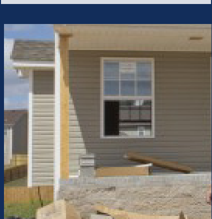
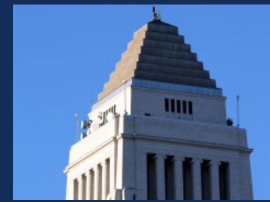
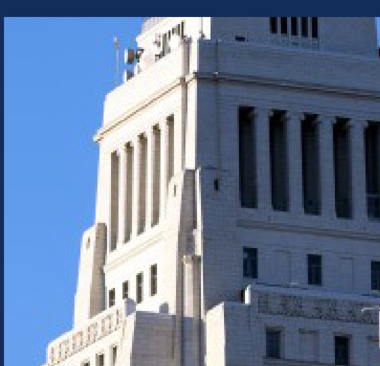





CUSTOMIZING FEDERAL & STATE LOAN GUARANTEE PROGRAMS

JUNE 2012



Federal guarantees make small business loans safer and more profitable for banks and other lenders. Broadening the range of borrowers and loans eligible for SBA and other guarantee programs can increase lending to small businesses, leading to accelerated job creation. However, wider eligibility may also increase the cost of federal guarantees, making program expansion difficult.

Specifically, the Federal Credit Reform Act of 1990 requires that each federal credit program be backed by an annual appropriation equaling the present value of the credit losses on loans made during a particular year. For example, SBA's $19.6 billion in loan-guarantee authority for FY 2013 will require an appropriation of about $300 million. This appropriation is called the credit subsidy. Because larger losses on guaranteed loans mean higher credit-subsidy costs, loans or borrowers that pose increased risk of default are often ineligible for federal support.

Many states have instituted their own loan guarantee and insurance programs to increase lending to small businesses. However, unlike the federal government, states are generally prohibited from pledging their credit on behalf of private interests. Instead, state-sponsored guarantee programs are backed solely by cash reserves. Because these accounts need to withstand catastrophic levels of loss, state programs tend to be overcapitalized. With a historic loss experience no worse than SBA's, a state loan guarantee program may only be able support about $7 in guaranteed lending for each $1 in reserves. For the same $1, SBA can provide about $65 in guaranteed lending. Employing state funds to pay SBA's subsidy costs—rather than to fill reserve accounts—would have two important advantages.

- It would enable states to offer stronger guarantees with fewer dollars.

- It could improve the targeting of federal guarantee programs without increased federal cost.

On June 14-15, the San Francisco Federal Reserve Bank—in cooperation with the Milken Institute, the Los Angeles Local Development Corporation, Capital Access Group, and Wall Street Without Walls—hosted a two-day meeting of 60 investors, lenders, and public officials to examine the potential of allowing states to use federal guarantees to strengthen their credit support for small businesses in exchange for paying the associated credit-subsidy costs. The workshop, "Customizing Federal Guarantees to Underserved Markets," produced the following broad agreements:

First, a hybrid credit-enhancement program combining the credit quality and capacity of federal guarantees with the flexibility and simplicity of state programs should be attractive to many lenders. Importantly, such hybrid programs would allow guarantees to be more effectively customized to market needs.

Second, a variety of public and private financing options are available to finance the credit-subsidy costs of a hybrid or customization program. For example, states may be able to use funds received under the Treasury Department's State Small Business Credit Initiative (SSBCI) to finance the credit-subsidy costs associated with hybrid or "customization" programs. California, in particular, should consider employing part of its allocation for this purpose to prevent the possible loss of more than $100 million in SSBCI funds yet to be disbursed.

Third, a "customization" business model should be developed and tested through pilot programs in California and other states. In organizing these tests, consideration should be given to the creation of special-purpose entities (SPEs) as vehicles for financing the costs of credit subsidies or providing collateral for federal guarantees. SSBCI and private funds could be used to capitalize these SPEs.