An Evaluation of the State's Alternative Energy Finance Program (SAFE-BIDCO)

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Introduction

Introduction

This report, submitted pursuant to the *Supplemental Report of the 1988 Budget Act*, contains our findings and recommendations concerning the State Assistance Fund for Energy, California Business and Industrial Development Corporation (SAFE-BIDCO). Specifically, the *Supplemental Report* directed our office to evaluate SAFE-BIDCO's performance in meeting its original statutory goals and to determine the cost-effectiveness of providing financial assistance to small businesses through the use of federal loan guarantees as opposed to other forms of state assistance (please see Appendix for exact language).

The SAFE-BIDCO program was authorized by Chapter 819, Statutes of 1980, for the purpose of making loans to small businesses for either the manufacture or purchase of alternative energy equipment. Chapter 819 defined "alternative energy equipment" as any device for producing or conserving energy which does not rely on conventional fuels derived from oil, natural gas or nuclear fissionable materials. In 1986, SAFE-BIDCO was authorized to make non-energy related loans to minority-owned small businesses and export financing loans to small businesses (Ch 1338/86).

Chapter I of this report reviews the Legislature's policy objectives for SAFE-BIDCO as stated in Ch 819/80. Chapter II provides an overview of SAFE-BIDCO's organization, funding and operations, including a discussion of SAFE-BIDCO's interaction with federal small business loan guarantee programs. Chapter III evaluates SAFE-BIDCO's performance in meeting its statutory objectives. Chapter IV presents options to the Legislature for utilizing SAFE-BIDCO's resources more effectively in the future.

This report was prepared by Steve Shea under the supervision of Jarvio Grevious. Secretarial services were provided by Senita Robinson-Taylor and the report was formatted for publication by Suki O'Kane. ❖

Executive Summary

Executive Summary

Legislative Analyst's Findings Regarding SAFE-BIDCO's Performance

- SAFE-BIDCO has not achieved its statutory objectives. The number of loans generated over the past seven years has fallen short of the goal set by SAFE-BIDCO'S Board of Directors. Moreover, in recent years, loan activity experienced a sharp decline. In addition, in six of its first seven years of operation, SAFE-BIDCO ended the year with an operating deficit.
- Our analysis identifies four factors which contributed to the decline in SAFE-BIDCO's loan activity: falling conventional fuel prices; the elimination of alternative energy tax credits; increased private sector participation in federal loan guarantee programs; and staff turnover at SAFE-BIDCO.
- In response to the decline in demand for its alternative energy loans, SAFE-BIDCO has begun to redirect its focus toward the financing needs of the minority-owned small business and small business exporter communities.

Legislative Analyst's Recommendation

- SAFE-BIDCO's recent lending history indicates that the demand for its alternative energy loans is not sufficient to warrant the continuation of the program. Although SAFE-BIDCO has begun to redirect its focus toward the financing needs of minority-owned small businesses and small business exporters, our analysis indicates that these efforts are duplicative of existing state programs and its lending approach is not a cost-effective means of serving the financing needs of these groups. Therefore, ***we recommend the enactment of legislation to eliminate SAFE-BIDCO and revert its funding to the General Fund.*** If SAFE-BIDCO is continued in its present form, it is likely to continue running annual operating deficits in the future as a result of limited loan activity and volume.

- If the Legislature wishes to devote SAFE-BIDCO's resources to the financing needs of minority-owned small businesses and small business exporters, we recommend that it consider transferring some portion of these funds to the state Department of Commerce and the World Trade Commission which operate similar programs. Before any funds are transferred, however, we recommend that these agencies demonstrate the need for additional funding to the Legislature during the budget review process. ❖

Chapter I

Chapter I
Purpose Of SAFE-BIDCO

This chapter examines the policy objectives of the State Assistance Fund for Energy, California Business and Industrial Development Corporation (SAFE-BIDCO). The chapter first reviews the objectives as stated in SAFE-BIDCO's authorizing legislation and in subsequent legislation which broadened SAFE-BIDCO's charter. Second, this chapter discusses the role SAFE-BIDCO plays in meeting the capital needs of small businesses.

Authorizing Legislation

Chapter 819, Statutes of 1980, (SB 16-Roberti) authorized the creation of the SAFE-BIDCO. It was created to provide loans to small businesses engaged either in the manufacture or purchase of alternative energy equipment. Chapter 819 defined "alternative energy equipment" as any device for producing or conserving energy which does not rely on conventional fuels derived from oil, natural gas or nuclear fissionable materials. As a practical matter, SAFE-BIDCO has made loans to firms involved in the solar power and wind power industries, as well as firms manufacturing various types of energy conservation devices (for example, a firm which manufactures exterior shading devices for windows).

