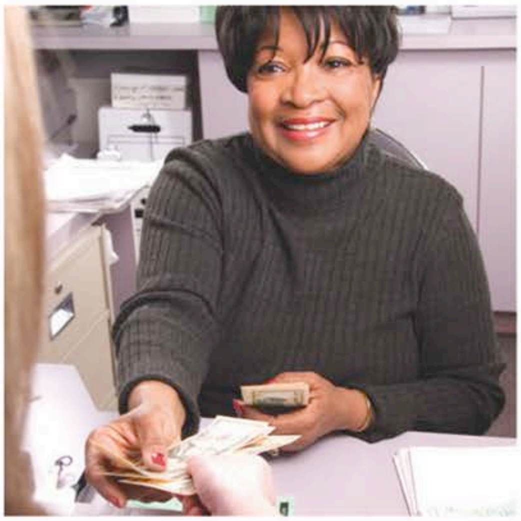
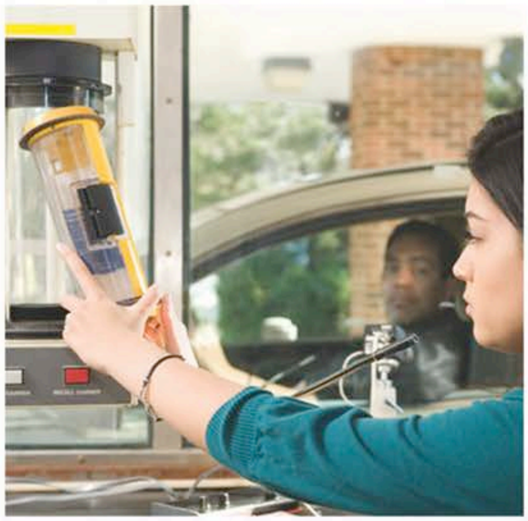
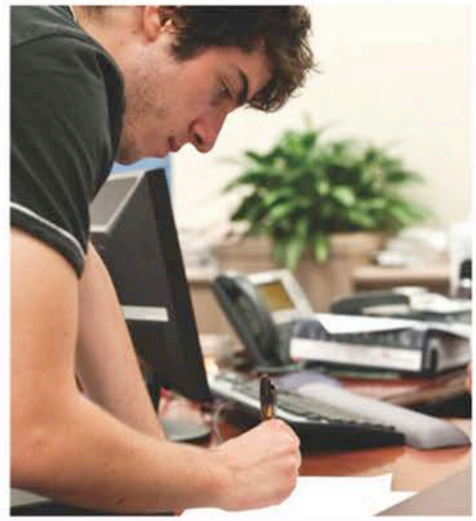
SSBCI State Small Business Credit Initiative

Best Practices from Participating States: Collateral Support Programs

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- Paul Brown, Vice President, Capital Markets Group, Michigan Economic Development Corporation, Co-Chair
- Nancee Trombley, CalCAP Manager, California State Treasurer's Office
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- Allen McConnell, Loan Officer, Ohio Development Services Agency
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- Mark Wells, Manager, District of Columbia Capital Support Program

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State Small Business Credit Initiative

Collateral Support Program Best Practices

Under the U.S. Treasury's State Small Business Credit Initiative (SSBCI), 15 States received funding for Collateral Support Programs (CSPs). To strengthen States' performance in these programs and to assist States considering a collateral support program, a working group of state officials met several times in-person and by phone to discuss the practical advice they would give to their peers. These best practices distill their most important advice for CSP managers across the country.

In an SSBCI CSP, the State provides collateral support in the form of a cash deposit held at the financial institution that makes the small business loan. In the event the borrower does not repay the loan, the lender collects against the borrower's collateral first and then collects against the cash deposit for any remaining loss. For working capital loans or a line of credit, the amount of collateral support can be determined as the difference between the proposed loan amount and the value the lender assigns to the working capital assets such as accounts receivable and inventory. For loans to finance fixed assets, collateral support can fill the financing gap between the amount a bank is willing to lend against the assets without credit enhancement and the borrower's equity contribution. CSP is an effective credit support when the borrower's cash flow is sufficient to repay the proposed loan, but a collateral shortfall exists due to insufficient asset values or a lender's more restrictive advance rates.

