Date of Hearing: April 17, 2012

ASSEMBLY COMMITTEE ON JOBS, ECONOMIC DEVELOPMENT AND THE ECONOMY
V. Manuel Pérez, Chair
AB 2523 (Hueso) – As Introduced: February 24, 2012

SUBJECT: Infrastructure and Economic Development Bank: Participation Loans

SUMMARY: Authorizes the California Infrastructure and Economic Development Bank (I-Bank) to enter into participation loan agreements with financial institutions for the purpose of expanding capital opportunities for small businesses. Specifically, this bill:

1) Authorizes the I-Bank, upon appropriation by the Legislature, to enter into participation loan agreements with financial institutions. Under these agreements, the I-Bank purchases a participation interest in an existing loan held by the financial institution. Compensation for the I-Bank's participation would come from collecting interest and principle payments on a pro rata basis of a loan or a package of loans.

2) Defines an eligible financial institution as including banks, savings and loan associations, credit unions authorized to conduct business in California and state charted commercial banks, trust companies and savings and loan associations.

3) Defines an eligible small business as an independently owned and operated business that is not dominant in its field of operation, the principal office of which is located in California, the officers of which are domiciled in California, and, which has 100 or fewer employees and average annual gross receipts of ten million dollars ($10,000,000) or less over the previous three years, or is a manufacturer, with 100 or fewer employees.

4) Authorizes the I-Bank to promulgate regulations to establish procedures and standards for entering into participation loan agreements.

5) Expands the I-Bank's existing reporting requirements to include information on activities related to this bill, as well as the policies and practices of the I-Bank for the investment and management of state funds.

EXISTING LAW:

1) Creates the I-Bank, within Business, Transportation and Housing Agency (BTH), for the purpose of promoting economic revitalization, enabling future development, and encouraging a healthy climate for jobs in California.

2) Authorizes the I-Bank to make loans to any sponsor or participating party in connection with the financing of a project. The project loan may be made either directly or by making a loan to a lending institution. The I-Bank may also make agreements to enter into loans for refinancing of projects. However, no loan shall exceed the total cost of the project as determined by the sponsor or the participating party and approved by the bank.

3) Defines a "project" to mean designing, acquiring, planning, permitting, entitling, constructing, improving, extending, restoring, financing, and generally developing public development facilities or economic development facilities within the state.

FISCAL EFFECT: Unknown

COMMENTS:

1) Author's purpose: According to the author, "Small businesses are a critical component of California's economy. They comprise 98% of all businesses in the state, employ more than 50 percent of California's workforce, and generate more than half of the state's gross domestic product. Expanding the I-Bank's funding programs by providing loans to small businesses will spur job development and economic growth."

   "Presently, the I-Bank has the authority to issue revenue bonds, make loans and provide credit enhancements for a wide variety of infrastructure and economic development projects. Eligible applicants include local government entities, including cities, counties, special districts, assessment districts, joint powers authorities and non-profit corporations formed on behalf of a local government. AB 2523 will include small businesses in I-Bank eligibility pool."

   "A direct and coordinated investment between the I-Bank and California's small businesses is an innovative and viable approach to address California's economic challenges. Providing small businesses with increased access to capital will revitalize communities and improve the quality of life for California's employees and small business owners."

2) Challenges in small businesses access to capital: Even as many areas of California are pulling out of the recession, small businesses continue to report that they face challenges in accessing and retaining credit through traditional financial institutions. For their part, financial institutions report that stricter federal regulations have left them with little flexibility in applying underwriting criteria to a small business community that has been especially hard hit during the recession.

   Businesses with less than 100 employees comprise nearly 98% of all businesses, and are responsible for employing more than 37% of all workers in the state. Therefore, finding ways to address this access to capital disconnect is essential for the state's full economic recovery.

   Among other advantages, small businesses are crucial to the state's international competitiveness and are an important means for dispersing the positive economic impacts of trade within the California economy. California small businesses comprised 96% of the state's 60,000 exporters in 2009, which accounted for over 44% of total exports in the state. Nationally, small businesses represented only 31.9% of total exports. These numbers include the export of only goods and not services.

   Historically, small businesses have functioned as economic engines, especially in challenging economic times. During the nation's economic downturn from 1999 to 2003, microenterprises (businesses with fewer than five employees) created 318,183 new jobs or 77% of all employment growth, while larger businesses with more than 50 employees lost over 444,000 jobs. From 2000 to

2001, microenterprises created 62,731 jobs in the state, accounting for nearly 64% of all new employment growth. More recently, the federal Small Business Administration's *Small Business Economy 2011*, states that small businesses nationally outperformed large firms in net job creation nearly three out of four times from 1992 through 2010 when private-sector employment rose.

During this current economic downturn, however, small business owners have been especially hard hit. Equifax has reported that bankruptcies in California rose by 81% in 2009, as compared to 44% nationally. This trend continued in 2010 where the Equifax report stated that while in general bankruptcies were down across the nation including some regions in the west, small business bankruptcies in California accounted for almost 20% of all small business bankruptcies in the nation.

