



STATE SMALL BUSINESS CREDIT INITIATIVE
WEBINAR SERIES:
**PROGRAM
SUSTAINABILITY**



SSBCI Webinar Series: Program Sustainability

SSBCI hosted a series of webinars on the sustainability of lending programs in May and June of 2017. The webinars featured the following presenters:

- Capital Access Programs: Rachael Dubin, New York and Renee Webster-Hawkins, California;
- Loan Guarantee Programs: Howard Willis, Alabama and Nancee Trombley, California;
- Collateral Support Programs: Chris Cook, Michigan and Cory Phelps, Idaho; and
- Loan Participation Programs: John Saris, Oregon and Tom Wall, North Carolina.

The following summarizes each webinar organizing content by recurring themes that included:

- Recycle capital as quickly as possible;
- Manage risk to minimize loss;
- Maximize capital availability;
- Market the program effectively to generate deal flow and fee income;
- Maintain a flexible program design capable of adapting to changing lender and business needs;
- Leverage outside funding resources; and
- Build state stakeholder support.

Strategies for Capital Access Program Sustainability

Representatives from California and New York, René Webster-Hawkins (Executive Director, California Pollution Control Financing Authority) and Rachel Dubin (Senior Director-Community Economic Development, Empire State Development), discussed sustainability strategies for capital access programs (CAPs) during a webinar on May 17, 2017.

CAPs have been in use for decades as a means of using small amounts of scarce public resources to leverage large amounts of private capital. The focus of these programs is to build a loan loss reserve for each participating CAP lender through small contributions from the state, lender and borrower on each CAP loan. The size of a lender's reserve is directly proportional to the dollar volume of CAP loans that lender originates, less any claims on the reserve to cover losses on enrolled loans. Historically, states funded CAPs with budget appropriations and the interest earned on CAP reserve.

The presenters offered the following points of discussion:

Recycle Capital as Quickly as Possible

Manage lender expectations regarding reserve account recapture.

From the outset CAP administrators should develop policies that help manage lender expectations about the circumstances under which a reserve account will be recaptured. For example, if a lender is inactive for a certain amount of time, CAP program policies should allow for the recapture of reserves no longer needed for matured loans. These funds can help support new loans or administrative costs. In situations in which CAP policies are expected to change or in which the state anticipates that funds would ultimately be returned to the state, the CAP program manager will need to develop a process through which program participants "buy in" to the change in policy.

Adopt a trigger to allow excess CAP reserves to be recycled to support new CAP loans.

To the extent a lender is holding "excessive" CAP reserves, resources are not being efficiently utilized. How each state defines what "excessive" means varies by state. In some states the recapture is focused solely on the state's contributions. In other states the recapture applies to the entire CAP reserve (including borrower and lender contributions). In California a dialogue with lenders on the state's plans for recapturing CAP reserves began in 2015 and included lender roundtables, one-on-one meetings with several stakeholders, and a public stakeholder symposium to solicit sustainability ideas. As a result of that dialogue California submitted emergency regulations to make their CAP more sustainable by allowing the state to recapture its contribution on matured CAP loans and on CAP loans that have been enrolled in the program for five or more years. Lenders would have the choice of continuing to enroll loans in the program and be subject to the annual recapture or to maintain their CAP reserve to service their existing CAP portfolio and forgo the ability to enroll additional loans in the program. (The emergency regulations discussed in the webinar were officially adopted in August of 2017).

Communicate changes in program parameters clearly and directly.

To develop a more sustainable program a state may choose to reduce the maximum size loan that may be enrolled into its CAP. As state funding replaces federal funding, a state may decide to reduce the CAP contribution rate for state-funded CAP contributions to extend their program resources further. States that have engaged their lenders through roundtables and other means of direct communication have found it to be an effective means of managing lender expectations and generating lender support for the changes.

Maximize capital availability

Product design.

New York maximizes the use of its CAP funds by limiting eligibility (borrower must be a New York State small business that otherwise finds it difficult to obtain regular or sufficient bank financing, is independently owned and operated, and has no more than 100 employees); loan size (maximum loan that may be enrolled in the program is \$500,000); and utilization (no borrower may have more than \$1 million in CAP loans outstanding at one time).

You can access both of the PowerPoints for the webinar [here](#). If you have any questions regarding this material you may contact the presenters directly for further information. For additional thoughts and best practices for CAP sustainability, please refer to the 2015 report on CAP best practices [here](#).

Strategies for Loan Guarantee Program Sustainability

Howard Wills (SSBCI Unit Chief, Alabama Department of Economic and Community Affairs) and Nancee Trombley (Chief Deputy Executive Director, California IBank) discussed sustainability strategies for loan guarantee programs (LGPs) during a webinar on May 23, 2017.

