Maximizing the Impact of SSBCI on Small-Dollar Small Business Loans: Program Design Recommendations

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Introduction

These briefs provide recommendations on how State Small Business Credit Initiative (SSBCI) administrators, at the jurisdiction level, may be able to increase collaboration with community development financial institutions (CDFIs) with the goal to increase small business loans of under $100,000 to socially and economically disadvantaged individuals (SEDI).[1] The Aspen Institute and Scale Link, with support from the Initiative for Inclusive Entrepreneurship, have reviewed current SSBCI offerings and how they intersect with the work of high-volume CDFI small business lenders. Recommendations are provided for three separate SSBCI product solutions: capital access programs, loan guarantee programs, and loan participation programs. **All statements in these briefs about a program's value or success are made through the lens of small business loans of less than $100,000.** The focus on small-dollar loans is driven by the importance of this product type to SEDI business owners.

To date, collaboration between microlending CDFIs and SSBCI administrators on loans under $100,000 has had uneven success. Our assessment is that this is due in large part to limited understanding among the three key parties — US Department of the Treasury, jurisdictions, and CDFI microlenders — of each other's incentives and priorities. SSBCI administrators may not always understand how the size, sophistication, product selection, and geographic and mission focus of a CDFI affect its perspectives on what it "needs" from SSBCI. In seeking feedback from CDFIs, administrators may receive input that is vastly different and confusing, making it hard to implement solutions or perhaps obfuscating the challenge most worthy of focus. Although there is clear strategy fatigue on the part of both CDFIs and administrators because of the uneven success to date, conversations with administrators and with CDFIs revealed a desire, and willingness, to find more effective solutions.

Participation in these new capital tools has both mission and financial implications for the CDFI, and decisions about whether and how to engage are complex to navigate. To assist CDFIs in making these choices, Scale Link and the Business Ownership Initiative have created this decision guide and financial modeling tool. It can be useful in making an initial decision on whether (or how much) to participate in a particular program or fund—or in assessing how to negotiate with a private or public funder about the parameters and economics of the program. This resource can also help CDFIs reassess the extent of their participation as they learn more over time about the financial and mission implications of a particular program.

[1] Although it is titled the State Small Business Credit Initiative, the current version of SSBCI also provides funding to tribal governments and US territories. As a result, we refer to the implementing entities as jurisdictions.

Understanding the Target Market of High-Volume CDFI Microlenders

Crafting successful programs begins with an understanding of the diversity of CDFIs in terms of size, sophistication, and mission focus. More than a thousand CDFIs exist across the country, many of which do not engage in small business lending. Among CDFIs that lend to small businesses, many do little to no volume of loans in amounts less than $100,000. All CDFI small business lenders are bringing important products and services to firms that have lacked access to capital.

However, to design programs and solutions that can be used effectively at the scale required under SSBCI, it is essential to differentiate among CDFI needs and capacities and to match solutions to specific product offerings. Thus, in our work with IIE, BOI and Scale Link have focused on the CDFIs that we believe have the greatest potential to use SSBCI resources to originate loans of less than $100,000 at high volumes. We refer to these CDFIs as high-volume microlenders.[2] Focusing on CDFIs that can make these loans at large volumes (e.g., can do large numbers of loans) is important in the context of SSBCI for two reasons. First, because of their targeted outreach efforts, product design, and focus on average loan sizes below $100,000, high-volume CDFI microlenders reach high levels of SEDI borrowers. Typically, 80% or more of their clients qualify under the SEDI definition in SSBCI regulations. Thus, SSBCI administrators who partner with microlenders can expect high levels of SEDI impact (even if the program is not solely or specifically targeted to SEDI borrowers). Second, even though these CDFIs are making small loans, their ability to originate at high volumes (e.g., to originate hundreds or thousands of loans annually) means that they can still contribute meaningfully to the program's deployment goals.

We define high-volume microlenders as CDFIs that originate hundreds or thousands of small business loans of less than $100,000 annually. Although hundreds of CDFIs originate small business loans of this size, a relatively small number (we estimate around 20) fit the description of high-volume microlenders. Four factors distinguish these lenders from other CDFI microlenders:

- Their target market is based on serving specific populations rather than a specific community; thus, they operate with large geographic footprints — at least statewide and typically multistate.
- They are willing to take on the financial challenge of making large numbers of microloans, which do not generate sufficient income to cover their costs when made at affordable interest rates.
- They have built the complex operational capacity required to originate and manage many hundreds or thousands of loans each year.
- They face competition in the marketplace. High-volume CDFI microlenders find themselves competing with lenders in the market that may be willing to sacrifice affordability, transparency, and even the borrower's ability to repay to achieve profitability. These lenders offer quick approval and funding times that are attractive to small business owners, and as such, CDFIs in this part of the market work to offer quick approvals and funding.

