EVALUATION OF NEIGHBORHOOD BUSINESSWORKS

FEBRUARY 2024

OFFICE OF PROGRAM EVALUATION AND GOVERNMENT ACCOUNTABILITY
DEPARTMENT OF LEGISLATIVE SERVICES
MARYLAND GENERAL ASSEMBLY

Evaluation of Neighborhood BusinessWorks

Department of Legislative Services
Office of Program Evaluation and Government Accountability
Annapolis, Maryland

February 2024

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Department of Legislative Services
Office of Program Evaluation and
Government Accountability
Maryland General Assembly

Victoria L. Gruber
Executive Director

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Director

February 26, 2024

Senator Clarence K. Lam, M.D., Senate Chair, Joint Audit and Evaluation Committee
Delegate Jared Solomon, House Chair, Joint Audit and Evaluation Committee
Members of the Joint Audit and Evaluation Committee

Dear Senator Lam, Delegate Chang, and Members:

At the request of the Executive Director of the Department of Legislative Services, the Office of Program Evaluation and Government Accountability has conducted an evaluation of the Neighborhood BusinessWorks program of the Maryland Department of Housing and Community Development (DHCD). This evaluation was performed consistent with § 2-1234 of the State Government Article.

Five recommendations for improving the efficiency and effectiveness of Neighborhood BusinessWorks are on page 28. DHCD's response is included as Appendix A.

We wish to express our appreciation for the cooperation and assistance provided by DHCD.

Respectfully submitted,

Michael Powell
Director

MP/mpd

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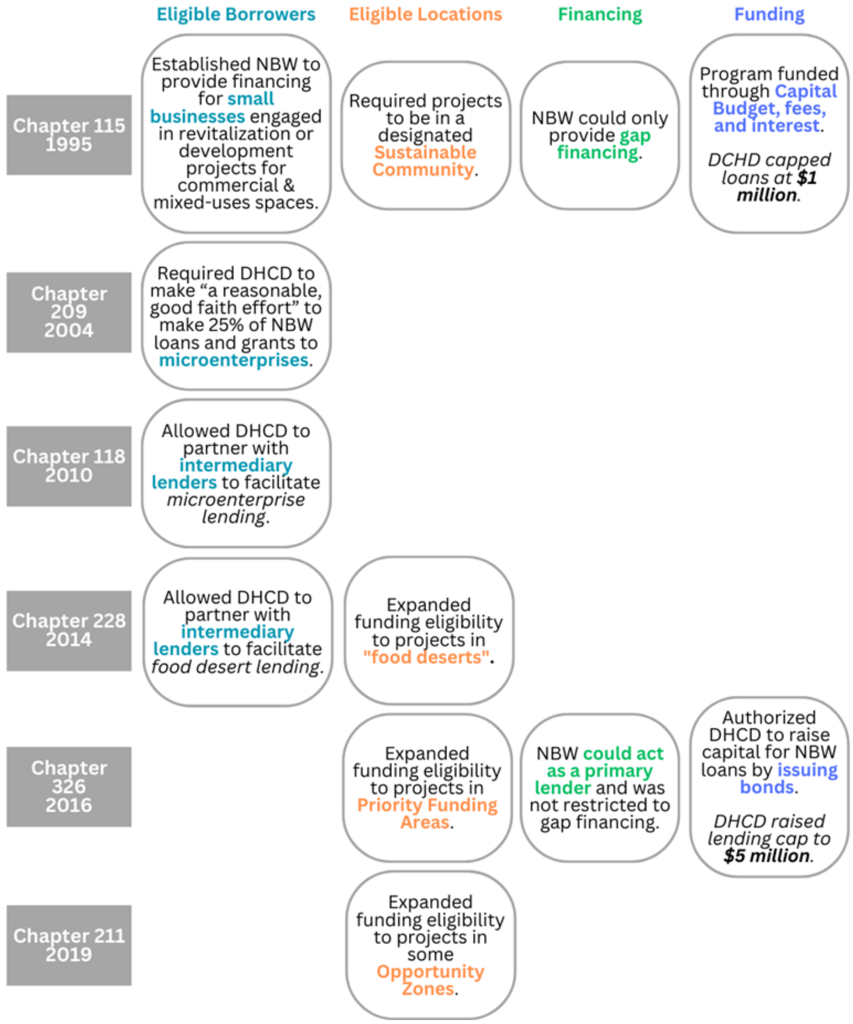
Overview

The Neighborhood BusinessWorks (NBW) Program is a small business financing program administered by the Department of Housing and Community Development's (DHCD) small business financing program. NBW was established by the General Assembly in 1995 to provide gap financing to small businesses in designated Sustainable Communities across Maryland. The program was rolled out under the State's Smart Growth Initiative, which aimed to protect the State's farmland, open spaces, and natural resources by revitalizing older neighborhoods and redirecting growth to already-developed areas.

