SSBCI PROGRAM PROFILE: LOAN PARTICIPATION PROGRAM

May 17, 2011

State Small Business Credit Initiative (SSBCI)

U.S. Department of the Treasury

What is a Loan Participation Program?

A Loan Participation Program enables small businesses to obtain medium to long-term financing, usually in the form of term loans, to help them grow and expand their businesses. States may structure a Loan Participation Program in two ways: purchase transactions, also known as purchase participation, in which the state purchases a portion of a loan originated by a lender; and companion loans, also known as co-lending participation or parallel loans, in which a lender originates a senior loan and the state originates a second (usually subordinate) loan to the same borrower. This program enables the state to act as a lender, in partnership with a financial institution lender, to provide small business loans at attractive terms.

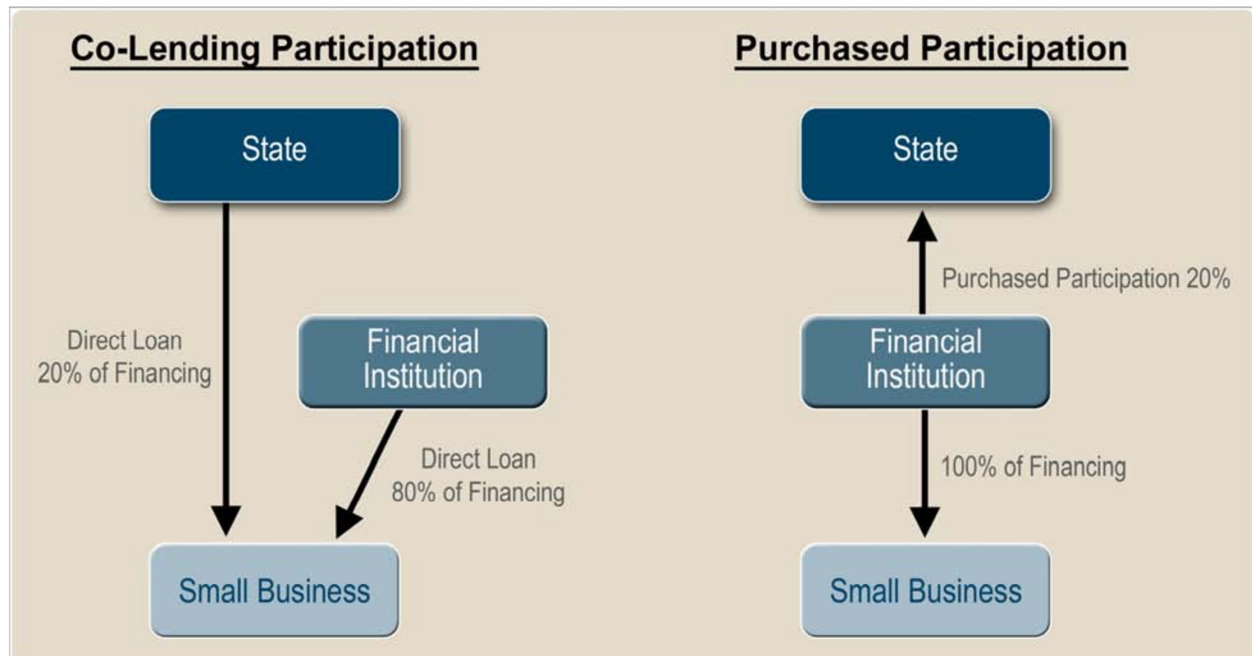
What are the Credit and Loan Characteristics?

Like all credit programs, a Loan Participation Program can be tailored to meet a state's objectives. The table below describes key credit and loan characteristics that should be considered when designing a Loan Participation Program.

