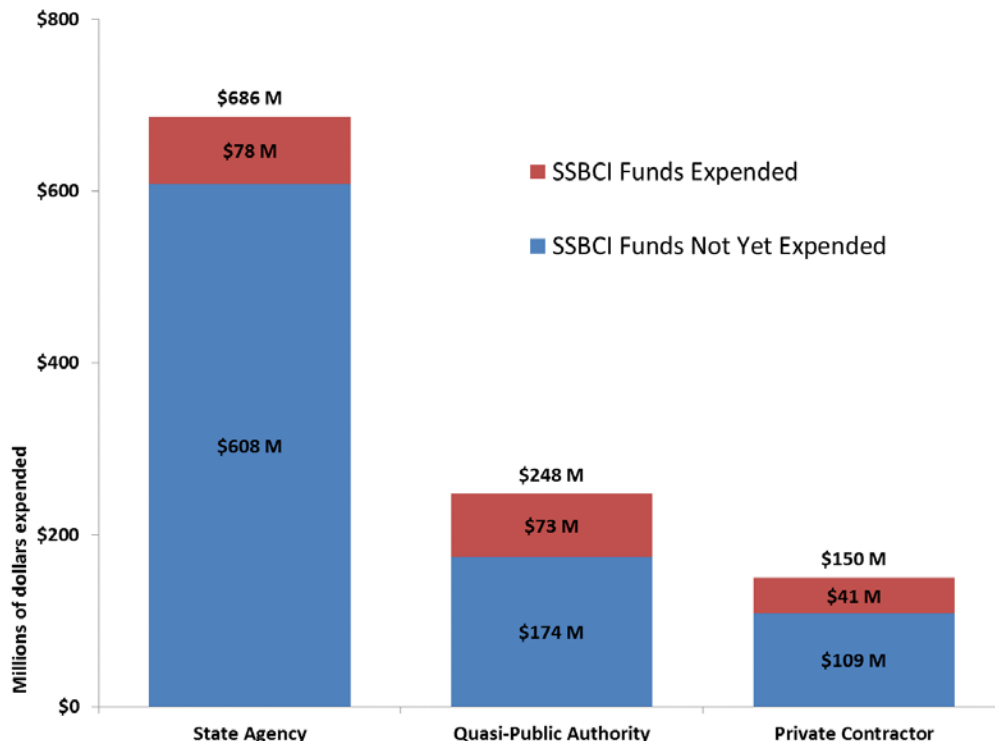
In other cases, SSBCI loan programs are managed through a contract with a private for-profit company. Municipal consortia in Wyoming and North Dakota engaged Development Capital Networks (DCN) in collaboration with local consulting company partners in each state to manage the credit guarantee programs.

### **Results to Date by Organizational Structure**

Most states opt to manage their SSBCI programs through existing organizational structures because they believe it best meets the state's immediate needs and will deliver results. States with greater flexibility have typically been quick to begin deploying the funds to lenders, and ultimately getting the capital into the hands of borrowers. Rapid deployment of resources represents an important way to assess the early effectiveness of the different organizational forms. In that regard, the quasi-public authorities and private contractors have out-performed state agencies.

As of December 2012, state agencies controlled 63 percent of the total SSBCI funds allocated for loan programs (\$686 million of \$1.1 billion), but their expenditures represent only 41 percent of the total funds expended. In contrast, states allocated 23 percent of SSBCI allocations for loan programs to quasi-public authorities, and those entities had expended 38 percent of the SSBCI funds. Private contractors

**Figure 11: Proportion of SSBCI Funds Expended for Loan Programs, by Agency Type (Cumulative through 2012)**



were allocated 14 percent of the SSBCI allocations for loan programs and they expended 21 percent of the total funds expended (see Figure 11).

As Figure 12 illustrates, quasi-public authorities were more likely to deploy funds through existing programs while private contractors deployed funds more rapidly through new programs. State agencies

**Figure 12: Percent of Loan Program Allocation Deployed, by Type of Organization (Cumulative through 2012)**

Percent of Allocation Deployed (December 2012)			
Agency Type	Existing Programs	New Programs	Total Programs
State Agency	13%	10%	11%
Quasi-Public Authority	33%	19%	30%
Private Contractor	15%	29%	27%
<b>All Organizations</b>	<b>20%</b>	<b>15%</b>	<b>18%</b>

trailed in deployment in both cases. The relative success of quasi-public authorities in using existing state programs may relate to the ability to build on existing infrastructure while private contractors were more nimble in adapting newly created programs to meet changing market conditions.

Examining more current state-level data from June 2013 reveals that nine of the top 15 quickest-deploying states used private contractors or quasi-public authorities to manage the SSBCI programs. As illustrated in Figure 13, seven manage the SSBCI programs exclusively through quasi-public authorities or private contractors, two states manage the programs through a combination of public and nonprofit models, while six manage all of the SSBCI loan programs through state agencies. By comparison, the 15

**Figure 13: Top 15 States in SSBCI Funds Used for Loan Programs Only, Ranked by Percent (Cumulative through 2Q 2013)**

State	Allocated	Used	Share	Agency Type
Arkansas	\$5,209,343	\$4,917,685	94%	State Agency & Quasi-Public Authority
Idaho	\$13,168,350	\$12,394,744	94%	Quasi-Public Authority
West Virginia	\$6,368,333	\$5,932,000	93%	Quasi-Public Authority
South Carolina	\$17,990,415	\$16,308,424	91%	Private Contractor
Montana	\$13,168,350	\$10,938,462	83%	State Agency
Michigan	\$73,157,742	\$55,911,431	76%	Quasi-Public Authority
New Hampshire	\$9,792,469	\$7,408,873	76%	Quasi-Public Authority
South Dakota	\$13,168,350	\$8,378,768	64%	State Agency
Alabama	\$31,301,498	\$19,351,944	62%	State Agency
Washington	\$14,722,515	\$8,974,150	61%	Private Contractor & State Agency
Louisiana	\$8,000,000	\$4,721,522	59%	State Agency
North Carolina	\$35,761,319	\$20,611,655	58%	Private Contractor
Nebraska	\$9,240,980	\$5,050,000	55%	Private Contractor & State Agency
Massachusetts	\$22,032,072	\$10,430,111	47%	Private Contractor & Quasi-Public Authority
North Dakota, M	\$9,710,768	\$4,507,956	46%	State Agency

states that have been slowest to deploy SSBCI funds included twelve that manage the programs through state agencies and three through private contractors or quasi-public authorities.

