



BEST PRACTICES FROM
PARTICIPATING STATES:
**LOAN
PARTICIPATION
PROGRAMS**

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SSBCI

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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), 39 states¹ received funding for Loan Participation Programs (LPPs). To strengthen states' performance in these programs and to assist states considering the creation of an LPP, working groups of state officials met to discuss best practices. This document distills the most important and practical advice LPP state managers would offer their peers.

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

- In a purchase loan participation program (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 companion loan participation program (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 39 states have LPPs: 29 states offer both purchase LPPs and companion LPPs; an additional 10 states offer only companion LPPs. The LPP Working Groups discussed and agreed upon successful practices that could be readily implemented by others. The working groups 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.**

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 local financial institutions most active in small business lending and guaranteed lending, as well as the banking associations, when starting an LPP:** 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

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

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.

- **Maintain a flexible LPP program design adaptable to unanticipated demand:** 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).
- **Establish maximum maturities that allow the state to meet lending and leverage goals:** Shorter maturities on the term of state loan participations increase the recycling of funds (and raise 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 encourage lenders to buy back participations recycle funds more quickly.
- **Establish participation levels that allow the state to meet loan demand and leverage requirements:** An LPP participation level of 15 to 25 percent of the lender's loan is generally sufficient to provide credit support to a borrower and attract lenders to 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 to reduce the borrower's debt service burden. The key is flexibility and avoiding deals where the borrower has "no skin in the game."
- **Subordinate the states' LPP loan 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.
- **Understand when to subordinate the states' LPP loan on cash flow:** Subordination as to cash flow in addition to a subordinated lien position on collateral increases the risks and potential losses in a state's LPP. Thus, very few states' LPP loans are subordinate as to cash flow. A state should agree to be so subordinated only if it has the requisite level of commercial lending expertise needed to underwrite these higher risk borrowers, and if the subordinated position is needed to address an identified short-term deficiency in the borrower's financial condition that can be rectified and the ultimate performance of the loan is considered stable.
- **Engage staff that are knowledgeable about commercial lending and are able to devote sufficient time to the program:** Successful programs have staff who are fully dedicated to the LPP and who possess 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.

- **Design loan terms to meet the needs of the borrowers and participating lenders as well as the leverage requirements, when launching a new LPP:** The loan terms may provide more flexibility initially, (*e.g.*, higher initial participation levels, lower or waived fees, and lower interest rates) until the program is solidly established.
- **Charge 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.
- **Consider focused outreach to underserved markets, but do not unduly subsidize a transaction:** States should consider the parameters of other federal and state government lending programs to minimize overlap in existing programs. States should target outreach to underserved markets to reach these borrowers.
- **Recognize job creation data as a valuable component of program results, but remember 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.
- **Consider high impact transactions to help make the LPP more saleable:** Doing some high impact and high visibility transactions can help gain more attention for the program.
- **Assess capabilities of lenders that are not financial institution lenders, credit unions, or Community Development Financial Institutions (CDFIs):** States should seek Treasury’s approval to use non-financial institution lenders prior to active engagement. If a state plans to use lenders that are not financial institution lenders, credit unions, or CDFIs as part of its distribution network, it should carefully screen those lenders to confirm they have the requisite lending experience, personnel, and policies. Participants in the network should be vetted for past portfolio performance, and the state should enter into a memorandum of understanding with those participants that clearly identifies their respective responsibilities. Qualifications can also be identified through a formal application process for program participation.

2. Operations

- **Understand the capacity and capability of the state’s existing infrastructure when starting an LPP:** 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 loan workouts.

- **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 lending 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 programs. 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.
- **Consider using an outside loan committee comprised of bankers to evaluate borrower creditworthiness, while the state approves compliance with SSBCI rules:** Sometimes the committee may ratify small loans but will directly review and 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.
- **Streamline the program application:** The application should be readily available and easily downloadable from the program’s website.
- **Review the lender’s underwriting or institute controls to confirm that loans meet program criteria:** In most instances, the lender sets the terms and conditions of the loan; however, states generally review the underwriting.
- **Establish Master Participation Agreements with lenders to 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.
- **Process loan approvals quickly:** Some states approve an application in 3-5 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 loan participation before the lender takes it for internal credit approval.
- **Include all conditions for the state’s participation in the loan in the commitment letters:** Defining key program-related terms and conditions in commitment letters can enhance compliance with common issues such as the prohibition on passive real estate investments.
- **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.

- **Plan for program continuation or succession:** States need to address the future of the program if federal funding is no longer available and how this future will be communicated to its participants.

3. Marketing

- **Identify all stakeholders:** Develop a comprehensive list of all stakeholders and understand what information may be useful to that constituency. Every effort should be made to tailor information to individual stakeholder groups.
- **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 plan 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.
- **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 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:** 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. Only a few states market directly to potential borrowers.
- **Coordinate with small business development centers and other technical assistance providers:** In order to control the quality of referrals to state programs that market directly to small businesses, staff of technical assistance providers must continuously be trained in the role and products of various capital providers within the state and particularly the state’s SSBCI program.
- **Highlight high impact transactions:** States that publicize high impact transactions will find greater interest from lenders to use the program.
- **Maintain borrower confidentiality, subject to public disclosure and other state laws:** Borrower permission should be obtained before using their story in marketing materials. Best practice is to include a provision in closing documents that permits programs to issue closing press releases, publish “tombstones” advertisements, or otherwise use the SSBCI financing transaction in marketing materials (the latter subject to borrower review).
- **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. Some states have ranked lender participation or identified highly successful program users.

