CAPITAL ACCESS PROGRAM

Basic Concept of Program

Although the Capital Access Program is based on an insuring concept, it is fundamentally different from the traditional type of insurance or guarantee program, such as the SBA 7(a) program, which guarantees some percentage of a loan on a loan by loan basis. By contrast, Capital Access is based on a portfolio concept.

If a bank participates in the Capital Access Program, a special reserve fund is set up to cover future losses from a portfolio of loans that the bank makes under the program. The special reserve is owned and controlled by ADFA, but it is set aside for that bank only. Thus, each bank participating in the program has its own earmarked reserve. A bank can withdraw funds from its reserve only to cover losses on loans made under the program.

Payments are made into a bank's reserve each time the bank makes a loan under the program. The borrower makes a premium payment, the bank matches that payment, and then ADFA matches the combined total of the borrower's payment and the bank's payment. ***The bank is allowed to recover the cost of its payment from the borrower, such as through a higher interest rate, up-front fees, or some combination.*** *Up-front premium payments and fees can be* ***financed*** *as part of the loan.*

The actual level of payments to be made into the reserve is determined before the loan is made by the bank within certain parameters. *The amount paid by the Borrower shall not be less than 1.5% of the amount of the loan, and shall not be greater than 3.5% of the amount of the loan. The amount paid by the Lender shall be equal to the amount paid by the Borrower.* ***The Lender may recover from the Borrower the cost of the Lender's payment, in any manner in which the Lender and Borrower agree.*** At a minimum, a contribution of 3% of the loan amount is required up-front to enroll a loan into the program; this amount is matched by ADFA for a total 7.5% *(150% of enrollment contribution for the first $1million in loans, after which, ADFA matches initial enrollment contribution at 100%)* contribution to a lender's earmarked loan loss reserve account. At a maximum, 7% of the loan amount is paid up-front and matched by ADFA for a total of 17.5% contribution to the loan loss reserve. ADFA owns and controls the reserve, but it is designated for use by the bank and usually held on deposit at that bank.

For any loan made under the program, an amount from 7.5% to 17.5% (for the first $1million of enrolled loans) of the loan is paid into the bank's earmarked reserve. After a bank has made a portfolio of loans under the program, it might have a reserve equal to, for example, 10% of the total amount of that portfolio. In such a situation, the bank could absorb a dollar loss of up to 10% on that portfolio and still be completely covered against loss. A key feature of the program is that the full amount in the bank's total reserve is available as needed to cover any loss from any of the loans made under the program. If loans get paid off without any loss, the funds stay in the reserve.

The loss reserve enables a bank to be more aggressive in making loans and expanding its market. However, if a bank's loss rate exceeds the coverage provided by the reserve, the bank will be at risk for that excess loss. Consequently, there is a clear built-in incentive for a bank to be prudent.

Nevertheless, since the reserve would enable a bank to withstand a substantially higher loss rate than it could tolerate under its conventional loan portfolio, the program enables a bank to prudently make "almost bankable loans." For example, these loans might be loans to companies with good management and a good direction, but for one reason or another, such as lack of sufficient track record, lack of sufficient net worth, or other reason, could not quite qualify for a conventional bank loan.

Because the program is structured to provide a built-in incentive for the bank to be prudent, there is no need for ADFA to be involved at all in reviewing the bank's decision on the loan. The reserve is available for the bank to protect and use. The bank makes the loan and files a one page Loan Filing Form with ADFA within 10 days <u>after</u> the loan is made. Enrolling loans under the program is designed to work as an automatic process.

Flexibility is a key characteristic of the program. It is completely up to the bank to determine how it wants to use the program. The bank sets its own criteria for determining whether to make the loan, determines what types of loans it wants to make under the program, and decides the interest rate, fees, term, and other conditions of the loan.. The loan can be short-term or long-term, fixed or variable, secured or unsecured, amortizing loans or balloon loans, term loan or line of credit, etc.

When filing a loan for enrollment under the program, the bank has the option of covering an amount under the program which is less than the full amount of the loan. This feature provides added flexibility, since borrower and bank premium payments would then be based on this smaller amount. For example, a bank makes a $100,000 loan under the program, but is convinced that under a worse case scenario the maximum possible loss on the loan would be $60,000. The bank could decide to specify a covered amount of $60,000 on the loan. In such an event the funds in the reserve could be used to cover the first $60,000 in principal loss on the loan, plus accrued interest, plus documented out of pocket expenses.