Characteristics	Description
What kinds of borrowers are eligible to participate?	• Borrower eligibility may be broad or targeted at the state's discretion. Eligibility is determined by each state and may target specific industries, regions, and types of businesses, depending on the state's objectives. • Under SSBCI, should target an average borrower size of 500 employees or less; should not exceed a maximum borrower size of 750 employees. In practice, small businesses targeted by existing state programs are typically much smaller than 500 employees. • Corporations, partnerships, and sole proprietorships are eligible, as well as non-profits and cooperatives. • SSBCI Policy Guidelines provide specific guidance on certain borrowers who are prohibited from participating in this program.
What sizes of loans are eligible?	• Under SSBCI, must target an average principal amount of $5 million or less and cannot exceed $20 million on any individual loan. In practice, the average small business loan is typically much less than $5 million.
What types of loans are eligible?	• Term loans are the most common. • Small Business Administration (SBA) guaranteed loans may not be purchased in loan participation. A state may, however, purchase participations in loans that are subordinate to, or make its own direct loan subordinate to, an SBA guaranteed loan.
How can loan proceeds be used?	• For any business purpose, including, but not limited to start-up costs, working capital, business procurement, franchise fees, equipment, inventory, as well as the purchase, construction, renovation, or tenant improvements of an eligible place of business that is not for passive real estate investment purposes. • Restrictions apply to refinancing and other uses; please refer to the SSBCI Policy Guidelines for additional details.

Characteristics	Description
Who negotiates the terms of the loan?	• For purchase transactions, interest rates, maturity, collateral and other loan terms are negotiated between the borrower and the financial institution lender, though the state may seek to approve terms prior to closing. • For companion loans, the state and financial institution lender negotiate interest rates, maturity, collateral and loan terms with the borrower.
What are the program's strengths?	• The state benefits from seeing the financial institution lender's credit analysis, though the state should also conduct its own underwriting of each loan. • The financial institution lender diversifies its risk by sharing exposure with the state. • The state may decide to offer its participation at low interest rates, which reduces the blended rate paid by a small business. • In a purchased participation, the financial institution lender conducts all of the customer interaction, including monthly invoicing, collections, and loan workouts.

How Does a Loan Participation Program Work?
Loan Participation Programs typically work in one of two ways: 1) purchase transaction loans, whereby a state purchases a participation in a loan that is issued by a financial institution lender; or 2) co-lending participation, companion loans, or parallel loans, whereby a state makes a loan alongside a financial institution lender loan. Typically the state's loan is subordinate to the lender's loan in terms of collateral priority.



Operating Mechanics	Description
What kinds of lenders are eligible to participate?	• Under SSBCI, any insured depository institution, insured credit union, or community development financial institution, as defined in section 103 of the Riegle Community Development and Regulatory Improvement Act of 1994. • SSBCI recommends that states confirm that financial institution lenders have sufficient commercial lending experience and financial and managerial capacity to participate.
Who originates loans in this program?	• For purchase transaction loans, the financial institution lender originates the loan, and the state purchases a portion of the loan from the financial institution lender. • For companion or parallel loans, the financial institution lender originates the primary loan, and the state or agent originates the secondary loan.
Who has underwriting responsibility?	• For purchase transaction loans, the financial institution lender underwrites the initial loan. The state typically underwrites its purchase participation but may gain further information from the lender's credit decision. • For companion loans, the financial institution lender and state each evaluate the application based on their own credit criteria, though the state may request the financial institution lender's credit analysis.
How are these loans monitored?	• States should establish a program to monitor both the repayment progress of borrowers and the servicing performance of participating lenders. • Servicing capabilities are particularly important for states with parallel or companion loans. • Many states periodically reevaluate the value of collateral in issued loans and make sure that the collateral is properly insured.
What kinds of fees may be charged?	• Application and origination fees may be charged, as determined by each state, to defray the cost of program operations and ensure sustainability. Typically, fees range from 0% to 3% of the loan amount.
What is the loan participation term?	• Varies from state to state and from loan to loan. Typically, the state's participation is no shorter than the term of the lender's loan.
In what percentage of the loan can the state participate?	• The state may purchase or issue a loan participation up to 80% of the total loan amount; a private lender must have at least 20% of its own capital at risk.
What happens in the case of a default?	• An agreement between participating lenders and the state should define each party's responsibilities in situations involving default, charge-off, and liquidation. Typically, if the state has a subordinate position, the lender has the first claim to all recoveries until its losses are covered.