The creation of SAFE-BIDCO was consistent with other energy policy initiatives developed during the late 1970s and early 1980s. These initiatives included tax credits for solar and wind energy investments and the development of statewide building standards to reduce energy consumption. Together, these policies were intended to advance technologies that rely on alternative energy sources and reduce consumption of imported energy fuels.

In 1986, the Legislature enacted Chapter 1338, Statutes of 1986 (SB 1146-McCorquodale), which directed the Governor's Office of Planning and Research, California Energy Extension Service (OPR/CEES) and the California Energy Commission to implement certain energy conservation programs using federal Petroleum Violation Escrow Account (PVEA) funds. In October 1987, OPR/CEES contracted with SAFE-BIDCO to manage the $3 million Energy Efficiency Improvements Loan Fund created by this act. The purpose of these funds is to provide direct low interest loans to small businesses which install energy efficiency improvement projects (for example, waste heat recovery sys-

tems). SAFE-BIDCO recently developed regulations for this program and now is processing loan applications. The program is scheduled to sunset on December 31, 1995.

Chapter 1338 also expanded the scope of permissible lending activities for SAFE-BIDCO's existing loan program. Specifically, Chapter 1338 authorized SAFE-BIDCO to make non-energy loans to minority-owned small businesses as well as small business export financing loans. (In general, export financing loans are short-term loans to cover cash flow problems related to the cost of labor, materials and other expenses leading to an export transaction.)

Thus, as a result of the initial and subsequent legislation, SAFE-BIDCO was authorized to provide small business loans for the following types of activities:

- the manufacture or purchase of alternative energy equipment;
- minority-owned small businesses; and
- export financing.

The Role of SAFE-BIDCO in Assisting Small Business

SAFE-BIDCO relies on a "direct lending approach" (that is, lending funds directly to support alternative energy technologies, minority-owned small businesses and export financing) instead of guaranteeing loans by private financial institutions for these purposes. This was done in order to address two difficulties faced by small businesses in obtaining financing from private lenders.

Risk Aversion of Commercial Banks

Commercial banks control the largest source of loanable funds available to small businesses, yet they tend to be risk averse in their lending practices. Banks are risk averse because the vast majority of their assets belong to their depositors. Banks are aware of the high failure rates of small businesses, particularly those in emerging industries (for example, alternative energy technologies), and therefore are cautious about lending to these businesses.

High Administrative Costs on Small Business Loans

Private lenders incur administrative costs to approve and service small business loans which tend to be high relative to the amount of the loan. The administrative costs for most small *consumer* loans, such as auto loans and home mortgages, are relatively low because the lender needs to perform only a basic credit review. For *business* loans, however, the lender must evaluate additional factors, such as the firm's management, its technology, and prevailing market conditions. The administrative costs involved in approving and servicing a $1 million loan may not be much greater than those associated with a $100,000 loan (which is the size of a typical small business loan), although the profit margin on the larger loan will be much greater. Thus, from the lender's perspective, small loans may not warrant the investment of administrative resources.

In addition, it is generally more difficult to evaluate the loan applications of firms which employ unfamiliar technologies than for loan applications from more conventional firms. Although larger lending institutions may specialize in lending to certain industries to lower their administrative costs, the market for small business loans is generally served by smaller local banks which are unable to do so.

Because of the risk and administrative costs associated with lending to small businesses in

the alternative energy industry, it was felt that many of these firms would be unable to obtain financing without government assistance. Chapter 819 established SAFE-BIDCO to address these financing difficulties by providing loans to firms whose applications for financing assistance have been rejected by at least one commercial bank. It was hoped that the SAFE-BIDCO staff's expertise in the alternative energy industry would serve to minimize the administrative costs of the loan review process. ❖

Chapter II

Chapter II

Organization, Funding And Operation Of SAFE-BIDCO

This chapter reviews the organizational structure, funding history and lending procedures which are established in statute for SAFE-BIDCO. In addition, this chapter discusses the interaction between SAFE-BIDCO and federal small business loan guarantee programs.

Organization

In 1975, the Legislature authorized the establishment of business and industrial development corporations (BIDCOs) for the purpose of serving the financing needs of small businesses. BIDCOs are nondepository financial institutions licensed and regulated by the State Banking Department. BIDCOs may be either public or private, and nonprofit or profit-making. They differ from commercial banks by their inability to accept deposits and their ability to make equity investments. (The statutory restrictions on SAFE-BIDCO's funding source, however, effectively precludes it from making equity investments.)

SAFE-BIDCO is a state-owned nonprofit corporation. It is the only publicly-owned BIDCO of the six BIDCOs licensed to operate in California. Because SAFE-BIDCO does not have a fiduciary responsibility to depositors, it has more flexibility to make loans available to small businesses which would not be served by commercial banks.