A key feature of the program is the flexibility it provides a bank to work with a borrower after the bank has made a loan to the borrower under the program. After a loan has been made under the program the bank can subsequently recast it as often as needed. The bank can extend the term of the loan, amend covenants, release collateral, etc., without having to obtain approval from ADFA, or even reporting the change to ADFA.

The bank also has the flexibility to refinance the loan and add principal. If the total amount of the refinanced loan does not exceed the covered amount of the loan as previously enrolled, no new borrower or bank premium payments need to be made into the reserve, and the fact of the refinancing does not even need to be reported. Once a year, the bank may be asked to file a simple report with ADFA containing merely a listing of the outstanding balance for each loan enrolled under the program. For example, if a $100,000 loan covered under the program has been paid down to $30,000, and then is refinanced back up to $100,000, then no new premium payments are owed. However, if the loan were instead refinanced up to $150,000, then premium payments would be owed on the incremental $50,000 above the $100,000, but only if the bank wanted to cover that additional $50,000 under the program.

Lines of credit are also treated with similar flexibility. In establishing a line of credit and filing it for enrollment, the amount of the loan, for the purposes of determining premium payments and the maximum covered amount, shall be the maximum amount that can be drawn down against the line of credit. Banks could use their normal approach, including informal arrangements as applicable, in establishing a line of credit. A line of credit, once established, could then be renewed each year, staying covered under the program, without new premium payments being required (unless the covered amount under the program is to be increased).

The collection and claims process is also designed to work in a routine, non-bureaucratic way. The bank simply uses its normal method for determining when and how much to charge off a loan. At the same time that a bank charges off all or part of a loan, the bank files a one page claim form with ADFA with loss repayment to be handled in a prompt and routine fashion.

Because of the payments that need to be made into the reserve, a loan made under the Capital Access Program is likely to be a bit more expensive to the borrower than a conventional bank loan. The premium payments into the reserve are one-time, up-front payments, the costs of which can be financed. Thus the longer the financing stays on the books, the smaller the increase in the borrower's effective interest rate. However, the transaction is still likely to be more expensive than a conventional loan. Borrowers who can obtain conventional bank financing to meet their needs would normally be better off and competition within the banking industry will work to steer such borrowers to conventional financing. From the perspective of borrowers, the central thrust of the Capital Access Program is that it can provide access to financing for many companies that otherwise might not be able to obtain bank financing to meet their capital needs. Moreover, financing under the Capital Access Program is likely to be much less expensive for a company than alternative non-bank sources of financing, if any are available.

It is important that prospective borrowers under the program understand that the loan is a private transaction between the bank and the borrower. While the program may assist a bank in being able to take more risk than normal, it is still the bank that is bearing the risk of the loan, and is responsible for the decision making.

Eligible Loans and Borrowers

The fundamental focus of the program is to make eligibility as broad based as possible to maximize the impact on Arkansas' economy and to avoid second guessing private market decisions. The borrower can be a corporation, partnership, joint venture, sole proprietorship, cooperative or other entity, whether for-profit or not-for-profit, which is authorized to conduct business in the State of Arkansas.

The basic approach is to keep the program flexible so that each bank can use the program in a manner which best suits the needs of the bank and its customers. Keeping the program broad based also assists banks in building a portfolio to take maximum advantage of the portfolio insurance effect, thereby making the program more attractive and useful. Moreover, the high degree of leveraging of public resources supports keeping the program broad based.

There are, however, a relatively small number of restrictions that are either mandated by statute or are necessary to protect the basic integrity and purpose of the program. These restrictions are described below:

1. Business Purpose in Arkansas - The proceeds of the loan must be used for a business purpose within the state of Arkansas. Generally, therefore, the program is geared to Arkansas businesses. In the case of a company with multi-state operations, the key test is that the primary economic impact of the endeavor financed by the proceeds of the loan must be in Arkansas.