The CSP Working Group discussion elicited comments on successful practices that could be readily implemented by other States. The working group agreed on two cardinal principles:

1) **Keep the program simple and flexible.**

2) **Develop the right program with the right criteria for your State.**

Best practices were developed in the categories of program design, marketing, operations, and monitoring and evaluation.

Program Design

- **<u>Assess existing credit support programs in the State</u>**. The State should know what programs are used successfully by local financial institutions and what resources are available. This background research helps the State understand what alternatives are available to lenders, what appeals to lenders, and where resources should be directed.

- **States should evaluate federal and other State lending programs that may compete with a new program. States launching new programs may also consider reducing overlap in existing programs and expanding outreach to a specific niche or market not currently being served**. Some States find the CSP works well for SBA 504 lenders by providing collateral support for the interim financing before the permanent SBA debenture is funded, when a lender's loan-to-value is especially high.

- **Starting a CSP involves consultation with local financial institutions and the local banking and industry associations**. Involving the lenders in the design of the program will improve their acceptance and usage of the program. Meeting in focus groups and one-on-one can elicit useful feedback on unmet needs and program design possibilities.

- **Get feedback both before and after launching the program**. Feedback is critical to matching the program design and operations so that it satisfies lenders, borrowers and the goals of the State.

- **Ensure that staff is knowledgeable about commercial lending and staffing levels are adequate**. It is critical that staff is focused on the program, especially at the outset. Knowledgeable staff who dedicate the majority, if not all, of their time to the program will maximize the opportunity for success. Staff administering the program should understand commercial lending, and be able to talk knowledgeably to lenders who assess incoming transactions.

- **Flexibility in the program design stage is critical to meeting the needs of stakeholders, keeping in mind the private financial leverage goal and effect on job creation/retention**. Financial institutions seek to manage financial risk, and are most comfortable with a partner with steady program performance. Some States use an advisory council of lenders to provide guidance to the program.

- **Fees should be reasonable**. Fees serve several purposes. They allow the State to recover administrative costs. They can be used to motivate the lender to request only the level of collateral support needed to support the loan. They can also be an additional source of funds for providing CSP once the initial allocation has been deployed. Waiving upfront fees can attract lenders' interest initially, but the State should consider the longer-term impact on the program. Some States charge an annual fee to encourage the borrower and lender to return the State's deposit more quickly.

- **Maturity of CSPs should be as short as possible for a viable program**. The shorter the maturity of the State's participation, the more quickly the State recycles its funds and increases its private financial leverage ratio. The most successful programs exist where States understand their markets and how they can best support lenders making viable loans.

- **The level of collateral support should respond to the needs of each State's market conditions, with consideration given to the type of loan**. The amount of collateral support is determined by the States and lenders, but it cannot exceed 80 percent of the loan amount. To determine the value of collateral, most States rely on the appraisals commissioned by the financial institution. Avoid deals where the borrower has "no skin in the game." Most successful programs have the ability to calculate the needed amount of collateral deposit to fill the collateral gap and no more.

- **Develop clear loan covenants**. Lenders and borrowers should know at the outset the requirements of the CSP. States may want to consider restricting salary increases or distributions to the owner until the State is out of the loan. Successful programs also specifically describe when the State will recover any collateral deposits above the value of the collateral shortfall -- quarterly, semi-annually or annually. Lenders should also know the requirements of State law, for example, public access to State records may require disclosure of borrower information.

- **SSBCI funding is a scarce resource, and the collateral deposit should meet a true collateral gap**. States use various methods to improve efficiency of their funding, for example, by charging an annual fee on the collateral deposit or limiting the maximum collateral deposit amount. Lenders are interested in programs when States can describe successful high-impact transactions.

- **Collecting data on estimated job creation can be useful as a benchmark, but rigid requirements can impede high-quality transactions**.

Operations

- **States should begin with an internal assessment of its infrastructure**. Starting a CSP requires a State to know the capacity and capability of its existing infrastructure; to understand that the State is always accountable for program performance, even when it uses contractors; and that the staff members who administer the program are knowledgeable about commercial lending. States should generally locate the program in the agency with the knowledge and familiarity with small business lenders. When a State is starting a new program, it is possible to minimize the number of staff in a CSP if the staff understands commercial lending.

