

Los Angeles Small Business Finance Forum
November 17, 2009
Meeting Summary

The Federal Reserve Board and the Federal Reserve Bank of San Francisco, in conjunction with the Small Business Administration and the Asian Pacific Islander Small Business Program, held a small business forum in Los Angeles focused on credit challenges facing small businesses on November 17, 2009. The first panel focused on credit access issues and was made up of commercial bank representatives (from community banks to large banks), the SBA regional administrator, and a senior-level Federal Reserve Bank director of examinations. The second panel focused on small business support organizations and included community development financial institutions (CDFIs) who provide both technical assistance and loans, a SBA certified development company (CDC), and state and local small business assistance entities. The event was well attended with more than 70 participants from commercial banks, the SBA, CDFIs, CDCs, and state and local government staff.

The following were the key themes that emerged from the forum:

There are insufficient resources for small businesses that had historically been strong, but may not survive due to the severity of the recession and poor economic conditions. These businesses could benefit from a combination of patient capital (e.g. deeply subordinated/mezzanine loans, equity) and more advanced technical assistance to help them survive the recession. Access to credit for needs such as financing receivables and lines of credit is a challenge for these firms due to a range of issues related to slower revenues, reduced collateral values, and other barriers. As an example, a SBA CDC described a situation where a business for which it had provided a second on its 504 loan was having difficulty finding a refinance source for its first mortgage (in the amount of \$400m) because of reduced cash flow, in spite of otherwise strong collateral and operations. Some construction firms which have had historically strong performance have had to decline contracts because of their inability to secure a line of credit. Firms like these could also benefit from more sophisticated technical assistance on issues such as operational restructuring and improved financial management (e.g. better inventory control, asset management). As the SBA regional administrator stated, we have to look at assistance to these viable firms as a “job preservation” strategy.

In spite of reduced loan demand by small businesses, certain credit needs may still be inaccessible. In response to a question about reduced loan demand (e.g. owners not wanting to overextend themselves during uncertain economic conditions) rather than supply conditions explaining the lack of small business lending, panelists emphatically cited conditions where critical credit needs were not being met. CDFIs reported an increase in demand for small business loans as many these applicants are now being denied by commercial banks because of both tightened underwriting standards and diminished credit quality. Further, loan demand has grown for finance needs related to challenges associated with diminished cash flow and economic conditions: loan renewals (LOCs, balloon loans) that were either denied or were in jeopardy of renewal because of tightened underwriting standards or diminished credit

standards; lines of credit, especially firms which had LOCs recently reduced by their banks; accounts receivable and general overhead financing; and debt restructuring.

Banks, particularly community banks, in the Twelfth District are experiencing significant deterioration in portfolio quality (many related to poorly performing CRE loans) which is straining available capital. Banks expressed concerns about approving any “impaired” loans because of the additional loan loss reserves it would need to post, in spite of guidance that allows for such loans. For example, finding a refinance source for many maturing CRE loans with balloon payments has been difficult. Declining real estate values have made these loans exceed LTV thresholds. The exam staff stated that guidance has been issued where maturing loans with high LTVs, but good cash flow can be approved. But if the loan exceeds the real estate value, the loan is considered “impaired” and must require additional reserves (e.g. \$10 loan, collateral value - \$8 results in \$2 impaired reserve). For banks that are already capital constrained, they are not likely to refinance these loans even though they fall within guidance requirements. Further, many banks complained that capital requirements have implicitly increased as a result of heightened concerns by bank regulators. As one executive community banker stated, “we were excited to receive TARP funds so that we could do additional lending, but ultimately we couldn’t because the TARP funds were used to prop up our balance sheet.”

Better coordination is needed between the constellation of small business capital stakeholders. Banks who are dealing with increased small business denial rates and deteriorating loan portfolio quality may not realize the resources available through CDFIs and other community-based organizations. Many CDFIs are facing increased demand for small business services (loans and TA) and are seeking more financial support from banks that are or may be relying more on their services. Many CDFIs, who have built expertise in the ability to structure difficult deals with, could also develop loan products (e.g. subordinated loans, LOCs) that complement the needs of a commercial banks' small business borrower in response to distressed economic conditions. Bank exam staff could benefit from feedback regarding recently issued bank exam guidance such as CRE reviews and other challenges to ensure that this guidance does not have an unintended consequence or unnecessarily slow lending.

SBA program enhancements seem to be working, but still face other challenges.

Both banks and SBA administrators stated the recent program enhancements have helped spur lending. For example, the fee waivers seemed to have motivated business borrowers to a point where the SBA may run out of funds that subsidized this effort. Banks stated that the increase in the guarantee level didn’t result in any changes to their underwriting standards, but did make them more comfortable with lending, which did pick up as a result of the program changes. While there was strong demand for the ARC loan, both banks and the SBA noted that the ARC loan program has not lived up to expectations because of the extensive paper work required relative to its small dollar amount and the reliance on banks to underwrite and fund this small dollar loan program. Alternatively, a more direct-funded model (e.g. CDFIs lending directly) would have likely been more successful for this much-needed loan product. The SBA 504 is experiencing losses and related challenges, especially since many of its loans are real-estate based. For example, although the SBA opened up refinancing as an allowed use of the 504 because of the tightening of commercial real estate credit, banks have found the application extremely

complicated to use even though they would like to use this program. There are also cases related where a mismatch in loan terms where the CDC is holding the second at 20 years, but having a difficult time finding a refinance for the first, whose term was 10 years.

