Section VI

Capital Access Initiatives

Capital Access Initiatives

One of the key problems facing businesses in the city is access to capital because investors are often unwilling or unable to provide financing due to real or perceived risk and lack of sufficient information. Below are several financial technologies that can increase capital access. Each is economical and has a successful track record in other localities. In the recommendations, we offer three specific initiatives best suited to Los Angeles.

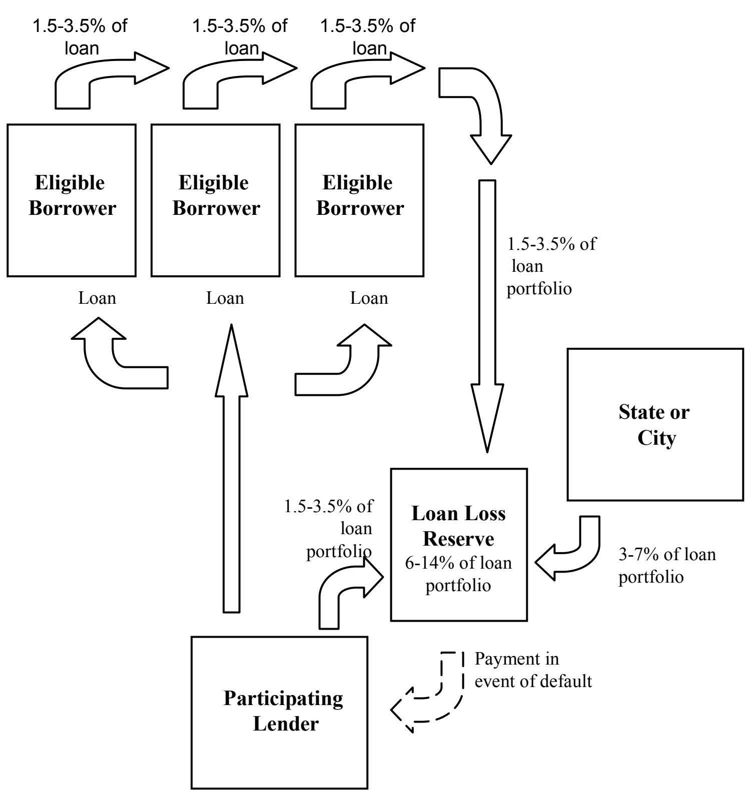
Capital Access Program

Capital access programs were first introduced in Michigan in 1986 and are currently operating in more than 25 states. They are designed to be a simple, nonbureaucratic[1] and – most importantly – low-cost economic development mechanism. They leverage a small initial government expenditure to provide market rate loans to firms that would otherwise be deemed excessively risky by banks and thus denied loans.

A schematic of a sample capital access program is provided in Figure 1. The mechanism is quite simple. Banks and borrowers pay a fee ranging from 3 to 7 percent of the loan amount that serves to provide a loan-loss reserve fund that is then matched by state or municipal money. This total loan loss reserve, which typically ranges between 6 percent and 14 percent of the loan, is held at the bank to cover potential losses from defaults.

Figure 1-VI

Sample Capital Access Program Schematic



As seen in Figure 1, fees paid by the lender and borrowers are pooled, then matched by a state or city government agency, creating a fund used to provide a form of insurance for the lender's eligible portfolio. In the event of loan defaults, money is drawn from the reserve to make good losses on the eligible loan portfolio up to 7-14 percent of its amount. So long as expected losses on the eligible loans are less than 7-14 percent, the structure is an attractive incentive to lenders. A key aspect of the program is high leverage; maximizing the potential impact of public spending. For example, with the government matching a 7 percent loan reserve, it is able to leverage this amount 14 times and with it matching a 3 percent reserve, 33 times.

The capital access programs in operation today differ in the size of eligible loans (some programs have maximum loan sizes while others have no such caps), the nature of eligible borrowers (many have geographic requirements while others require businesses to be classified as small businesses), and size of the potential loan loss reserve. Table 1 shows variations among a number of capital access programs currently run by both states and cities. Clearly, even among this small group, there are substantial differences. Some of them have no maximum loan sizes while amongst those that do there is great variation in the maxima. There appear to be fewer differences with regard to maximum firm size, with most focused on small- and medium-sized businesses. There are however, greater variations in the maximum and minimum reserves that range from 6 percent to 28 percent.