Generally, NBW provides secondary loans to small businesses in downtown areas that are looking to renovate or expand into an existing commercial property. However, the General Assembly passed multiple pieces of legislation that expanded the NBW program between 2004 and 2016. These changes are outlined in **Exhibit 1**.

Exhibit 1
Legislative History of the NBW Program



DHCD: Department of Housing and Community Development
NBW: Neighborhood BusinessWorks

Source: Department of Legislative Services

Following these changes, the current iteration of the NBW program has the following objectives:

- **Objective 1:** Help develop, redevelop, or expand small businesses[1] and microenterprises[2] in priority funding areas and eligible opportunity zones.

- **Objective 2:** Stimulate investment by the private sector in priority funding areas and eligible opportunity zones.

- **Objective 3:** Invest in revitalization projects for small businesses and microenterprises in priority funding areas and eligible opportunity zones.

- **Objective 4:** Stimulate political subdivisions to participate in developing and expanding small businesses and microenterprises in priority funding areas and eligible opportunity zones.

- **Objective 5:** Help create and retain small businesses and other food-related enterprises that provide fresh fruits, vegetables, and other healthy foods to residents in food deserts or parts of priority funding areas or eligible opportunity zones that serve food deserts.[3]

To achieve these objectives, NBW partners with Community Development Financial Institutions (CDFI)[4], private lenders, and other government programs to provide financial assistance to small businesses, microenterprises, and nonprofit organizations located in priority funding areas and eligible opportunity zones throughout Maryland.

- The priority funding area (PFA) designation was created in 1997 to preserve existing neighborhoods and agricultural, natural, and rural resources and prohibit State agencies from approving specified projects that are not in priority funding areas. Each locality must apply for a PFA designation by submitting a PFA Certification request to the Maryland Department of Planning. The process for submitting the request is established by each jurisdiction. The Maryland Department of Planning will approve the request if the area meets the statutory criteria for a PFA.

- The opportunity zone (OZ) designation is a nationwide initiative administered by the U.S. Department of the Treasury. The initiative provides federal tax incentives for investment in distressed communities. Low-income communities and certain contiguous communities qualify as OZs if a state nominates them for an OZ designation and the U.S. Department of the Treasury certifies that nomination.

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[1] A business that meets the U.S. Small Business Administration's (SBA) established industry size standards. Size standards vary widely by industry. The SBA defines small business by firm revenue (ranging from $1 million to over $40 million) and by employment (from 100 to over 1,500 employees).

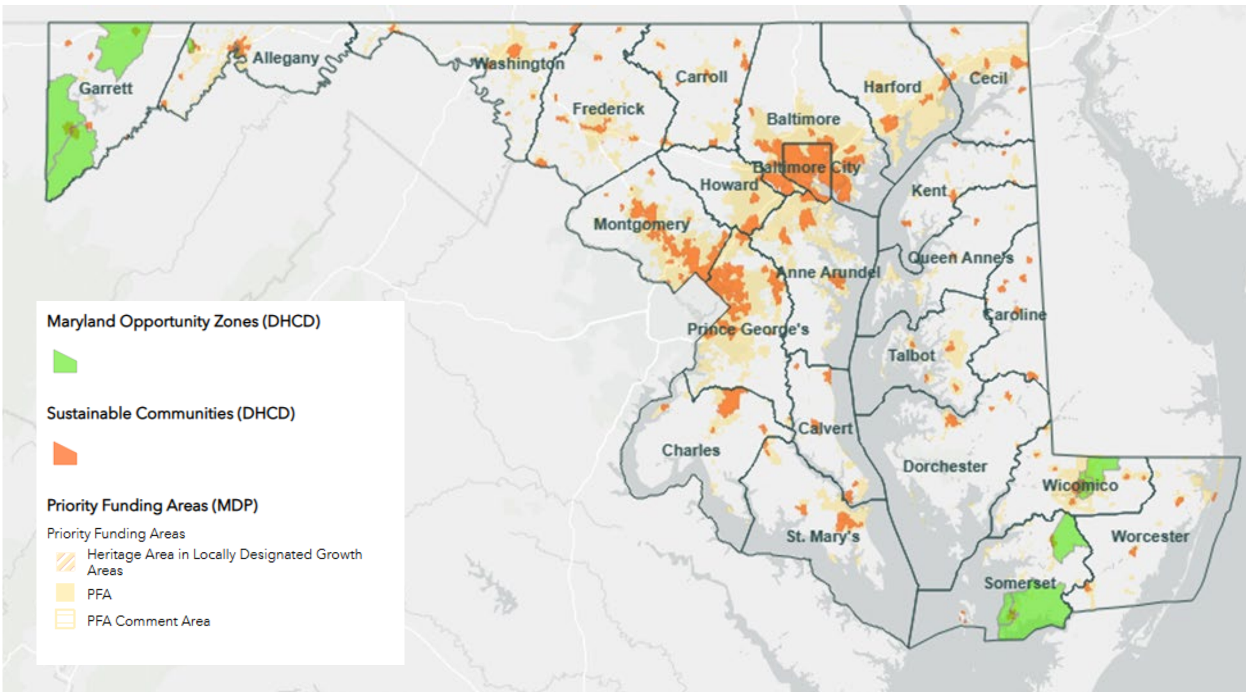
[2] A small business not exceeding $500,000 in annual revenue and with no more than five employees.

