Approved February 16, 1989
Date

MINUTES OF THE HOUSE COMMITTEE ON ECONOMIC DEVELOPMENT.

The meeting was called to order by Elizabeth Baker at
Chairperson

3:40 xxxx./p.m. on Thursday, February 9, 1989 in room 423-S of the Capitol.

All members were present except: Representatives Goossen, Weimer and Mead. Excused.

Committee staff present:
Jim Wilson, Revisor
Lynne Holt, Research
Elaine Johnson, Secretary

Conferees appearing before the committee:
Allen Bell, President of Kansas Development Finance Authority
Jeff Rockett, Kansas Association for Small Business
Dr. Charles Krider, Director of Business Research for the Institute for Public Polity and Business Research, University of Kansas

The meeting was called to order by Chairman Baker at 3:40 p.m. Lynne Holt was recognized.

Ms. Holt gave the committee a briefing on H.B. 2020. (Attachment l).

Allen Bell, President of Kansas Development Finance Authority was the first conferee. Mr. Bell testified in support of H.B. 2020. Mr. Bell feels there are two key features to this financing structure that derserve attention, l) the Loan Guarantee Fund and 2) the Participating Lenders. (Attachment 2). Mr. Bell also felt that the meaning of "Eligible Kansas basic enterprise" should be changed. He also recommended that the wording in line 116 (4) be changed to read "which is not eligible."

Mr. Bell responded to questions from the committee.

Jeff Rockett on the behalf of the Kansas Association for Small Business was the next conferee to testify in support of H.B. 2020. Mr. Rockett testified that manufacturing technology is changing and shops must invest in new computerized manufacturing equipment. Access to both working and collateralized capital is a problem for some of the parts manufacturers. The program outlined in H.B. 2020 provides a source for financial assistance for firms where more traditional forms of financing are unavailable. Small business would find the Kansas basic enterprise loan program a viable alternative and a welcome addition. (Attachment 3).

Dr. Charles Krider, Director of Business Research for the Institute for Public Policy and Business Research, University of Kansas was the last conferee to testify in support of H.B. 2020. Dr. Krider feels that H.B. 2020 provides for direct loans from the state for Kansas Basic Enterprises and supports the definition of Kansas Basic Enterprises. He supports this program aimed at the financing of such small businesses, but believes that consideration should be given to adding loan guarantee authority to the program, allowing the Finance Authority to offer either direct loans or guarantees as appropriate. Dr. Krider stated that if the loan guarantee were not added he would still give his full support to this bill. (Attachment 4).

This closed the hearing on H.B. 2020. No action was taken. The committee will meet on Tuesday, February 14, 1989 for possible action on the bill.

The meeting adjourned at 4:26 p.m.

Elizabeth Baker

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GUEST REGISTEF

HOUSE

Committee on Economic Development

NAME	ORGANIZATION	ADDRESS
Roger Nelson	IPPBR	Lawrence
Todd Rockett	Ks. Assoc. for Small Business	Topeka
Jack Montgomery	KDOC	Topeka
Lozanna Honeycutt	Sedgwick County	Wichita
Arnie Samuelson	R-1	Newton Ks
Ole Gee	KDFA	Topeka
Ann Patterson	KDOC	Topeka
Bud Means	KDOC	Topeka
Jay Frost	City of Topeka →	
Charles Warren	KS Inc	Topeka
Wayne Zimmerman	KDOC	Topeka
Dr. Charles Krider	IPPBR	Lawrence

Staff Brief on H.B. 2020

This bill is an outgrowth of a study which was undertaken by the Joint Committee on Economic Development during the 1987 interim. In its report to the 1988 Legislature, the Joint Committee recommended the establishment of a small business loan guarantee program. The Committee observed that such a program would be preferable to a direct loan program in that it would be less risky for the state and would also increase the state's leveraging capacity. The 1988 Legislature enacted 1988 H.B. 2909 which would have authorized the Kansas Development Finance Authority to develop and implement the Kansas Basic Enterprises Loan Program and to issue bonds for financing of those loans. This bill was vetoed by the Governor as it contained provisions from another bill incorporated into the loan guarantee bill in Conference Committee. The veto message essentially took issue with certain provisions of that other bill. The 1988 Joint Committee on Economic Development revisited this topic and a copy of the Committee report has been distributed to each of you. The 1988 Joint Committee recommended the introduction of legislation to establish a small business loan guarantee program with similar provisions to the program included in H.B. 2909. Hence this bill!