SAFE-BIDCO is administered by a president who is appointed by a board of directors. The board of directors is responsible for setting financial and administrative policy, and consists of seven members: the Secretary of the Business, Transportation and Housing Agency; a member of the California Energy Commission; and five public members, two appointed by the Legislature and three appointed by the Governor. SAFE-BIDCO currently has four staff who administer the program.

Funding

Chapter 819 appropriated $750,000 from the Energy Resources Conservation and Development Reserve Account in the General Fund to SAFE-BIDCO on a one-time basis to fund the costs of its start-up operations. In addition, the legislation created the State Energy Loan Fund (SELF) to provide a continuously appropriated "line of credit" for SAFE-BIDCO to use for loans. The Legislature provided the SELF with $2.5 million for loans; $1.5 million from the General Fund and $1 million from the Energy Resources Program Account within the General Fund. Chapter 819 directed SAFE-BIDCO to borrow from the SELF at a 6 percent annual interest rate and lend these funds to qualifying small businesses at higher market interest rates. The Legislature authorized SAFE-BIDCO to pay its administrative costs through the use of the income produced by the interest rate differential between its borrowed and loaned funds (that is, the interest "spread").

As discussed in Chapter I, SAFE-BIDCO is under contract with OPR/CEES to develop and administer a federally-funded low-interest loan program for small business energy conservation projects. The contract authorizes SAFE-BIDCO to spend up to $250,000 of the $3 million in the Energy Efficiency Improvements Loan Fund to support the costs of developing and administering this program.

The SAFE-BIDCO Loan Review Process

Chapter 819 specified the procedures that SAFE-BIDCO is to follow when making loans to small businesses involved in the alternative energy industry. The loan applicant must qualify as a small business under the size standards used by the Federal Small Business Administration (for manufacturing firms, the maximum number of employees may range from 500 to 1,500, depending on the industry). In addition, the applicant's credit-worthiness is evaluated according to the traditional lending criteria of experience, cash flow, collateral, and future business prospects. The applicant also must demonstrate that the alternative energy system it manufactures meets or exceeds standards of quality and performance prevailing in the industry or established by government regulation. Applicants intending to purchase an alternative energy system must demonstrate that the system will result in a net reduction of conventional fuel consumption. In practice, SAFE-BIDCO relies on staff at the California Energy Commission (CEC) to evaluate the technologies used in the alternative energy equipment which the loan applicants wish to manufacture or purchase.

SAFE-BIDCO has developed separate lending procedures for its minority-owned business lending and export financing activities. However, SAFE-BIDCO has approved only a small number of these loans to date. (SAFE-BIDCO's progress in these areas is reviewed in Chapter III.)

Leveraging Funds Through the SBA Loan Guarantee Programs

SAFE-BIDCO will not grant final approval to a loan application unless it can secure a guarantee for the loan through a federal or state loan guarantee program. Government agencies which guarantee loans agree to reimburse the lender (in this case, SAFE-BIDCO) in the event that the borrower defaults on a loan.

The largest loan guarantee programs are operated by the federal Small Business Administration (SBA). The SBA guaranteed $572 million in small business loans in its Western Region (California, Nevada, Arizona and Hawaii) during federal fiscal year 1988--approximately 80 percent of these loans ($458 million) occurred in California. The SBA will guarantee up to 90 percent of a qualifying small business loan made by a private lender or government agency, up to a maximum amount of $750,000 per loan. (Congress recently authorized guarantees of up to $1.2 million for export financing loans.) The loans may be obtained for equipment, working capital, inventory, real estate, and other business purposes.

The term on SBA guarantee loans ranges from at least one year up to a maximum of 25 years for the purchase or major renovation of business premises. Interest rates in the guarantee program are negotiated between the borrower and the lender, subject to SBA maximums. Generally, interest rates cannot exceed: (1) 2-1/4 percent over the New York prime rate for loans with maturities of less than seven years, and (2) 2-3/4 percent over the New York prime rate for loans with maturities of seven years or more.

Through the SBA loan guarantee programs, SAFE-BIDCO is able to "leverage" (that is, increase) its available funding. SAFE-BIDCO can leverage its funds by selling the guaranteed portion of its loans to investors, such as banks, pension funds, money market funds, credit unions and other private investors. The receipts from these sales are used to finance new loans, which in turn can be leveraged again. In theory, SAFE-BIDCO could leverage its $2.5 million line of credit from the SELF into a loan portfolio of more than $20 million. (SAFE-BIDCO's actual performance in this regard is discussed in the next chapter.)