Of course, rapid deployment of funds represents only the first milestone; it does not measure how the programs have helped small businesses. CREC found that more than two-thirds of

SSBCI loans were originated through quasi-public authorities although the loans are somewhat smaller than those originated through state agencies or private contractors.

The volume of lending may not necessarily be directly tied to the job creation impact. As Figure 14 illustrates, while state agencies have been slower to deploy their funds, the programs they manage directly reported greater job creation and retention. The state agencies accomplished these impacts with smaller loans. For instance, state agency-managed programs originated 69 percent of all new loans (as measured by the number of loans rather than loan volume), but only 41 percent of the total dollar volume of all loans. Those loans helped to account for 59 percent of the reported job creation and retention activity (28,679 jobs). The difference between the number of loans and the amount loaned or invested suggests that the programs that state agencies manage may well be those designed to provide relatively smaller loans to the smallest businesses. The data in 2011 and 2012 may be skewed by the high number of CAP loans in California. By comparison, private contractors have made fewer, larger loans resulting in a higher total lending volume than quasi-public authorities.

**Figure 14: Jobs Created and Retained for Loan Programs, by Type of Organization  
(Cumulative through 2012)**

Type of Agency	Jobs Created	Jobs Retained	Jobs Created or Retained	Jobs Percent of Total	Number of Loans Percent of Total	Amount Loaned or Invested Percent of Total
State Agency	7,267	21,412	28,679	59%	69%	41%
Quasi-Public Authority	5,122	6,058	11,180	23%	16%	41%
Private Contractor	2,151	6,419	8,570	18%	14%	18%
<b>Totals</b>	<b>14,540</b>	<b>33,889</b>	<b>48,429</b>			

Most states retained direct control over their SSBCI programs through their state agencies. In some of these states, implementation ramp-up was slow because the state policy makers needed to develop policies, procedures, and relationships before they could begin supporting loans. In quite a few states, leaders also needed to deliberate further on their SSBCI program goals or to decide on how best to implement their program offerings. Those states that delegated responsibility for their SSBCI program implementation to a quasi-public authority or private contractor implied that the state already had clearly laid out policy goals and priorities for SSBCI investments. This preliminary data suggests that states that have delegated the loan programs to quasi-public authorities and private contractors were able to focus their efforts in ways that led to quicker deployment of the funds, but the data also suggest that programs managed by state agencies are more successful in capturing job creation and retention benefits from lending activity.

## **Section 3: Lessons Learned and Recommendations**

### **A. Lessons Learned**

SSBCI relies on the active participation of three entities—Treasury, the states, and private lenders as well as loan demand from qualified small businesses. Congress charged the states with managing SSBCI’s implementation in collaboration with those partners. During SSBCI’s first years, the economic situation demanded that states respond quickly. Based on CREC interviews and site visits, it is clear that the states greatly appreciated the freedom to develop customized loan programs to meet fast-changing and unique economic conditions, market needs, and policy priorities at the state level. Given the fact that not every state was starting from the same position nor trying to address exactly the same issues, it follows that the SSBCI start-up and ramp-up phases have happened more quickly in some states than others.

With diverse state programs seeking to address a variety of challenges, it may not be appropriate to compare states because they operate so many different types of programs. Instead, it may be more appropriate to compare how well different states are implementing the same type of program, especially as SSBCI evolves and the programs mature. Based on our site visits, telephone interviews, and data analysis, CREC noted key trends and practices that reflect state experiences that have been most closely associated with successful SSBCI deployment and outreach to small businesses.

### **Policy Priorities**

#### ***Strong state leadership facilitates SSBCI execution and impact.***

New leaders in state economic development organizations often bring new visions of how economic development should be implemented. These changes in leadership typically re-direct the state’s economic development strategy and create an environment in which new leaders review all of the state’s investments, including resources allocated to SSBCI, in light of that new strategy. This process slowed implementation in a few states. This challenge was particularly acute in states that did not already have resources allocated to support small business lending in the form of organizational infrastructure or previously existing programs.

A few states enjoy a long-standing consensus among their leaders about the importance of small business lending to the state’s economic development. Those states typically have well-established state financing institutions designed to manage changes in state leadership, and so state leaders were focused more on operational questions about how SSBCI would be implemented rather than on strategic questions about defining the state’s goals. States with strong leadership support and consensus had an important head start in deploying SSBCI capital and reaching small businesses.

#### ***Some states integrate SSBCI into their multi-faceted economic development strategies.***

During the SSBCI application process, Treasury asked states to identify the credit gaps the program sought to address and the loan programs best suited for this purpose. By requiring the governor’s office to be engaged and by allowing states to develop their own solutions, the process helps to align a variety



of interests and foster unique collaborations. States without a clear choice of financing organization to serve as lead SSBCI allocation recipient must come together in new ways to develop a strategy for implementing the program. This creates new relationships that may not have previously existed. The SSBCI application also highlights how SSBCI might be used to emphasize investment in certain underserved areas—helping rural areas (e.g., North Carolina), targeting certain industries (e.g., environmental sector in California), promoting certain types of lending (e.g., export financing in Florida), serving low-income areas (e.g., the use of CAP in California), or developing the capacity of the state’s CDFIs (e.g., Montana, Pennsylvania or Georgia).

Furthermore, some states, recognizing the critical challenge that small businesses face in accessing credit, integrate the SSBCI program into a broader development agenda by focusing on entrepreneurial business growth and innovation, economic diversification, or job creation. SSBCI resources become a critical linchpin for state investments that address capital gaps for innovative new companies.