What does H.B. 2020 do? This bill authorizes the Kansas Development Finance Authority to develop and implement this program and issue bonds to finance the loans. For the information of new members, the Kansas Development Finance Authority was created by statute in 1987 as a self-financing instrumentality of the state to issue bonds primarily for state agencies but also for municipalities, on a pooled basis, and for small businesses. The "meat" of the bill is (f)1 on p. 7. The Authority enters into an agreement with financial institutions which qualify, originate program loans, and service the loans. A participating financial institution acts as an agent for the Authority and receives a fee for its services. The minimum amount of the loan is $20,000 and the maximum amount is $200,000. Each loan has to be matched by a subordinated loan from a participating financial institution, in an amount of not less than 15 percent of the amount of the program loan. The loan recipient would contribute equity capital equalling at least 10 percent. The Authority could pledge moneys in security for bonds issued to finance program loans but its commitment cannot exceed 75 percent of total project cost. One provision apparently added to the bill which was not included in 1988 H.B. 2909 is an explanation beginning on line 267 of the authorized uses of the loans--in particular that they may be used for working capital.

The businesses eligible for a loan must meet the definition of "Kansas basic enterprise" on p. 3. In many ways this definition resembles the one that the Committee considered in the enterprise zone bill. There are, however, two additional qualifications. A business must have had gross revenues in its most recently completed year of not more than

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$1.5 million and must have been ineligible for a loan or loan guarantee from the Small Business Administration or the Farmers Home Administration, other than as part of a packaged loan arrangement from one or both of the federal agencies, for the same project for which an application has been made under the program in this bill.

A special fund would be created in the state treasury. Moneys credited to the fund would be used for purposes of pledging security for bonds issued to finance program loans. All expenditures from this fund would be subject to appropriations. The 1988 Legislature authorized EDIF expenditures of $500,000 for use by the Authority to implement the program. However, the Governor recommends deletion of these expenditures as the bill which would have established the program had been vetoed.

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TOPIC VI*

The Committee continued to evaluate the need for a financial assistance program for small businesses.

Major Issues and Background

The policy questions underlying this topic are the following:

1. Should the state provide financial assistance to small contractors and small businesses?

2. If it is determined that the state should provide such assistance, what mechanism should be used to provide that assistance?

The Joint Committee on Economic Development initiated its study on this topic during the 1987 interim. In its report to the 1988 Legislature, the Joint Committee recommended the establishment of a small business loan guarantee program. The Committee observed that such a program would be preferable to a direct loan program in that it would be less risky for the state and would also increase the state's leveraging capacity. The 1988 Legislature enacted 1988 H.B. 2909 which was vetoed by the Governor. This bill would have authorized the Kansas Development Finance Authority to develop and implement the Kansas Basic Enterprises Loan program and to issue bonds for financing of those loans. In addition, this bill would have required that all loans be made to eligible Kansas basic enterprises, defined in the bill, and that each loan be qualified, entered into, and serviced by a financial institution acting as an agent of the Authority and receiving a fee for services rendered. Other specifications included the following: (1) each loan would be for a minimum of $20,000 and not more than $200,000; (2) each loan had to be matched by a subordinated loan from a participating financial institution, in an amount of not less than 15 percent of the amount of the program loan; (3) the recipient basic enterprise would have to contribute equity capital equalling at least 10 percent of the total project cost; and (4) the Authority could pledge moneys in security for bonds issued to finance program loans but its commitment could not exceed 75 percent of the total project cost.

The bill would have established a Kansas Basic Enterprises Loan Guarantee Fund with a provision that moneys credited to that Fund be pledged by the Authority for bonds issued to finance program loans. The 1988 Legislature authorized FY 1989 expenditures of $500,000 from the Economic Development Initiatives Fund (EDIF) for use by the Kansas Development Finance Authority in implementing this program.