SBA guaranteed loans are attractive investments to investors because they: (1) are backed by the United States Government, as in the case of U.S. Treasury Notes, and (2) offer a variable interest rate. In the event of a loan default, the SBA immediately pays off investors and then undertakes liquidation of the loan. ❖

Chapter III

Chapter III

Evaluation of SAFE-BIDCO's Performance

This chapter evaluates SAFE-BIDCO's performance in achieving its statutory objectives. This chapter first discusses the standards which are used to measure SAFE-BIDCO's performance. Second, the chapter examines data relevant to assessing SAFE-BIDCO's performance. Finally, the factors affecting SAFE-BIDCO's performance are discussed.

Performance Standards

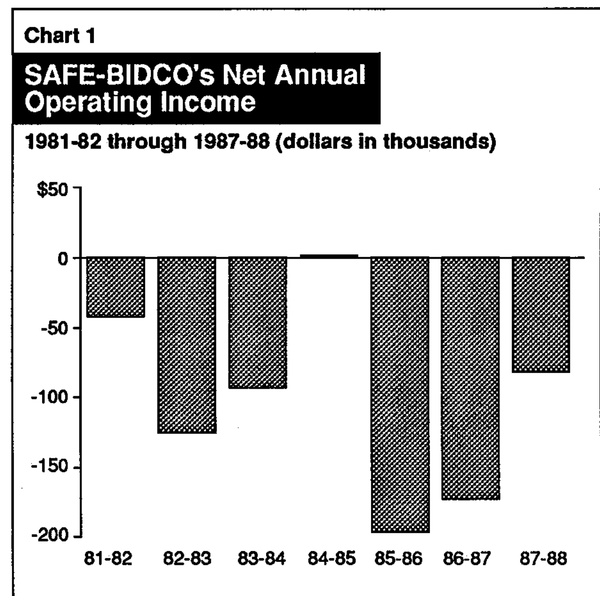
Our analysis identifies two standards for measuring SAFE-BIDCO's performance. The first standard, established by Ch 819/80, is that SAFE-BIDCO be financially self-sufficient. In other words, its annual operating costs are to be completely financed by the spread between the 6 percent interest it pays on the funds that it borrows and the interest it earns on the funds it loans to small businesses. The second standard established by SAFE-BIDCO's board of directors, is that SAFE-BIDCO should achieve a loan volume in excess of $20 million by leveraging its funds through federal and state loan guarantee programs.

We assessed SAFE-BIDCO's progress in achieving the goals of self-sufficiency and a leveraged loan portfolio by reviewing the corporation's financial statements and related documents for the period 1981-82 through 1987-88. These documents also provided other useful information for measuring SAFE-BIDCO's performance, such as the annual number of loans approved each year and the dollar amount lost due to loan defaults.

Financial Self-Sufficiency

As mentioned above, Chapter 819 directed SAFE-BIDCO to support its administrative costs from the interest spread between its borrowed and loaned funds. In addition to this interest spread, SAFE-BIDCO also earns income from interest on funds which are not currently loaned out, as well as fees for originating and servicing loans. From these revenues, SAFE-BIDCO must cover the following expenses: (1) administrative costs, such as salaries and overhead; (2) interest payments on funds borrowed from the SELF; and (3) provisions for loan losses. Chart 1 displays SAFE-BIDCO's annual net operating incomes (income less expenses) for the period 1981-82 through 1987-88.

Chart 1 shows that SAFE-BIDCO's expenses have exceeded its income in six of the seven years; only in 1984-85 did SAFE-BIDCO's income exceed expenses when it essentially broke even, earning a profit of $1,172. The annual operating deficit peaked in 1985-86 at $197,000. SAFE-BIDCO was able to substantially reduce its operating deficit in 1987-88 from the previous year, primarily because of its contract with OPR/CEES to develop and administer a low-interest loan program for small business energy conservation projects. This contract employed staff resources during a period of otherwise slack demand for SAFE-BIDCO loans, helping to reduce the operating deficit during 1987-88.



Interest Forgiveness in 1988 Budget Act. Despite the OPR/CEES contract, SAFE-BIDCO still incurred an operating deficit of $82,000 in 1987-88. Traditionally, SAFE-BIDCO has funded its operating deficits by drawing down funds from the original $750,000 appropriation provided in Ch 819/80. By the end of 1987-88, however, the cumulative total of SAFE-BIDCO's annual operating deficits had reached $712,242, virtually depleting the original $750,000 appropriation.

In order to provide SAFE-BIDCO with sufficient funds to cover its operating expenses in 1988-89, the Legislature forgave SAFE-BIDCO's annual interest payment owed on funds borrowed from the SELF.

Lending Volume

Chart 2 displays SAFE-BIDCO's lending volume for the period 1982-83 through 1987-88. (Although program operation began in 1981-82, no loans were actually approved until 1982-83.)