Table 1-VI

Differences among Capital Access Programs

	Maximum Loan Size	Maximum Firm Size (employees)	Reserve Size
California	$2.5 million	500	8-28%
Illinois	$2 million	500	6.99-17.5%
Milwaukee	None	None	6-14%
New York City	$1 million	None	n.a.
Phoenix	$2.5 million	500	8-28%
Texas	none	500	6-18%

The admittedly limited research conducted on capital access programs (such as the Treasury Department's 2001, 1999 and 1998 studies of the performance of capital access programs) suggests that losses on admissible loans have been low (less than 4 percent), and the programs have not appeared to crowd out conventional lending. By 2000, some $1.6 billion in loans had facilitated through capital access programs with an average loan size of $60,000. Data on job creation and retention are less readily available, however, data reported by states and municipalities suggest that as many as 113,000 jobs have been created or retained at an average subsidy per job of $540.

In creating a Los Angeles capital access program, the city would be joining other cities such as New York and Phoenix in making use of the mechanism. Rather than attempting to make loans or grants directly to small- or medium-sized firms, the city could maximize the impact of a relatively small initial spending allocation through working with private lenders to leverage this amount. In a Los Angeles capital access program, the city could make use of tried and tested structures and create something similar to the New York program or the California program. In both of those programs, the public sector provides 50 percent of the reserve for eligible loans originated by participating banks with the remaining portion provided jointly by the lending bank and the borrower. Details of the program to be considered would include maximum loan size and maximum eligible firm size. Additionally, some capital access programs offer more than 50 percent of the reserve (e.g. more than 100% matching of lender and borrower fees) on loans made to eligible firms owned by ethnic or racial minorities (examples include Colorado and Pennsylvania) or on loans made to firms with operations in economically depressed areas (Connecticut and Illinois, for example). Other programs second guess banks by offering higher matching on loans made to firms in selected industries. Such industrial policies have had a mixed success rate.

Small-Business Loan Securitization

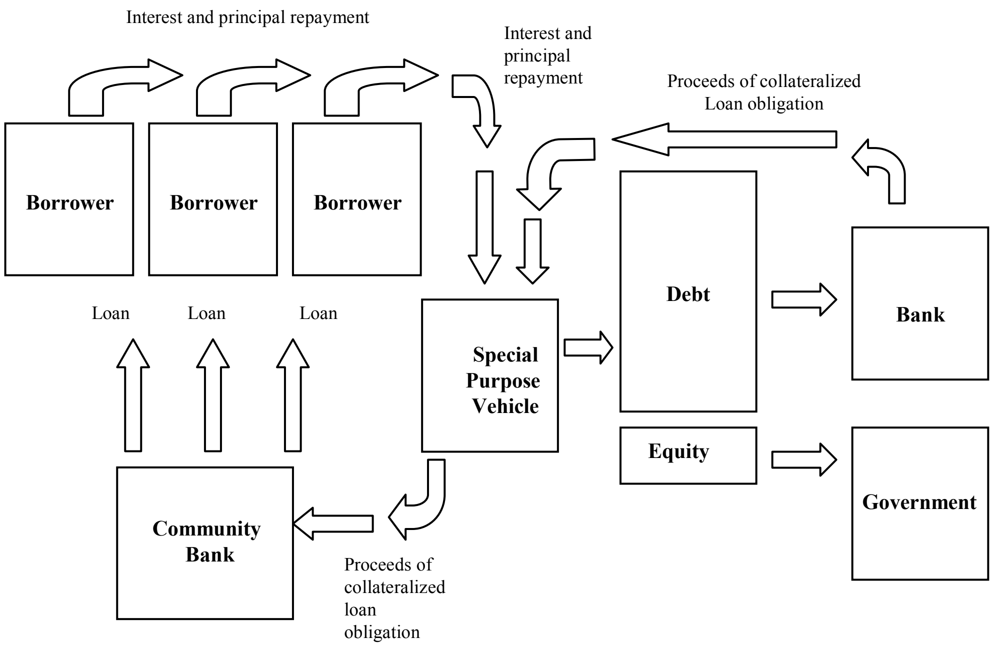
Securitization is the process of issuing securities backed by the cash flows from an underlying asset. Typically it involves the bundling up of a portfolio of loans or bonds and issuing bonds backed by these assets. It is, however, not unheard of to have more exotic securitizations. These have included the issuance of bonds backed by future royalty payments, bonds backed by firm receivables and bonds backed by inventories of anything from steel to diamonds.[2] Securitization is now a well-established financial tool and the growth of asset-backed securities over the past nine years has been exponential. From 1995 to 2004, the stock of asset-backed securities outstanding increased by 560 percent – some 21 percent per year on an annualized basis. Securitization brings liquidity to often illiquid markets – such as those for bank loans – and in so doing can lower the cost of borrowing by decreasing the liquidity risk lenders face. Additionally, securitization allows lenders to sell portions of their loan portfolios and then make new loans with the sale proceeds. Thus securitization increases the amount of credit available to borrowers.

