



Management Alert



Report Number: OIG-SBLF-14-001

STATE SMALL BUSINESS CREDIT INITIATIVE:
Treasury Needs to Modify Its Capital-at-Risk Requirements
For Capital Access Programs

October 24, 2013

Office of
Inspector General

Department of the Treasury

This Page Intentionally Left Blank

Contents

Background.....	2
Observations and Conclusions.....	2
Recommendation.....	3
Management Comments and OIG Response.....	4
Appendix 1: Management Response	5
Appendix 2: Major Contributors.....	6
Appendix 3: Distribution List	8

Abbreviations

The Act	The Small Business Jobs Act of 2010
CAP	Capital Access Program
MCAP	Massachusetts Capital Access Program
OIG	Treasury Office of Inspector General
SSBCI	State Small Business Credit Initiative



*The Department of the Treasury
Office of Inspector General*

October 24, 2013

Don Graves, Jr.
Deputy Assistant Secretary for Small Business, Housing, and
Community Development

During our audit of the Commonwealth of Massachusetts' use of funds awarded under State Small Business Credit Initiative (SSBCI),¹ we observed that guidance established by Treasury to ensure lenders participating in state Capital Access Programs (CAPs) have a meaningful amount of capital-at-risk is at odds with the longstanding operating structure of CAPs. Because this issue has implications for all SSBCI participants with CAPs, we are issuing this as a separate *Management Alert*.

The observations and conclusions in this report are based on our analysis of the capital-at-risk requirements contained in Treasury's *SSBCI Policy Guidelines*, a review of the operating structure of the Massachusetts-run CAP, SSBCI program data maintained by Treasury on the number of SSBCI-funded CAPs and their operating structures, and discussions with Treasury SSBCI program staff. The work supporting our conclusions was performed as part of our audit of Massachusetts' use of SSBCI funds and completed in accordance with *Government Auditing Standards*. A more detailed description of the objective, scope, and methodology of that audit is included in Appendix 1 of report number OIG-SBLF-13-007. We believe that the supporting evidence obtained provides a reasonable basis for our observations and conclusions.

¹ Report No. OIG-SBLF-13-007, *State Small Business Credit Initiative: Massachusetts' Use of Federal Funds for Capital Access and Other Credit Support Programs*, May 14, 2013.

Background

SSBCI is a \$1.5 billion Treasury program that provides participating states, territories, and eligible municipalities with funds to strengthen credit programs that provide financial assistance to small businesses and manufacturers. CAPs are one of the primary types of credit programs financed under SSBCI, and they work by providing portfolio insurance for business loans based on a separate loan loss reserve fund for each participating financial institution. Currently 26 of 57 participating states operate CAPs with their SSBCI funds. As of December 31, 2012, the 26 states have expended \$4.1 million on premiums related to CAP-enrolled loans.

Under SSBCI, when a participating lender originates a loan in a State CAP, the lender and borrower combine to contribute a percentage of the loan or line of credit, from 2 percent to 7 percent, into a reserve fund, held by the lender. The State matches the combined lender/borrower contribution, and sends the State contribution to the lender-held reserve fund. The State can use the SSBCI funds as its matching contribution. The reserve fund is available as cash collateral to cover losses on all loans in a lender's CAP portfolio.

Observations and Conclusions

Treasury's *SSBCI Policy Guidelines* establishing lender capital-at-risk requirements for CAP transactions is at odds with how State-run CAPs have operated over the last 20 years. Consequently, States may be unable to comply with the capital-at-risk requirement or unwilling to change their current practices, thereby curtailing the extent to which CAPs participate in the SSBCI program.

The Small Business Job Act authorizing the SSBCI states that "A loan to be filed for enrollment in a State CAP shall require the financial institution lender to have a meaningful amount of its own capital resources at risk in the loan." According to Treasury's *SSBCI Policy Guidelines*, the "meaningful amount" requirement is met when private lenders bear 20 percent or more of the loss from a loan default.

However, CAPs operate as portfolio insurance programs where a lender's aggregate CAP reserve fund, built through the accumulation of premiums paid by the lender, borrower, and State, can be used to recover 100 percent of a lender's losses on any loan. In many instances, CAP lenders may have sufficient funds in their reserve accounts to cover 100 percent of a loan default. However, based on a strict application of the current *SSBCI Policy Guidelines*, the transactions would be deemed non-compliant, as a lender's at-risk capital would be limited to the 2 percent to 7 percent of the defaulted loan value it contributed to the reserve fund. Moreover, Treasury's capital-at-risk requirement would be satisfied only when the balance of a lender's aggregate CAP reserve fund was 80 percent or less of the defaulted SSBCI loan balance.