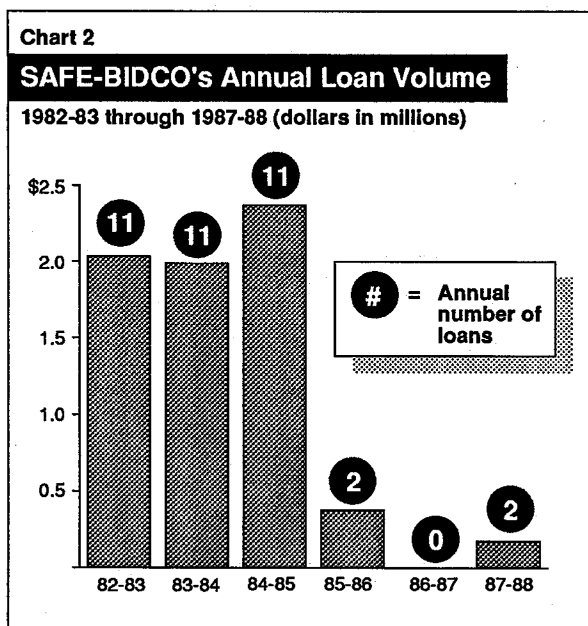


Chart 2 illustrates that SAFE-BIDCO: (1) has not leveraged its state funding into a $20 million loan portfolio and (2) has experienced a sharp decline in loan activity in recent years. SAFE-BIDCO approved 37 loans totaling $6.9 million between 1982-83 and 1987-88. However, the bulk of these loans--33 of the 37--were approved during the three-year period between 1982-83 and 1984-85. Only four loans were approved during the three-year period between 1985-86 and 1987-88.

Of the 37 loans, 36 were made to firms involved in either the manufacture or purchase of alternative energy equipment. One loan was made to a minority-owned fence contracting business.

Loan Defaults. As discussed in Chapter II, SAFE-BIDCO's risk or "exposure" on its loan portfolio is limited by loan guarantees secured through federal and state programs. Of the 37 loans approved between 1982-83 and 1987-88, 35 were guaranteed by the federal SBA and two were guaranteed through the state Department of Commerce's Regional Development Corporations. The average loan guarantee was for 88 percent of the amount loaned.

Because most of SAFE-BIDCO's loans are still outstanding, the actual losses on its loan portfolio will not be known for several years. To date, however, SAFE-BIDCO has recognized losses totaling $121,000 in loan defaults (representing the unguaranteed portion of the defaulted loans). This translates into over $1 million in losses for the SBA.

Recent Activity. Chart 2 does not show that SAFE-BIDCO has entered into commitments to fund four additional loans during 1988-89: two for minority-owned businesses; one for export financing; and one for a manufacturer of alternative energy equipment. In addition, SAFE-BIDCO has developed regulations and is beginning the process of reviewing loans for its PVEA energy conservation low-interest loan program in 1988-89.

Factors Affecting the Decline in Loan Activity

Our analysis indicates that four factors are responsible to varying degrees for the decline in loan activity experienced after 1984-85. These factors are discussed below.

Falling Conventional Fuel Prices. The demand for SAFE-BIDCO alternative energy loans is obviously linked to the health of the alternative energy industry. For households and businesses, the conversion to alternative energy fuels imposes capital costs which become less attractive when conventional fuels are plentiful and cheap. The decline in worldwide oil prices during the 1980s reduced the level of demand for alternative energy equipment, and consequently the demand for SAFE-BIDCO loans.

Elimination of Alternative Energy Tax Credits. Both the federal and state governments instituted several tax credits for the purchase of alternative energy equipment during the 1970s and the early 1980s. Many of these credits were subsequently repealed by the 1986 federal Tax Reform Act (TRA) and conforming state legislation. Specifically,

- The TRA repealed the Investment Tax Credit, which allowed a 10 percent credit for certain capital investments plus an additional 15 percent if the investment qualified as Business Energy Property.
- The state repealed its Energy Conservation Tax Credit at the end of 1986.
- The state repealed its Solar Tax Credit for residential property and narrowed the credit to exclude wind energy investments for commercial property at the end of 1986.
- The state will repeal its Solar Tax Credit for commercial property effective at the end of 1989.

The repeal of these tax credits has in effect increased the cost of alternative energy equipment; thereby reducing the demand for alternative energy investments which can be funded with SAFE-BIDCO loans.

Increased Private-Sector Participation in the SBA Loan Guarantee Programs. At the time SAFE-BIDCO was established, many banks did not participate in the federal SBA loan guarantee program because the costs of complying with the SBA regulations were perceived as being too high. Subsequently, the SBA streamlined its regulations in an ef-

fort to increase private sector participation in the loan guarantee programs.

