BEST PRACTICES FROM PARTICIPATING STATES:

LOAN GUARANTEE PROGRAMS

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SSBCI

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State Small Business Credit Initiative
Loan Guarantee Program Best Practices

Under the U.S. Treasury's State Small Business Credit Initiative (SSBCI), 19 states[1] received funding for Loan Guarantee Programs (LGPs). To strengthen the states' performance in these programs and to assist states considering the creation of a LGP, working groups of state officials met to discuss their best practices. This document distills the most important and practical advice LGP state managers would offer their peers.

In an 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 Groups' discussions elicited comments on practices that were successful and can be readily implemented by other states. The working groups agreed that four key principles apply to all LGPs:

1) **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. Every state has its own strategies and tactics to support job creation and retention including the provision of assistance generally to small businesses, expanding access to capital among minority-, women-, veteran- and disabled-owned businesses, and increasing economic activity in the state, among others.**

3) **Allow lenders to underwrite the loans while the state underwrites the lender.**

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

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

1. Program Design

- **Consult with the local financial institutions most active in small business lending and guaranteed lending when starting an LGP:** Consultations with state banking associations are a valuable way to disseminate information and obtain feedback. 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. Consultations with lenders and state banking associations should be on-going to identify the evolving needs of lenders to support continued program utilization.

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

- **Maintain a flexible LGP 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 and distinguish SSBCI's LGP program from the SBA and USDA guarantee programs:** Guarantees can be applied to a portion of a loan ranging from 20 percent to 80 percent. Lower guarantee percentages encourage better underwriting by the lender. A guarantee percentage of 50 percent has worked well for new LGPs to balance making sure that lenders have enough "skin in the game" and the level of loan re-underwriting by state program managers or their contractors. Experienced programs have enjoyed success with higher guarantee levels though this generally requires more re-underwriting by state program managers or their contractors. Guarantee percentages lower than 50 percent generally are not attractive to lenders.

- **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 guarantees 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 and the state's ability to underwrite to varying levels of risk. 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 the program will support.

- **Encourage lenders to work with borrowers that encounter difficulties:** States have found that lenders who 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.

- **Staff the program adequately:** 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, the 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.

- **Charge fees 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.

- **Focus outreach to underserved markets, but the 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.

- **Raise LGP visibility through high-impact transactions:** Guaranteeing loans for high impact and high visibility transactions can help gain more attention for the program.

- **Focus on customer service to lending partners:** The best LGP salesperson is a happy lending partner. Having visible lending partners who publicly advocate and provide testimonials for a state's LGP can boost acceptance and participation by other lenders.

2. Operations

- **Understand the capacity and capability of the state's existing infrastructure:** 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.

- **Hire staff with commercial loan 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 LGP 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.

- **Engage the banking and business community:** Engaging bankers on an outside loan committee to evaluate borrower creditworthiness, while the state approves compliance with SSBCI rules can promote the LGP. Adding bankers to the loan committee can promote buy-in to the program, a better understanding of the state's underwriting goals, and add to the outreach. States should set clear expectations about the procedures of a loan committee, *i.e.*, 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.

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

- **Review the lender's underwriting to confirm 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 and manage its risk. The higher the guarantee percentage and the longer the term of the guarantee, the greater the amount of re-underwriting required by the state or its contractor. The state must monitor and enforce compliance with the SSBCI program rules.

- **Consider using master participation agreements to reduce redundancy and paperwork:** Using master participation agreements will lessen the burden on banks to certify eligibility of loans it enrolls in the program. Banks are familiar with these types of agreements. Allowing banks to use their own credit forms is a draw for the program.

- **Maintain a quick turnaround time:** Some states reply to an application in 5-7 business days. It is most important to respond to the loan guarantee request in the timeline promised. Banks will accept a longer turnaround time if they know 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.

- **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 is 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. In addition to requiring notifications from lenders when loans become delinquent and/or go into default, successful state LGPs require periodic reports from lenders on their entire portfolios. States should request these reports at least quarterly.

- **Encourage loan workouts:** In lender participation agreements, some states have found it useful to remind lenders of the economic development goals of the program, encouraging the lender to take steps to work with a troubled borrower.

- **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

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

- **Address the 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.

- **Meet one-on-one 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.

- **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 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 their programs in local newspapers and on local radio talk shows and through forums with civic and nonprofit groups and other state federal agencies. Promoting the program broadly allows the state to differentiate its LGP program from other credit enhancement vehicles. Getting the word out to the general community will generate interest among small businesses.

- **Identify the 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, lender roundtables and small business conferences. Marketing targets can include CEOs, chief credit officers, and small business loan officers. Only a few states market directly to small business borrowers.

- **Make use of testimonials from lenders who have successfully used the program:** Regularly email news about the program to lenders; include information such as number of 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. Recognize strong performance by individual lenders by giving them awards such as "lender of the year."

- **Reach out to state regulators as they 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.

- **Partner with state banking associations to promote the program:** 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.