[2] In the United States, microloans are typically described as loans of less than $50,000. This is the case in most industry definitions as well as in several federal programs. For this work, BOI and Scale Link were specifically asked to focus on loans of $100,000 or less. Although this focus includes somewhat larger loans, many of the cost and market factors related to loans of less than $50,000 also exist for loans of less than $100,000.

CDFIs — and, frankly, any lenders that originate smaller-dollar loans — face a complex decision about how they will structure and make microloans. They must balance (1) a high volume of transactions, (2) affordability to the customers, and (3) profitability. Empirically and historically, achieving two of these three adversely affects the third. Given the costs involved in originating and servicing these loans, they can achieve a high volume and profitability, but they must sacrifice affordability to the borrowers. CDFIs that make smaller-dollar loans at high volumes generally decide to prioritize volume and affordability and are willing to sacrifice profitability. As a result, they must consistently raise subsidy.[3] **This has important implications for SSBCI programs that support this form of lending, as lenders will focus as much or more on the revenue and operational cost implications of the program as its potential to help them manage losses and liquidity. They will also highly value speed, efficiency, and clarity for all parties when considering whether to participate in a particular funding program.**

A Tool to Guide Decision-Making and Program Design

Given the variety of new federal and state lending programs being created (many as part of SSBCI), CDFIs must make sound decisions about the impact of each program. In addition to these program design briefs, our work with IIE has involved the creation of a tool to assist CDFIs, donors, and others in understanding the relative financial and mission impact of lending programs as they are developed. This tool is available free of charge on the Scale Link and BOI webpages. We encourage those considering or designing new lending programs that might involve CDFIs to use the tool to evaluate their implications.

[3] See Joyce Klein and Timothy Ogden, "Lessons for Global Microfinance from… the United States? — Working Paper," Business Ownership Initiative, Economic Opportunities Program, The Aspen Institute, December 2023, https://www.aspeninstitute.org/publications/lessonsfor-global-microfinance-from-the-united-states-working-paper/, and also Adam J. Levitin, "The Financial Inclusion Trilemma," *Yale Journal on Regulation* 41, no. 109 (2024): 109-163.

Critical Program Constraints and Design Factors

Because SSBCI provides federal funding to states, tribal governments, and territories to use in creating programs to support private sector lending, the product or program solutions must meet the needs of the US Treasury, the jurisdictions, and the lenders. To craft solutions, we wanted to ensure we had a clear understanding of the critical constraints and factors for each of these parties so that our recommended solutions could solve for them. They are as follows:

Key Federal Requirements

- SSBCI was originally designed and funded in 2011. Although SSBCI "2.0" is similar to the original program, it contains a variety of statutory changes. The US Treasury must operate within the bounds of the statute authorizing the program.
- The statute requires SSBCI funds to "cause and result in" private financing. Funds are expected to be additive to enable new lending. Refinancing of a lender's existing debt is generally not allowed.
- Capital must continue to revolve within a Treasury-approved program until the end of the federal program.
- Funds cannot be used to make "grants" to CDFIs during the federal period, but contract agreements with jurisdictions can allow CDFIs to retain funds after the federal period ends.
- Key decision-making power resides at the jurisdiction level, but new product solutions proposed by jurisdictions must be approved by the Treasury. This can take several months.
- The Treasury has made, and continues to make, decisions on how the statute is applied across the many jurisdictions, and it is motivated to support capital flowing as deeply into communities as it can.

Note that BOI and Scale Link believe that the following recommendations fit within the guidelines and statutes of the Treasury, although they may require jurisdiction approval by the Treasury.

Key Priorities (of Varied Levels of Importance) for Administering Jurisdictions

- **Compliance**: Each jurisdiction expects to be audited by the Treasury's Office of Inspector General, putting its ability to receive and retain funds at risk if noncompliance with program criteria is found.
- **Capacity**: Most jurisdictions have limited staff and technology capacity. As a result, they generally have limited capacity to quickly process, and ensure compliance, on a high volume of small-dollar transactions.
- **Meeting drawdown timelines**: Funds not allocated by the required timelines (33% within three years and 66% within six years) will be lost. As a result, there is a very clear incentive for jurisdictions to prioritize large-dollar transactions as opposed to smaller dollars, at least in the early years of the program.

- **Maximizing incentives**: Jurisdictions are required to hit targets for reaching certain percentages of SEDI and very small business customers. If a jurisdiction overperforms, it may have access to additional funds. If goals are not hit by the end of the second or third of three tranche of funding, those incentive funds will be lost. (Note that early reporting shows that achieving SEDI goals has not been difficult for most jurisdictions. This is because the SEDI definition is quite broad. Although SEDI goals have been met, many states have room to improve in reaching business owners of color; increasing smaller-dollar lending has strong potential to improve these results.)