Additionally, we noted that some states allow lenders to use payments from subsequently enrolled loans to pay prior losses when a lender depletes its reserves. Thus, lenders may recover 100 percent of their loss even when the reserve fund is insufficient to cover the loss at the time of a loan default. Treasury acknowledged that CAPs traditionally operate in this manner to help comfort lenders when there is an early loss that wipes out their reserve funds. It also provides an incentive for lenders to continue enrolling new loans, making CAPs appealing to prospective SSBCI lenders.

The SSBCI Program Director acknowledged that applying the capital-at-risk requirement on a loan basis with a 20-percent capital-at-risk threshold, as required in the *SSBCI Policy Guidelines*, is inconsistent with the standard operational design of CAPs. Doing so could also reduce the marketability of CAPs and their effectiveness within SSBCI.

Recommendation

We recommend that the Deputy Assistant Secretary for Small Business, Housing, and Community Development:

- 1) Revise the *SSBCI Policy Guidelines* to (a) redefine how the capital-at-risk requirement should be applied within the context of the traditional operational design of CAPs, and (b) specify whether

lenders may use subsequent premium payments to cover past losses.

Management Comments and OIG Response

We provided a draft of the report to Treasury on September 24, 2013, and received Treasury's formal written comments on October 22, 2013. Treasury accepted the report's recommendation to revise the *SSBCI Policy Guidelines* to redefine how the capital-at-risk requirement applies to CAPs and specify whether lenders may use later premium payments to cover earlier losses.

We agree with Treasury's response to the recommendation, and believe that Treasury's planned actions are fully responsive.

* * * * *

We appreciate the courtesies and cooperation provided to our staff during the evaluation. If you wish to discuss the report, you may contact me at (202) 622-1090, or Lisa DeAngelis, Audit Director, at (202) 927-5621.

/s/

Debra Ritt

Special Deputy Inspector General for

Office of Small Business Lending Fund Program Oversight

Appendix 1: Management Response



DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

October 22, 2013

Debra Ritt
Special Deputy Inspector General for
Office of Small Business Lending Fund Program Oversight
U.S. Department of the Treasury
1500 Pennsylvania Avenue, NW
Washington, DC 20220

Dear Ms. Ritt:

Thank you for the opportunity to review the Office of the Inspector General's (OIG) draft report entitled *State Small Business Credit Initiative: Treasury Needs to Modify Its Capital-at-Risk Requirements For Capital Access Programs* (the Report). This letter provides the official response of the Department of the Treasury (Treasury).

The Report evaluates the application of the capital-at-risk requirement to capital access programs (CAPs) supported by State Small Business Credit Initiative (SSBCI) funding and concludes that the *SSBCI Policy Guidelines* are not consistent with the operations of State-run CAPs. The Report also notes that some Participating States allow lenders to use premium contributions from later enrolled loans to pay losses on earlier enrolled loans when a reserve fund is depleted. The Report recommends that Treasury revise the *SSBCI Policy Guidelines* to redefine how the capital-at-risk requirement applies to CAPs and specify whether lenders may use later premium payments to cover earlier losses. We appreciate the OIG's analysis and accept the recommendation.

Thank you once again for the opportunity to review the Report. Treasury appreciates our work together throughout the course of the SSBCI program.

Sincerely,

A handwritten signature in black ink, appearing to read "Don Graves".

Don Graves
Deputy Assistant Secretary
Small Business, Community Development, and
Affordable Housing Policy

Appendix 2: Major Contributors

Debra Ritt, Special Deputy Inspector General

Lisa DeAngelis, Audit Director

Clayton Boyce, Audit Director

John Rizek, Audit Manager

Andrew Morgan, Auditor-In-Charge

Safal Bhattarai, Auditor

Diane Baker, Program Analyst

Kimberly McKeithen, Referencer

Appendix 3: Distribution List

Department of the Treasury

Deputy Secretary
Office of Strategic Planning and Performance Management
Risk and Control Group

Office of Management and Budget

OIG Budget Examiner

United States Senate

Chairman and Ranking Member
Committee on Small Business and Entrepreneurship

Chairman and Ranking Member
Committee on Finance

Chairman and Ranking Member
Committee on Banking, Housing, and Urban Affairs

Chairman and Ranking Member
Committee on Homeland Security and Governmental Affairs

Chairman and Ranking Member
Appropriations Subcommittee on Financial Services and General
Government

United States House of Representatives

Chairman and Ranking Member
Committee on Small Business

Chairman and Ranking Member
Committee on Financial Services

Chairman and Ranking Member
Committee on Oversight and Government Reform

Chairman and Ranking Member
Appropriations Subcommittee on Financial Services and General
Government

Government Accountability Office

Comptroller General of the United States