***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.***

The contrast in approaches between states emphasizing small business lending and states emphasizing economic development alignment represent two different philosophies about how SSBCI should be implemented. Currently, most states make SSBCI funds available to any eligible small business that fits SSBCI restrictions and can demonstrate the need for credit and an ability to repay. However, some states choose to align SSBCI-supported lending more narrowly on targeted economic development priorities.

For the states with a broader appetite for increasing small business lending, deal flow and deployment may be quicker. On the other hand, focusing strictly on rapid deployment may contribute less directly to larger economic development strategies. Several state program managers express an interest in serving industries—such as retail, food services, or personal services—that they have not historically been able to assist due to the state’s own program rules.

Others, however, emphasize that they believed SSBCI should focus on helping basic industries such as manufacturing or professional and technical services. These industries are likely to create the most wealth, offer the best wages, and generate the most tax revenue in the long term. For these states, it is important for SSBCI to be closely aligned with other state economic development priorities. Concerns about the time required to deploy SSBCI are offset by the desire to make loans that match long-term economic development priorities. These state policymakers and program managers hold firmly to the belief that targeting SSBCI to the capital needs of basic industries ultimately will have a larger long-run impact on job creation and capital investment goals.

***Some states choose to monitor SSBCI impacts beyond the initial focus on loan deployment.***

In the program’s early stages, Treasury and state program managers focused on loan deployment as the first milestone of progress. The legislation required states to gather and report other program

information: (1) the number of borrowers receiving assistance, (2) the total amount of new loans, (3) a breakdown of the lending by industry type, loan size, annual sales, (4) the number of employees of the borrowers that received loans, and (5) the location of the borrower by zip code. Treasury may request other data as necessary to manage the program.

In some states, there is also a keen interest in understanding in more granular detail which businesses receive financing. For example, Arkansas, Mississippi, North Carolina, Virginia, Delaware, and New Jersey collect data on the demographics of the borrowers so that they can report on the amount of loans/investments received by small, minority, and women-owned businesses. South Carolina monitors whether the owner is disabled. Georgia, Massachusetts, and South Carolina collect information about the business owner's veteran status. North Carolina monitors the proportion of its lending in rural communities. Georgia and Montana have created maps to show where SSBCI-supported loans are being made by county.

For those states interested in using SSBCI to achieve broader economic impacts, program managers are monitoring alternative metrics. For instance, Arizona tracks wages as well as job creation, gathering the number of jobs by job title and salary level. Likewise, New Hampshire monitors borrowers for evidence that they are creating jobs that meet certain criteria. Virginia monitors the quality of jobs by requiring that businesses pay at least \$10 per hour to employees to be eligible for the program. Wyoming asks borrowers about the benefits they offer employees.

Several other states go beyond this analysis and examine spin-offs from investments. Delaware and Kentucky assess lending results not just on the direct job creation generated by the borrowers, but also by the borrower's suppliers. Using commercial economic impact analysis software, e.g., IMPLAN, Louisiana assesses whether a project should be eligible for the program, requiring that companies create at least one permanent new or retained job for the smallest loans and at least two jobs for loans above \$100,000. New Mexico conducts a similar economic analysis for each loan using U.S. Bureau of Economic Analysis-produced economic multipliers. Virginia seeks to achieve a portfolio goal of adding or retaining at least 1 full-time equivalent for every \$35,000 loaned. Massachusetts, Arizona, and Minnesota monitor the amount of follow-on financing received by borrowers. South Carolina tracks which borrowers move from leased to owner-occupied facilities.

In summary, all states collect the data that Treasury requires, but many collect much more. While financial information about the borrower is well-documented, borrowers self-report other information and no process yet exists to validate that data. A few states are seeking to understand the economic impact of the SSBCI lending activity, but only a few conduct analyses of program impacts as a way to prioritize loan approvals or to assess the return on investment to the state and/or federal government.

## **Program Design**

*The most attractive state SSBCI programs are simple to explain and operate.*

Lenders tend to favor programs that are relatively straightforward. Many states make the application process easy and the fees relatively modest. States note that lenders prefer to use their own application

and closing documents, and states frequently cite efforts to minimize additional paperwork that would burden the lender or borrower.

Successful states seek to develop lender-friendly loan management processes. The more SSBCI programs that rely on lenders' existing guidelines experience greater acceptance. For instance, successful states frequently use the participating lenders' own documents in the loan closing process, reducing not only the extra paperwork but also the need for additional education or training for loan originators.

Lenders report that they are most impressed with states that respond quickly to specific questions. The goal is to help the lender better understand any potential issues that might preclude using SSBCI funds for a transaction before the lender spends much time exploring the SSBCI option.

Lenders also express support for programs in which the state loan processing period is short. An unwieldy review processes could add weeks or even months to the loan approval timeline. Lenders do not want to participate in programs that create delays or uncertainty in the loan timelines. The most proactive states design accelerated turn-around approval procedures. Expedited processing has become part of the marketing pitch to attract new lenders.

***States are most effective in deploying SSBCI funds when the programs are designed to fill product niches that can be clearly described.***

The most frequently identified credit gaps were for loans that:

- Do not meet the guidelines for SBA or USDA loan programs;
- Require some degree of 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 during construction, prior to the closing of permanent financing from the SBA 504 program.

Even if a state did not initiate its SSBCI program with a clear target borrower in mind, with more program expertise, most states have now identified how they can best meet local credit market gaps while complementing other available government-guaranteed loan programs. Often states identified generic small business credit needs when they initially designed the SSBCI programs, and may not necessarily have had a clear sense of the actual credit gaps that needed to be addressed.

As the programs have matured, the credit gaps are becoming clearer to the savviest SSBCI program managers. A key source for this market intelligence is the types of transactions that lenders are actually trying to facilitate with the state's SSBCI programs. As states become more knowledgeable about the marketplace, they refine the programs to more clearly address the needs of identified borrower groups.