- **<u>After the assessment, determine if outsourcing is a viable option</u>**. Some States determined that outsourcing to a known provider can be effective. Outsourcing can be done in entirety or for a specific function, such as monitoring loan covenants or advance rates, and for any duration. To adapt the CSP for non-depository institutions that make commercial loans, some States engage a trustee bank to hold collateral deposits.

- **<u>At the State level, it is beneficial to have staff with commercial underwriting experience and personal familiarity with lenders in the small business market</u>**. The ability of the program staff to relate to the partner banks will make the program more appealing to the lending community. Knowledgeable staff will also know if the program can be used to complement an existing government lending program.

- **<u>The program application should be streamlined and readily available, and ideally, easily downloadable from the website</u>**. States generally review the lender's underwriting to assure that they did a credible job. However, the lender sets the terms and conditions of the loan. States need to be aware of their State's requirements with respect to public records and other information-sharing laws.

- **<u>Turnaround time for loan approval should be quick.</u>** Some States can approve loans in less than 5 business days. Most importantly, States must meet the turnaround time that was promised initially. Banks will accept a longer turnaround time if they know what to expect. Some States will approve a CSP before the lender takes it for internal credit approval, so that the lender is already assured of State's support at the time of lender's approval.

- **<u>The State's loan covenants should address repayment of the deposit</u>**. There is no fixed or standard repayment schedule. The participation agreement and deposit agreement should clearly describe the repayment requirements so that the lender and borrower understand what is expected. The documents should require lender to repay the State promptly in the event a loan is paid off. For ongoing loans, lenders should repay collateral deposits on a schedule that matches the term of the loan.

- **<u>Default policies vary by State but the critical element is that the lender understands what the course of action will be in the event of a default</u>**. Some States freeze the collateral deposits in the bank, others use a trustee bank to hold the deposit and administer any payout. Be clear in all the program documents how this will be handled.

- **Managing compliance needs to be part of the process from application to repayment**. Develop compliance checklists for internal staff and lenders and follow them closely.

Marketing

- **Have a marketing plan**. A marketing plan needs to be in place before the program is launched and followed while the program is being operated. Determine if the State has business development officers that can promote this program.

- **Find a champion within the participating lenders**. States that can identify a champion of the program within the financial institution will find that it is easier to “sell” the program. Chief credit officers are good possibilities.

- **Marketing efforts should be consistent**. Assess what resources are available in your State and where it is possible to distribute/disseminate information about the program.

- **Websites should be current, easy to find (remember the “3-click” rule), and contain all the pertinent information**. State bankers’ association newsletters and websites are ideal places for stories and informational pieces about the program. Ask the association to email a letter or information about the program to their members.

- **Identify the small group of key small business lenders in the State and reach out to them**. Calling programs, regular email updates, round tables, and participating in SBA conferences are options. Marketing targets can include CEOs, chief credit officers, and small business loan officers.

- **Identify non-depository lenders such as SBA 504 certified development companies that may be willing to promote the program to their lending partners**.

- **Testimonials from lenders who successfully use the program can be helpful**. Regularly email news to lenders in the program; include information such as loans made, lender rankings, and dollars available. Press releases about success stories can generate interest from lenders. Make use of marketing by other States/Treasury that can be customized to your State.

- **State regulators can be a helpful resource**. Ask the bank commissioner for the opportunity to explain the program to State examiners. Examiners can help spread the word to the bankers.

Monitoring and Evaluation

- **Stay current on program rules from Treasury**.

- **Get feedback from the lenders and borrowers about what is working and what may need to be adjusted**.

- **Confirm that compliance checklists are being followed**.

- **Review internal control procedures to monitor adherence to the program requirements**.

- **Establish metrics up front for expected results and actual performance**. Some States have measured the success of the program using any one or all of variety of factors such as number of loans, additional private capital received, job creation, job preservation and/or serving low income or underserved communities. Having the metrics allows for the measurement.