



BEST PRACTICES FROM
PARTICIPATING STATES:
**COLLATERAL
SUPPORT
PROGRAMS**

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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), 17 states¹ received funding for Collateral Support Programs (CSPs). To strengthen states' performance in these programs and to assist states considering the creation of a CSP, working groups of state officials met to discuss the practical advice they would give to their peers. This document distills the most important advice CSP managers would offer their peers.

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 lines 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 Groups' discussions elicited comments on successful practices that could be readily implemented by other states. The working groups agreed on two cardinal principles:

- 1) Keep the CSP simple and flexible.**
- 2) Develop the right program with the right criteria for your state.**

The working groups developed best practices in the categories of program design, marketing, operations, monitoring and evaluation, sustainability, and loss mitigation.

1. Program Design

- **Assess existing credit support programs in the state:** The state should know what programs are used successfully by local financial institutions and what resources are available. This background helps the state understand what alternatives are available to lenders, what appeals to lenders, and where resources should be directed.
- **Evaluate existing federal and other state lending programs to minimize overlap and expand outreach to markets not currently being served:** Some states find that CSPs work 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.

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

- **Consult with local financial institutions and the local banking and industry associations when starting a CSP:** Involving the lenders in the design of the program will improve their acceptance and usage of the program. Focus groups and one-on-one meetings 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 they satisfy lenders, borrowers, and the goals of the state.
- **Engage staff that is knowledgeable about commercial lending and maintain adequate staffing levels:** 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.
- **Seek stakeholder input during program design and throughout implementation:** Financial institutions are most responsive to a program that helps them mitigate risk, is consistent with regulatory requirements, and is not overly prescriptive. Some states use an advisory council of lenders to provide initial and ongoing guidance and feedback to the program.
- **Charge reasonable fees:** Fees recover administrative costs, motivate lenders to request only the level of support truly needed, and can also be an additional source of program funds. 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.
- **Make the maturity of CSPs as short as possible for a viable program:** The shorter the maturity of the state's support, 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.
- **Let the level of collateral support 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. Make sure borrowers have "skin in the game." Most successful programs are able to calculate and provide the 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.

- **Confirm the collateral deposit meets a true collateral gap because SSBCI funding is a scarce resource:** 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.
- **Collect data on estimated job creation as a useful benchmark:** Rigid job creation requirements can impede high-quality transactions which may have other valuable impacts.

2. Operations

- **Begin with an internal assessment of the state's 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 to make sure that the staff members who administer the program are knowledgeable about commercial lending. States should generally locate the program within an agency with knowledge of and familiarity with small business lenders. When a state is starting a new program, it is possible to minimize the number of staff if the staff understands commercial lending.
- **Determine if outsourcing is a viable option after the assessment:** 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.
- **Hire staff with 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 lending community. Knowledgeable CSP staff will also know how the program can be used to complement an existing government lending program.
- **Streamline the program application:** The applications should be readily available and easily downloadable from the website. 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.
- **Process loan approvals quickly:** Some states can approve loans in less than 5 business days. It is most important to meet the turnaround time that was promised. Banks will accept a longer turnaround time if they know what to expect. Some states will approve a transaction before the lender evaluates it for internal credit approval, so that the lender is assured of the state's support at the time of lender's approval.
- **Address repayment of the deposit in the state's loan covenants:** 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.

- **Make sure that the lender understands the course of action in the event of a default as default policies can vary by state:** Some states freeze the collateral deposits in the bank while others use a trustee bank to hold the deposit and administer any payout. Be clear in the program documents how this will be handled.
- **Manage compliance to be part of the process from application to repayment:** Develop compliance checklists for internal staff and lenders and follow them closely.
- **Plan for staff succession:** Always assume that the program's existing staff may change. Develop operation manuals and policies that address tasks and processes and keep them up-to-date. Develop checklists for key operational activities, such as loan approvals and closings, collections, reporting, and compliance. Similarly, each staff member should identify his or her primary responsibilities and commit them to writing.

