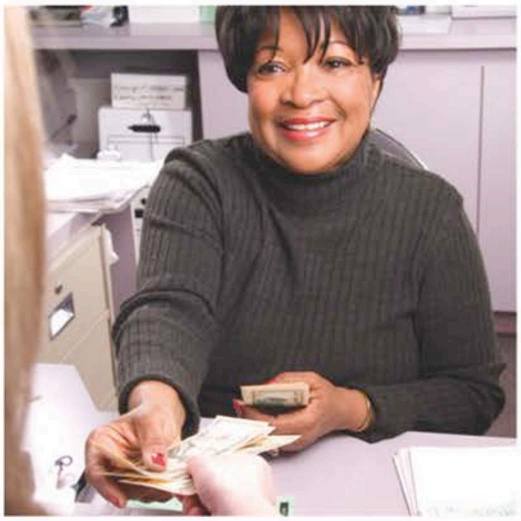
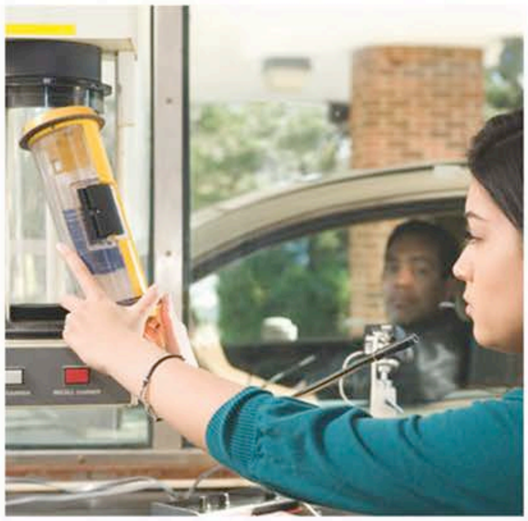
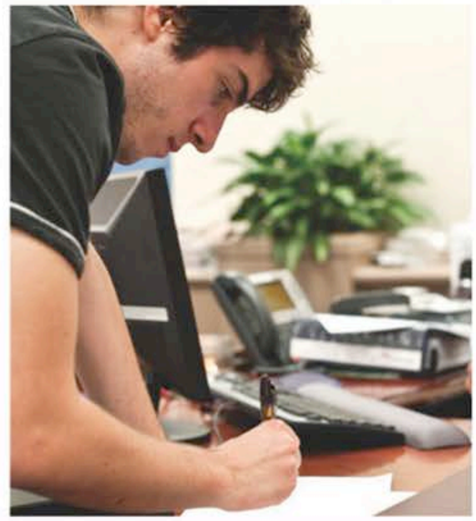
SSBCI State Small Business Credit Initiative







Best Practices from Participating States: Loan Participation Programs

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- Tony Johnson , Senior Director, North Carolina Rural Economic Development Center, Co-Chair
- Edwin Lesley, President, Business Development Corporation, Columbia, South Carolina, Co-Chair
- David Rodriguez, Manager of Capital Programs, Enterprise Florida
- Stanley Luboff, Capital Programs Manager, Illinois Department of Commerce and Economic Opportunity
- Andre Porter, Executive Director, Office of Small Business and Entrepreneurship (Massachusetts)
- Susan Mania, Director of Credit Underwriting, New Jersey Economic Development Authority
- Scott Parsons, Executive Director, Virginia Small Business Financing Authority

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State Small Business Credit Initiative
Loan Participation Program Best Practices

Under the U.S. Treasury's State Small Business Credit Initiative (SSBCI), 36 States received funding for Loan Participation Programs (LPPs). To strengthen States' performance in these programs and to assist States considering the creation of an LPP, a working group of State officials met to discuss best practices. These best practices distill the most important and practical advice these LPP state managers would offer their peers.

In an SSBCI LPP, the State[1] lends money to a small business in partnership with a financial institution. States structure their SSBCI LPPs in two ways:

- In a <u>purchase loan participation program</u> (purchase LPP), a State buys a portion of a loan originated by a lender, and may or may not be on a subordinated basis (in the event of liquidation). The lender manages the customer relationship, collects the repayments, and remits a pro rata share of each payment to the State.

