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An Overview of the State Small Business Credit Initiative

PRESENTED TO:

Assembly Budget Subcommittee No. 4
on State Administration
Hon. Wendy Carrillo, Chair
and
Assembly Committee on Jobs, Economic Development, and the Economy
Hon. Sabrina Cervantes, Chair

LEGISLATIVE ANALYST'S OFFICE

California Businesses Have Unequal Access to Credit

- ***Small Businesses May Have Less Access to Credit Than Large Businesses.*** Small businesses may have less access to low-cost loans. Typically, from a lender's perspective, bigger businesses have greater cashflows, more assets, and longer credit histories that make them appear to be more creditworthy. In addition, evaluating a business's creditworthiness is costly and the fees and interest from a larger loan are more likely to offset these costs than a smaller loan.
- ***Most Lenders Give Preferences to Borrowers With an Existing Banking Relationship.*** Banks commonly give preference to businesses with which they have a pre-existing banking relationship because they already have some information about the creditworthiness of those customers.
- ***Some Lenders Specialize in Making Business Loans.*** Different kinds of lenders specialize in different types of lending—such as consumer lending, real estate lending, or business lending. Some lenders specialize in developing a deep understanding of specific industries or geographic areas, while others have a broader focus. Lenders adopt different lending policies depending on their specialization, meaning some business will find it easier to borrow from some lenders than others.
- ***Unequal Access to Credit for Minority and Women-Owned Businesses.*** Research has found that minority-owned and women-owned businesses face disproportionate challenges with lending—most recently in the processing of federal Paycheck Protection Program (PPP) loans in 2020. In some cases, this arises from lenders' preferences for larger businesses and pre-existing relationships. Sometimes this occurs because lenders use factors like the applicant's address to gauge creditworthiness. In other cases, a loan officer may discriminate against a small business owner based on the officer's implicit or explicit biases.

California Businesses Have Unequal Access To Credit

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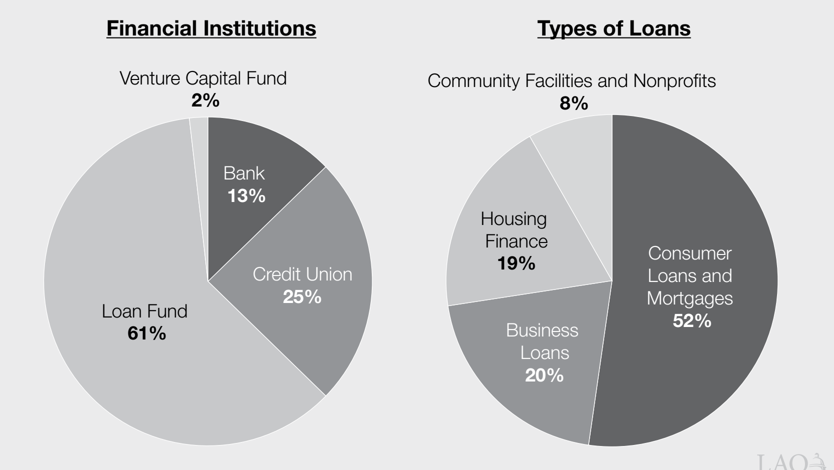
- ***Many Community Development Financial Institutions (CDFIs) Focus on Lending to Small Businesses in Underserved Communities.*** CDFIs are mission-based private financial institutions that provide financial products and services to people and communities underserved by traditional financial markets. There are 110 CDFIs in California. California CDFIs made $2.3 billion in loans in the 2019 fiscal year. The figure below shows that business loans account for about 20 percent of these loans.

Community Development Financial Institutions in California



- ***CDFIs Receive Funding From a Variety of Sources, Including the State.*** CDFIs may receive grants and investments from other banks, insurance companies, philanthropic institutions, and the U.S. Treasury. In 2020, the Legislature provided $25 million General Fund to the California Infrastructure and Economic Development Bank (IBank) to further expand the financial capacity of CDFIs.