2. Exclusion of Housing - The proceeds of the loan cannot be used for the construction or purchase of residential housing. However, this is interpreted to mean permanent housing, so loans to motels or hotels or for the construction of motels or hotels are eligible.

3. Passive Real Estate Ownership - The loan cannot be used to finance passive real estate ownership. Passive real estate would occur if a company was to buy land or buildings simply as an investment, without developing or improving the real estate in any way, and without intending to use it for its own business operations.

   It is important to stress, however, that except for the restrictions against passive real estate ownership and housing discussed above, the program can be used for real estate financing. For example, the program can be used to assist a company to finance the acquisition of land or buildings intended to be used in the business operations of the company. In addition, the program can be used to finance the activities of a developer or builder in acquiring real estate for development or in constructing or renovating a building. In the case of a loan to a developer for construction or renovation financing, the loan under the program should be intended to cover the period through the construction or renovation phase. The permanent financing can also be included, if the borrower will be the company that will use the real estate for its own business operations.

4. Refinancing Prior Debt Which is Not in Program - A bank is not permitted to take an existing loan on its books (or on the books of an affiliate) which is not in the program and simply refinance it, without adding new money, and put the refinanced loan under the program. However, if a bank refinances an existing loan and adds new money by increasing the outstanding balance, it is permissible to cover under the program an amount not exceeding the amount of the new money. For example, if an existing loan, not under the program, has an outstanding balance of $100,000, and that loan is refinanced with a new balance of $150,000, the refinanced loan can be enrolled under the program, but the covered amount could not exceed $50,000.

5. Conflicts of Interest - A bank is not permitted to use the program for "insider" transactions. Insider transactions are defined to include a loan to an executive

officer, director or principal shareholder of the bank, a member of the immediate family of such an executive officer, director or principal shareholder, or to a company controlled by any of these people. The basic definitions used in this conflict of interest prohibition tie in to basic terms used in the Federal Reserve's Regulation O, which the bank should be familiar with in any event for their normal operations.

6. Size - There are no borrower size requirements or minimum or maximum loan sizes. It is recognized, of course, that the structure of the program will tend to focus the program on assisting small and medium sized companies. However, no arbitrary limits are provided. It should be noted, however, that the maximum amount to be paid by ADFA into a bank's earmarked reserve in connection with any one borrower shall be $150,000 in any three year period, unless ADFA has approved, in writing, a greater payment. With ADFA making payments between 3% and 7% of the loan amount, a $150,000 contribution would support a loan from $2.1 million to $5 million. This provision does not mean that loans exceeding this level cannot be made, only that advance authorization must be obtained. This requirement will assist ADFA in its own planning purposes.

Collection and Claims

The process for bank loss reimbursement on loans made under the program is intended to be as routine and non-bureaucratic as the process for enrolling loans under the program. ADFA relies on the bank to exercise reasonable care and diligence in its collection activities. If a loan gets into trouble, the program calls for the bank to determine when and how much to charge off an enrolled loan in a manner consistent with the bank's normal methods for making such determination on its conventional business loans. A bank would file a claim under the program at the time it charges off all or part of a loan. The claim may include the full amount of principal charged off, plus accrued interest, plus out of pocket expenses. If the amount of the loan that the bank covered under the program is less than the amount of principal charged off, then the amount of principal and accrued interest included in the claim shall not exceed the principal amount covered under the program, plus accrued interest attributable to such covered principal amount.

In keeping with the extremely non-bureaucratic nature of the program, the claim form submitted by the lender to ADFA is only a half-page form. The program provides prompt and routine loss payment.

The program is structured so that when the bank makes a loan and then enrolls it in the program, the bank is automatically making a small number of representations and warranties to ADFA that the loan complies with program requirements. If the bank later suffers a loss on that loan and properly files the claim form, the only grounds for denial of the claim would be if the enrollment of the loan were known by the bank to be false at the time of the loan was filed for enrollment.

The claims process allows a bank to recover its loss at the time it recognizes the loss, prior to having to exercise its collateral rights or other legal remedies in connection with the loan. However the bank would be expected to continue to exercise its collateral or other rights in a manner such as a conventional bank loan. If there were a subsequent recovery from the exercise of such rights, so that the amount of loss ultimately were less than the amount for which the bank had been reimbursed from the earmarked reserve, the bank would put the relevant amount of the recovery, net of out of pocket expenses, back into the earmarked reserve. This is similar to the process that a bank would follow in putting recoveries on conventional loans back into the bank's internal loan loss reserve.