- In a <u>companion loan participation program</u> (companion LPP), also called a direct lending program, a financial institution lender originates a senior loan and the State originates a second loan, which may or may not be subordinate to the senior loan. The State receives its own promissory note from the small business and collects repayments for its loan directly from the borrower. Companion LPPs allow the State more flexibility to offer terms they design, however, companion LPPs also require more staffing, can be more time-consuming and require two loan closings for the borrower.

Currently 36 States have LPPs: 22 States offer both purchase LPPs and companion LPPs; an additional 14 States offer only companion LPPs. The LPP Working Group discussed and agreed upon successful practices that could be readily implemented by others. The working group agreed that two cardinal principles apply to all LPPs:

1) **No matter how a program is structured or operated, the ultimate responsibility for success rests with the State. The State is always accountable for results and oversight compliance**.

2) **Keep the LPP simple and flexible**.

[1] "State" includes States, territories, the District of Columbia and municipalities approved to participate in SSBCI.

Program Design

- **<u>The first step in starting an LPP is consultation with local financial institutions most active in small business lending and guaranteed lending, as well as the banking associations</u>**. Typically, the State proposes a program design that targets a specific market segment or type of underwriting challenge. For example, a State may design its LPP to reduce a lender's overall credit limits, to reduce high loan-to-value exposure, or to temporarily reduce debt service during the State's participation time period. Lender input will inform the decision to expand an existing program or develop a new one.

- **<u>Maintain a flexible LPP design adaptable to unanticipated demand</u>**. Flexibility in the program design stage is critical to meeting the needs of stakeholders, keeping in mind the private financial leverage goal and impact on job creation/retention. Financial institutions seek to manage financial risk, and are most comfortable with a partner with steady program performance. Financial institutions generally prefer to manage the customer relationship exclusively. An added enticement for lenders is to include language in the participation agreement offering the financial institutions the opportunity to buy back all or a part of the State's participation after a period of time (e.g., 18 months).

- **<u>Establish maximum maturities that allow the State to meet lending and leverage goals</u>**. Shorter maturity on the term of State loan participations increases the recycling of funds (and raises the private leverage ratio) while spreading the program benefits to more borrowers. The maturity of the State's participation should be no longer and may be shorter than the financial institution's loan. Once funds are fully deployed, the State may de-emphasize the financial leverage ratio, though faster recycling improves the number of borrowers that can benefit from the State's program. States that offer the buy back of the State's participation option to the lender find this allows for faster recycling of State funds.

- **<u>Establish participation levels that allow the State to meet loan demand and leverage requirements</u>**. An LPP participation level of 15-25 percent of the lender's loan is generally sufficient to provide credit support to a borrower and also attract lenders' interest in the program. Some States offer higher participation levels when the maturity of the State's participation is relatively short. For simplicity, some States set a standard participation level. However, one successful program frequently purchases loan participations of up to 50 percent of the loan amount and provides a "debt service holiday" of one to two years in order to reduce the borrower's debt service burden. The key is flexibility and avoiding deals where the borrower has "no skin in the game."

- **Most States' loan participations are subordinate to the lender's loan on collateral**. Lenders like the LPP's focus on collateral because it allows them to issue and honor commitment letters even if a collateral appraisal comes back lower than expected.

- **Very few States' loan participations are subordinate on cash flow**. States will be subordinate on cash flow to match the borrower's financial condition and address the deficiency the lender identifies. This requires an understanding of commercial lending on the part of the State to be successful.

- **Successful programs have staff knowledgeable about commercial lending and able to devote sufficient time to the program**. Successful programs have staff who are fully dedicated to the LPP and who possess an expertise in commercial lending. Knowledgeable staff will gain the confidence of the lenders by demonstrating that they can "talk the talk," and are empowered and able to structure deals that work for the borrower, the lender, and the State.

- **When a State launches a new LPP, loan terms should be designed to meet the needs of the borrowers, participating lenders, and the leverage requirements**. The loan terms may provide more flexibility initially, (e.g., higher initial participation levels, lower or waived fees, and State interest rates lower than the lenders) until the program is solidly established.