Small Business Loan Programs

- ***Public Loan Programs Improve Businesses' Access to Credit.*** Public loan programs make it easier and less costly for small businesses to borrow money. The five most common types of programs are:
  - ***Loan Guarantee.*** Loan guarantees are the most common type of lending assistance. Under a loan guarantee program, a public agency works with participating lenders to guarantee a portion of individual loans—typically between 50 percent and 90 percent. In the event that a borrower defaults on their loan, the public agency pays their portion of the outstanding balance.
  - ***Loan Participation.*** Under a loan participation program, a public agency directly lends money to businesses in partnership with a private lender. Typically, a public agency purchases a portion of a loan made by the lender or it makes a second loan to the same borrower that is subordinate to the first loan.
  - ***Collateral Support.*** Private-sector lenders often require borrowers to pledge assets to secure a loan. In the event that a borrower defaults on their loan, the lender receives the collateral to reduce their loss. Under a collateral support program, a public agency pledges cash collateral for borrowers that otherwise lack a sufficient amount of collateral.

Small Business Loan Programs

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- – ***Capital Access Program (CAP).*** Under a CAP, a public agency insures portfolios of loans made by one or more lenders. Whenever a participating lender makes a loan, the borrower, the lender, and the public agency all add funds into a loan loss reserve fund. In the event that a borrower defaults on their loan, the lender files a claim to the loan loss reserve fund for the outstanding balance.
- – ***Venture Capital Fund.*** Under a venture capital program, a public agency may either directly invest in a business or invest money in a fund that invests in other venture capital funds that, in turn, invest in individual businesses.

- As borrowers repay loans, programs redeploy funds to support additional lending activity.

Major Federal Loan Programs

The federal government provides a significant amount of assistance to small business lenders. The most widely used programs are administered by the Small Business Administration (SBA) and the U.S. Department of Agriculture (USDA).

- ***SBA Is Lead Federal Agency for Aiding Small Businesses.*** The SBA administers a variety of programs to provide financial and technical assistance to small businesses. In the 2021 fiscal year, the SBA had $713 billion in direct and SBA-guaranteed loans outstanding. This amount is significantly higher than it would have been—around $150 billion—in a typical year because of the PPP and economic injury disaster loan (EIDL) programs. The SBA had about $320 billion in outstanding PPP loans and about $240 billion in outstanding EIDLs. Other SBA programs include:
  - ***7(a) Small Business Loan Guarantee Program.*** The 7(a) program is the most widely used small business assistance program in the nation. Under this program, the SBA typically guarantees 75 percent to 85 percent of the principal of loans up to $5 million. Businesses must qualify based on industry-specific employee headcount or revenue limits. The SBA had about $105 billion in guaranteed loans under this program in 2021.
  - ***Other SBA Programs Tailored to Specific Needs.*** The 504 Certified Development Company Loan program usually is SBA's second largest. Under the 504 program, the SBA helps to provide long-term financing of real estate and heavy equipment. The SBA had about $35 billion in outstanding 504 loans in 2021. The SBA also has a variety of smaller, specialized programs for microbusinesses, exporters, and investment funds that make equity and debt investments in small businesses.
- ***USDA Farm Loans Tailored to Needs of Agricultural Industry.*** The USDA farm loan programs provide loan guarantees and direct loans to farmers, ranchers, and other agricultural businesses. In the 2019 fiscal year, the USDA had $5.7 billion in direct and USDA-guaranteed loans.

