CALIFORNIA INFRASTRUCTURE AND ECONOMIC DEVELOPMENT BANK

SMALL BUSINESS FINANCE CENTER
SMALL BUSINESS LOAN CATALYST PROGRAM – SMALL BUSINESS LENDING FUND PARTICIPATION

STAFF REPORT

INTRODUCTION

The California Infrastructure and Economic Development Bank ("IBank") staff recommends the IBank Board of Directors (the "Board") approve Resolution No. 20-15, delegating authority to the Executive Director to negotiate and execute one or more agreements to provide $25 Million to an entity created to fund California small business loans. IBank and others would loan money to the entity (hereinafter, the "Fund"), which would then aggregate this money and make loans to California Community Development Financial Institutions (collectively, "CDFIs" and individually, a "CDFI"). The CDFI's would draw from the Fund to make numerous small business loans. IBank staff has determined this financing structure is the most efficient and highly leveraged means of rapidly increasing the volume of lending activity to underserved California small businesses in dire need of low-cost loan capital.

IBank is presenting Resolution No. 20-15 in tandem with Resolution No. 20-14, seeking Board adoption of Amended and Restated Directives and Requirements creating the Small Business Loan Catalyst Program within IBank's Small Business Finance Center (the "Center"). The transaction discussed in this Staff Report will be administered under IBank's new Small Business Loan Catalyst Program.

BACKGROUND – THE PROBLEM

California small businesses, particularly those in underserved and underbanked communities, are starved for capital. The Center's traditional small business financing activities are not sufficiently reducing this gap. The Center was created to help California small businesses obtain loans that otherwise may not be available. The Center administers a number of small business financing programs, including the Center's marquise program, its Small Business Loan Guarantee Program. The Center's existing programs (collectively, the "Existing Programs") operate well during normal economic times. Unfortunately, these are not normal economic times and the Existing Programs by themselves are not able to fill the need of getting low-interest loans to underserved small businesses during a statewide and nationwide pandemic-fueled economic downturn.

The Existing Programs are largely dependent upon existing small business lenders having sufficient liquidity and balance sheet capacity to make small business loans. The Existing Programs work with these lenders through Financial Development Corporations to provide credit support and other financial vehicles for California's small businesses. IBank staff has determined that a subset of California's small business lenders, particularly CDFIs and other mission-based lenders do not have sufficient cash on hand to make more small business loans and therefore IBank's Existing Programs are not able to stimulate significant small business lending activity to these lenders' customers. In other words, while IBank is willing to off-load risk via our guarantee programs, these lenders have limited available capital to lend, limiting the efficacy of the Existing Programs.

ANALYSIS – THE SOLUTION

Solving the problem requires a new IBank program and new financing vehicles to move needed cash to lenders focusing on the underbanked and underserved California small business community. Access to capital would enable lenders to make more loans to struggling California small businesses. After significant study and analysis, IBank staff has determined the best way to achieve this goal is to participate in a multi-party structured financing. As discussed in the Staff Report for Resolution No. 20-14, the IBank Act was recently revised to provide the necessary legal basis for IBank to enter into this type of financing. With these legislative revisions, IBank was also provided with an allocation of money from the General Fund to use for the Center Programs. Additionally, Resolution No. 20-14 would create a new program authorizing IBank's participation in this type of transaction.

The cornerstone of the proposed transaction is the creation of the Fund. The Fund would be formed as a limited liability company, created to facilitate small business lending in California. IBank would be the Fund's anchor lender.

The Fund would issue three series of debt, a Series A to commercial lenders, a Series B to commercial lenders and philanthropic organizations, and a Series C to IBank. The Series A lenders would be the senior priority lenders and would receive an interest rate of up to 2.5%. The Series B lenders would be in second priority position and potentially receive interest. IBank's loan would be in third position and would not charge any interest.

The Fund would aggregate the Series A, B, and C loans and use them to make loans to CDFIs. The CDFI's would use this money to make small business loans and assign the loans to a holding entity. The holding entity would be wholly-owned by the Fund and created solely to hold the loans for the benefit of the Fund.

IBank's Series C loan to the Fund would be for $25 Million. The Fund would start making loans to CDFIs when it raised a total of $125 Million in Series A-C Loans ($25 Million from IBank's Series C loan and at least $100 Million from Series A and B loans). If for some reason the Fund did not hit the $125 Million threshold, IBank would not make its $25 Million Series C loan. The Fund will target a total capital raise of between $250 Million and $500 Million, enabling it to loan a corresponding amount to CDFI's for small business loans.

IBank and the other lenders would be secured by the Fund's interest in the holding entity. The small business loans assigned to the holding entity would be the sole source of repayment for the Series A-C loans. The Series A-C lenders get repaid only if the underlying small businesses repay their underlying loans.

As the lowest-priority Series C lender, IBank's money is most at risk. The Fund and the CDFIs intend that many of the small business loans will be made to California's traditionally underserved and underbanked small businesses. These small businesses are on precarious financial footing due to the economic havoc caused by the coronavirus pandemic. These small business loans are intended as an economic lifeline to the small businesses. They will be made at a very low interest rate (Wall Street Journal Prime plus 1%, currently 4.25%) for a 5-year term. The first year will include interest only payments and the loans will then be fully amortized over the next four years. The maximum loan amount will be $100,000. Significant loan defaults are expected and as the lowest priority lender, IBank will bear the brunt of those defaults. It is highly likely that IBank's loan will be lost in its entirety. The Series A lenders will be paid first from the small business loan proceeds. While the Series B lenders will be paid next, they may also expect to incur losses. IBank's Series C loan will be repaid only once the Series A and B loans have been repaid.

As discussed above, loan defaults will be charged against IBank's loan first. IBank holding the "first loss" position in the lending hierarchy is key to attracting low-cost capital from the Series A and Series B lenders. These lenders are willing to loan to the Fund at very low rates (which ultimately will be passed-along to the small business borrowers) because any losses will accrue to IBank first, making repayment to the Series A and B lenders more likely. Without IBank holding the first loss position, the Series A and Series B lenders would not be likely to participate in the fund and potentially hundreds of millions of dollars of small business loans would never be made.

Despite the expected loss, IBank nonetheless recommends proceeding with this transaction. IBank's dividends from this transaction would not be paid in dollars, but instead by supporting small business to retain or grow their base of employees and to continue contributing to our tax base and economic vibrancy. The sponsors forecast that a $25 Million IBank loan to the Fund coupled with substantial philanthropic participation could result in $250 Million, or more, of small business loans. In other words, for $25 Million, IBank could help pump up to ten times that amount into California's economy. IBank staff believes this to be an excellent use of the General Fund money recently allocated to the Center for this purpose.

RECOMMENDATION:

Staff recommends approval of Resolution No. 20-15 approving the A&R Directives and Requirements to create the SBLCP within the Center.