Key Priorities of High-Volume CDFI Microlenders

As detailed previously, lending up to $100,000 requires trade-offs. Lenders must choose between significant lending volume, profitability, and providing affordable capital. Because high-volume CDFIs trade profitability for volume and affordability, and they compete against high-cost lenders that offer rapid turnaround, they are rigorous in their focus on efficiency and cost reduction wherever possible. As such, they have the following needs and expectations for participating in a lending program such as SSBCI:

- Revenue and expense impacts at CDFIs are positive and seen quickly. Programs that do not reduce fundraising needs for CDFIs will have little interest.
- Enrollment approvals are received within 24 to 48 hours of submission of a completed application.
- They are able to participate in SSBCI programs in a state or territory regardless of whether they have an office there.
- They can manage borrower loan modifications for small-dollar loans quickly and flexibly.
- They are able to sell some, or all, of the loans they originate and enroll in SSBCI programs to increase leverage and, in some cases, expand limited revenue. Note that at least 5% of a loan balance must be retained by the lender per SSBCI guidelines.
- Nondepository institutions are able to participate.
- They have a high level of predictability regarding which loans will or will not be approved for enrollment.
- Consistent product criteria across jurisdictions reduce complexity and cost in participating.

Summary

With $10 billion at stake, SSBCI is an enormous opportunity to transform how capital is deployed to small businesses seeking less than $100,000 in financing across the country. CDFIs that have had limited access to credit enhancements and tools to strengthen their balance sheets see potential in SSBCI, but the path forward has not been clear. Initial efforts at expanding lending under $100,000 between CDFIs and SSBCI administrators at the jurisdiction level have had uneven success, but great potential still exists. SSBCI is approximately a 10-year program, and we are at approximately the 2-year mark. Capital retained by the jurisdiction at the end of the federal program can be used at the discretion of that jurisdiction, so opportunities for collaboration between CDFIs and administrators will go well beyond the 10 years. Implementation of this program is a marathon, not a sprint.

We believe there is a willingness to work together to find solutions. And we are excited about the next steps, as we continue to work to quantify and assess the potential impact of these changes for individual jurisdictions and to support CDFIs and jurisdictions as they consider the following recommendations.

Solutions for Loans up to $100,000: Capital Access Program (CAP) Optimal Design

General Product Description

Capital access programs (CAPs) create a cash loan loss reserve to cover losses incurred by enrolled lenders. In many jurisdictions, CAP lenders include both CDFIs and banks. To fund the reserve, the lender contributes to a loan loss reserve account, and that amount is matched by the state administrator. To fund its contribution, the lender charges a fee to the borrower and then uses some combination of that fee and its own cash to contribute. The administrators then match that contribution at varying rates with a statute-imposed cap of 7%. For example, a 7% contribution from a lender may be matched at 7% by the administrator for a total cash reserve of 14%. If an enrolled loan does not default, then the contribution to the loss reserve remains in the account to cover losses on other enrolled loans, creating a tool to manage losses over the long term. Program designs vary considerably from one jurisdiction to the next. In the initial round of Treasury approvals, 12 jurisdictions committed up to $339 million to this type of program (Texas represents more than half of this amount), which hypothetically could support more than $4.8 billion of lending based on the maximum match amount.

Benefits for Loans Under $100,000 via CDFIs

CDFI lenders specializing in loans under $100,000 and originating more than 100 loans per year typically experience cumulative losses on those loans of 5% to 10% (cumulative means over the life of a portfolio). At this loss rate, with a 1:1 match, the average CAP could effectively cut a lender’s loan loss expenses in half. Given that loan loss provisioning expense is one of the largest operating expenses of many CDFIs, particularly those that are growing, a CAP can significantly improve the economics of lending. To maximize the value of this program, lenders should approach CAP contributions dynamically over time. In the early years of the program, a lender is likely better off contributing to the loss reserve at higher rates and then lowering the percentage as the account accumulates dollars and loss rates stabilize. Depending on the legal agreement with the jurisdiction, lenders typically show the balance of their contributed amounts as an asset on their balance sheet.

Challenges in Current Programs for Loans Under $100,000 via CDFIs

Although CAPs have important benefits, they also carry a significant administrative burden for both CDFIs and administrators. The CDFI must set up a new bank account for its contributions, and many jurisdictions require the account to have some type of deposit account control agreement with the administrator. Depending on the control agreement, it may be difficult in some cases to find a bank willing to enter into the agreement, and/or account management fees will be higher. For a high-volume CDFI working in multiple jurisdictions, a CAP can quickly become a major administrative burden. Administrators carry the same administrative burden of opening bank accounts for each enrolled lender.