A common form of securitization is a collateralized loan obligation (CLO). It involves the creation of a special purpose vehicle (SPV), a corporate entity that exists for the sole purpose of securitizing assets. The SPV buys up parts or all of one or more banks' loan portfolios and then uses the cash flows from these loans (the interest payments and the principal) to issue asset-backed securities. Commonly, a CLO will make use of a structure that involves the issuance of a large investment-grade – highly rated and more or less risk-free – tranche of bonds and a smaller, junior, noninvestment-grade – more risky – tranche of bonds. It may also have an equity tranche. The noninvestment-grade debt and equity tranches are junior to the investment-grade debt. That is, all the holders of the investment-grade debt must be paid in full before the holders of the noninvestment-grade debt and equity receive anything. The credit risk of the underlying loans is thus concentrated in the junior debt and the equity, leaving the senior debt with much lower credit risk than the loan portfolio.

In the current context, a securitization of loans to Los Angeles' small- and medium-sized firms could lower the cost of borrowing for Los Angeles businesses, allow lenders to increase their lending and, if the securitized loans were those made to firms in low and moderate income (LMI) areas, allow the buyers of the securities to meet their CRA requirements. This last potential feature is an especially valuable one as it increases the attractiveness of the asset-backed securities to banks that lack expertise in underwriting loans to LMI firms. It can be expensive for many banks to originate CRA loans, as they lack specialized information regarding the LMI opportunities in their areas of operation. At the same time, banks that have expertise in originating CRA loans, currently hold these loans on their balance sheet and are thus limited by capital requirements from making more of these loans. A CRA collateralized loan obligation can solve some of these problems. A schematic of a sample CLO is provided in Figure 2.

Figure 2-VI

Sample CLO Schematic



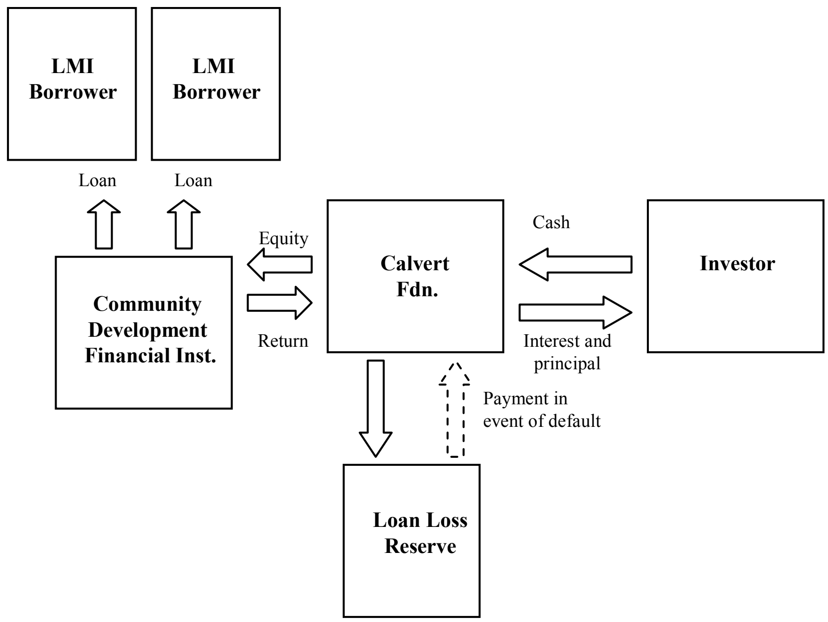
Here the loans to LMI firms underwritten by a community bank or other lender are purchased by a special purpose vehicle. The cash flows of the loans are used by the SPV to back the issuance of a tranche of senior debt and a tranche of risky equity. The senior debt is rated as investment grade by a rating agency while the equity acts much like a loan loss reserve as it absorbs all loan losses up to its face value. In the above example, a government entity purchases the equity portion, but this could quite easily be a nonprofit like philanthropy or even a risk-acceptant market rate investor.