***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.***

Subordinated LPPs and CSPs are two relatively new loan program models. Prior to SSBCI, almost no states had experience with these two types of programs. As SSBCI evolves and states continue to experiment with different program designs, program managers seek to learn more about how the programs are working in other states.

Lenders appear to accept more readily the programs that reflect familiar private sector banking practices, for example, LPPs or LGPs. This acceptance is because lenders historically purchase loan participations or they know about loan guarantee programs. Programs like CSPs and CAPs can be successful, but lenders are less familiar with them.

Some of the loan programs provide greater potential revenue for the lender than others. For instance, an LPP reduces a lender's loans outstanding by the amount of the loan participation. On the other hand, a CSP or LGP maintains the full amount of the loan on the lender's balance sheet. In fact, a CSP adds to the lender's deposits, generating additional revenue for the lender.

While states retain flexibility in setting deal terms, they are also learning how best to accommodate lender needs associated with reporting and documentation. These lessons can lead to standardized documents or procedures that could be readily shared across all states. As the states begin to coalesce around common program characteristics, it will make describing these new models to lenders and policy makers much easier.

A key challenge for policy makers, however, is assessing how much of the states' success with these new models can be attributed to well-crafted program designs versus strong managerial capacity. Quite often, those states with the most innovative financing models also employ staff with the most commercial lending experience. As the programs evolve and mature, this distinction will also become clearer.

***Lenders are interested in SSBCI programs that solve a clearly identified borrower credit issue.***

States are successful in attracting private lender interest in SSBCI programs when the loan product solves a clearly identified credit weakness that brings otherwise acceptable loan requests into conformance with credit standards. SSBCI programs help the lender provide financing to a borrower that can demonstrate sufficient cash flow to repay the loan but lacks appropriate collateral coverage.

SSBCI offers a credit enhancement for borrowers that may not have an adequate track record to meet a bank's standard lending policies. For instance, young businesses may not yet have the two to three years of financial statements that are required by a lender when assessing a loan request. By lowering the lender's exposure in case of default, states can demonstrate that SSBCI helped a lender make a loan to a borrower that would not otherwise meet the lender's standard guidelines.

***Typically, the highest volume lending products subordinate the state's collateral interests to the lender's interests.***

States take different approaches to sharing risk of loss with lenders. Many states opt to share the risk on a pro-rata basis as a way to protect the state's interests and ensure that lenders are doing appropriate credit underwriting. Because the lenders service and collect the loan, they generally prefer to have a first security interest on the available collateral. For states willing to subordinate collateral interests to the lender, the goal is to balance the lender's interest in mitigating risk with the state's interest in leveraging as much of its resources as possible.

## **Program Marketing**

***SSBCI's credibility with state policy leaders and with lenders depends on whether the program receives high-level endorsement and visibility.***

Successfully managed state programs often attract attention from state policy leaders. In quite a few states, either the Governor or the state's Commerce Secretary becomes personally involved in advocating for the program as part of their job creation efforts. SSBCI loan programs with strong support from state governors and agency leaders attract the attention of lenders, in turn, and small business borrowers alike.

This visibility instills confidence that SSBCI programs will actually deliver on the state managers' promises to mitigate risk. Furthermore, "credit-taking" for the small business lending need not be done in a partisan manner, but simply to demonstrate the agency's responsiveness to the needs of small businesses within the state.

State program managers engage policy and financial leaders by describing success of a program in different ways. While the quantitative results of SSBCI lending are compelling, many leaders also appreciate the qualitative "success stories" to communicate SSBCI's results to a broader audience. Policy makers often use these case studies of SSBCI loan recipients to grab the attention of other lenders. Case studies help craft a narrative that, in combination with SSBCI lending statistics, can drive home the importance of SSBCI to public and private sector leaders.

***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.***

Of course, state SSBCI programs enroll loans with all approved lenders. However, most large-volume lenders are less interested in loans with unusual terms or collateral. Similarly, transactions that involve complex multi-layered financing are difficult to process in large volume. These "hand crafted" loans are more typical of community-based lenders or specialized units of larger financial institutions. These loans can be processed through state SSBCI programs without any special difficulty.

***Successful marketing campaigns initially target a specific group of small business lenders.***

Successful marketing efforts are directed to lenders most likely to respond positively, rather than trying to reach every possible financial institution. States initially viewed national lenders as important to engage. So far, the greatest success has been with community banks, CDFIs, and certain regional banks.

Community banks as a group are the most active participants in SSBCI programs, although there remains a wide divergence of views about the value of SSBCI. Some community banks are reluctant to participate in SSBCI program, while others embrace it actively. The characteristics of community bankers who are most likely to engage with the program are not clear at this stage. Like larger banks, community banks that are SBA Preferred Lender Program (PLP) Lenders may view SSBCI as too costly to implement in parallel to the SBA loan programs they already know well. However, lenders that embrace the program recognize that SSBCI can help the bank address important market niches not fully addressed by SBA. Lenders that do not currently participate in the SBA program find SSBCI a suitable option to make loans that they would otherwise not do.

Credit unions, which historically have focused on making personal loans and home mortgages to members, have not yet been a major presence in SSBCI programs. Many credit unions have enrolled in SSBCI and participate, but none are major producers at this time. Those credit unions that did participate in SSBCI were enthusiastic, echoing the accolades of community bank participants.

In general, few credit enhancement programs exist for loans made by non-depository CDFIs. USDA allows some non-bank CDFIs to participate in the B&I program, and SBA recently created the Community Advantage program to allow non-bank CDFIs to make SBA-guaranteed loans, but they are exceptions. At this point, few non-depository CDFIs participate in USDA or SBA programs. Non-SSBCI credit enhancements that are available tend to be too cumbersome for micro-lenders that specialize in business loans below \$50,000.

The design of CAPs is well-suited for these micro-lenders. The five most active non-depository CDFI lenders in SSBCI use CAPs to support micro-loans. The average loan size ranges from \$8,238 to \$23,546. The primary barrier to greater participation by non-depository CDFI micro-lenders is CAP loan fees. Two active micro-lenders that CREC interviewed reported that they use third-party grants to pay CAP fees for both themselves and borrowers.