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*H.B. 2020 accompanies this report.

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Committee Activities

During the 1988 interim, the Committee heard a proposal from the Executive Director of the South Central Kansas Economic Development District (SCKEDD) to establish a rural industry placement program. The concept underlying this proposal has been endorsed by the Kansas Association of Certified Development Companies. According to the Executive Director, the intent of the proposal is to strategically place industry in rural areas of Kansas by assisting businesses with industrial equipment investments. The Committee learned that annual investments of $2 million in highly specialized equipment would be required. The proposal provides that either the state hold title to the equipment or that it be held by a local development group which, in turn, could lease the equipment directly to the business. A designated state entity would make investments with gaming funds for five years, after which time the program would become self-sustaining due to repayments on the principal and interest by businesses for the leased equipment. The proposal also specifies that state universities would evaluate the equipment and that a portion of the interest on the leased equipment would eventually defray expenses associated with such evaluations.

Dr. Charles Krider, Institute for Public Policy and Business Research (IPPBR), the University of Kansas, noted that the SCKEDD proposal had merit and offered certain suggestions for drafting legislation to establish such a program. Among the suggestions offered were the following: the program should be based on loan guarantees; preference should be given to small Kansas businesses; a one-time commitment fee of 1/2 percent of the guaranteed amount could be assessed upon acceptance of the guarantee by the applicant to cover administrative costs; and the plan should be implemented under the Kansas Development Finance Authority with moneys coming from funds set aside from the EDIF pool.

In response to a Committee request, Dr. Krider reported on research conducted by IPPBR concerning operating loan guarantee or insurance programs in the states of Connecticut, Maine, Indiana, Maryland, Missouri, New Hampshire, and Vermont. In his report, Dr. Krider cited the example of a loan guarantee program in Maine which provided guarantees for 71 small business loans in FY 1987 and generated over $7 million in lending activity with the guaranteed portion exceeding $5.2 million. Program loans from the Small Business Loan Insurance Program were apportioned as follows: 45 percent for equipment; 45 percent for buildings; and 10 percent for technology transfer projects. The Committee was informed that defaults accounted for less than 2 percent annually of all loans and that an additional 3 percent of all loans were considered problems, although not yet defaults. The Committee also learned that the Finance Authority of Maine was satisfied with the performance of the Small Business Loan Insurance Program and other financial assistance programs; however, the introduction of tax exempt bonds in December, 1986 has resulted in a reduction of guaranteed loans.

Dr. Krider's report concluded that the general consensus among states with loan guarantee programs seemed to be that such programs can be very successful and can operate at reasonably low cost to the state if properly managed. An issue underscored for Committee consideration was that of targeting the program to a particular type of business or investment project. The report disclosed that targeting has been generally confined to factors of business size or location and not to type of expenditure (land and building, equipment, machinery).

In a report on the 1988 activities of the Kansas Development Finance Authority, the President of the Authority expressed concern about two aspects of 1988 H.B. 2909, related to the loan guarantee program.

1. Authorized program expenditures of $500,000 may be insufficient to attract underwriters; at a minimum, $1 million should be credited to the program fund in order to leverage a bond issue of at least $2 million.

2. The provision that program loans be confined to basic enterprises may restrict the number of companies that can borrow from the program, thus undermining the program's chances of success.

Committee Conclusions and Recommendations

The Committee notes that there appears to be a continued need for a state-supported loan guarantee program to assist small businesses with working capital and capital investment needs. The Committee also notes that H.B. 2909 which would have established a small business loan guarantee program was enacted by the 1988 Legislature but, due to other provisions contained in the bill, was vetoed by the Governor. In addition to demonstrated widespread legislative support for a loan guarantee program, a recommendation by the Governor's Task Force on the Future of Rural Communities (September, 1988) likewise endorses the establishment of such a program. Recognizing that small businesses, particularly in rural areas, may benefit from financial assistance, the Committee recommends introduction of legislation to establish a small business loan guarantee program with similar provisions to the program included in 1988 H.B. 2909, discussed above.