Major California Loan Programs

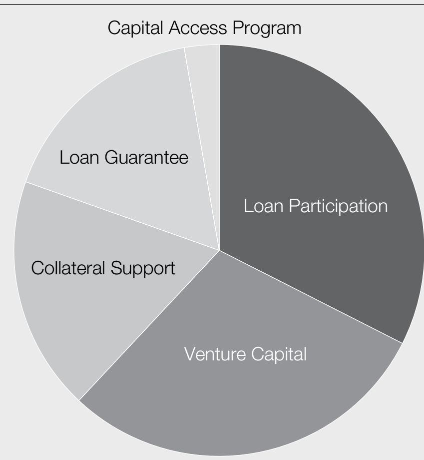
California has several general-purpose small business loan programs. These currently are administered by IBank, which is situated in the Governor's Office of Business and Economic Development, and the California Pollution Control Financing Authority (CPCFA), which is situated in the State Treasurer's Office.

- ***IBank Small Business Finance Center (SBFC) Guarantees Small Business Loans.*** SBFC, created in 1968, works with seven Financial Development Corporations to guarantee 80 percent of qualified loans, up to $2.5 million. As of March 2022, 121 lenders participate in the loan guarantee program. Eligibility differs from the SBA 7(a) program in some respects. For example, the maximum loan amount of $20 million is higher and nonprofit businesses are eligible to apply. SBFC guaranteed 470 loans totaling $240 million in the 2019-20 fiscal year. SBFC also administers a COVID-19 disaster relief loan guarantee program to benefit small businesses that are ineligible for federal programs.
- ***CPCFA Aids Business Lending Through the California Capital Access Program (CalCAP) and Collateral Support Program.*** CalCAP is a loan portfolio insurance program created in 1994 to encourage lenders to make loans to small businesses. As of March 2022, 20 lenders participate in CalCAP. In 2020, CalCAP lenders made 5,312 loans totaling $362 million. CalCAP also administers several narrowly targeted programs, such as for seismic retrofits and electric vehicle charging equipment, that support fewer loans. CalCAP deposited $36 million into lenders' loan loss reserve accounts in 2020. CPCFA also administers a collateral support program that was created in 2013 in response to the federal State Small Business Credit Initiative (SSBCI) discussed on the following page. In 2020, the Collateral Support Program contributed $7 million to support 41 new loans to small businesses.

State Small Business Credit Initiative

- ***2010 Federal SSBCI Program Supported State Lending Assistance Programs.*** The federal SSBCI program, created in 2010 and administered by the U.S. Treasury, allocated $1.5 billion to states to develop state lending assistance programs that address the small business credit needs specific to their states. This program provided significantly greater flexibility than the SBA and other federally backed loan programs. The figure below shows how the funding was allocated by states overall among the various types of loan assistance programs. States were required to develop a plan for increasing lending to underserved small businesses and underserved communities. States also were required to leverage $10 in private investment for each $1 in federal funds over the life of the program.

Allocation of SSBCI Funds by Type of Program



SSBCI = State Small Business Credit Initiative.

State Small Business Credit Initiative

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- ***California Received $168 Million in SSBCI Funding.*** In California, federal SSBCI funding was split equally between the IBank SBFC loan guarantee program and the CPCFA CalCAP and collateral support programs. Between 2010 and 2016, these SSBCI supported lending programs supported 10,286 new loans totaling just over $1 billion. The figure below details the average loan amounts and leverage ratios for these programs. About 50 percent of the number of transactions and 40 percent of the dollar amount of the loans were made to businesses in low- and moderate-income communities. CDFIs accounted for 78 percent of the number of loans. By the end of 2016, nearly $11 million had been redeployed to support additional lending activity.

Comparison of SSBCI Loan Programs in California with National Averages

	Loans/Investments		Total New Financing (In Millions)		Average Financing/Loan (In Thousands)		Leverage Ratio	
	U.S.	California	U.S.	California	U.S.	California	U.S.	California
Capital access	13,965	8,908	$640	$337	$45.83	$37.83	22.5:1	22.2:1
Collateral support	1,530	135	1,325	156	866.01	1,155.56	5.6:1	2.8:1
Loan guarantee	2,779	1,243	1,395	559	501.98	449.72	7.7:1	8.6:1
Loan participation	2,065	—	3,157	—	1,528.81	—	7.5:1	—
Venture capital	1,623	—	4,171	—	2,569.93	—	12.8:1	—
Overall	**21,962**	**10,286**	**$10,688**	**$1,052**	**$486.66**	**$102.27**	**8.9:1**	**7.5:1**

SSBCI = State Small Business Credit Initiaitve and U.S. = United States.