Other Issues

- A large commercial bank says that it is actively allowing loan deferrals, but the maximum period is six months (not sure if this is the bank's policy or exam rule), which is not long enough.
- SBA 504 rules have changed to allow refinance, but it is extremely complicated and as much as a bank would like to use it, they are not having success with it.
- For entrepreneurs, particularly those who have been laid off, who want to start a business, start-up capital and other support services are extremely difficult to find.
- Can CRA guidance be issued so that banks can receive credit for not just new loans to CDFIs, but extending the terms to them?
- Credit quality of loan applicants is dropping notably. Many banks cite that it is difficult to find eligible borrowers. Could TA be used to address these deficiencies?
- 7(a) lending is not as active as it could be. Could CDFIs play a larger role in being certified SBA lenders? A related challenge would be that these CDFIs would then be subject to examinations.
- A CDFI expressed the current state of minority small businesses, "when small businesses have a cold, minority small business owners have pneumonia."

Summary of Recommendations/Next Steps

Hold Special Purpose Convenings:

- Create a small business taskforce of CDFI's , commercial banks, and examiners to address the following recommendations and continue the larger conversation of ways to preserve small businesses.
- Convene a meeting with the CDFI Fund and SBA officials to talk specifically about ways to support TA providers. Share information regarding the specific financing needs (e. g. patient capital, LOCs) that small businesses expressed a demand for.

Create New Sources of Capital:

- Develop new sources of patient capital (e.g. deeply subordinated/mezzanine loans, equity), a refinance source for maturing CRE loans, and advanced technical assistance for counselors (like their foreclosure related peers).
- Enable CDFIs who have built expertise in the ability to structure difficult deals to develop loan products such as subordinated loans and LOCs or create a more direct-funded model (e.g. CDFIs lending directly).
- Certify CDFIs as SBA lenders.
- Provide more financial support to CDFIs facing increased demand for small business services (loans and TA) from banks which are or may be relying more on their services.

- Declare the small business finance crisis in California a federal disaster, rendering new sources of capital.

Strengthen Existing Credit Programs:

- Encourage more commercial and industrial lending by enhancing the New Markets Tax Credit program.
- Reinstate the expired 90% guarantee and no fee features of the SBA 7(a) program.
- Provision the SBA to be a direct lender.
- Reduce the paperwork required on ARC loans and provide greater incentives for banks to engage in the program

Build the capacity of TA Providers:

- Support TA capacity building of nonprofits to improve the credit quality of small business applicants, in general.

Regulatory Guidance

- Encourage feedback to bank exam staff on CRE reviews and other challenges.
- Issue CRA guidance so that banks can receive credit for not just new loans to CDFIs, but extending the terms to them.
- Pass on to the FRS Board of Governors the impact of restricted small business underwriting guidelines.
- Develop more CRA incentives, particularly for recipients of TARP funds.

Incentivize collaborative activity:

- Build stronger connections between financial institutions and nonprofits.
- Create partnerships of banks, CDFI's, loan funds, and credit unions.
- Develop a better system for referrals of inquiries and applications from banks to community lenders.
- Develop classes for entrepreneurship.
- Pass on recommendations to policy makers.

Note: The foregoing summary of recommendations and next steps was compiled from John Moon's Meeting Summary and transcribed comments taken during the audience Q&A session at the event by Melody Winter Nava of the FRBSF.

Participant Evaluations:

Five questions were posed to participants regarding their comprehension and satisfaction with the event and their future training or resource needs. 19/55 audience participants responded (35%)

1. came away with a better understanding of the credit issues affecting small business owners:

All 19 participants indicated agreement (100%).

Comments:

- The panel discussions were very helpful. Gave great insight from different channels
- Banks still don't seem willing to assist the small business owner in other areas than real estate.

2. I learned of small business recovery tools under the American Recovery & Reinvestment Act?

10/19 participants indicated agreement (53%).

Comments:

- Would like a larger discussion on the use of these funds!
- Learned that the SBA has run out of \$.
- Doesn't seem like there's any recovery available - especially in the minority communities
- We did not touch on this too much. Would love to see about more tech. support

3. I identified new resources or partners for supporting small business access to credit or other assistance?

17/19 participants indicated agreement (89%)

Comments:

- Conference gave enough time to network with valuable leaders in the industry.
- However the new resources are not lending or helping the small biz at all.
- As long as they can fit into the pretty box, some businesses want smaller amounts – lend to those people that qualify.
- Pacific Coast and other nonprofits

4. The format of the meeting provided adequate time for questions, discussion and networking?

16/ 19 participants indicated agreement (84%)

Comments:

- Maybe more networking
- Some additional questions and audience participation time would be helpful
- Put bankers and nonprofits on the same panel
- Great facilities, locations, and opportunities to network, diverse audience
- Too fast
- Needs more time for audience participation

5. What additional information or resources will be helpful to you in serving small businesses?

Comments:

- Refer to data sources, regulatory issues, programs other than SBA. E.g. NMTC
- More discussion with Safety & Soundness audit/examinations staff @FRB, OCC, FDIC

- More discussion opportunities that bring these types of participants together & more of them
- Have active CDFI lenders discuss how this program can be better used for commercial credit
- Regulatory reform re: sale of loans – too stringent
- Banking interest in providing EQ2 investments and what criteria do they need to actually make the investment
- This investment should continue; it's very helpful to hear varying perspectives
- Need direct money from govt. to assist small biz, not giving money to the bank and lending to small biz, need direct lending from govt. to small biz
- Provide info with specific identification of resources meeting today's challenging credit needs & fulfillment process
- Participant contact list will be helpful. I didn't have sufficient time to meet with every participants & get to know them
- Provide specific partnership & alliance recommendation & connections.