Second, many jurisdictions have interpreted federal compliance guidelines to require loan modifications of any kind to be reviewed by the state, thus creating significant burdens on loan management and default withdrawals. Many lenders find the reviews to be lengthy, while generally not adding value to the administration of the portfolio. Third, few jurisdictions allow bulk enrollment of loans, resulting in lengthy manual processes to seek approval to enroll one loan at a time. These administrative issues increase the burden on both the administrator and the CDFI, resulting in less effective CAPs.

We believe that allowing lenders to retain matching funds at the end of the federal period would provide a useful incentive to CDFIs to do proper reporting, management of credit quality, and loan servicing. Jurisdiction contributions could be retained by the lender at the end of the federal program period if the lender meets requirements such as the following for the life of the federal program:

- The noncompliance rate is less than 5% on enrollment requests.
- All reports are filed on time, complete, and with an error rate of 2% or less.
- All loan servicing decisions for restructures and extensions fit within established criteria.
- Loan losses stay within 75% of total CAP fund amount.

Finally, some jurisdictions have added borrower qualification variables (such as minimum FICO scores) that are not well tailored to lending under $100,000 and particularly to SEDI borrowers. The variables do not significantly improve credit risk (because the state's risk is capped in the CAP), but they significantly curtail the impact of the program as fewer loans are enrolled and the net value to the lender may be lost.

Here we identify a set of modifications that significantly improve the way that a CAP program could function for CDFIs originating loans of less than $100,000. In the proposed process map at the end of this section, green text indicates new steps that improve the program design.

Changes to Current Programs to Accelerate Loans Under $100,000 via CDFIs

Specific Actionable, Near Term

- Ensure systems and processes for bulk enrollment of the loans.
- Push the initial SSBCI compliance check to CDFIs. This does not remove jurisdictional responsibility for compliance. It would, however, allow the lender to move faster if it is willing to absorb the risk that some loans could be unenrolled if found to be noncompliant.
- Reduce or remove credit risk-based enrollment minimums that have marginal benefit to risk versus the cost to financial access outcomes.
- Create modification and withdrawal processes that defer more authority to the CDFI.
- Where possible, align program guidelines with neighboring jurisdictions.
- Build financial models to ensure CDFI lenders understand the financial benefits of the program.
- Allow CDFIs to sell 85% to 95% participation in enrolled loans to increase leverage outcomes quickly.

Unique, New Design Adjustments

- To further reduce the review burden on modifications and restructuring, use the administrator's match funds to create economic incentives for CDFIs to treat modifications extra carefully. Allowing the CDFI to retain administrator match funds after the 10-year period would enable the CDFI to move dollars remaining onto their balance sheet slowly over time.
- A third-party administrator of CAPs across different jurisdictions would result in significant process standardization and efficiency for both CDFIs and administrators. Note that this may require a modification to a jurisdiction's agreement with the Treasury.
- Philanthropy should consider supporting legal and operational costs to create standardization.

	Current Process	Proposed Process
Lender Review	None.	Lender reviews SSBCI compliance requirements to determine borrower eligibility.
Loan Closing	Lender closes loan, collects certifications and fees for enrollment.	Unchanged.
Enrollment Request	Lender submits application to administrator to enroll the loan.	Capability in place to enroll multiple loans, with supporting documentation, via API or similarly simple method.
Compliance Review	Administrator performs compliance check to ensure loan meets SSBCI guidelines.	Create a preferred lender program, when lender is deemed low risk, use sampling method.
Enrollment Approval	Jurisdiction notifies lender of approvals.	Approvals provided in 48 hours, preferred lenders are automatically approved.
Enrollment Rejection	Loans are rejected prior to approval.	Any loans subsequently found to be ineligible will be removed from the program and funds returned.
Matching Funds	Administrator matches deposited funds at agreed to level.	Match amounts maximized to 7% by all CAP programs.
Loan Management	Lender seeks permission from Administrator to modify or charge-off loan(s).	Lender given authority to make 2 modifications, replace collateral, and charge-off loan.
Loss Coverage	When charge-off occurs, lender seeks permission from Administrator to remove cash to cover loss.	Permission is granted in 10 business days or less.
Cash Distribution	Lender's share of cash can be removed when a loan is paid in full.	At end of federal period, some of Administrator's matched funds granted to lender.

Our view: What is the probability this type of program with adjustments can significantly expand CDFI lending under $100,000?

CAP is a great tool to support CDFI lending under $100,000. Most CAPs would benefit immediately from the near-term proposals described, many of which could be implemented with minimal effort. With these added efficiencies, more activity should be expected.