Operating Mechanics	Description
What leverage requirements exist?	• Under SSBCI, each OCSP must individually demonstrate a minimum private financing ratio of 1:1 over the lifespan of the SSBCI program. • States must demonstrate a plan that creates a reasonable expectation that the approved programs, when considered in sum, will result in 10:1 leverage over the lifespan of the SSBCI Allocation Agreement or Allocation Time Period.
What is the state's liability?	• The state bears losses up to the amount of its participation. The state may also need to participate in costs of workout as negotiated with the lender. • The lender has no recourse against the state in case losses exceed recoveries.

Who are the Key Stakeholders and What are Their Roles?

The stakeholders in a Loan Participation Program include the state, financial institution lenders, and an implementing agency/entity, if assigned by the state to manage the program. Implementing entities may include a specific department, agency, or political subdivision of the state, or an authorized agent of, or entity supervised by, the state.

Stakeholder	Role
What is the role of the state?	• Conducts outreach to inform lenders, small businesses, and trade associations of the program. • Verifies the eligibility of individual loans, which includes confirming borrower eligibility requirements and certifying that proceeds will be used for acceptable business purposes. • Has direct lending responsibilities, including underwriting loan participation purchases and companion loans and ongoing loan monitoring and reporting. • Establishes an agreement with the lender specifying who is responsible for servicing, modifying, reporting, and collecting loans. • Some states select an agent to perform their responsibilities on their behalf.
What is the role of a lender?	• For companion loans, the senior financial institution lender generally has few or no responsibilities to the subordinate state loan unless spelled out in an inter-creditor agreement. • In purchased participations, the financial institution lender's role is written into the participation agreement. • In each case, the financial institution identifies potential opportunities for state participation.
What is the potential role of an implementing agency/entity?	• May act on behalf of the state, as a lender, to administer the loan participation program, to include underwriting, monitoring, reporting, and possibly servicing. • May assist in marketing the program in their region or community.

What Kind of Operating Model is Needed to Manage a Loan Participation Program?

Loan Participation Programs' operating costs include underwriting, ongoing loan servicing, and portfolio monitoring. These costs differ based on the state's involvement in the program, as purchase transactions generally require fewer resources to manage because states may rely to a greater degree on the originating financial institution lender's infrastructure. Essential state knowledge and experience should include: credit analysis and underwriting with subordinate lending, loan servicing, portfolio monitoring and reporting, and loan participation purchase process management. States may acquire these skills in-house or through agents such as Economic Development Corporations or other states.

How Does a Loan Participation Program Help to Achieve a 10:1 Private Financing Ratio?

To be eligible for federal funding, a state is expected to reasonably demonstrate that, when considered with all other SSBCI programs of the state, such programs together have the ability to generate private lending of at least 10 times the new federal contribution amount, also known as the private financing ratio by December 31, 2016. Eligible private financing includes all loans or investments from a private source to an eligible borrower or eligible portfolio company, whether occurring at or subsequent to loan/investment closing, and whether funded or unfunded as well as any new infusions of cash by the borrower.