3) Changing financial markets: From being reserved for only the most complex and large size loans, the use of multi-lender financing is becoming a common structure for addressing the capital needs of small businesses. These types of transactions can take many forms, as proposed to be amended, AB 2523 proposes the use of two: syndications and participation loan agreements.

   One of the key factors impacting the ability of a financial institution to provide loans is the lenders capitalization. In general, federal law and regulation allow a financial institution to loan $100 for every $1 of money held in reserve. Once the initial loan is given, the lender must hold a certain amount of money in reserve until the debt is repaid. Regulators carefully review lenders financial records to ensure that sufficient moneys are held in reserve and that lenders are adhering to prescribed risk limitations. In the past few years, this need to recapitalize has resulted in some lenders discontinuing small business lines of credit, choosing to not renew expiring loans, and tightening the underwriting standards for new business loans. In short, accessing the necessary capital to maintain and grow businesses has become very difficult.

   Without multi-lender financial structures, institutions can be limited in their ability to meet the financial needs of a customer. As one example, a growing business may need a loan that would require a financial institution to loan an amount that exceeds its lending limits. By bringing in one or more additional lenders, the needs of the business can be effectively met through its current lender without requiring the business to undertake an extended search for a larger size lender that can both accommodate the size of the loan and be willing to extend the loan.

   From the financial institution's perspective, multi-lender financial structures offer a number of key advantages, including, but not limited to, allowing an institution to continue serving a long-time customer, offering new lending opportunities to emerging and small community development financial institutions, and providing diversification to the institution's loan portfolio, which benefits the overall risk to capital ratio.

4) Managing multi-lender financial structures: As proposed to be amended, AB 2523 authorizes the I-Bank to facilitate and/or enter into two specific types: syndication and participating loan agreements. As the name suggests, each of these entail the sharing of some percentage of an individual loan or a package of loans by one or more financing entities.

   Two of the key structural differences between the types of loans is the relationship between the borrower and the individual financial institutions and who sets the terms for the loans. In a syndication model, the lead bank sets the terms and each bank signs a loan agreement with the borrower and receives a note representing their individual share of the indebtedness. This means that each lender in the syndication has a separate and distinct relationship and risk profile with the borrower.

Alternatively, under a participation loan agreement, the lead lender sets both the terms and serves as the sole entity that deals with the borrower. The other lenders in a participation agreement have no rights directly against the borrower and must advance their interests through the lead lender.

5) Oversight hearing: In March 2011, the Assembly Jobs, Economic Development and the Economy (JEDE) Committee held an oversight hearing to examine how the I-Bank's activities impacted local, state and federal economic recovery efforts and California's economic position in the post-recession economy. Following the hearing, JEDE released a preliminary list of recommendations to better align the authorities of the I-Bank with the state's current and future economic development and infrastructure needs. JEDE Members voted to amend four bills to address many of the structural and infrastructure related recommendations including: AB 696 (Hueso), AB 700 (Blumenfield), AB 893 (V. Manuel Pérez) and AB 1094 (John A. Pérez). The Governor vetoed these measures and, instead, proposed to reorganize the I-Bank within the administrative structure of the Governor's Office of Business and Economic Development.

   Recommendations related to increasing the I-Banks engagement on economic and business development issues were deferred for additional research and discussion. This year, two measures were introduced by JEDE Committee Members that would heighten the I-Bank's role in meeting the access to capital needs of small businesses: AB 2523 relating to debt finance and AB 2619 (V. M. Pérez) relating to equity capital.

6) Amendments: Committee staff understands that the author will offer amendments that do the following:

   a) Authorize the I-Bank to establish a California Preferred Broker-Dealer Program whereby the I-Bank would enter into cooperative agreements with financial institutions that serve as financial intermediaries with community development banks. These cooperative agreements would be based on the financial institution's ability to:

      i) Demonstrate experience in working with community development lenders;
      ii) Commit a percentage of their own capital in each loan or loan package;
      iii) Facilitate the syndication and/or take the lead position on participation loan agreements in a manner that serves the needs of small business and provides a basis for the issuance of loan-back securities by the I-Bank.

   b) Provide priority access to certain state small business loan guarantees.

   c) Extend the definition to financial institution to include nonprofit financial intermediaries and microbusiness lenders.

d) Clarify that the participation loan agreements can include the refinancing of loans where the term of the existing loan is within 18 months of coming due.

e) Specify that the purpose of the program is to fill gaps in the financial market relative to small business access to capital.

f) Provide a more generic definition of a "participation loan agreement" in order to provide the I-Bank with flexibility in designing a program that best reflects the needs of small businesses in accessing private sector capital.

g) Modify the definition of a small business to be consistent with the state's other small business lending programs, i.e. the Small Business Loan Guarantee Program and the California Capital Access Program. Also include small size nonprofit organizations.

h) Add a definition for co-finance of loans and syndication.

i) Remove the requirement to promulgate regulations, and, instead, requires the I-Bank Board of Directors to adopt guidelines.

j) Remove the general reporting language relating to the policies and practices used by the I-Bank to invest and manage money, and, instead, add more specific detail on outcomes including the number of jobs created and retained, number of businesses served, geographic distribution of loans and the industry sectors of the businesses served.