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MARTY BLOOMQUIST, ASSISTANT

February 9, 1989

M E M O R A N D U M

TO: Members of the House Committee on Economic Development

FROM: Allen Bell, President
Kansas Development Finance Authority

SUBJECT: Testimony in Support of House Bill 2020

House Bill 2020 calls for the implementation of a major economic development financing program by the Kansas Development Finance Authority. In fact, KDFA was created by the 1987 Legislature for just this purpose. We therefor support the general concept of HB 2020.

We believe that the bill would be improved if the definition of Kansas basic enterprises was amended so that any private sector job creating enterprise could qualify. It would then be left up to the KDFA Board of Directors to determine a criteria for the type of businesses that could participate in the program. This flexibility is needed to insure the success of the program. We believe that a minimum volume of loans is needed for this approach to succeed. With a narrow definition of the types of businesses that can participate, we may not be able to generate enough loan volume.

The attached flowchart is intended to show in simplified fashion how this type of "loan-to-lender" financing would work. It is modeled after single-family mortgage bond financing with which many of you are no doubt familiar.

There are two key features to this financing structure that deserve your attention:

1. **The Loan Guarantee Fund** is the essential feature in that without it bonds cannot be issued. The guarantee fund provides the needed credit enhancement that negates the diversity-of-credit problem that plagues all private sector pooled bond issues. The guarantee fund can be leveraged through a bond

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issue to produce a loan pool two or three times the size of the guarantee fund. The loan guarantee fund must contain at least one million dollars in order to attract bond underwriters to the program with at least a two million dollar bond issue.

2. **The Participating Lenders** are the key to making the loan program work administratively. KDFA is not a bank and does not want to become one. The basic lending decisions must be made by institutions whose business that is. That is why it is crucial that the participating lenders share the exposure to loan defaults. My opinion is that a 10% matching loan from participating lenders is an absolute minimum and that the bondholders may well require a more significant participation.

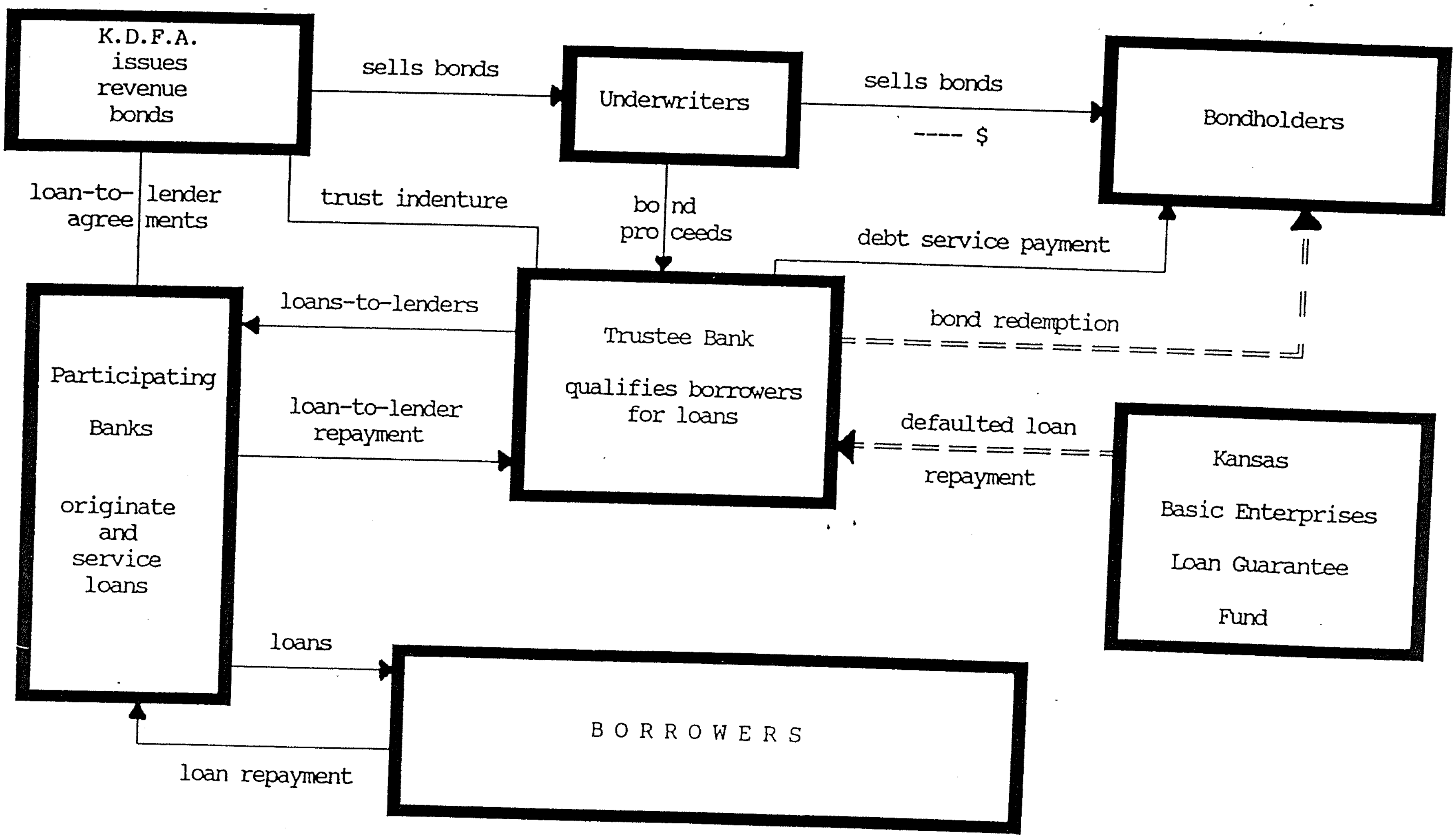
The cost of administering this program is another reason to use paricipating lenders. As an inherently self-financing operation, it is important to KDFA that each of the programs it undertakes pays for itself. KDFA could not expect to earn more than $15,000 on the issuance of bonds under this program, which is not enough to hire an additional staff person to administer it. The participating lenders and the trustee bank enjoy the economies of scale to make their administration of the program feasible.