Only a few states have had success engaging multi-state banks to participate in the SSBCI programs. In general, SSBCI appears to be best suited for community banks, CDFIs, and other institutions that limit their market areas to one state. While a few multi-state banks have made the program work, they have been the exceptions, especially when those banks already had well established SBA loan programs in place.

***State managers must demonstrate the value of the SSBCI program to lenders' key executives as well as loan officers.***

State program staff observed that while lenders may express interest in SSBCI, it is much more difficult to convince them to actually make loans. Typically, a loan officer takes action only after multiple conversations to explain the program's benefits and operations. The loan officer's first loan is usually one he or she feels strongly about approving, but is just outside of the institution's credit guidelines. The loan officer turns to the SSBCI program to bring that first loan application within credit guidelines. With that experience, the loan officer is more likely to continue enrolling loans in the future.

Multiple conversations are necessary because an institution's participation requires buy-in from the executive level as well as loan officers. Program managers frequently seek out bank presidents and/or chief lending or credit officers to secure institutional acceptance of the program.

Many states with high deployment levels trace the success to establishing strong relationships—meeting with senior executives as well as lending officers—in a few community banks, CDFIs, or regional banks. As they mature, the relationships become mutually beneficial to the state program, the financial institution, and the small business community.

## **Program Implementation**

***While states can be effective in managing programs through any of three different organizational structures, quasi-public authorities and private contractors deployed SSBCI funds most rapidly so far.***

States implement the programs through state agencies, quasi-public authorities, nonprofits, and for-profit organizations. For states with no pre-existing lending experience, those most successful in deploying SSBCI funds quickly relied on entities with lending experience. In most cases, these states turn to quasi-public authorities or mission-oriented nonprofits to implement the program. Those organizations often have experienced staff, or are better equipped to quickly recruit and employ individuals with pre-existing lender relationships.

Where existing financing organizations or programs have the confidence of state leaders, states allocate funds to them. Numerous states have existing quasi-public or private organizations with decades of experience in commercial or related lending. Furthermore, these organizations often employ staff with prior commercial lending experience and industry relationships dedicated solely to SSBCI programs. If these organizations have a strong prior track record, the states are quick to seek them out, and the organization's presence provides a head start in SSBCI implementation.

***Successful states use three different 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.***

Congress passed SSBCI with an aggressive leverage ratio target of 10:1 to encourage private sector participation in the program. Early on, several states did not fully appreciate how the 10:1 leverage goal



worked. Treasury measures the leverage goal over the five-year life of the SSBCI program. A few states focused on meeting that goal in every loan, and they designed programs with too little credit support to appeal to lenders. States achieve the 10:1 leverage ratios through three strategies: (1) recycling funds quickly through shorter-term loans and bridge financing, (2) combining SSBCI supported-loans as part of a larger financing package, and (3) reducing the percentage of SSBCI support after a loan program is widely used. Shorter-term loans include lines of credit, construction lending, and SBA 504 bridge financing. States use SSBCI in collaboration with other loan programs when the loans are for separate loan purposes. For example, SSBCI can support a loan to purchase equipment when another loan is for a real estate purchase. Finally, as programs gain greater acceptance with lenders, they are willing to consider a smaller level of support per loan. For example, support as low as 10 percent may be meaningful when the state's collateral position is subordinate.

***States build success based on relationships of trust and dependability between the state's SSBCI program and participating lenders.***

The quality of the lender/state partnership is largely based on the frequency and quality of two-way communication during the loan servicing, monitoring and reporting processes; the lender's performance in making the loans leveraged with SSBCI credit enhancements; and the state's responsiveness and timeliness in addressing any issues that may require loan modifications, workouts, or pay-out of the credit support.

Financial institutions are more likely to find an individual credible if he or she has prior private sector lending experience. Where the state staff does not have lending experience, they benefit from access to support personnel or contractors with the requisite commercial lending experience. For the states that had to create new programs or develop new relationships as part of the start-up, the programs required more time to ramp-up and earn lender confidence.

***Early evidence suggests that states working through mission-oriented lenders have the greatest success in reaching underserved borrowers.***

SSBCI programs successfully reached underserved borrowers, especially businesses located in LMI areas, young companies, and companies with fewer than 50 employees. Several states use CDFIs and revolving loan funds to reach underserved groups (California, Montana, Georgia, Washington and Pennsylvania). CDFIs and nonprofit economic development intermediaries are instrumental in providing loans to these groups.

***By paying close attention to compliance with federal rules, many states avoid potential missteps that could have slowed progress in deploying SSBCI funds.***

SSBCI represents a classic problem for stimulus programs designed to impact the economy quickly: the program funds must be deployed rapidly but responsibly. Achieving results requires all due speed. Protecting taxpayer interests requires continued diligence. SSBCI was designed to be flexible, but Congress also sought to use the efficiently. Congress created a Special Inspector General responsible for auditing and investigating activities related to SSBCI (U.S. Department of the Treasury, 2013). With this

level of oversight, states are keenly interested in avoiding non-compliance. At the same time, SSBCI had to create a new set of rules to manage the program. This need for speed balanced with accountability presented a particular challenge for the states.

As the program matures, states learn that the key to ensuring that they meet program goals while remaining in compliance with program rules is to document decisions and support their actions with written guidance from Treasury. To ameliorate these issues and avoid future ones, several states hired an independent person to monitor compliance. In some states this is a dedicated staff person, while other states use an independent contractor familiar with SSBCI and general commercial lending practices.

## **Program Sustainability**

*To date, only a few states focus on what will happen to the SSBCI programs after 2017.*

At this point in SSBCI's evolution, most state program managers seek to deploy and leverage SSBCI funds as expeditiously as possible. Highly motivated by a shared desire to catalyze the small business sector and increase economic activity, state program managers are well aware that rapid deployment of funds into loans translates into drawing down additional tranches of SSBCI capital in advance of upcoming deadlines. One of the key benefits of successfully deploying SSBCI funds is that the states can continue to use the funds after the federal program sunsets in 2017.