- **State LPPs should consider charging fees to cover program costs and discourage transactions that may be eligible but do not require credit support**. Fees must be reasonable and competitive. Although practices vary, some States were comfortable applying the same pro rata fees as their portion of the purchased loan.

- **State LPPs may require focused outreach to underserved markets, but the State LPP should not unduly subsidize a transaction**. States should consider the loan sizes of other federal and State government lending programs to reduce overlap in existing programs. States should target outreach to underserved markets to reach these borrowers.

- **Job creation data on LPPs is a valuable component of program results, but some worthwhile transactions may create fewer jobs**. Collecting data on estimated job creation can be useful as a benchmark, but rigid requirements can impede high-quality transactions which may have other valuable impacts.

- **High impact transactions can make LPPs more saleable**. States have found that doing some high impact and high visibility transactions can help gain more attention for the program.

Operations

- **Starting a LPP requires a State to know the capacity and capability of its existing infrastructure, and to know that the State is always accountable**. States should generally administer the program in the agency where there is knowledge and familiarity with small business lenders. Starting with a survey of capabilities, the State can determine if the program should be administered internally or outsourced. If a State is starting a new program, it is possible to minimize the number of staff in an LPP if experienced commercial lenders are involved. A companion LPP has greater staff requirements than a purchase LPP because it requires the State to send its own monthly bills, process collections, and manage any loan workout situations.

- **It is important to hire staff with commercial loan underwriting experience and personal familiarity with lenders in the small business market**. The ability of the State's program staff to relate to the partner banks will make the program more appealing to the lender community. Knowledgeable LPP staff will also know how the program can complement an existing government lending program. Knowledgeable staff is critical, particularly at the start of the program. It is better to have one full time employee focused on the program than to spread responsibilities over a larger number of staff where no one "owns" the program.

- **Some States use an outside committee of bankers to evaluate borrower creditworthiness, while the State approves compliance with SSBCI rules.** Sometimes the committee may ratify small loans but will directly approve loans over a certain amount, for example over $500,000. Adding bankers to the loan committee can promote buy-in to the program and a better understanding of the State's underwriting goals.

- **The program application should be streamlined, readily available, and easily downloadable from the website**.

- **States generally review that the underwriting by the lender to assure that loans meet program criteria**. In most instances, the lender sets the terms and conditions of the loan.

- **Master Participation Agreements with lenders can reduce redundancy and paperwork**. Banks are familiar with these types of agreements. Relying on the bank's underwriting will also reduce the burden on State for purchase participations. Companion LPPs require the State to re-underwrite their portion of the loan. Banks are more likely to use a program that allows them to set the terms and conditions. Loan committees can be used for approval of loans over a pre-set amount.

- **Turnaround time for loan approval should be quick**. Some States approve an application in 3-5 business days, but it is most important to turnaround the loan request in the timeline promised. Banks will accept a longer turnaround time if they know what to expect. Some States will approve a loan participation before the lender takes it for internal credit approval.

- **Commitment letters should include all the conditions for the State's participation in the loan**. Such letters can enhance compliance with the prohibition on passive real estate investments and explain the definitions.

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 approvals on applications.

- **Websites are important to lenders, and they 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 to place 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 that have been successful for some States. Marketing targets can include CEOs, chief credit officers, and small business loan officers. Only a few States market directly to potential borrowers.

- **Highlight high impact transactions**. States that publicize high impact transactions will find greater interest from lenders to use the program.

- **Testimonials from lenders that successfully use the program can persuade their peers of the program's value**. 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. Some States have ranked lender participation or identified highly successful program users.

- **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.

Monitoring and Evaluation

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

- **Review the State's procedures against the SSBCI National Standards for Compliance and Oversight to ensure adherence to the program requirements**.

- **Get feedback from the lenders and borrowers about what is working and what may need to be adjusted in program design or operations**.

- **Establish metrics up front for expected results and actual performance**. For example, States have established a variety of criteria such as number of loans, additional private capital received, job creation, job preservation, and serving low income or underserved communities, any or all which allow for measuring the program's success.