LGPs are the most widely used program structure among state economic development agencies. Many states adopted them before SSBCI to respond to underserved local business credit needs. Banks that did not have SBA lending capacity or that planned to retain the loan on their books were more likely to use state LGPs.

Alabama's LGP was created as a result of SSBCI and thus had no prior track record in the state. Its development required extensive outreach to lenders for feedback on program design. In response, the state provided lenders with broad freedom to handle their own due diligence, servicing of loans, and other administrative tasks. California's program has been around for four decades and has a network of state-chartered financial development corporations to reach lenders and borrowers on a regional basis and handle underwriting, servicing, and other administrative issues. Both programs emphasize the importance of building stakeholder engagement, including positive state legislative perceptions about the program's impacts.

The presenters offered the following points of discussion:

Recycle capital as quickly as possible

Redeploy excess reserve funds quickly.

Both California and Alabama periodically review outstanding loan balances to determine the amount of cash that may be used to support new guarantees. By putting these "idle" reserve funds to work program managers are able to maximize the use of LGP funds and program impact.

Leverage the guarantee trust reserve.

States like Alabama, who created new LGPs, generally funded their initial guarantees at 100%. As Alabama has reviewed the performance of its guarantee loan portfolio it has determined that it no longer requires a dollar in reserve for every dollar of guarantee outstanding. This has allowed Alabama to increase the guarantees outstanding to a prudent multiple of its actual reserve. California, with four decades of experience, has a 5:1 leverage on its guarantee reserve and legislation has been signed into law allowing the program to increase to 10:1 in the future. States should constantly evaluate the performance of their guarantee pool to determine the appropriate level of leverage.

Maintain a flexible program design capable of adapting to changing lender and business needs

Adapt the LGP design to ensure that it remains useful and relevant to lenders and small businesses.

Credit markets continuously change as interest rates rise and fall, lender regulations change, and market conditions shift. LGPs that are unique can help address the problems of small business but they may be less interesting to banks not interested in servicing the loans for the long term. For instance, Alabama found that continuous program improvement and marketing were key to maintaining lender participation. Alabama and California both noted that community and regional banks were more likely to participate than large banks (with their centralized credit processing systems and SBA lending capabilities).

Market the program effectively to generate deal flow and fee income

Keep all stakeholders informed of the successes of your LGP.

There is a cost associated with the need for on-going communications with smaller banks and other key partners that may not be as familiar with a small state program. Both California and Alabama program managers maintained weekly contacts with potential lenders to promote their program to keep the LGP at top of mind as they review potential deals. Communication with partner lenders and key investors (including state economic development policy makers) is the optimal way to keep lender participation high.

Cultivate lender ownership of programs to encourage engagement and continued participation by reducing unnecessary administrative costs.

While both Alabama and California underwrite their guarantees, they allow lenders to use their own loan underwriting templates, determine the extent of collateralization, and use their own loan closing forms. This differs significantly from SBA and other government LGPs. Each state has structured its LGP to meet specific business needs – Alabama provides a maximum 50% guarantee designed to primarily assist existing businesses while California's maximum guarantee of 80% allows for the financing of start-up businesses. Both states focus on timely response and can provide a lender with a decision on a loan in less than 10 days.

Manage risk to minimize loss

Diversify borrowers to enhance sustainability.

Alabama and California welcome applications from a broad range of businesses. A diversified borrower base can help overcome potential economic cycles that affect specific industry sectors. While providing guarantees to smaller loans may require more administrative resources per dollar loaned, this expansion and diversification of the borrower base can help mitigate potential losses. Both states have limits on the maximum guarantee they will provide, however, they do not have a minimum.

Build state stakeholder support

Build sustainability into your marketing.

Marketing to build a broader base of lending partners is a vital element of any state's strategy. Relying on a few lenders can be problematic if the lender decides to shift strategies and forego lending to SSBCI-qualified businesses. California noted that its efforts to attract numerous lenders have supported program sustainability. The state has a broader number of lending partners, thus diversifying the source of new loans, increasing the number of reviewers, and extending the pipeline of potential deals. This larger customer base means that California has a large pool of potential returning lender relationships. Meanwhile, Alabama's LGP provides support for lines of credit, which provides a unique loan niche for lenders compared to most other government LGPs.

Maintain a proactive dialogue with the legislature.

Both state program managers noted the importance of helping legislators recognize the value of the LGP so that reserve funds remain available to support ongoing lending initiatives. The presenters recommended informing key legislators of success stories and sharing those stories with the public as often as possible. Highlighting how the program has impacted local community or "Main Street" businesses is an important part of demonstrating the value of the program.