Currently, few state SSBCI programs appear to be financially sustainable. The programs generally do not have sufficient capital to continue the loan programs without additional appropriations from the state legislature. Almost no state credit enhancement programs—SSBCI or legacy programs—generate sufficient loan volume to earn the interest and fee income necessary to cover program administrative costs. Only a few states account for default risk in their interest rate or fee pricing policies. The cost of these loan programs represents a fundamental reason why federal and state intervention is necessary.

The challenge is to determine the optimal level of subsidy to maintain program sustainability while continuing to respond to a market that has made certain types of small business lending insufficiently profitable (or even unprofitable) for lenders. Successfully managing this balance will ultimately create the economic development impact that the public desires from SSBCI funds.

## **B. Recommendations for State Policymakers and 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."*

SSBCI could have a greater impact if the program reached more companies and engaged more lenders. Many states spend a great deal of time and energy reaching out to lenders to participate in SSBCI. As the SSBCI program evolves, it is clear that these efforts may help in creating greater awareness, but may not lead to active program use. States with substantial activity find that a few financial institutions are the most active users. State program managers should analyze the state's

banking sector and target institutions that seem most aligned with the mission of SSBCI. States should focus the limited resources for outreach on those institutions that the state expects to provide the bulk of SSBCI loans. Marketing efforts should continue even after the lender makes its first SSBCI loan so that the state program remains top-of-mind for lenders.

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

States should develop a strategic approach to the full range of federal and state business financing tools to address the breadth of business lending needs. States should develop clear messages about how SSBCI programs complement available SBA and USDA loan guarantee programs. The goal is to help lenders quickly understand which market niches are best suited for SSBCI (e.g., a collateral gap), and which are best suited for other programs.

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

States could create a marketing toolkit—working collaboratively if they wish— with the key program and product messages. The toolkit could also provide a template for success stories to share with lenders and borrowers, describe the benefits of each program or product for different audiences, and include a strategy for using the materials. The toolkit would include resources for print, web, and mass media. Special efforts should be made to include both on-line and printed material suitable for meetings and websites sponsored by specialized business and lender groups. The toolkit should also describe how to use different information dissemination vehicles, including social media, and different messages that appeal to target market segments.

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

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

Program staff members with lending experience are familiar with loan underwriting and the constraints under which lenders operate. States should consider independent training sources to provide program staff with improved selling and loan servicing skills. The end result is to increase loan volume and to convince financial institutions to become more active participants.

***B. Employ dedicated compliance officers.***

Because of SSBCI's compliance requirements and the continuous monitoring of state SSBCI programs by the Special Inspector General, several states hire compliance officers. States without the loan volume to employ someone full-time may wish to join a collaborative with similar states to retain an independent contractor or share an employee for compliance audits of the SSBCI programs. While this increases the administrative burden of the program, it helps avoid inadvertent non-compliance that could result in embarrassing public relations issues or significant financial costs to correct the situation.

**(3) Encourage continued program review and innovation.**

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

On a day-to-day basis, state program managers operate in relative isolation from other states' SSBCI programs. States should consider organizing a three-person panel composed of program managers from other states' programs. The reviews would provide an outside, peer assessment of a state's SSBCI programs and analysis of the state's lending environment. Panel participants might exchange services whereby program managers would take turns hosting other states and alternately serving on panels reviewing other states' programs. The goal of these reviews would be to provide an organized one- or two-day in-depth discussion among program managers about what they have accomplished, what they could do better, and how they can address issues to enhance capital deployment and impact.

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

States should learn from the experience with SSBCI and continue to innovate as market conditions change. One way to do this is to conduct periodic working sessions with state SSBCI stakeholders—internal staff, lenders, in-state experts, and other key partners—to review and adapt existing loan programs. This could be done every 12 months or so to enhance the state's existing programs as well as identify and experiment with potential new loan products or services. This process would help states to remain at the forefront of the lending market as it evolves. States that remain rigid in the program delivery models may miss important opportunities to anticipate the needs of continuously changing private lending markets.

**(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.***

Pursuant to the SSBCI legislation, Treasury requires states to report a limited amount of data about borrowers, including the industry and census tract of borrowers. A few states gather extensive demographic information about company owners and report that data to state policymakers. All states should consider collecting additional demographic information that can tell a compelling story about SSBCI's role in addressing underserved small business credit market needs.

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

States should develop strategies for validating certain borrower information that they receive. Financial information goes through extensive verification during the due diligence process, but some of the most important information regarding the company's projected job impacts are simply accepted. Only a few states monitor job data over time. 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.

This validation might be done in different ways, for example, a survey of borrowers sometime after closing, or through well-documented economic estimation techniques. The post-closing data would provide a foundation for a more robust evaluation system to provide greater insights about SSBCI's long-term impacts.

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

Many states express concern that they do not have adequate processes or information management tools to monitor loan performance in real-time and to track impacts over time. As the size of the loan portfolio increases, the state managers' workload will shift to portfolio monitoring. States will need to assess their portfolio management skills and computerized systems.

A loan application and servicing system that tracks borrowers from application to payoff can provide insights about the state of small business credit markets; SSBCI's responsiveness to those markets; the quality and performance of the SSBCI loan portfolio; emerging or existing credit quality issues; and the impact of SSBCI loans.

While an ad hoc approach to tracking loans may be adequate for programs with few loans, larger programs would benefit from a more systematic approach. States with sufficient loan volume should consider developing a tracking system to manage transactions from prospective loan to loan payoff. Such monitoring could also incorporate impact tracking. Furthermore, large-volume states should consider utilizing a web-based loan application, servicing and monitoring system. This would allow the state to manage applications and loans outstanding more systematically.