Challenges will remain, however, because of the program's operational complexity. Regardless of efficiencies, credit boxes, or even having a third-party administrator that could work with multiple jurisdictions, CAP inherently requires increased complexity as small cash transactions must be made for **each** loan enrolled and every loan that defaults. Unfortunately, that burden means the programs will always struggle to be administratively efficient because the volume of work per loan does not substantively decrease with scale. Many CDFI lenders already maintain 10to 20 bank accounts, and each additional account adds compliance and review burdens. As a result, higher-volume CDFI lenders are likely only willing to participate in states where they have significant volume — not because the higher volume lowers the cost to participate in CAP but because the savings on loan loss expense are high enough to warrant the ongoing operational complexity of participating.

Jurisdictions that seek to attract new high-volume lenders to their state will struggle to do so unless they provide significantly more efficient operational solutions (as recommended previously) and maximize their matching rates to the CAP. Even then, lenders face many trade-offs in these decisions, and even highly remunerative programs may not bring new lenders to states with smaller populations.

Solutions for Loans up to $100,000: Loan Guarantee Program Optimal Design

General Description

Guarantee programs allow CDFIs to manage loan loss risk and open a multitude of options for managing both their balance sheets and profit and loss statements. Loans are enrolled based on qualification criteria set by the jurisdiction and then receive a guarantee to cover a percentage (typically 50% to 80%) of potential loan losses after any collateral has been collected and liquidated. To enroll loans, the lender typically submits a full loan package and an application, pays an enrollment fee, and, in some cases, pays an annual fee to maintain the guarantee. When losses occur, a lender can file a claim on the amount of the guarantee available on a per-loan basis. Administrators typically expect guarantee programs to be sustainable, so set guarantee fees must cover program operating costs. This often leads to minimum guarantee amounts that limit the program's access for loans below $100,000. Twenty-eight states initially dedicated $1.4 billion for loan guarantee programs.

Benefits for Loans Under $100,000 via CDFIs

Much like CAP, guarantees allow CDFIs to manage loss exposure and reduce provision expenses. But in the case of guarantees, those benefits come with lower postloan administrative costs because cash does not change hands until a loss actually occurs. Given that provision expense is a primary cost driver for CDFIs and guarantees help manage this cost, losses can be reduced by 50% to 80% (higher than a maximum of 50%, based on 1:1 match rates up to 7%, for a CAP). With these better economics, and no need to tie up cash, CDFIs can do more loans with their existing resources. Additionally, where jurisdictions have allowed secondary market sales of the guaranteed loans to third parties, CDFIs have been able to raise capital and generate premiums as loan buyers have more confidence in the underlying credit quality of the asset. This provides significant financial benefit to the CDFI through loss avoidance, new premiums on sales, cost of fund reductions, and the ability to deleverage their balance sheets. With secondary markets, administrators can significantly leverage the impact of their guarantees in terms of total capital raised and deployed.

Challenges in Current Programs for Loans Under $100,000 via CDFIs

Designed with scale in mind, guarantees would be the preferred mechanism for most CDFIs given the benefits and opportunities they create. Unfortunately, many jurisdictions have designed this solution for larger loans (some even maintaining a minimum loan size). For larger loans, a longer average time from application to funding and a longer and more manual enrollment process are not a significant issue for lenders or borrowers, who expect the origination process will take weeks. Unfortunately, although that process may not create much friction for larger loans, it becomes cumbersome and/or impossible to enroll smaller loans. Administrators often re-underwrite loans one at a time, creating uncertainty about enrollment and moving too slowly for most high-volume CDFI microlenders making loans up to $100,000 (who need approvals in one to two days rather than two to four weeks, which is the current norm in current SSBCI guarantee programs). In some cases, jurisdictions have also created

fee structures for enrollment that render the program worthwhile only for catastrophic loss scenarios (e.g., when suddenly 15% to 25% of the portfolio is being charged off). In terms of the economics at enrollment, the resulting fee structure in noncatastrophic scenarios means the fees entirely offset the potential financial benefits of loss avoidance. Finally, loan modifications and restructuring have been difficult to implement given administrative and compliance oversight required by jurisdictions.

Although guarantee programs are administratively more efficient than CAP, the lack of consistency across jurisdictions also means that CDFIs seeking to work in multiple jurisdictions face significant administrative challenges with these programs as well.

Following is a set of modifications that significantly improve the way that a guarantee program could function for CDFIs originating loans of less than $100,000. In the proposed process map at the end of this section, green text indicates new steps that improve the program design.