3. 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.
- **Market consistently and repeatedly:** Assess what resources are available in your state and where it is possible to distribute/disseminate information about the program.
- **Engage in effective and frequent communication with key stakeholders:** Points of emphasis should be success stories; program benefits for the banking and small business communities; the effectiveness of the program in reaching low-income communities and in supporting job creation and retention; and the importance of building "homegrown" small businesses that become long-term anchors in their communities.
- **Integrate direct marketing to banks and other financial service providers as a vital part of a program's marketing plan:** Effective tools or venues include "road shows" to meet with individual bankers or to participate in roundtables in a community, webinars, and banker conferences.
- **Recognize that websites are important to lenders and make sure they are current, easy to find (remember the "3-click" rule), and have 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 a small group of key small business lenders in the state and reach out to them:** Some successful outreach options include calling programs, regular email updates, round tables, and participating in small business conferences. 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:** Be prepared to explain how a CSP can fill the financing gaps lending partners encounter.
- **Make use of testimonials from lenders that successfully use the program:** 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.
- **Reach out to state regulators as they can be a helpful in addressing questions about regulatory treatment:** Ask the bank commissioner for the opportunity to explain the program to state examiners. Examiners can help spread the word to the bankers.

4. Monitoring and Evaluation

- **Review the state's procedures against the SSBCI National Standards for Compliance and Oversight to adhere to the program requirements:** It is critical to stay current with program rules.
- **Solicit feedback from lenders and borrowers:** It is important to find out what is working and what may need to be adjusted in program design or operations.
- **Create a compliance checklist and confirm it is being used:** A checklist ensures that the program administrators and the lenders know what is expected.
- **Establish performance metrics up front and track them:** States have used a variety of metrics including number of loans, additional private capital received, job creation, job preservation and/or serving low income or underserved communities, any or all of which allow for measuring the program's success.
- **Retain all records pertinent to the program:** Whether or not a state program continues after the SSBCI program ends, states should maintain documentation regarding the program so it is available for any compliance and audit inquiries. States should retain all financial records, supporting documents, statistical records, and all other records pertinent to its SSBCI allocation for a period of three years from the date of submission of the final quarterly report.

5. Sustainability

To enhance long-term stability and impact, consider various aspects of sustainability, including continuous product availability, preservation and expansion of available capital, and the extent to which program income is needed to cover some or all operating expenses.

- **Tailor the amount of collateral support to avoid over-collateralization of loans:** States should review the lender's collateral analysis for loans submitted for support to confirm the amount requested is not in excess of that needed to bring the bank within its regulatory and policy requirements. Over-collateralization leads to more rapid depletion of CSP capital and limits program continuity.
- **Structure the amount of collateral support to minimize CSP losses:** If the amount of CSP support is tailored to match the collateral gap in a loan and over-collateralization is avoided, the lender has significant principal at risk and thus a strong incentive to underwrite the loan conservatively. Over-collateralization can reduce that incentive.
- **Provide incentives to lenders to use collateral support for shorter-term loans to increase capital recycling:** Strategies for providing these incentives include higher maximum percentages of collateral support for shorter-term loans and higher fees for longer-term loans. States also can focus on loan types that are inherently short-term, such as interim financing for SBA 504 loans.
- **Establish a maximum term that the CSP will support a loan:** Each state determines a maximum term with input from the banking community to ensure that the CSP product continues to be attractive, capital is recycled, and the desired economic development impacts are achieved. For example, a state can limit collateral support for lines of credit to three years and term loans to five years. Other options are to approve support for loans with terms in excess of five years only in cases of exceptional impact, to require an accelerated release or "claw back" of CSP funds after a specified time period, or to charge higher fees after five years.
- **Establish a maximum dollar amount that the CSP will provide in collateral support:** A maximum amount will allow a state to support more loans and avoid concentrating its resources in a few larger loans. For example, in addition to a maximum percentage, a program can establish a maximum amount in collateral support, *e.g.*, \$500,000. The maximum amount should be based on the small business loan market and typical transaction size in that state.
- **Require a gradual release of CSP capital as a loan is paid down to maintain a constant percentage exposure on that loan:** Most programs require an annual claw back to stay within the same percentage exposure as at origination. States can also require excess balances to be returned quarterly. Periodic reports required of lenders should include current outstanding balances of supported loans so the state can determine current percentages secured through the CSP.
- **Reduce the maximum percentage for which a program will provide collateral support as the program matures:** To establish the CSP as a valuable asset within the lending community,

