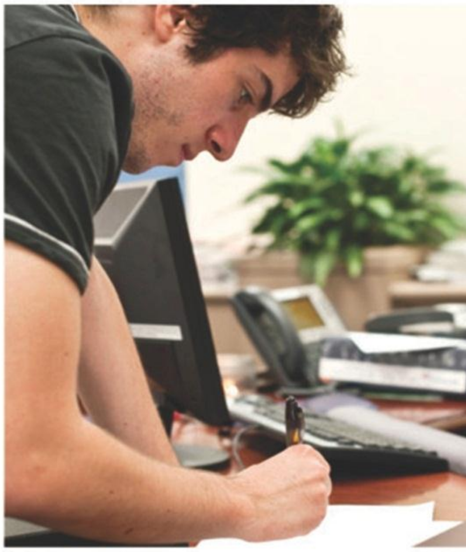
SSBCI State Small Business Credit Initiative



Best Practices from Participating States: Loan Guarantee Programs

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- Howard Wills, SSBCI Coordinator, Alabama Department of Economic and Community Affairs;
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Clifton G. Kellogg
Director
State Small Business Credit Initiative

State Small Business Credit Initiative
Loan Guarantee Program Best Practices

Under the U.S. Treasury's State Small Business Credit Initiative (SSBCI), 18 States received funding for a loan guarantee program (LGP). To strengthen the States' performance in these programs and to assist States considering adding an LGP, a working group of States met to discuss their best practices. This document summarizes the advice they would offer other state managers.

In a SSBCI LGP, the State guarantees a portion of the principal balance of a loan originated by a financial institution. The State provides a guarantee to cover a deficiency in the event a loan originated by a lender does not fully repay.

The LGP Working Group discussion elicited comments on practices that were successful and can be readily implemented by other States. The working group agreed that four key principles apply to all LGPs:

1) **The ultimate responsibility for program success rests with the State, and lenders must always have "skin in the game."**

2) **Program focus should remain on assisting small businesses' efforts to retain and/or expand jobs.**

3) **Allow lenders to underwrite the loan while the State underwrites the lender.**

4) **Keep the LGP simple and flexible.**

Best practices are set forth in the categories of program design, marketing, operations, monitoring and evaluation.

Program Design

- **<u>The first step in starting an LGP involves consultation with the local financial institutions most active in small business lending and guaranteed lending. Consultations with state banking associations are a valuable way to disseminate information and obtain feedback</u>**. Typically, the State proposes a program design that targets a specific market segment or industry. One example that has been successful is using the program to guarantee the unsecured lines of credit that typically accompany an SBA-guaranteed term loan.

- **Maintain a flexible program design adaptable to unanticipated demand.** Flexibility in the program design stage is critical to meeting the needs of stakeholders. Program designers should keep in mind the private financial leverage goal and impact on job creation/retention. Financial institutions must manage their financial risk, and they are most comfortable with a partner they trust.

- **Determine the guarantee percentage that will maximize the program's reach.** Guarantees can be applied to a portion of a loan ranging from 20 percent to 80 percent. Lower guarantee percentages often encourage better underwriting by the lender.

- **Determine risk-sharing strategy.** States need to determine upfront how the loan guarantee will work in the event the loan fails to repay: programs can be designed to share losses pro rata between the lender and the State, or losses may be borne first by the State up to the amount of the guarantee (also called "first loss"). Pro rata losses minimize the State's financial exposure, but "first loss" guarantees encourage lenders to use the program to expand access to credit. The policy choice between pro-rata and first loss guarantees depends on understanding the local market conditions. Ultimately, lenders need to fully understand the program's liquidation strategy. Some States vary the approach based on the loan; others decide on the approach for the entire program.

- **Understand the local market.** States should consult with lenders and businesses to understand whether creditworthy borrowers are struggling to obtain loans. It is important that the State understands the markets this program will be supporting.

- **Encourage lenders to work with borrowers that encounter difficulties.** States have found that lenders that work more closely with a borrower may avoid liquidation. This strategy also extends the life of the business and the jobs related to that business.

- **Adequate program staff is essential.** Successful States have staff with expertise in commercial lending for the LGP. Knowledgeable staff will gain the confidence of the lenders by demonstrating that they can "talk the talk" and facilitate deals that work for the borrower, lender and the State. Successful programs have a staff dedicated to the program rather than spreading responsibilities over a larger number of staff where no one owns the program.

- **Fees should be used to cover program costs and discourage transactions that do not require credit support.** Practices vary among the States, and fees can be assessed up front or annually. Fees are based on a percentage of the loan amount, ranging from

0.5 to 2 percent. Some States found that waiving fees for loans in distressed areas can benefit economic development.

- **State LGPs may require focused outreach to underserved markets, but the State LGP should not unduly subsidize a transaction.** States should consider the parameters of other federal and state government lending programs to reduce overlap and expand outreach to underserved markets.

- **Job creation data on LGPs is valuable to observing the program results, but some worthwhile transactions may create fewer jobs.** Collecting data on estimated job creation can be useful as a benchmark, but rigid job requirements can impede high-quality transactions.

- **High-impact transactions can make the LGP more visible and attractive.** States find that guaranteeing loans for high impact and high visibility transactions can help gain more attention for the program.

Operations

- **Starting a LGP requires a State to know the capacity and capability of its existing infrastructure. The State is always accountable.** The agency that administers the program should be knowledgeable and familiar with small business lenders. Starting with a survey of capabilities, the State can determine if the program should be administered with an existing agency or outsourced to a capable contractor. Even if the LGP hires a contractor, the State remains responsible for compliance with program rules and for reviewing the contractor's performance.