Private sector participation also increased because the federal and state government deregulated certain banking activities. In general, deregulation has increased competition for depositors among banks and allowed nonbank corporations to establish financial services subsidiaries. As a result of the increased competition in the industry, some banks and nonbank lenders have begun to specialize in the SBA loan guarantee market in order to carve out a profitable lending niche.

The increased participation of private lenders in the SBA loan guarantee market has placed SAFE-BIDCO, as well as the state's other five BIDCOs, at a competitive disadvantage. This is because the banks that specialize in the SBA market have an established relationship with their own depositors, who serve as a "natural" client base as applicants for loans. In addition, the nondepository private financial institutions which specialize in the SBA market generally can afford to advertise to attract loan applicants. By contrast, SAFE-BIDCO faces the challenge of marketing its services without the advantages of a client base of depositors or advertising funds to attract borrowers. In addition, both the bank and nonbank lenders have larger staffs than SAFE-BIDCO (which has only four staff) and consequently, can offer superior servicing on the loans.

Staff Turnover. Finally, the SAFE-BIDCO staff experienced significant staff turnover during 1986-87 and 1987-88. SAFE-BIDCO's President/CEO resigned in August 1986 and was replaced by an interim president until October 1987, when the current President/CEO was appointed. In addition, the Treasurer/Chief Financial Officer position was vacant between July 1986 and February 1987. These disruptions to SAFE-BIDCO's staff coincide with the decline in SAFE-BIDCO's loan activity. The staff has stabilized in the past year and the loan activity appears to be increasing somewhat in 1988-89.

In summary, SAFE-BIDCO has not been successful in achieving the goals of financial self-sufficiency and a leveraged loan portfolio. In fact, SAFE-BIDCO has experienced a sharp decline in its loan activity in recent years. Our analysis identifies four reasons for the decline in loan activity: falling conventional fuel prices; the elimination of certain federal and state tax credits; increased private sector participation in the SBA loan guarantee programs; and staff turnover at SAFE-BIDCO.

Should the SAFE-BIDCO Program Be Continued?

The evidence presented above suggests that the business prospects for the alternative energy industry are not as promising as they were at the time SAFE-BIDCO was established. Obviously, the factors contributing to the decline of this industry--the fall in conventional fuel prices and the repeal of alternative energy tax credits--were beyond the control of SAFE-BIDCO. Nonetheless, the fact that it is no longer profitable for most small businesses to either manufacture or purchase alternative energy equipment has served to restrict demand for SAFE-BIDCO's alternative energy loans (as evidenced by the decline in SAFE-BIDCO's loan activity in recent years).

SAFE-BIDCO has responded to the decline in demand for alternative energy loans by redirecting its focus towards the minority-

owned business and export financing areas. As mentioned earlier in this chapter, SAFE-BIDCO has entered into commitments to fund four additional loans in 1988-89: two for minority-owned small businesses; one for export financing; and only one for a manufacturer of alternative energy equipment. In our judgment, the primary purpose of SAFE-BIDCO at this point in time is to provide loans to the minority-owned small business and small business exporter communities; thus, at present, it is an "energy" program in name only.

However, our analysis indicates that the present SAFE-BIDCO program does not offer a cost-effective means for the Legislature to provide financing assistance to the minority-owned small business and small business exporter communities. Our reasons for reaching this conclusion are discussed below.

SAFE-BIDCO is Duplicative of Other State Programs

Public policies are pursued most efficiently when administrative costs are minimized. Obviously, it does not make sense to have two programs--with two sets of administrative overhead--each pursuing the same policy goal. As discussed above, the primary focus of SAFE-BIDCO today is to provide financing assistance to the minority-owned small business and small business exporter communities. However, the state has already established loan guarantee programs to serve the financing needs of these constituencies. For example, the state Department of Commerce's six Regional Development Corporations (RDCs) use approximately $33 million in state funds to guarantee small business loans. About one-half of the loan guarantee funds are geared toward minority-owned small businesses. In addition, the World Trade Commission, through its California Export Finance Program (CEFP), guarantees export financing loans for the small business community through a continuously appropriated $3 million fund. Our analysis indicates that SAFE-BIDCO is now pursuing the same goals as these other programs, resulting in duplicative administrative costs. If the Legislature wishes to devote SAFE-BIDCO's funds to the financing needs of minority-owned small businesses and small business exporters, we recommend that it consider expanding its established loan guarantee programs. (This point is discussed more fully in the following chapter.)

SAFE-BIDCO's Direct Lending Approach Is Not A Cost-Effective Form of Assistance

In theory, SAFE-BIDCO's direct lending approach could be as cost-effective as a loan guarantee program if it effectively leveraged its funding through the SBA loan guarantee programs. In practice, however, SAFE-BIDCO's lending history indicates that it simply has not been able to successfully compete against private lenders in the SBA loan guarantee market in order to leverage its funds. Moreover, we have no analytical basis for believing that SAFE-BIDCO's performance in this area will improve in the future: the SBA loan guarantee market is becoming increasingly competitive, and the SAFE-BIDCO staff has little experience in serving the minority-owned small business and small business exporter communities.