**(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.***

Several states develop extensive relationships with CDFIs and other intermediary organizations that target underserved groups. CDFIs and similar organizations work with the smallest businesses, with potential borrowers that have historic credit issues, or with other hard-to-reach groups. These activities can be costly to manage. A challenge for CDFIs in participating with SSBCI is the lack of administrative funding to support the lending activities. To encourage greater participation, states will need to develop alternative program models that provide CDFIs and other non-bank lenders with administrative funding necessary to originate and service loans to targeted underserved populations.

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

States should consider lowering borrower fees or subsidizing interest rates for the companies. Data presented earlier in this report indicate that these companies are more likely to create jobs but are also more likely to be turned down for credit. State marketing efforts could highlight the success

with younger companies. This might provide lenders with greater insights regarding the barriers they face in accessing capital as well as the successes that result from these loans.

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

States should experiment with ways to enhance the support of lending in LMI areas, such as lowering the private leverage expectation for loans in those areas. Some states lower fees for borrowers in underserved groups or businesses located in LMI areas. SSBCI lending in LMI areas is an important opportunity to change lenders' approach to these communities. States should examine whether these policy changes could further increase the lending that occurs in LMI areas.

Based on states' lending through 2012, CAPs are a particularly effective tool in serving underserved markets. CAP loans provide capital for the smallest businesses and in small amounts. For the lenders, the challenge is to make enough loans to build an adequate loss reserve. This creates a significant barrier to participating in the program. States are shifting resources away from CAPs for a variety of reasons including lack of lender interest. Based on CREC's analysis, some CDFIs and community banks appear willing to use CAPs more aggressively but they must first build a reserve and also help small borrowers find funding sources to pay fees associated with CAPs. Since the CAP model represents an important tool for meeting the credit needs of young companies in LMI areas, states should test whether reducing borrower fees or providing subsidized loss reserve start-up funds 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.***

States provide staff to administer, market, and manage SSBCI loan programs. However, many states appear to have only a limited understanding about the total cost to the state or value of these resources. This makes it challenging to assess whether the current SSBCI set-aside for administrative expenses is adequate. Private nonprofit entities face the same issue. It may even be more complicated to measure for private entities since they sometimes manage SSBCI loan programs as a loss leader to build relationships with business clients or lenders. CREC has learned that some CDFI lenders use foundation grants to provide an operating subsidy. These contributions are laudable, but they also leave the total cost of managing some SSBCI programs unclear. To fully account for all the resources required for administrative activities, SSBCI policymakers and program managers need to understand the true total cost of the program.

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

CREC found in its interviews that most state program managers expect to retain the residual SSBCI funds for business lending after 2017, although all acknowledge that the final decisions rest with the governors and legislatures. In the intervening time, states must address two important questions:

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

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

## **Appendix: Advantages and Disadvantages of Three Organizational Structures**

### **Managing SSBCI through State Agencies**

#### *Advantages*

- Agencies operate within the state government that supports the program financially.
- State agency fiduciaries can maintain close SSBCI program control to ensure accountability.
- SSBCI business lending is integrated with other state economic development goals and initiatives.
- States often subsidize the SSBCI program indirectly through in-kind staff and administrative support.
- The state can enlist economic development agency staff to increase marketing outreach to potential SSBCI lenders and borrowers.

#### *Disadvantages*

- State agencies often struggle to provide market-competitive compensation to attract and retain the expertise required to design, market and manage complex loan programs.
- State SSBCI program managers often rely on state funding and state management systems to provide information technology and other administrative resources that sometimes are inadequate.
- State SSBCI program managers rely on the annual state budgeting cycle, which may not align with lending program resource requirements, especially during periods when activities ramp up or slump rapidly.
- Where the SSBCI funds are shown as a budget item, state legislatures could choose to re-allocate program funds to other activities once the SSBCI funds lose their federal character.
- State-administered programs are often viewed skeptically by private sector lenders who are concerned about dealing with public sector bureaucracies.

### **Managing SSBCI through Quasi-Public Authorities**

#### *Advantages*

- Many quasi-public authorities existed before SSBCI, often with missions closely aligned with Treasury's SSBCI goals.
- Quasi-public authorities have significant financial expertise rarely found elsewhere in state government.
- States could easily transfer the Treasury allocation to quasi-public authorities, reducing delays in program start-up.
- Quasi-public authorities have the ability to generate and retain program income and related revenues to support on-going operations as well as operation of the SSBCI program.
- Governors and state legislatures hold quasi-public authorities accountable by requiring annual reports on activities and outcomes and through certain public disclosure requirements.
- Quasi-public authorities maintain a separate budget from other state agencies and receive periodic supplemental state funding allocations as needed.
- Quasi-public authorities frequently have the authority, ability, and expertise to issue bonds and leverage capital for other financing programs.



### *Disadvantages*

- State legislative authority is required to create quasi-public authorities.
- Quasi-public authorities are required to abide by many state rules and policies that can sometimes restrict their operational flexibility.
- Quasi-public authorities are sometimes subject to state budget, personnel, and procurement procedures even though much of the revenue may be generated from program income.
- Program income alone in a low-interest rate environment may be insufficient to support on-going operations.
- Quasi-public authorities may receive periodic state investments in the program activities but these investments are not necessarily predictable.
- Multiple funding sources and related program missions can divert attention and resources to other lending activities.

## **Managing SSBCI through Private Contractors**

### *Advantages*

- Private contractors have broad operational flexibility, especially in setting policies, hiring and managing personnel, travel, and procurement.
- Private contractors have a significant stake in successfully managing risks associated with leveraged private investments.
- Private contractors are highly motivated to deploy capital quickly and prudently in order to generate interest and fee income.
- Investments made by private entities move off-budget and are less likely to be subject to potential future efforts to re-program funds to other activities.
- Private contractors operate in the small business environment so they have first-hand knowledge about the opportunities and barriers that exist in small business capital markets.

### *Disadvantages*

- States maintain less control over the actual loan quality once the funds are disbursed.
- Private contractors are less likely to respond to priorities important to state leaders such as conducting broad outreach or spreading investments across the state.
- Private contractors are more likely to be focused on meeting the technical requirements of the contract with the states, and may have less sensitivity to the state's economic development priorities.