The following table shows how interest rates and up-front points might be set:

<u>Borrower Rate</u>	
Index Rate (90-day T-Bill)	8.00%
Spread	+1.00%
Bond Rate	9.00%
Trustee Fee	.25%
Lender Service Fee	.50%
Total	9.75%
<u>Points</u>	
Underwriters Discount	1.50%
Cost of Issuance	1.00%
KDFA Fee	.50%
Total	3.00%

KANSAS BASIC ENTERPRISES LOAN PROGRAM

Preliminary Flow of Funds



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KASB

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TESTIMONY H.B. 2020
HOUSE ECONOMIC DEVELOPMENT COMMITTEE
February 9, 1989

Chairperson Baker, Members of the Committee, I am Jeff Rockett, representing the Kansas Association for Small Business, an organization of over 150 small businesses. The majority of these businesses are subcontract manufacturers for the aerospace, farm machinery, and electronics industries, thus coming under the definition of basic industries as defined in H.B. 2020.

I am testifying today in support of H.B. 2020.

Manufacturing technology is changing. To stay in business, even five to ten person shops must invest in new computerized manufacturing equipment. The cost of change does not stop with the new equipment. Assistance is needed in programming the equipment, money is needed for training employees, salaries are higher, office computers need to be upgraded.

Larger companies began retooling five to six years ago. The small shops now realize that they must change or go out of business. There are real opportunities for industrial growth in subcontract manufacturing. Strong aviation, farm machinery and electronics manufacturing in Kansas will maintain the existing jobs and new ones will be created if more subcontract work can be done by Kansas firms.

Access to both working and collateralized capital is a problem for some of these parts manufacturers. The program

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outlined in H.B. 2020 provides a source for financial assistance for firms where more traditional forms of financing are unavailable. Small business would find the Kansas basic enterprise loan program a viable alternative and a welcome addition.

During the past year, The Kansas Association for Small Business has worked with 30 businesses that are making their first moves into new high technology equipment. They cannot meet either the low bid or quality demands of prime contractors without changing their manufacturing technology.

