Loan Guarantees

- Overview of guarantee terms
- SBA 7(a) program
- Capital access program
- Guarantee program policies and challenges
- Design of emerging technology fund

Overview and Terms

- “Wholesaling” approach: insure losses to get private lenders to make riskier loans.
- Efficient tool to expand capital availability: fund only expected losses
- Balance “moral hazard” with lending incentive
- Key guarantee terms:
  - Loss covered: principal, interest, collection costs
  - Percent of loss guaranteed
  - Order of loss payment: first, second or pro rata
  - Maximum guarantee amount
  - Guarantee term (time period)
  - Payment timing (direct pay vs. post-collection)
  - Pricing: historic losses, option prices, bond prices

SBA 7a Program

- Largest small business finance program—guaranteed 88,845 loans valued at $14 billion in FY2005
- Guarantees up to $2 million on bank or finance co. loans for working capital and/or fixed assets:
  - 85% guarantee on loans ≤ $150,000
  - 75% for loans > $150,000.
  - Interest rate cap at prime + 2.25% to prime + 4.75%.
  - Loan terms up to 10 years (WC) and 25 years (FA)
- In FY2005, $61.1 billion 7(a) portfolio equaled 5.9% of outstanding commercial & industrial loans by commercial banks. Estimate of 4.7% for all banks

SBA 7a Program: Impact on Private Lenders

- 7(a) program allows lenders to provide longer terms loans, lower equity requirements, and serve more start-up, women and minority-owned firms
- Based on 1996 GAO study:
  - Average 7(a) loan term was 13 years vs. 3.3 years for non-guaranteed loans--51.5% of non-guaranteed loans were lines of credit vs. 2.1% for 7(a) loans.
  - 22.1% of 7(a) borrowers were start-ups versus 0.4% for non-guaranteed loans.
  - 7(a) borrowers were more likely to be minorities (13.5%) than firms receiving non-guaranteed loans (8.2%).
  - These findings are consistent with results in Haynes study of the SBA 7(a) program, and lender survey data.
- Share of loans to minority and women-owned firms grew to 32% and 38%, respectively, in FY2005

SBA 7(a) Program: Innovations and Key Findings

- Two important innovations over past 20 years:
  - Preferred lender program: delegates decision to lender
  - LowDoc program: simplify process for loans < $100,000
- Findings from studies of 7(a) program:
  - Haynes: strong evidence that SBA guarantees expand credit for high-risk borrowers; less evidence of increased lending in concentrated markets.
  - Hunter: guarantees levels affect lenders' care overseeing loans and default rates. Using a SBA guarantee to refinance loans increased default probability by 12%.
- Implications for practitioners:
  - 7(a) program expands credit availability on better terms
  - Work to maximize use of 7(a) program by local lenders
  - Apply lessons of 7(a) program to other guarantee programs:
    - Risk-based fee, no refinancing, incentives for lender care

Capital Access Program

- Portfolio-based guarantee
  - Borrower fee (3%-7% of principal) and CAP program match deposited into a dedicated loan loss reserve at participating bank
  - Reserve covers losses on CAP loans made by the member bank, with no additional recourse
- 20 states had CAP programs in 1999 with 315 participating banks and $1.2 billion in loans
- Thee states (CA, MI, MA) had 68% of CAP loans
- Two cities, New York and Akron, have CAP programs

CAP Program: Best Practices

- Increase CAP match to target loans to distressed areas and/or under-served firms:
  - CT: 20% match in targeted urban areas
  - IL, IN, PA raise match for minority-owned firms
- CAP loans seem to serve riskier firms that might not otherwise get credit: higher loss rates (3.9% cumulative), modest loan size (59,000) and high % of start-ups (18% in MA, 15% in IL)
- Best Practices for CAP program include:
  - Active marketing and enrollment of banks
  - Significant funding of reserves with capacity to expand them over time
  - Use broad eligibility criteria with incentives to target lending to specific groups or areas

Guarantee Program Policies

- **Targeting policy:** compliment 7(a) program, but broad enough to gain lender participation
- **Financing policy:** terms and fees match risk and create incentives for lender oversight
  - Maximum 1st-loss guarantee: 75 to 80%
  - Tie fees to risks and their value
- **Security for guarantee**: GO pledge (govt.), cash reserve or cash collateral
- **Underwriting standards:** reflect targeting & financing policies
- **Approval & monitoring process:** maximize lender role—use their analysis & reporting or delegate

Emerging Technology Fund: Discussion Questions

- What financing problem does the ETF seek to address? What type of guarantee best fits this problem?
- For key program design issues:
  - What is known to inform the design?
  - What new information would you want?
- Are there lessons from the 7(a) and CAP programs that apply to ETF?
- How attractive is the program for lenders? What might help generate lender participation?
- What policies/process would foster greater lender care in loan underwriting and oversight?