## References

- Bates, T., & Robb, A. (April 11, 2013). *Loan Availability Among Small Businesses Operating in Urban Minority Communities*. Federal Reserve Community Development Research Conference.
- Bosworth, B., & Flaaen, A. (2009). *America's Financial Crisis: the End of An Era*. Washington, DC: Brookings Institution.
- Council for Community and Economic Research. (2013, October 11). *State Business Finance and Incentives Resource Center*. Retrieved from [www.stateincentives.org](http://www.stateincentives.org)
- Council for Community and Economic Research. (2013, September 10). *State Economic Development*. Retrieved from State Economic Development Expenditure Database: [www.stateexpenditures.org](http://www.stateexpenditures.org)
- Cromwell, E., & Schmisser, D. (February 2013). *Information and Observations on State Venture Capital Programs: Report for the U.S. Department of Treasury and Interested Parties in the State Small Business Credit Initiative*. Washington, DC: U.S. Department of the Treasury.
- Dilger, R. J. (2012). *Small Business: Access to Capital and Job Creation*. Washington, DC: Congressional Research Service.
- Dilger, R. J. (2013). *Small Business Administration 7(a) Loan Guaranty Program*. Washington, DC: Congressional Research Service.
- Federal Deposit Insurance Corporation. (2013, September 15). Retrieved from Call and Thrift Financial Reports : <http://www2.fdic.gov/qbp/index.asp>
- Federal Reserve Bank of Atlanta. (June 2013). *Small Business Survey – First Quarter 2013* . Atlanta: Federal Reserve Bank of Atlanta.
- Feser, E., & Poole, K. E. (October 31, 2011). *Public and Private Roles in State Economic Development: Trends and Implications*. Washington, DC: white paper prepared for Pew Center on the States.
- Haltiwanger, J., Hyatt, H., McEntarfer, E., & Sousa, L. (November 2012). *Job Creation, Worker Churning, and Wages at Young Businesses*. Kansas City, MO: Ewing Marion Kauffman Foundation. Retrieved from <http://www.kauffman.org/newsroom/2012/11/young-firms-lead-recovery-in-hiring-and-job-creation-according-to-kauffmanfunded-census-brief>
- Hill, E. W., & Shelly, N. A. (1990). An Overview of Economic Development Finance. In E. W. Richard D. Bingham, *Financing Economic Development* (pp. 13-28). Newbury Park, CA: Sage Publications.
- Krugman, P. (2009). *The return of depression economics and the crisis of 2008*. New York: WW Norton & Company.
- Morgenson, G. (2013, August 24). New Jobs! If Only It Were True. *New York Times*.

- National Association of State Development Agencies. (1991). *Directory of Incentives for Business Investment and Development in the United States: A State-by-State Guide*, 4th Edition. Washington, DC: Urban Institute.
- National Federation of Independent Business Research Foundation. (January 2012). *Small Business, Credit Access, and a Lingering Recession*. Nashville: National Federation of Independent Business Research Foundation.
- Office of the Comptroller of the Currency. (June 2012). *2012 Survey of Credit Underwriting Practices*. Washington, DC: U.S. Treasury.
- Shiller, R. J. (2008). *The subprime solution: How today's global financial crisis happened, and what to do about it*. Princeton, NJ: Princeton University Press.
- Stangler, D., & Kedrosky, P. (September 2010). *Neutrality and Entrepreneurship: The Structural Dynamics of Startups, Young Firms, and Job Creation*. Kansas City, MO: Ewing Marion Kauffman Foundation.
- U.S. Department of the Treasury. (2013). *State Small Business Credit Initiative FY 2013: President's Budget Submission*. Washington, DC: U.S. Department of the Treasury. Retrieved from [www.treasury.gov/about/budget-performance/Documents/16%20-%20FY%202013%20SSBCI%20CJ.pdf](http://www.treasury.gov/about/budget-performance/Documents/16%20-%20FY%202013%20SSBCI%20CJ.pdf)
- U.S. Department of the Treasury. (January 2001). *Capital Access Programs: A Summary of Nationwide Performance*. Washington, DC: U.S. Department of the Treasury.
- U.S. Department of the Treasury Office of the Comptroller of the Currency. (June 2012). *2012 Survey of Credit Underwriting Practices*. Washington, DC: U.S. Department of the Treasury.
- U.S. Department of the Treasury Office of the Comptroller of the Currency. (June 2012). *USDA's Business and Industry Guaranteed Loan Program, June 2012*. Washington, DC: U.S. Department of the Treasury.
- U.S. Department of the Treasury Small Business Loan Fund. (June 30, 2013). *Results of the First Annual SBLF Lending Survey*. Washington, DC: U.S. Department of the Treasury.
- U.S. Department of the Treasury Special Inspector General for the Targeted Asset Relief Program. (April 2013). *Banks that Used the Small Business Lending Fund To Exit TARP*. Washington, DC: U.S. Department of the Treasury.
- U.S. Department of the Treasury State Small Business Credit Initiative. (September 25, 2013). *A Summary of States' 2012 Annual Reports*. Washington, DC: U.S. Department of the Treasury.
- U.S. Rural Development Administration. (January 2013). *2012 Progress Report*. Washington, DC: U.S. Department of Agriculture.

U.S. Small Business Administration. (2010, October 25). SBA Information Notice #5000-1182. *Small Business Jobs Act of 2010: Changes to the to the 7(a) Loan Program*. Washington, DC.

U.S. Small Business Administration. (2013, September 15). *SBA Weekly Lending Report*. Retrieved from [http://www.sba.gov/about-sba/sba\\_newsroom/weekly\\_lending\\_report](http://www.sba.gov/about-sba/sba_newsroom/weekly_lending_report)

U.S. Small Business Administration. (March 31, 2013). *Loan Program Performance Reports, Tables 2 and 3*. Washington, DC: U.S. Small Business Administration.

U.S. Small Business Administration Office of Advocacy. (July 2013). *Small Business Lending in the United States, 2012*. Washington, DC: U.S. Small Business Administration.