As described above, the intent of the program is for the bank to be fully responsible for collection activities and for ADFA to stay out of the bank's way. However, as a safeguard against the extreme situation where a bank is abusing the intent of the program by ignoring its obligation to exercise reasonable care and diligence in its collection activities, ADFA will reserve for itself, in limited circumstances and as a last resort, the right to be subrogated to the rights of the bank. The subrogation would apply to any collateral, security or other right of recovery, in connection with a loan, which has not been realized upon by the bank. This provision could only take effect after the bank has filed a claim and has had its loss fully covered. It is hoped that ADFA will never have to exercise this right of subrogation.

Maintenance of the Reserve Fund

A central concept of the program is that ADFA owns the funds in the bank's earmarked reserve, but that these funds are legally dedicated solely to cover losses on loans made by the bank under the program. Legally, ADFA actually pledges the funds in the reserve fund to be available to pay claims on loans under the program.

For administrative convenience for both ADFA and the bank, and to provide an extra benefit to the participating bank, it is the plan of ADFA to open up an account at the bank, and deposit the monies in the bank's earmarked reserve right at the bank. The plan, as it has been implemented, involves establishing a money market deposit account in ADFA's name at the bank's published rate of interest.

It should be pointed out that although the above procedure is consistent with the full intent of ADFA, and there are no plans to do otherwise, the legal Agreement between the bank and ADFA does not bind ADFA to maintain the funds in a deposit account at the bank. For example, if a bank abuses the intent of the program, ADFA will have the flexibility to close that deposit account and deposit the monies in the reserve elsewhere. However, this would not change the legal status of the reserve as dedicated solely to cover losses from loans that the bank makes under the program. Moreover, in the event that ADFA does not deposit the funds in an account at the bank, the funds may be invested or deposited only in 1) direct obligations of the United States government, or in obligations the principal and interest of which are unconditionally guaranteed by the United States or, 2) a deposit account at a federally insured depository institution.

Half of the interest earned on the funds in the bank's earmarked reserve will stay in the reserve, to help it grow. ADFA is authorized to withdraw the other half of the interest for use by ADFA for whatever use the ADFA Board determines.

Although ADFA technically owns the funds in the reserve, it is intended and expected that banks will develop a proprietary interest in the reserve. The reserve takes on the character of an off balance sheet asset of the bank, which enables it to be more aggressive in its lending activities. The bank controls the amounts of payments going into the reserve and the reserve is reduced only when a bank suffers a loss on a loan made under the program. The program rewards good performance, in that as loans are successfully paid off, the funds stay in the reserve, and actually increase over time through the earning of interest. However, if at some point in the future, the bank were to completely drop out of the program, and after all of the loans previously made had all been paid off, ADFA would ultimately be able to withdraw the funds from the reserve.

Bankers sometimes ask why the bank wouldn't be able to get back some or all of the funds from the reserve in the event that they have dropped out of the program and the loans have been paid off. The primary answer is that a key provision in maintaining the structural integrity of the program is that the bank can only gain access to the funds in their reserve to cover losses on loans made under the program. If a bank knew that it could ultimately withdraw funds from the reserve after dropping out of the program, this might create an incentive for the bank to put conventionally bankable loans under the program, because the bank might reason that it will ultimately get the money back anyway. By contrast, if the only way that a bank can gain access to the funds in the reserve is to cover losses from its program loans, the only way that a bank can get any advantage from the program is to use it for its intended purpose, as a flexible tool to enable the bank to expand its market by taking more risk.

The program contains a formula for addressing the effective dropping out of the program by the bank. If for a consecutive 36 month period the amount in the reserve fund continuously exceeds the outstanding balance of all of the bank's enrolled loans made since the beginning of the program, ADFA is authorized to withdraw any such excess to bring the reserve down to an amount equal to 100% of the outstanding balance. As a practical matter, this formula would only come into play for a bank that has effectively dropped out of the program. Even if a bank has been inactive for a long period, if it begins making loans during the 36 month period, the aggregate outstanding balance would generally quickly exceed the reserve. The formula is intended to give ADFA the ability to withdraw funds from the reserves earmarked for banks that have effectively dropped out of the program, but to do it in a manner that in no way jeopardizes the protection that the reserve provides for any loans still outstanding.