While these companies may not move to another state, the subcontracts they have been given could. The prime contractors could award these subcontracts to companies in other areas of the country where businesses have been able to adapt to new manufacturing technologies. The improved access to capital in the program described in H.B. 2020 will allow more Kansas companies to modernize, keeping subcontract work and jobs in Kansas.

Thank you for your attention. I will try to answer any questions you might have.

TESTIMONY ON HOUSE BILL 2020:
SMALL BUSINESS LOAN PROGRAM

Presented to

The House Committee on Economic Development

Presented by

Charles Krider
Professor of Business,
University of Kansas
and
Director of Business Research,
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February 9, 1989

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The Small Business Finance Problem

Past research by the Institute for Public Policy and Business Research has identified the lack of financing as an important factor limiting the formation and expansion capabilities of Kansas small businesses. The 1986 Kansas Economic Development Study conducted by IPPBR included a number of recommendations regarding financing for small businesses. The state legislature has addressed the problem through support of venture and seed capital programs. What has not yet been addressed is the financial need of those small businesses which do not need specific venture or seed capital, but simply require financing for continuing or expanding their existing operations.

Recommendation 23 of the Redwood/Krider report is to establish a loan guarantee program to facilitate financing of new or expanding businesses in primary (basic) industries. HB 2020 would accomplish the same goal, "to provide access capital for basic job-creating manufacturing, research and development, or other special enterprises when either adequate financing is not available, or financing terms are prohibitive."

Other states have acted on this problem, through implementation of a variety of financing programs, such as the Connecticut Development Authority, which includes a number of different programs targeted at different regions and business types within the state. The CDA provides for both direct loans

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and loan guarantees with its programs. Maine has a very active Loan Insurance Program, insuring over $5,000,000 worth of lending activity in FY 1987.

Eligible Kansas Basic Enterprise

I support the definition of basic enterprise as included in the bill, as it would target state financial assistance to Kansas small businesses that are engaged in export-related activities, and thus bring in wealth from outside the state. I also believe that the restriction to those businesses who either could not qualify for SBA financing at all, or were not approved by the SBA for an amount sufficient for their needs, is a positive point. Through this provision, the state program would act as a supplement to federal financing, by:

1. providing assistance where no federal funding is available; or
2. providing financing as part of a package with financing from the SBA and other sources to bring the amount of financing up to the required sum.

Bank / Business Participation

I also believe that the provision requiring participation by banks for 15% of the loan amount is also a good component. Making the loan part of their own personal interest will help to ensure objective and honest evaluation of the prospective loan recipient, and local banks would also have much greater knowledge

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of the performance, structure, and other characteristics of the business than would the state. The 10% matching requirement for the business itself is also a positive aspect of the program as outlined in the bill.

Loans or Loan Guarantees?

As I have stated in prior testimony related to both a small business loan program and the proposed export finance program, I support the implementation of a loan program based on guarantees. The major advantages of guarantees are that they provide a greater degree of leverage for a limited pool of funds, thus allowing for a greater amount of assistance and economic stimulation. Also, other states have been successful with loan guarantee programs, and have found that they carry relatively low risk for the state. Guarantees overall are more cost effective than direct loans. A 1986 report prepared for the state by ASLAN strongly recommended that Kansas consider a loan guarantee program, based on their findings that:

> "Loan guarantees are highly cost-effective. They are an excellent tool for leveraging private investment resources. Well managed programs require only initial capitalization and become self-sustaining thereafter." (ASLAN, sec. 1-7, March 1986)

Direct Loan Alternative

One issue that has been raised in reference to this proposed program is that of whether smaller banks actually have sufficient depository funds to grant loans to eligible businesses, even with a guarantee from the state. This is an important point, and although I am in favor of a guarantee-based program in general, I believe that the flexibility of a program able to make direct loans under those particular circumstances could be the best alternative available. This would allow banks of any size to take part in the program, despite limitations on available capital.

Conclusion

House Bill 2020 provides for direct loans from the state for Kansas Basic Enterprises. I am in support of this program aimed at the financing of such small businesses, but I believe that consideration should be given to adding loan guarantee authority to this program. This would allow the Finance Authority to offer either direct loans or guarantees as appropriate.