State Small Business Credit Initiative

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- ***Significantly More SSBCI Funding Available in Second Round.*** The federal American Rescue Plan Act provided $10 billion to reauthorize SSBCI. Of this amount, California has been allocated an estimated $1.2 billion. About half of this amount was allocated based on California's 2020 unemployment rate. Other funds are available to states that meet goals for funding to businesses owned and controlled by socially and economically disadvantaged individuals (SEDI). Other amounts are reserved for tribal government loan programs, technical assistance programs, and other administrative costs. California will receive funding in three separate tranches. To maximize its allocation, the state would need to meet the following U.S. Treasury requirements:
  - Expend or obligate at least 80 percent of the first and second tranches of funding.
  - At least 49 percent of funds must be expended for SEDI-owned businesses.
  - At a minimum, $1 of public expenditure must result in $1 of new private investments. The state's programs should target an overall leverage ratio of at least $10 of new private investment for each $1 of public funds.

Issues for Legislative Consideration

The SSBCI funded programs will increase the amount of capital that could be loaned to small businesses and potentially improve the balance sheets of some banks, credit unions, and loan funds that specialize in small business lending. The federal programmatic requirements to deploy funds quickly, at a high leverage rate, and to focus on SEDI-owned businesses work, to some extent, at cross purposes. As it provides oversight of these lending assistance programs, we recommend the Legislature consider the following key issues.

- ***Improving Access to Credit for Businesses That Would Otherwise Have Difficulty Could Conflict With Leverage Goals.*** Small business lending programs to specifically aid businesses that have difficulty borrowing money without insurance or public guarantees often have leverage ratios that are below the 10:1 goal of the SSBCI program. As the real or perceived risk of a borrower increases, the amount that must be obligated by the public agency increases. For example, the state COVID-19 disaster relief loan program requires SBFC to encumber $1 for every $2 loaned. The SSBCI programs may need to allocate funding to programs that have both high and low leverage ratios. However, programs with high leverage ratios may in some instances benefit businesses that might not require aid.
- ***Expending Funding Quickly Could Conflict With Both SEDI and Leverage Goals.*** Programs with a relatively high leverage ratio, like CalCAP, may expend funds more slowly because, for a given amount of private investment, programs with a high leverage ratio require less public funding than programs with a low leverage ratio. Funds could be more quickly expended if they are used to support larger loans or venture capital investments. However, these types of programs may not serve SEDI-owned businesses as well as other programs. To meet the federal government's expectations that the state expends 80 percent of the first tranche of SSBCI funding as quickly as possible, the state may want to consider ways to expand support for both large and small loans simultaneously.

Issues for Legislative Consideration

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- ***Consider Tolerance for Risk.*** The default rates in the existing state programs have historically been somewhat lower than for the SBA loan programs. However, as the influx of SSBCI funding will require these programs to expand, they likely will support lending to higher-risk borrowers who may default on their loans at higher rates. The Legislature will need to consider its tolerance for higher default rates. Ultimately, to the extent the expansion focuses on improving access to credit for borrowers who otherwise would have difficulty qualifying for a loan, somewhat higher default rates are likely unavoidable.
- ***Legislative Oversight.*** The state lending assistance programs will be subject to U.S. Treasury oversight through 2030. The Legislature may want to consider how its oversight and policy guidance of these programs relates to federal oversight during that time. In addition, the Legislature may also want to look ahead to 2030 and how funds that are made available following the repayment of loans are redeployed and what level of ongoing General Fund support, if any, would be required.