Community Investment Note

The Calvert Foundation offers "Community Investment Notes" to individual and some institutional investors. The notes, available in values of $1000 or more and terms of one, three, five, seven or 10 years, are designed to allow individual investors the opportunity to invest funds in community development organizations. Community investment notes are unsecured, fixed-rate instruments that offer below-market-rate interest of between 0 percent and 3 percent. The proceeds are used to invest in community development organizations, as well as to fund a loan loss reserve to protect the investors' capital. A loan loss reserve of 1 percent is maintained for loans of minimum risk, 3 percent for moderate risk, and 10 percent for high-risk loans. A schematic of a sample community investment note is shown in Figure 3.

Investments are made in institutions involved in providing low-income housing, microlending, community economic development and business lending in urban and rural areas. Eligible investment targets include micro-enterprise funds, community development banks, community development funds and low-income housing funds. At present, the Calvert Foundation invests in a number of Los Angeles-based institutions, including Broadway Federal Bank, Community Financial Resource Center and Community Commerce Bank.

Figure 3-VI
Community Investment Note Schematic



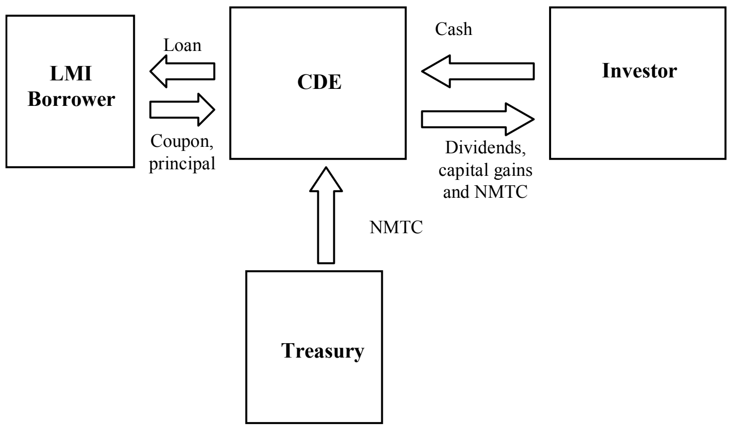
In addition to offering community investment notes for sale to the investing public, the Calvert Foundation also administers more specialized notes for other entities. It would be quite straightforward for the City of Los Angeles to work with the Calvert Foundation to launch a special Los Angeles Community Investment Note. Such a product would extend an existing and successful model to allow individuals, foundations and institutional investors to invest in small businesses operating in Los Angeles' low- to moderate-income (LMI) areas.

New Markets Tax Credit

The New Market Tax Credit (NMTC) program is a federal tax credit equal to 39 percent of an equity investment made in an eligible Community Development Entity (CDE). Investors taking equity positions in designated CDEs receive a credit of 39 percent of the investment against their federal income tax. Designed to increase investment in institutions engaged in community economic development, the NMTC was introduced in 2000 by Congress as part of the Community Renewal Tax Relief Act. A total of $15 billion was made available with $2.0 billion to be disbursed in 2005, $3.5 billion in 2006 and $3.5 billion in 2007. NMTCs are distributed to CDEs that are selected by the Treasury's CDFI Fund from all CDEs that apply for credits. The credits are then made available to equity investors in the recipient CDEs. The mean NMTC request in the 2003-2004 round of awards was for $113 million and some 10 percent of applicants were successful. A schematic of the NMTC is shown in Figure 4.