7) Background on the I-Bank: The I-Bank was established in 1994 to promote economic revitalization, enable future development, and encourage a healthy climate for jobs in California. Housed within BTH, it is governed by a five-member board of directors comprised of the BTH Secretary (chair), State Treasurer, Director Department of Finance, Secretary of the State and Consumer Services Agency, and a Governor's appointee. The day-to-day operations of the I-Bank are directed by the Executive Director who is an appointee of the Governor and is subject to confirmation by the California State Senate. Currently, the I-Bank has authority for 24 staff members.

The I-Bank does not receive any ongoing General Fund support, rather it is financed through fees, interest income and other revenues derived from its public and private sector financing activities. According to its 2009-10 independent audit, its programs continue to provide sufficient revenues to support all operating expenses.

The I-Bank administers two categories of programs: 1) The Infrastructure State Revolving Fund (ISRF) which provides direct low-cost financing to public agencies for a variety of public infrastructure projects; and 2) Bond Financed Programs which provide financing for manufacturing companies, nonprofit organizations, public agencies and other eligible entities. There is no commitment of I-Bank or state funds for any of the category #2 conduit revenue bonds. Even in the case of default, the state is not liable.

Since its inception, the I-Bank has loaned over $400 million to local agencies, developing a high-level of expertise in the financing of public infrastructure. The I-Bank also serves as the state's only general purpose financing authority with broad statutory powers to issue revenue bonds. Over $30 billion in conduit revenue bonds have been issued by the I-Bank since 2000. The I-Bank has also been involved in other unique financings, including Tobacco Securitization Bonds, Tribal Compact Asset Securitization Bonds, and Imperial Irrigation District Preliminary Loan Guarantees.

8) Reorganization of the I-Bank: On March 30, 2012, the Governor submitted a reorganization plan to the Little Hoover Commission, which proposes the following I-Bank related items:

- Dismantle BTH and move programs to other existing and new government entities. Overall, the number of state agencies is reduced from 12 to 10.

- Move the following programs from BTH to the Governor's Office Business and Economic Development (GO-Biz):
  - Small Business Loan Guarantee Program;
  - The California Travel and Tourism Commission;
  - The California Film Commission;
  - The Film California First Program; and
  - The I-Bank.

- Replace the Secretary of BTH with the Director of GO-Biz as Chair of the California Travel and Tourism Commission and the I-Bank. The newly established Secretary of Transportation replaces the Secretary of State and Consumer Services on the I-Bank board.

The Little Hoover Commission has 30 days to analyze the reorganization plan and submit its recommendations to the Governor and Legislature. The Legislature then has 60 days to consider the plan. The plan goes into effect unless the Legislature takes an action to disapprove the plan with a majority of the Members in each house voting.

9) Related legislation: Below is a list of related bills.

a) *AB 901 (V. Manuel Pérez) Implementation of Small Business Jobs Act*: This bill expands the definition of financial institutions and increases reporting requirements in the California Capital Access Program, which is one of the programs receiving multimillion dollars in federal and state funding for small businesses through the federal and state Small Business Jobs Act of 2010. Status: The bill was signed by the Governor, Chapter 483, Statutes of 2011.

b) *AB 981 (Hueso) Implementation of the Small Business Jobs Act*: This bill modifies the administrative procedures to the California Capital Access Program in order to encourage greater participation by financial institutions. This is one of the programs receiving multimillion dollars in federal and state funding for small businesses through the federal and state Small Business Jobs Act of 2010. Status: The bill was signed by the Governor, Chapter 484, Statutes of 2011.

c) *AB 1632 (Blumenfield) State Small Business Jobs Act*: This bill provides the necessary statutory changes in the area of job creation and small business development in order to implement the 2010 Budget Act. The bill transfers $32.4 million from the General Fund to support four small-business and jobs programs that exist in current law. The funding appropriated in this bill goes to the Small Business Loan Guarantee Program ($20 million); California Capital Access Fund ($6 million); Small Business Development Centers ($6 million); and the Federal Technology Centers ($350,000). Status: The bill was signed by the Governor, Chapter 731, Statutes of 2010.

d) *AB 2619 (V. Manuel Pérez) Start-Up California Impact Investment Fund*: This bill authorizes the I-Bank to administer the Start-Up California Impact Investment Fund Program for the purpose of providing equity financing to start-ups and other small size businesses. Status: The bill pending in the Assembly Committee on Jobs, Economic Development and the Economy.

10) Double referral: The Assembly Committee on Rules voted to refer this measure to JEDE and the Assembly Committee on Banking and Finance. Should this measure be approved at the April 17, 2012 hearing, the bill will be referred to the second policy committee for additional policy consideration.

REGISTERED SUPPORT / OPPOSITION:

Support

The California Bankers Association

Opposition

None Received

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