To demonstrate the private financing ratio for Loan Participation Programs, total estimated federal contributions to support loans should be compared to total estimated private loan amounts over the lifespan of the SSBCI program. States that have Loan Participation Programs in place may rely on historical data. States that plan to enact new programs may rely on data from other states. SSBCI considers the total private financing for the loans and any borrower cash infusions to constitute "total private financing." In the context of Loan Participation Programs, Treasury considers the aggregate federal portion of the loans to constitute the "SSBCI funds used." The following is an example of a private leverage calculation for a Loan Participation Program calculated within one calendar year:

a. SSBCI Funds Used (aggregate federal participation)	$20,000,000
b. Private Financing	$60,000,000
Private Leverage Ratio (b to a)	**3:1**

Treasury recognizes that Loan Participation Programs will rarely achieve 10:1 leverage based only on the original loan participation unless the participation is 10% or less of the entire transaction amount. For this reason, states may also include: subsequent private financing to the borrower closed or committed before December 31, 2016, that is the cause and result of the initial SSBCI-funded transaction; and additional transactions to other borrowers closed or committed before December 31, 2016, that are funded with recycled SSBCI funds.

Where Has the Loan Participation Program Worked Well?

Several states have Loan Participation Programs, including Maryland, Michigan, Missouri, and Vermont. Vermont has operated its Loan Participation Program since the mid-1990s, and it is a popular, self-financing program that does not receive appropriations from the state. Key features of the Vermont program were discussed in an SSBCI conference call on Loan Participation, and in a follow-up discussion

between representatives from Vermont and Treasury. Highlights from these discussions are summarized below. This information is not drawn from Vermont's SSBCI application.

Highlights from Vermont's Loan Participation Program

- **Overview**: The Vermont Economic Development Authority (VEDA) supports two types of Loan Participation Programs to assist borrowers in purchasing fixed assets: purchase participation (i.e., state purchases interest in originating lenders' loan) and companion loans (i.e., state makes a second loan parallel to the originating lenders' loan). Lenders tend to prefer companion loans because VEDA's interest rates are fixed, rather than tied to an index.
- **Loan Amount**: VEDA is authorized to fund up to 40% of a loan, not to exceed $1.3 million. The maximum size of its small business loans is $250,000.
- **Rates and Terms**: VEDA offers subsidized and unsubsidized rates, currently ranging between 2% and 3.75% above its cost of funds. Projects perceived as having a high development impact are eligible for the most attractive rates. Terms vary by asset type: 10 years for real estate, and 5 to 7 years for machinery and equipment.
- **Underwriting**: The lender underwrites its loan, and VEDA underwrites the state's loan, which is subordinate. VEDA relies on lender appraisals and other lender documentation to streamline the approval process. VEDA loan officers are experienced commercial lenders, and loans up to $250,000 may be approved internally. Loans greater than $250,000 are reviewed by VEDA's board.
- **Losses and Recoveries**: Historically, VEDA has experienced high delinquency rates (around 8% to 12%) but low loss rates (below 1%). VEDA typically allows lenders to take the lead in loan workouts with the agreement that lenders will pass along excess recoveries to VEDA. Because of its subordinate position, VEDA often requires personal guarantees and subordinate agreements as additional protection, and is persistent in pursuing loan workouts, sometimes for several years.
- **Leverage**: The estimated private financing ratio is 15:1 and the estimated private capital ratio, including borrower equity, is 19:1. VEDA achieves this high leverage ratio because it has access to other sources of loan capital and uses SSBCI funds not as loan capital, but as a subsidy to buy down the interest rate charged to borrowers.
- **Marketing**: VEDA actively markets its program in three ways: 1) The CEO meets with lender presidents to discuss VEDA's programs; 2) Loan officers market the programs through their individual relationships with financial institution lender loan officers; 3) VEDA meets with committees of lender loan officers to explain programs; and 4) VEDA does promotional advertising in trade journals and at trade shows.
- **Staffing**: VEDA has a staff of 28 full-time employees to administer all of its credit products, which includes 10 loan officers, 5 staff to manage loan closings, and a 4-person team to handle disbursements, loan systems, payables and receivables. VEDA also employs a full-time consultant to do workouts.

Who Can You Contact With Questions on Loan Participation Programs?

Treasury has posted policy guidelines and application materials on its website, available here: http://www.treasury.gov/ssbci. Questions may be asked via phone (202-622-0713) or via email at SSBCIquestions@treasury.gov.