many programs initially offered collateral support for as much as 50 percent of the loan amount. To extend their capital availability, established programs have reduced the percentage of collateral support to 20 to 25 percent. Programs often allow higher percentages to support loans in areas that are particularly vulnerable to fluctuations in collateral value, such as rural and low-income communities.

- **Consider charging a reasonable fee for use of the program to cover loan losses or to generate operating funds or additional capital:** Unlike loan participation programs, CSPs do not generate interest income, and thus are reliant on fees for income. Pricing philosophies vary, with the maximum fees among working group participants being 3 percent of the deposit amount or 2 percent of the full loan amount, with the fee typically being passed through to the borrower. Some programs also charge annual fees. The fee structure should be determined in consultation with lenders participating in the program and based on local market conditions.
- **Explore supplementing SSBCI capital with state or private funds:** Potential sources include legislative appropriation; reallocation of unused funding from other programs; and public agencies and private sector programs or foundations advancing economic or community development.

6. Loss Mitigation

- **Clearly define a lender's responsibilities in monitoring, servicing, and collecting loans through a deposit agreement or similar governing document:** Clear benchmarks should be established for communication by the lender with the state program. Similarly, it should be documented in writing that the lender will follow prudent underwriting and collection practices with respect to any loan.
- **Prohibit lenders from making material changes to the terms of a loan without the CSP's consent through a deposit agreement or similar governing document:** This mitigates the risk that modifications to the loan are non-compliant or otherwise fall outside the state's program criteria.
- **Withdraw collateral support for a loan after a material violation of program rules or the deposit agreement by the lender with respect to any given loan:** For example, if a lender provides a request for collateral support that states the lender will be in a first lien position and closes the loan without a first lien, a program should have the right to require a release of all collateral support provided for that loan.
- **Review the lender's underwriting with respect to borrower collateral:** Programs should review the lender's collateral analysis to confirm both the amount of collateral support requested and the loan-to-value ratio are reasonable. Some programs undertake a more complete underwriting of the loan, including a review of the lender's credit memorandum and spreads as well as of the borrower's raw financial data. A state should turn down requests for collateral support that do not meet its underwriting standards or economic development goals. A state's decision with respect to the degree of underwriting should be based on its assessment and knowledge of the lenders participating in the program.

- **Require borrowers to provide personal guarantees and/or secondary sources of collateral to help mitigate loan losses:** Personal guarantees generally should be required. Programs should be aware of various federal and state rules and regulations governing spousal guarantees. Most states follow the lead bank's requirements with respect to second mortgages on a borrower's home. While it is difficult and expensive to collect on a personal guarantee or a second mortgage, they can provide leverage when negotiating a loan workout. Loans can also be partially secured by cash collateral pledged by the small business or its owner(s).
- **Require the lender to periodically provide reports on portfolio status and review those reports:** A state should review delinquency lists at least quarterly or semi-annually.
- **Require copies of all notices of delinquency, default, covenant violations and any other adverse changes:** Upon receipt of notices, the state should be in immediate communication with the lender on loan status and any workout or collection strategies and related timelines.
- **Require the lender to liquidate all other material collateral held with respect to a loan before liquidating the collateral support account:** Most lenders take other collateral and use the CSP to cover any collateral shortfalls. Therefore, in the event of loan loss, the program should stipulate that the lender's other collateral be liquidated first before collecting against the SSBCI cash collateral for any remaining losses.