Our analysis indicates that SAFE-BIDCO is unlikely to effectively leverage its funding, and thus, existing loan guarantee programs (like the RDCs and CEFP) offer a more cost-effective means of providing financing assistance to minority-owned small businesses and exporters. Such loan guarantee programs can support a greater volume of loans, with a given level of funding, than can a direct lending program that is not leveraged.

SAFE-BIDCO Cannot Effectively Service Its Loans

Based upon our discussions with the SBA and private lenders, it appears that a regional or branch approach is desirable in the lending business. This is because it allows the lender to be more aware of local business conditions and to monitor the borrower more closely. The servicing component of lending is even more vital when the lender specializes in "high risk" loans, as in the case of SAFE-BIDCO. Although Ch 819/80 requires SAFE-BIDCO to provide management and technical assistance to its clients, SAFE-BIDCO's efforts in this area have long been hampered by its central location in Sacramento and its limited staff.

SAFE-BIDCO Cannot Effectively Market Its Services

One of the challenges faced by small government programs is to make the public aware of their existence. As mentioned above, SAFE-BIDCO does not have the advantage of a "natural" client base, like commercial banks, nor does it have the resources to advertise in the same manner as private nondepository lenders. Consequently, SAFE-BIDCO's poor lending history reflects not only a lack of demand for its services, but also lack of public awareness of SAFE-BIDCO's existence.

Conclusions and Recommendation

SAFE-BIDCO's recent lending history suggests that the demand for its alternative energy loans is not sufficient to warrant the continuation of the program. Although SAFE-BIDCO has begun to change its focus away from the alternative energy industry and toward minority-owned small business and small business exporters, our analysis indicates that SAFE-BIDCO's efforts are duplicative of other state programs and its direct lending approach is not a cost-effective means of serving the financing needs of these groups. If SAFE-BIDCO is continued in its present form, it is likely to continue running annual operating deficits in the future, which will require additional infusions of General Fund resources, without providing any substantial benefit. Therefore, ***we recommend that the Legislature enact legislation to eliminate SAFE-BIDCO and revert its funding to the General Fund.***

The next chapter discusses options available to the Legislature to handle SAFE-BIDCO's existing loan portfolio and to use its resources in a more cost-effective manner in the future.

Chapter IV

Chapter IV
Legislative Options For Using SAFE-BIDCO's Resources

This chapter discusses the Legislature's options with regard to using SAFE-BIDCO's resources in the event the program is terminated. We first discuss options available to the Legislature for handling (1) SAFE-BIDCO's existing loan portfolio, and (2) the PVEA low-interest loan program. We then discuss options available to the Legislature for providing financing assistance to minority-owned small business and small business exporters.

If the Legislature enacts legislation to eliminate SAFE-BIDCO, it could redirect the funds made available by this action to various programs. The elimination of SAFE-BIDCO would make available approximately $3.3 million in assets for other purposes. About two-thirds of these assets are in the form of cash and temporary investments, which could be redirected to other programs immediately. The other one-third of the SAFE-BIDCO's assets consist of loans receivable, which are loan repayments owed to SAFE-BIDCO by borrowers. Since the loans receivable are obligations which are owed to SAFE-BIDCO in the future, they are less liquid than the cash and temporary investments.

Existing Loan Portfolio and PVEA Low-Interest Loan Program

If SAFE-BIDCO is eliminated, the Legislature would have two options available for administering the outstanding loan obligations owed to SAFE-BIDCO. First, the Legislature could transfer SAFE-BIDCO's loan receivable accounts to the Department of Commerce or the California Energy Commission, each of which runs small business loan programs and would be capable of servicing SAFE-BIDCO's outstanding loans. The other option available to the Legislature would be to sell SAFE-BIDCO's loans receivable, to a private lender who would service the outstanding loan obligations itself. The question of which option is preferable would depend on the price the Legislature could obtain for the portfolio.

The PVEA low-interest loan program presently being operated by SAFE-BIDCO could be transferred to either the Energy Commission or the Department of Commerce, each of which is currently developing similar programs with PVEA funds.

Minority-Owned Small Business and Export Financing Loans

To pursue the policy objectives established by the Legislature for SAFE-BIDCO in 1986 (that is, loans to minority-owned small businesses and small business export financing), the Legislature may wish to transfer some portion of SAFE-BIDCO's funds to the Department of Commerce's Regional Development Corporations (RDCs) and the World Trade Commission's California Export Financing Program (CEFP). By transferring resources to these programs, the Legislature could pursue its policy objectives without the duplicative administrative costs of SAFE-BIDCO, and thus allow more of the funds to actually benefit the target groups. In addition, these loan guarantee programs appear to offer a more cost-effective approach to achieving the Legislature's policy objectives than SAFE-BIDCO's direct lending approach. The following section discusses how these programs operate in greater detail.