You can access both of the PowerPoints for the webinar **here**. If you have any questions regarding this material you may contact the presenters directly for further information. For additional thoughts and best practices for LGP sustainability, please refer to the 2015 report on LGP best practices **here**.

Strategies for Collateral Support Program Sustainability

Cory Phelps (Vice President, Idaho Housing Finance Agency) and Chris Cook (Director-Capital Access, Michigan Economic Development Corporation) discussed sustainability strategies for collateral support programs (CSPs) during a webinar on May 25, 2017.

CSPs are a recent innovation in state-supported lending programs with very few states having such programs before 2011. In most states, these programs do not have a track record of state support before SSBCI's creation so their long-term sustainability and ability to attract state public investment is uncertain.

Idaho's CSP was created with SSBCI funding, relies heavily on community and regional banks, and places a priority on lender feedback and leadership. The demand for the program is so great that it has forced Idaho to develop innovative strategies to meet the needs of borrowers. Michigan's program (the first in the nation), was created by the state to address the collapse of collateral values as a result of the financial crisis.

The presenters offered the following points of discussion:

Recycle capital as quickly as possible

Monitor outstanding loan balances and amounts in collateral deposit account.

Both Idaho and Michigan periodically review lender loan balances to ensure that the collateral support does not significantly exceed the contract percentage. Michigan contacts participating banks on a quarterly basis to monitor deposit-to-outstanding loan balance ratios on its entire portfolio. If the ratio is above the contracted amount for a loan Michigan will "claw-back" that portion of the collateral deposit in excess of the contracted amount if the difference is at least \$10,000.

Leverage CSP funds for short term loans.

Idaho and Michigan both aggressively price and structure their collateral support products to encourage short-term uses. Michigan found that an annual fee not only discourages lenders from over-collateralizing loans, but also encourages lenders and borrowers to have discussions about whether full or partial collateral support is needed, and whether a portion can be returned. Idaho's closing fee is based on the length of the transaction, the longer the term the greater the fee. Idaho also reduces the maximum amount of collateral support provided based on the term of the loan (up to \$1,000,000 for terms of less than 1 year, but only \$250,000 for terms in excess of five years).

Maintain a flexible program design capable of adapting to changing lender and business needs

Engage participating lenders before implementing any program changes.

Lender input can help in making changes that improve program performance and help increase loan volume and related program activity. For instance, industry discussions have allowed Idaho to incentivize short term loans and develop an innovative strategy for stretching capital further while addressing lender concerns about loans at risk of default.

Communicate honestly about resource availability.

Keeping lenders informed about the program's loss rate, especially at the level of the chief credit officer, is reassuring and encourages use of the program. Lenders prefer to work with reliable programs that will have funding available when they need it and that will not be withdrawn inconveniently.

Market the program effectively to generate deal flow and fee income

Target community lenders for CSP participation.

Community-focused lenders are more interested in CSPs because these lenders will work with businesses that can demonstrate an ability to repay the loan but may have inadequate collateral to secure a loan. Idaho found that community-focused lenders are more likely to work with smaller businesses to meet their unique credit needs.

An annual fee can generate needed program income and encourage better communications with lenders.

If CSP operations are not being subsidized by the state, an annual fee on CSP transactions can be an important source of program income to support operations and replace any CSP loan losses. The fee also becomes an important communications channel for an annual conversation with each participating lender on program issues and changing lender/borrower needs.

Maximize capital availability

Use partial deposits.

In 2015, Idaho restructured their program into a "quasi-guarantee" structure. In this model, the state deposits 50% of the cash collateral when a loan closes with a promise to deposit the other 50% if the borrower defaults on their loan payments. A reserve is maintained to permit the state to respond quickly to any calls on cash collateral that may occur. This practice allows Idaho to stretch their program funds approximately 50% further.

Use federal funds to leverage state funds.

Idaho's CSP is housed in the state Housing Finance Agency (IHFA). The CSP has been able to "borrow" agency deposits by guaranteeing that any lender calls on cash collateral would be covered by SSBCI funds. This practice of insuring the agency against any loss has allowed Idaho's CSP to further expand

the resources it has available to meet borrower needs without any permanent capital injection into the program.

Target specific industries.

Michigan decided early on in their program that they did not have enough money to adequately meet every collateral need in the state so they have targeted their program on specific industry groups that generate the highest economic return to the state. Michigan has an LGP and CAP for other companies, but the focus of their CSP is primarily manufacturing. This “economic gardening” approach has allowed the state to adequately meet sector demand and increased support for the program in the legislature and governor’s office.