- **Acknowledge the limitations of the program:** Not all loans or all lenders are good fits for an LGP. Lenders will appreciate the state's honesty and frankness in quickly identifying loans that are not "right" for LGP and are better structured using other credit enhancement programs. Successful states differentiate their LGP from other credit enhancement programs. If a loan is better structured using an SBA guarantee, then the state should encourage the lender to use SBA.

4. Monitoring and Evaluation

- **Create a compliance checklist and confirm it is being used prior to closing each loan:** A checklist informs the program administrators and the lenders of what is expected.

- **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.

- **Consider engaging external resources to help with compliance audits:** States may wish to contract for compliance audits with a third party, but the state is always responsible for compliance.

- **Keep lenders involved:** 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.

- **Keep staff involved:** Regular meetings with staff to discuss SSBCI program changes, compliance issues, and deal flow are important to update staff and to safeguard program integrity.

- **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 serving low income or underserved communities, any or all of which allow for measuring the program's success. Some states ask for this information on the loan enrollment forms; others collect this information at loan closing. Some states follow up with borrowers at a future date to confirm final job creation and retention figures. The extent of the state's future data collection and auditing activities should be clearly outlined in its guarantee agreement.

- **Consider implementing a loan management reporting system:** States have found that a loan monitoring system allows for better and easier reporting.

- **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, states should consider various aspects of sustainability, including continuous product availability, preservation and expansion of loan fund capital, and the extent to which program income is needed to cover some or all operating expenses. To support sustainability, states need to begin loan programs with the end in mind—knowing what they want to accomplish and how long they want the program to be operational.

- **Cover most of the operating costs of an LGP through fee income and earnings on reserve funds:** Many states have found that guarantee, documentation, and closing fees combined with interest earned on the investment of funds set aside for guarantee claims can cover all or a significant amount of the operating costs of an LGP. Loan losses, however, are generally covered from the corpus supporting the LGP, resulting in the reduction in funds available to underwrite future loan guarantees.

- **Determine who effectively pays for guarantee, documentation, and closing fees and whether these fees can be financed in the loan amount:** Lenders are required to pay all fees associated with LGP to the state. However, most states allow borrowers to reimburse lenders for those fees. Most states also allow those fees to be financed in the loan amount. Lenders may charge additional fees on LGP loans; most states do not limit those fees.

- **Consider limiting the life of the LGP guarantee in order to revolve LGP funds more quickly:** Other sustainability techniques to consider include shorter allowed maturities on lines of credit, charging higher fees for longer loan maturities, and charging new fees for loan renewals/extensions. Most states price their LGP guarantees very competitively compared to other small business credit enhancement programs. To enhance long-term sustainability of SSBCI-funded LGPs, most states will need to consider changing their fee structure after the operating subsidy provided by Treasury for SSBCI programs ends. There are alternatives for increasing overall LGP program income without having to increase the base guarantee fee for all loans.

- **Consider other approaches to reasonably increase program capitalization:** States should explore other capitalization opportunities such as the creation of a secondary market for the guaranteed portion of LGP loans and reinsurance of state LGP guarantees by third parties.

6. Loss Mitigation

- **Routinely monitor the LGP portfolio for risk:** States can do this internally or by using a third party. A risk rating system can be useful. The goal is for the state to be ahead of any problems that might arise in its LGP portfolio. If the state does not set aside funds equal to the total amount of its outstanding loan guarantees, then the state can use a risk ratings system to adjust the amount reserved for each loan guarantee based on each loan's risk rating.

- **Communicate early with the lender in the event of a loan default to limit the amount the state may lose on the transaction:** States with legacy programs generally require lenders to regularly inform them of delinquencies and defaults and to submit work-out plans when a loan goes into default. If a loan goes into liquidation, states generally require lenders to submit liquidation plans. The state should provide feedback to lenders on their work-out and liquidation plans and hold lenders accountable should a defaulted loan result in a claim on the state's guarantee.

- **Determine when the state will pay claims on its guarantees:** Some states require lenders to liquidate collateral prior to processing claims on the state's guarantee. Other states pay claims after an event of default and/or after a liquidation plan has been approved but before the collateral has been liquidated; the state then shares in the recovery with the lender. In all cases, lenders are responsible for managing loan work-outs and liquidations.

- **Respond to claim requests in a timely manner:** To maintain credibility in the marketplace, states have found that they must respond quickly to claim requests from lenders even if the response is to deny the claim, to request that the lender repair the claim, or to request additional information.

- **Pay claims quickly if the claim is in order:** States generally pay within 30 days of receipt of a completed, compliant claim. Small claims should generally be paid as quickly as possible.

- **Adjust the amount of the claim if the lender's claim is not in order:** Lenders who do not follow approved or commercially reasonable work-out and liquidation plans generally should not be paid the full amount of their claims, especially if they fail to secure collateral to preserve it from theft and vandalism or if they fail to liquidate collateral with limited life quickly. Lenders should be required to support the diligence of their collection efforts.

- **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).