The Department of Commerce's Regional Development Corporations

In order to provide additional financing assistance to minority-owned small businesses in a more cost-effective manner than provided by SAFE-BIDCO, the Legislature could transfer some portion of the SELF to the Department of Commerce's RDCs. Although this program has experienced management difficulties in the past, such as inadequate accounting controls and conflicts of interest in lending practices, the Office of Small Business within the Department of Commerce has recently taken steps to increase its oversight of the program.

There are six RDCs located throughout the state using state funds to guarantee loans made by banks or other financial institutions to small businesses for a wide variety of purposes. The program guarantees up to 90 percent of a loan with a maximum guarantee amount of $350,000. Although the RDCs are not required by statute to devote a specified portion of their funds to minority-owned small businesses, in practice, about one-half of the RDCs' guarantee funds are dedicated to minority-owned small businesses. The remainder of the guarantee funds are available to small businesses without restriction. The regional approach allows the RDCs to acquaint themselves with local economic conditions and to be responsive to the local business community.

The consolidation of the SELF with the RDC program could take one of two forms. First, the funds in the SELF could be apportioned among the six existing RDCs. As mentioned above, the RDCs collectively have about $33 million in their reserve accounts which they use to guarantee loans. A second option would be to create a seventh RDC in a region not presently served by the program, such as San Diego or the North Coast. In general, new RDCs maintain about $3 million in their reserve accounts to guarantee loans, which is the approximate amount remaining in the SELF.

The World Trade Commission's California Export Finance Program

In order to make additional export financing funds available to small businesses in a more cost-effective manner than provided by SAFE-BIDCO, the Legislature could transfer some portion of the SELF to the World Trade Commission's California Export Finance Program (CEFP). This program guarantees up to 85 percent of the amount of private export financing loans to small businesses. The maximum guarantee amount is $350,000 for a period of up to 360 days. These loans are for short time periods because they are intended to

smooth out the cash flow difficulties involved with manufacturing for export, rather than to finance facilities or equipment acquisition costs. The CEFP guarantees are backed by $3 million which is continuously appropriated from the Export Finance Fund (EFF). The EFF must maintain a reserve equal to 25 percent of the outstanding loan guarantees. The 25 percent reserve requirement on CEFP loan guarantees, as well as the short-term nature of these loans, allows the CEFP to effectively leverage its modest resources. Since its inception in 1985, the CEFP has guaranteed 107 loans for a total of $21 million.

The CEFP is pursuing a regional approach to the greatest extent possible. For example, the Export Finance Office has regional offices in Los Angeles and San Francisco, and "satellite" offices are maintained throughout the state. The regional approach offers accessibility to small businesses located in the vicinity of the state's largest business centers, and the satellite offices can identify additional clients throughout the state.

Summary

If the Legislature wishes to devote SAFE-BIDCO's resources to the financing needs of minority-owned small businesses and small business exporters, we recommend that it consider transferring some portion of the funds in the SELF to the Department of Commerce's RDCs and the World Trade Commission's CEFP. By transferring funds to these programs, the Legislature would pursue its policy objectives without duplicative administrative costs, and thus allow more of the funds to actually benefit the target groups. In addition, these loan guarantee programs appear to offer a more cost-effective approach to achieving the Legislature's policy objectives than SAFE-BIDCO's direct lending approach.

In our view, however, before any funds are transferred to these programs, we recommend that the Department of Commerce (DOC) and the World Trade Commission (WTC) demonstrate the need for additional funding to the Legislature during the budget process. Specifically, the DOC and WTC should demonstrate that an unmet demand exists for their services. ◆

Appendix

Appendix

Supplemental Report of the 1988 Budget Act

Item 3300-001-021--SAFE-BIDCO

Evaluation of Program. Not later than January 1, 1989, the Legislative Analyst's Office shall prepare and submit to the appropriate fiscal subcommittees of the Senate and Assembly a review of the State Assistance Fund for Energy, Business and Industrial Development Corporation (SAFE-BIDCO).

The review shall include an assessment of the corporation's success in meeting its original statutory goals, the cost-effectiveness to the state of providing financial assistance to small businesses through access to federal loan guarantees compared to other forms of state assistance, and the alternatives to the current structure and scope of the corporation, its lending activities, and its relationship to other state small business programs. The Analyst shall provide recommendations with regard to possible consolidation and revision of SAFE-BIDCO and other energy and small business assistance programs, in consideration of available fiscal resources and small business financing needs. ♦