The Process for a Bank to Sign Up for the Program

ADFA Board has approved a master form of Agreement to be separately entered into between ADFA and each bank that wishes to participate in the program. Entering into this Agreement does not commit a bank to make any loans under the program, but does spell out the full and official parameters that apply if a bank makes loans, and the obligations of ADFA and the bank under the program.

In its resolution approving the form of Agreement and authorizing ADFA staff to enter into such Agreements, the ADFA Board stated that "it is the policy of the Board that such Agreements should be entered into with any depository institution, which has its principal office located in Arkansas, that wishes to enter into such Agreement and that has sufficient experience and capacity to participate in the program, and that such depository institution should be considered to have such experience and capacity absent any credible evidence to the contrary."

Consistent with the entire approach to the program, the process for a bank to sign up is being kept simple and routine. Staff is utilizing a half-page application form to obtain information on a depository institution's year-end commercial and industrial loans outstanding for each of the last three years. Absent any credible evidence that a depository institution lacks sufficient experience and capacity to participate in the program, staff is signing up lenders that wish to participate by entering into the Agreement.

Early Stage Incentives

How does a bank proceed in the early stages of its participation in the program, before a substantial reserve has been built up? Many banks will understandably have a tendency to be rather cautious initially. As the reserve begins to build, and as the bank gains more experience under the program, the bank may gradually evolve to a more aggressive posture, expanding its margin that much further.

Even if a bank is unfortunate enough that one of its early loans in the program gets into trouble, it is likely to be some time before the loan actually defaults, and by that time hopefully the bank will have a portfolio of loans and have built an adequate reserve. Nevertheless, other things being equal, there is some extra risk attached to these early loans made before a substantial reserve has built up.

In order to assist a bank to build up the reserve more rapidly and to address risk issues in the early stages of a bank's participation in the program, two special features have been included in the program. The first special feature applies to the first $1 million of loans that a bank makes under the program. This feature provides that ADFA will contribute a greater portion to the reserve. While the minimum and maximum payments for the borrower and the bank would remain the same, ADFA, rather than simply matching 100% of the combined total of the borrower and the bank, will instead contribute an amount equal to 150% of the combined total of the borrower and the bank. Thus, in the minimum case, the borrower contributes 1.5%, the bank 1.5%, and ADFA 4.5%, for a total of 7.5%. In the maximum case, the borrower would contribute 3.5%, the bank 3.5%, and ADFA 10.5%, for a total of 17.5%. This special feature is designed to help build the reserve more rapidly, and to give the bank an extra incentive to begin to use the program.

The second special feature applies to the first $3 million of loans that a bank makes under the program. If one of those loans suffers a loss and at the time of the loss there is not enough in the reserve to fully cover that loss, the bank would initially be able to withdraw all of the amount in the reserve at the time of the loss, to cover the loss as much as possible. If the bank then continues making loans under the program and begins to build the reserve back up, the bank would be allowed to withdraw from the reserve at a subsequent time in order to fully cover the earlier loss. The only restriction is that the amount subsequently withdrawn to cover the earlier loss cannot exceed 75% of the amount in the reserve immediately prior to such subsequent withdrawal. Thus, even at the beginning of its participation in the program, the bank has the comfort of a portfolio insurance effect, because it knows that in the long term its losses are kept to a reasonable level, it will be fully protected against loss, and the bank will not suffer due to early losses.

In order to be able to implement the program in a fully non-bureaucratic manner, ADFA needs to be able to prevent the program from being abused. So that ADFA can move quickly if necessary to stop abuses, ADFA retains, in the legal Agreement entered into with each participating bank, the absolute discretion to terminate a bank from the right to make new loans under the program. The status of loans already made under the program is not affected. Obviously ADFA's objective is to have as many banks as possible use the program successfully. ADFA's intention is to enforce this provision against a particular bank only if such bank has exhibited a pattern of abuse of the program.