You can access both of the PowerPoints for the webinar **here**. If you have any questions regarding this material you may contact the presenters directly for further information. For additional thoughts and best practices for CSP sustainability, please refer to the 2015 report on CSP best practices **here**.

Strategies for Loan Participation Program Sustainability

John Saris (Finance Manager, Business Oregon) and Tom Wall (Director, Small Business Credit Initiative, North Carolina Rural Center) discussed sustainability strategies for loan participation programs (LPPs) during a webinar on June 8, 2017.

North Carolina's LPP was new and placed a priority on marketing both at the outset of the program and in daily operations. The state's contractor, the North Carolina Rural Center, worked closely with the local bankers, the state bankers association, and the business community to market the program and held 11 convenings across the state. North Carolina program does a risk assessment and bad-debt reserve analysis based on bank underwriting and a bad-debt reserve calculation to maximize the capital available to be recycled.

Oregon has a 34-year-old LPP that frequently offers loans directly to businesses. The state relies on in-house expertise to underwrite risk, assist struggling businesses, and provide the appropriate level of lending support to businesses. As part of its ongoing marketing activity, Oregon provides incentives to economic development partners to source loans.

The presenters offered the following points of discussion:

Recycle capital as quickly as possible

Create a consistent flow of funds from existing loans to new loans.

Lenders are sometimes averse to loan prepayment, but prepayment may be desirable for the state to ensure the availability of sufficient funds to support new loans. North Carolina and Oregon do not require prepayment fees making the prepayment decision easier for the lender and/or borrower. Oregon policy requiring Automated Clearing House (ACH) payments directly from borrowers not only accelerated the recycling of funds but also reduced loan delinquency by approximately 15%. Oregon has also adopted the practice of reallocating recycled funds as necessary among all its credit enhancement and direct loan programs to meet current demand. This allocation flexibility helps ensure that its programs are not dependent upon legislative appropriations.

Monitor the mergers and acquisitions of local banks.

Changes in lender ownership offer opportunities to review and revisit loan purchases made from those institutions. For instance, mergers of several community banks in North Carolina resulted in the early repurchase of loan participations increasing recycled capital for LPP relending.

Manage risk to minimize loss

Manage risk aggressively through loan structuring, routine monitoring of loan portfolios, and creating a sufficient loan loss reserve.

If the state is not comfortable with the risk profile of a borrower it has options. It can always say “no” to the deal or the state can use a last-in-first-out (priority lien) or a shared security position (pari-passu) structure instead of either passing on the loan or taking a riskier subordinate position. Oregon periodically rates all loan participations as to the risk associated with the loan to determine the adequacy of its loan loss reserves. Both North Carolina and Oregon have funded loan loss reserves from program income.

Hire staff with commercial underwriting experience.

Having staff with the appropriate credentials ensures quality due diligence of potential deals and helps build credibility with lenders that will accelerate program acceptance. Staff with relevant experience can be vital in helping to source deals as they leverage prior relationships. When working with a diverse group of lending partners, in-house expertise can lessen the difficulties arising from inconsistencies in underwriting capabilities among lenders.

Create work out and liquidation plans.

Effective LPP managers are typically willing to structure work outs for businesses encountering financial difficulties. Yet, managers are clear that if the work out is not successful, then they create a plan for liquidation as a fall back. For instance, Oregon will work closely with troubled businesses by deferring or restructuring payments, reducing interest rates, releasing collateral (when appropriate), and being otherwise creative to avoid foreclosure. In the event of default on a subordinate loan participation, the state will frequently work with the senior lender to ensure that the liquidation plan appropriately protects its position. If the state is unsure about whether its ability to be repaid is appropriately protected, the agency should consider the benefit of buying out a senior lender. In pari-passu transactions, since the state receives a pro-rata share of the proceeds, it may rely on the senior lender to handle the liquidation process.

Market the program effectively to generate deal flow and fee income

Share fees with lenders to generate deal flow.

Fees are an important source of funds for sustaining a program’s operations, but a program that shares the fees with lenders and economic development partners helps to strengthen those partnerships. In North Carolina’s case, the Rural Center often allows lenders to keep all origination fees collected from borrowers to enhance the lender’s yield and to compensate the lender for servicing 100% of the loan. In Oregon, the program will pay a referral fee to local and regional economic development partners on closed loans that originate from these sources. These fees provide a significant incentive for economic development agencies to partner with the state.

Leverage outside funding resources

Leverage returns from other programs to support the LPP program.

Program managers should explore multiple avenues for raising capital for loan participation and other lending programs. The North Carolina the Rural Center participates in the USDA intermediary relending program to increase the capital available for its LPP.

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