- **Program Staff should have commercial underwriting experience and personal familiarity with lenders in the small business market.** The ability of the program staff to relate to the partner banks will make the program more appealing to the lender community. Knowledgeable staff will also know if the program can be used to complement an existing government lending program. If possible, staff should be fully dedicated to the LGP.

- **Consider engaging the banking and business community.** Engaging bankers on the loan committee can promote the LGP, and accountants and business leaders can add to the outreach. States should set clear expectations about the procedures of a loan committee, who will maintain the records, and who will be accountable for compliance on behalf of the State. States should adopt rules for conflicts of interest, including appearances of conflicts. Some States use loan committees to approve larger loans and allow program staff to approve smaller loans.

- **Loan applications should be streamlined, readily available and easily downloadable from the website.**

- **States generally review the underwriting by the lender to assure that loans meet program criteria.** In most States, the lender underwrites the loans and sets the terms and conditions. The State must sufficiently underwrite the loan to understand its risk. The State must monitor and enforce compliance with the SSBCI program rules.

- **Master participation agreements are an alternative that can reduce redundancy and paperwork.** Banks are familiar with these types of agreements. Allowing banks to use their own credit forms is a draw for the program.

- **Turnaround time should be quick; some States reply to an application in 5-7 business days.** Most important is to respond to the loan guarantee request in the timeline promised to the bank. Banks will accept a longer turnaround time if they know upfront what to expect. Informing a lender quickly if the loan needs to go to the internal loan committee for approval builds trust in the program.

- **Programs should require lenders to report regularly on nonperforming loans.** Most States require lenders to inform them as soon as a borrower's loan is classified as less than a 'pass' credit or no longer compliant with the terms of the loan. States also may require an action plan from the lender focusing on working out the loan with the goal of avoiding liquidation where possible.

- **Encourage loan workouts.** In lender participation agreements, some States have found it useful to remind lenders that the intent of the LGP is job creation, and therefore the lender should take steps to work with a troubled borrower.

Marketing

- **Marketing needs to be consistent and repeated.** Assess what resources are available in your State and where it is possible to distribute/disseminate information about the program. Develop a marketing program before the program is implemented and then execute as designed. Promote key aspects of the program that make it easy to use, such as quick turnaround times on applications.

- **Promote the unique aspects the LGP.** SSBCI funds can be used for lines of credit, for bridge financing, and for loans to nonprofits for "business purposes." Under LGPs, the bank retains the full amount on its balance sheet, which is different than companion or purchase loan participation programs.

- **Marketing should address liquidation process.** Whether a State opts for first loss or pro-rata loss sharing guarantees, the marketing materials should clearly set forth the liquidation process so the lenders understand it upfront.

- **Marketing to banks requires one-on-one meetings with the commercial lending team.** For smaller banks, the initial meeting may be with the bank president. The introduction to the program should not be by email or with the branch staff.

- **Identify program champions.** Bankers who successfully utilized the program become the most effective advocates for the program, both within the bank and with their industry colleagues.

- **The LGP website is important to lenders, and it should be current, easy to find (remember the "3-click" rule), and have all the pertinent documents.** 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.

- **Use media outlets to promote the program.** States have promoted the program in local newspapers and on local radio talk shows. Getting the word out to the general community will generate interest among the small business population.

- **Identify the small group of key small business lenders in the State and reach out to them.** Some outreach options include calling programs, regular email updates, lender roundtables and small business conferences. Targets of the marketing include CEOs, chief credit officers, and small business loan officers. Only a few States market directly to small business borrowers.

- **Testimonials from lenders who successfully used the program can persuade their peers of the program's value.** Regularly email news about the program to lenders; include information such as number of loans made, which lenders made the most loans, and the SSBCI dollars available in the state. Press releases about success stories can generate interest from lenders. Make use of marketing by other States and by Treasury that can be customized to your state.

- **State regulators can be helpful in addressing questions about regulatory treatment.** Ask the bank commissioner for the opportunity to brief state examiners on the program. Examiners can help spread the word to the bankers.

- **<u>Partner with state banking associations to promote the program.</u>** To increase exposure and control costs, States can work with the state banking association to promote the program in newsletters, websites, local meetings and direct emails. States can also partner with the association to form informal advisory groups to discuss how to market the program.

Monitoring and Evaluation

- **<u>Create a compliance checklist prior to closing each loan.</u>** A checklist ensures that the program administrators and the lenders know what is expected.

- **<u>Review the State's procedures against the SSBCI National Standards for Compliance and Oversight to adhere to the program requirements.</u>** It is critical to stay current with program rules.

- **<u>States may wish to contract for compliance audits with a third party, but the State is always responsible for compliance.</u>**

- **<u>Keep lenders involved.</u>** Regular conversations with program participants reveal what is working and what may need to be adjusted in program design or operations. It is also an opportunity to emphasize the focus on job creation and retention, where possible.

- **<u>Establish metrics up front for expected results and actual performance.</u>** Some of the metrics states have used to measure success in the program include: number of loans, additional private capital received, job creation, job preservation and serving low income or underserved communities. Some states ask for this information on the loan enrollment forms.

- **<u>States should consider implementing a loan management reporting system.</u>** States have found that a loan monitoring system will allow for better and easier reporting on the program.