Changes to Current Programs to Accelerate Loans Under $100,000 via CDFIs

Specific Actionable, Near Term

- Ensure systems and processes for bulk enrollment of the loans by the administrator.
- Push the initial SSBCI compliance check to CDFIs.
- Allow loans originated for the purpose of the SSBCI program to be enrolled within a reasonable time frame after closing provided that all requirements are met at the time of closing and that the lender is operating under an agreement with the administrator.
- Create modification and claim filing processes that defer more authority to the CDFI.
- Eliminate minimum loan sizes for participation. Allow lenders to determine which loans sizes are worth enrolling and which are not based on their own administrative cost.
- Where possible, align program guidelines and legal agreements with neighboring jurisdictions.
- Reexamine fee structures in light of appropriate loss expectations to ensure the program design works for all parties.
- Allow CDFIs to sell guaranteed and unguaranteed portions of loans to third-party investors. Based on SSBCI guidelines, lenders must retain 5% of any loan.

Unique, New Design Adjustments

- Use advanced credit risk scoring mechanisms to provide lenders with a quick window into enrollment eligibility.
- Work with a third-party guarantee administrator. Note that this may require an amendment to the Treasury’s agreement with participating administrators.

	Current Process	Proposed Process
Lender Scoring	None.	Lenders run the loan through a credit risk scoring system to determine what guarantee is available for that loan.
Lender Compliance	None.	If guarantee possible, lender does initial SSBCI compliance.
Enrollment Request	Lender submits underwriting package to Administrator for approval. Lender decisions are conditioned on approval.	API or similar tool, with simplified underwriting file, used to ease a high volume of requests.
Compliance Review	Administrator performs compliance check, ensures loan meets SSBCI guidelines and credit risk targets.	Credit scoring system used to determine if acceptable credit risk.
Enrollment Approval	Jurisdiction notifies lender of approvals.	Approvals provided in 48 hours.
Loan Closing	Lender closes loan, collects certifications, and pays guarantee fees.	No change.
Enrollment	Administrator enrolls loan.	No change.
Loan Management	Lender seeks permission from Administrator to modify or charge-off loan(s).	Lender given authority to make 2 modifications, replace collateral, and charge-off loan.
Guarantee Payment	If loan is charged-off, lender applies to Administrator to exercise the guarantee. If approved, payment made.	Decision made in less than 5 days, payment made in less than 15 days.

Our view: What is the probability that this type of program with adjustments can significantly expand CDFI lending under $100,000?

Loan guarantees, such as the SBA 7a program, have a long history and clear upside to lenders, especially after accounting for benefits of secondary market sale of the guaranteed portion of the loans. These benefits present clear opportunities for lenders to expand their lending. Loan guarantees also require cash to change hands only in the case of losses, significantly simplifying administration. These two facts — historic precedent and administrative structure — lend themselves to expanded use of guarantees. The key challenges to guarantees — better and faster enrollment, proper fee structures, and simpler loan modifications — also have clear solutions.

Although the SBA 7a program has worked effectively for larger loans, it has not been a good solution for loans of less than $100,000. SSBCI guarantee programs can be that solution. One of the best ways to take advantage of guarantees and to solve the administrative challenges for both jurisdictions and CDFIs is for jurisdictions to allocate funds to a third party to manage a guarantee program for loans up to $100,000 on their behalf. This approach has many benefits. Guarantees across jurisdictions would be administered the same way; a centralized effort would achieve significant economies of scale; and a third party with experience in loans of this size would be better able to create streamlined credit risk models, eligibility criteria, and fee structures. This approach is particularly beneficial for jurisdictions and lenders because the ease of use would allow jurisdictions to quickly gain lenders and volume through a common process, thus expanding access and funding to local firms and likely strengthening local CDFIs in the process.

Solutions for Loans up to $100,000: Loan Participation Program Optimal Design

General Description

Loan participation programs offer lenders access to capital in exchange for future earnings of a portion of a loan. Benefits to lenders generally stem from some combination of limiting credit risk, increasing available liquidity, and potentially increasing margins. Which benefit is most dominant depends mainly on how the program is designed and implemented. Currently, great variation exists in the design of loan participation programs. In some cases, the programs are combined with an application portal that is unique to the program and to a specific loan product that lenders must originate in order to participate. In other cases, lenders make a loan-by-loan decision on whether to seek participation in their nonstandardized loans. When losses occur, in some instances, participations are pari passu; in others, they are subordinate. Revenue shares may favor the participant, favor the lender, or be pro rata. A significant amount of capital has been allocated to loan participation programs with over $2.3 billion across the various jurisdictions. Most programs are run by jurisdictions, but some are also run by third parties.

Benefits for Loans Under $100,000 via CDFIs

This product, more so than any of the others, has the potential to be marginally valuable or costly for CDFIs depending on the structure. Under most current programs, the primary benefit to lenders making loans of less than $100,000 has come from support for customer acquisition, when the program is tied to a central application portal and marketing for the program is subsidized or supported by the jurisdiction or another third-party entity. Customer acquisition is a key cost driver for most small business CDFIs, so loan participation programs that direct customers to lenders drive volume. Secondary benefits are primarily around loan loss protection as the program's portion of the loan (30% to 85%) is purchased as a nonrecourse sale. Other benefits vary significantly based on how the program deals with servicing revenue, but approaches have provided significant liquidity and, in some cases, marginal revenue increases to CDFIs (although the loans remain unprofitable for the CDFI). All these benefits can help drive new loans under $100,000.