- **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.
- **Communicate effectively and frequently:** Program managers should clearly communicate to lenders, the small business community, and policy makers how the LPP is different from other credit enhancement programs. Managers should also communicate its successes and overall impact. Several states emphasize program benefits for specific businesses or localities; the effectiveness of the program in supporting job creation and retention; and the importance of building “homegrown” small businesses that become long-term anchors in their communities. Several states also work closely with their local Chambers of Commerce as well as accounting firms and law firms to promote the SSBCI program.

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.
- **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.
- **Monitor audits of other state programs and implement changes to improve compliance operations:** Review completed external audits of state programs for opportunities to improve compliance program and follow-up with questions as needed with peers who have completed the audit process.
- **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.
- **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.

- **Manage programs, to extent feasible, so that capital is continuously available for new loans:** Banks and other lenders are more likely to use a program that is continuously available and long-term. Sporadic availability can cause the program to lose the momentum and benefit of initial marketing efforts and can lead to lenders' reluctance to participate in a program.
- **Increase capital availability:** This can be achieved through a variety of strategies, including structuring participations so that they are relatively short-term and structuring incentives for lenders or borrowers to buy back the participation. States can put in place faster amortization schedules than the lead lender. States can also have a 5- or 10-year balloon, depending on the loan type. To provide an incentive for the bank or borrower to buy back or repay the participation, states can charge a higher interest rate than the lead lender; require no prepayment penalty; and/or mandate a shorter term if the loan is not leveraging other capital at least 10:1. States can also allow a lender to buy back the participation or a portion thereof in a seasoned loan and revolve those proceeds into a new participation with the same bank, thus giving the lender an incentive to increase its small business loan volume without using new capital.
- **Structure participations to minimize losses and preserve existing capital:** In purchase participation programs, rigorous underwriting by lead lenders is critical. The LPP product should be designed so that the lead lender has substantial principal at risk and a strong incentive to underwrite the loan conservatively.
- **Charge interest and fees to at least partially cover operating costs:** Pricing philosophies vary. Some states set the interest rate on their participations based on risk; some charge the same interest rate as the lead lender; and others offer a subsidized interest rate. Nevertheless, in all cases states were earning interest and fee income that could be used to fund loan losses, pay operating expenses, and/or provide capital for new lending. Several states also charge fees for "undrawn usage."
- **Explore supplementing SSBCI capital with state or private funds:** State funding sources can include legislative appropriation; one-time events such as an allocation of the proceeds from the sale of state assets; and reallocation of unused funding from other programs to supplement SSBCI capital. Foundations can also provide funding for technical assistance to small business borrowers. States can also use CDFIs to solicit funds from banks to provide additional capital for a loan program.
- **Communicate the positive outcomes of the program, including its economic development benefits:** SSBCI advances a state's economic development policies, particularly through strong support for local small businesses. The effectiveness of SSBCI programs in reaching businesses in low- and moderate-income communities and in helping banks, particularly smaller community banks, grow their local small business portfolios are positive messages to potential capital

providers. States also need to track jobs created and retained to demonstrate the effectiveness of the program.

6. Loss Mitigation

- **Develop written loan and monitoring policies, documenting the reasons for any exceptions:** Adherence to policies and exception tracking are important in controlling losses, documenting compliance, and responding to any inquiries as to why any particular loan was made. To the extent feasible, keep minutes of credit committee meetings.
- **Use the U. S. Small Business Administration (SBA) Loan and Lender Monitoring System (L/LMS) to monitor lender performance:** The Lender Portal is one component of SBA's L/LMS and is the primary way that SBA communicates lender performance information, including a quarterly lender risk rating. The Portal can be an effective risk management tool by providing an early warning of deterioration of participating lenders' small business loan portfolios.
- **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 borrowers to obtain key man life insurance:** As added protection for the loan, states can require the borrower to obtain this insurance even if the lead lender declines to do so.
- **Reduce the degree or scope of subordination to mitigate loss on subordinated participations:** A state is most at risk if the first lien lender can collect its principal, interest, and expenses on a defaulted loan before the state receives any proceeds. A state potentially reduces its losses if the first lien lender collects principal, then the state program receives principal, then the first lien lender collects interest and expenses. Alternatively, a state can subordinate its SSBCI participation as to only specified collateral, but otherwise be able to pursue collection actions against the borrower without constraints.
- **Require loan payments to be deducted from a borrower's bank account through Automated Clearing House (ACH) for companion loan programs:** This can reduce delinquencies and subsequent defaults.
- **Use staged disbursements to reduce risk:** States generally rely on the lead lender in managing construction loan disbursements. Some states release funds as the small business meets certain milestones, such as raising matching private capital or obtaining contracts. States also need to confirm that bank funds have been disbursed prior to the SSBCI funds being advanced.

- **Collect and review portfolio monitoring reports, prioritizing the loans most at risk:** States typically review delinquency lists monthly or quarterly. States that are participating in loans (as opposed to making companion loans) should require the lead lender to periodically provide reports on portfolio status.
- **Engage in proactive outreach and communication to participating program lenders who are acquired or merged:** This is important from a marketing perspective and for maintaining portfolio quality, especially to the extent a problem loan is part of the acquired portfolio. The acquiring bank may take a very different approach in managing its relationships with borrowers supported by the state's SSBCI program. Some states use the initial loan program documents to address how loans in banks acquired or merged will be handled.
- **Look for warning signs for potential troubled loans in addition to delinquency:** Several state programs that offer only direct participations expect the lead lender, typically a bank, to be the primary point of customer contact. Those programs have limited borrower communication making warning signs harder to spot. In those states that have direct customer contact, non-responsiveness of the customer to inquiries for information is often an early indicator of stress. Other indicators include the customer drawing down a revolving line of credit to its maximum amount or seeking a non-routine modification of the loan.