In order to qualify as a CDE eligible to bid for NMTCs, organizations need to 1) have a mission of serving or providing investment capital for low-income communities or low-income persons, 2) maintain accountability to residents of low-income communities through their representation on a governing board of or advisory board to the entity and 3) apply for certification as a CDE by the CDFI Fund.

Figure 4-VI
NMTC Schematic



The City of Los Angeles could make use of the NMTC program by partnering with an existing CDE[3] or forming a new corporate entity. The new partnership or entity would have to apply for CDE status, but if it complies with the CDFI Fund's requirements, this should not be problematic. In seeking CDE status and then in applying for NMTCs, a Los Angeles CDE would be able to make reference to the city's existing commitment to economic development and redevelopment. If successful in its application for NMTCs, the CDE could then make loans to qualified borrowers, issue equity and use the NMTC to provide equity investors with a market rate of return. Alternatively, the CDE could also issue equity and debt and pay the equity investors' returns out of the NMTC and the debt investors' out of returns from the loans made.

Community Development Venture Capital Fund

Community development venture capital (CDVC) funds make private equity investments in LMI area businesses. At present there are 68 active CDVC funds in the United States with an additional 11 in formation. The total funds under management have reached $550 million. There are already two CDVC funds active or expanding into Los Angeles: Pacific Community Ventures Fund[4] (based in the Bay Area since 1999, currently lending throughout California and seeking to open a Los Angeles office), and the CDVCA Central Fund (administered by the industry's trade association, Community Development Venture Capital Association).

CDVC funds often draw upon both private investors and the Small Business Authority's New Market Venture Capital (NMVC) program. That program provides matching of up to 150 percent of the equity invested in funds that are designated by the SBA as NMVC companies. To gain certification, a fund must provide the SBA with an application, detailing the "proposed business plan and management team, the need for developmental venture capital investments in the geographic areas in which they intend to invest, the extent to which they will concentrate their activities on serving these areas, the anticipated impact of their activities on economic opportunities in these areas, their plan for providing operational assistance to their portfolio companies, and their ability to raise the required minimum investment capital and operational assistance funding" (http://www.sba.gov /INV/overviewventure.html). At least $5 million in private capital must be raised to take advantage of the matching funds, which are provided as SBA-guaranteed deferred payment debentures.

A Los Angeles CDVC fund could raise money from private and public mission-oriented or double-bottom line investors and use the proceeds to make direct investments in small growth businesses in LMI areas of the city. Additionally, it could seek NMVC company status and enjoy SBA matching of its capital.

Targeted Community Development Fund

A Los Angeles-focused, privately managed, public-purpose equity/mezzanine fund could target business and project financing in LMI areas and small businesses in the city. Such a fund would bring private management techniques and disciplines to investments in Los Angeles with a public benefit (e.g., job creation, capital access), while introducing flexibility to the capital structure of small businesses.

Its leveraged structure would magnify the social return on contributed capital and thus increase its impact. Capital provided by foundations or government agencies would mitigate risk to capital invested by the private sector and leverage the impact of that investment. With an asset composition of debt and equity of Los Angeles small businesses, the fund would issue liabilities consisting of both equity and debt to investors, including mission-oriented/double-bottom line investors and market rate investors. The varied liability mix would allow different investors to accept different levels of risk and associated levels of return.

Risk adverse investors such as foundations and governments could purchase less risky debt, while more risk tolerant investors could buy riskier equity. Alternatively, investors (e.g., foundations using program-related investments) could provide a first-loss guarantee and thus accept a lower level of seniority in the capital structure and a lower level of return in order to subsidize the risk and return of market-rate investors. Figure 5 shows a schematic of a sample Community Development Fund.

Figure 5-VI

Community Development Fund Schematic