Challenges in Current Programs for Loans Under $100,000 via CDFIs

All participation programs carry a significant administrative burden for the jurisdiction and the CDFI as numerous transactions occur from application to the initial purchase to the sharing of pro-rata portions of payments with the participant. All other things equal, this complexity alone makes the programs challenging for lenders to participate across jurisdictions; thus, as with CAP, participation programs are most valuable in markets where a lender expects loan volume to be significant.

Understanding the financial and mission implications of participation programs can be a significant challenge for CDFIs. From a return on investment perspective, many current participation programs make limited or no financial sense for CDFIs originating loans of less than $100,000. CDFIs primarily gain revenue from participating through an origination fee, interest earnings on the small portion of the loan they retain, and potentially a monthly servicing fee. The CDFI, especially if making loans under $100,000, often does not make enough revenue from the program to cover its expenses to underwrite, service, report, and manage compliance on the loans. The participation programs we have reviewed, in the best case, have a marginal positive impact on the economics of these smaller loans – and in some cases exacerbate a CDFI's financial challenges in making these loans. Participation programs do provide helpful liquidity, although the 15% to 30% of the loan typically retained on the books of the CDFI can still strain its balance sheet leverage ratio if the CDFI does substantial volume under the program.

Notably, participation programs with centralized client acquisition channels that successfully create many leads and originations for CDFIs (and thus reduce their cost of customer acquisition) can eventually create other financial challenges related to balance sheet leverage and servicing costs. Some CDFIs that have participated in programs have needed to increase their fundraising (in some cases, doubling their fundraising needs) to cover their increased operating expenses and to increase net assets to avoid breaking leverage covenants on their debt. This can happen, for example, if a CDFI takes on significant servicing obligations over the long term without sufficient future revenue to cover expenses. If a participation results in even marginally higher delinquency levels for the CDFI, the burden of portfolio management can quickly cause ever greater expense burdens. And if CDFIs are not able to add capacity (and costs) to manage delinquencies, the result can be loan losses for the program administrator. In such instances, a participation program may support rapid disbursement of loans, but a CDFI may later need to curtail its involvement.

Finally, in some cases, loan participation programs have used third parties that expect to use the jurisdiction's SSBCI funds to facilitate a credit enhancement in securitizing the loans purchased in the program. Given the economics of loans under $100,000 this in effect means that the jurisdiction's funds will likely be used to subsidize private capital investors and that dependent on loan losses and other costs, a portion of the funds could well be transferred to outside investors.

The following proposed approach to a loan participation program would both better support the financial needs of CDFIs that originate loans of less than $100,000 and ensure that SSBCI funds are retained and continue to be utilized in the jurisdiction (ideally in programs that continue to support CDFI lending in amounts of less than $100,000). In the proposed process map at the end of this section, green text indicates new steps that improve the program design.

Changes to Current Programs to Accelerate Loans Under $100,000 via CDFIs

Specific Actionable, Near Term

- Ensure systems and processes for bulk enrollment of the loans by the administrator.
- Push the initial SSBCI compliance check to CDFIs.
- Allow loans originated for the purpose of the SSBCI program to be enrolled within a reasonable time frame after closing provided that all requirements are met at the time of closing and that the lender is operating under an agreement with the administrator. Lenders must accept bearing the risk of a loan being rejected.
- Create modification and collections processes that defer more authority to the CDFI.
- Eliminate minimum loan sizes for participation. Allow lenders to determine which loans sizes are worth enrolling and which are not.
- Where possible, align program guidelines and legal agreements with neighboring jurisdictions.
- Review the financial case for CDFIs to ensure the program covers costs to participate and adjust revenue share as needed.
- Create increased customer acquisition benefit with advertising and support.
- Allow the lender to further sell or participate in loan balances except for 5% to15%, which must be retained.
- Consider third parties capable of handling monthly payment reconciliation in an efficient manner for CDFIs.

Unique, New Design Adjustments

- Use advanced credit risk scoring mechanisms to provide lenders with a quick window into enrollment eligibility.
- Consider unique program structures (similar to Montana) to incorporate and enhance long-term financial benefits to the CDFI.

	Current Process	Proposed Process
Lender Scoring	None.	Lenders run the loan through a credit risk scoring system to determine what participation is available for that loan.
Lender Compliance	None.	If participation possible, lender does initial SSBCI compliance.
Enrollment Request	Lender submits underwriting package to Administrator for approval. Lender decisions are conditioned on approval.	API or similar tool, with simplified underwriting file, used to ease a high volume of requests.
Compliance Review	Administrator performs compliance check, ensures loan meets SSBCI guidelines and credit risk targets.	Credit scoring system used to determine if acceptable credit risk.
Enrollment Approval	Jurisdiction notifies lender of approvals.	If less than $100,000, and originated for this program, can be enrolled after closing. Rejection risk born by lender.
Loan Closing	Lender closes loan, collects certifications, and invoices Administrator for share of loan.	No change.
Loan Servicing	Lender services the loan, collects payments, and remits required amount to Administrator each month.	Administrators may utilize 3rd party software providers to simplify this process for all parties.
Loan Management	Lender seeks permission from Administrator to modify or charge-off loan(s).	Lender given authority to make 2 modifications, replace collateral, and charge-off loan.

Our view: What is the probability that this type of program with adjustments can significantly expand CDFI lending under $100,000?

Loan participation programs are some of the most visible SSBCI-funded programs but are also the most complicated. Many CDFIs that originate loans of less than $100,000 remain wary of participation unless the economics of participating are clear, which has not been the case in many program designs. Participation programs have been able to drive significant lending when complemented by a clear marketing campaign by the jurisdiction or other third parties.

Given the administrative burden of loan participation programs, jurisdictions should consider the long-term benefit of ongoing loan management operations. They should also consider the long-term trajectory their SSBCI funds will support. Short-term strategies that by their nature consume subsidy should be considered carefully. Jurisdictions should look for ways to use SSBCI resources to help build the balance sheets of CDFIs working in the state, using long-term geographically restricted funds where possible. The carrot of long-term balance sheet strength through participation would certainly induce more lending and would connect program participation to a CDFI's long-term sustainability plan. Structures for this approach include stripping out the interest payments on loans to send more revenue to CDFIs and allowing the CDFI to retain a portion of the jurisdiction's share of the loan.

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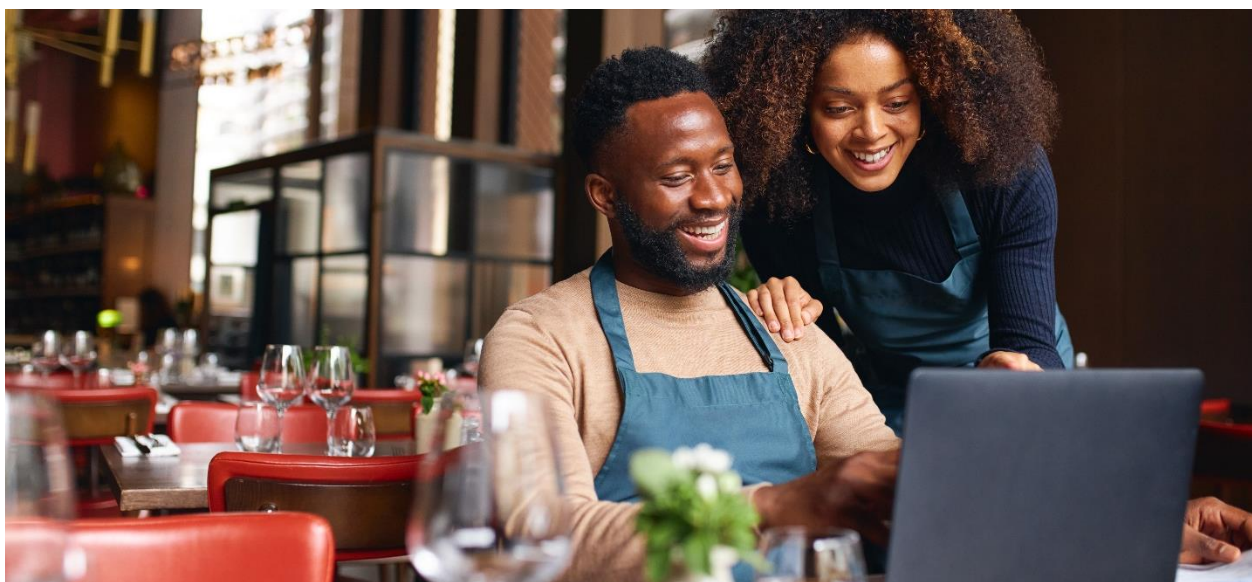

About

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Scale Link created and manages an innovative secondary market for microloans from community development financial institutions (CDFIs). By enabling CDFIs to sell loans, Scale Link's secondary market helps CDFIs expand their impact while also helping commercial banks meet their Community Reinvestment Act lending goals. Scale Link's secondary market provides CDFIs with consistent, unrestricted funding that complements public sector and philanthropic support and helps the CDFI sector scale. Learn more at scalelink.org.