[3] An area with limited access to affordable and healthy food, often featuring large proportions of households with low incomes, inadequate access to transportation, and a limited number of food retailers providing fresh produce and healthy groceries for affordable prices.

[4] A CDFI is a financial institution that provides credit and financial services to underserved markets and populations.

Exhibit 2 shows a map of the targeted priority funding areas and NBW-eligible opportunity zones for NBW business lending.

Exhibit 2
Priority Funding Areas and NBW-eligible Opportunity Zones



NBW: Neighborhood BusinessWorks

Source: Maryland Department of Planning

Per Housing and Community Development Article § 6-310, the Neighborhood Business Development Fund (the fund) can be used to cover the operating expenses of the NBW program and to provide financial assistance to small businesses, nonprofit organizations, and microenterprises.

The fund consists of:

1. money appropriated in the State budget;

2. repayments or prepayments of financial assistance;

3. money transferred from another fund;

4. money received from the sale, assignment, or other disposition of NBW loans and equity interests;

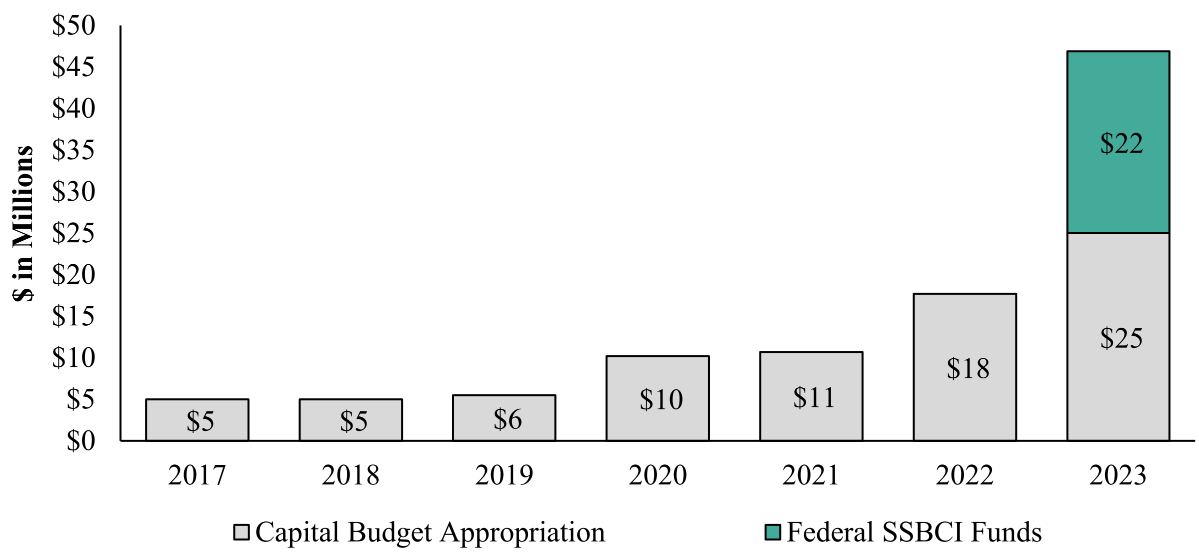
5. investment earnings of the fund;

6. other money received from the Community Development Administration; and

7. fund balance carried over from the previous fiscal year.

Most money in the fund comes from State appropriations. State appropriations to the NBW program are made through the capital budget process. NBW represented around 5% of DHCD's capital budget appropriation each fiscal year between 2018 and 2021. As shown in **Exhibit 3**, the capital appropriation for the NBW program has grown substantially in recent years.

Exhibit 3
NBW State and Federal Appropriations
Fiscal 2013-2023



NBW: Neighborhood BusinessWorks
SSBCI: State Small Business Credit. Initiative

Source: Department of Budget and Management

NBW is one of several programs available through State government agencies to help fill the financing gap for Maryland small businesses. Other State programs targeting small businesses are outlined in **Exhibit 4**.

Exhibit 4
Selected Maryland Small Business Financing Programs

Small Business Development Financing Authority	Video Lottery Terminal Fund	Neighborhood BusinessWorks	Economic Development Assistance Authority Fund	TEDCO Earl-stage Investment Funds
Department of Commerce	Department of Commerce	Department of Housing and Community Development	Department of Commerce	Maryland Technology Development Corporation
Financing for small businesses unable to obtain financing on reasonable terms through traditional lenders.	Financing for small, minority, and women–owned businesses. Businesses in target areas around 6 casinos are prioritized.	Financing to small businesses and nonprofits whose activities contribute to a broader revitalization effort in existing commercial districts.	Financing to support jurisdictions and businesses to pursue local development initiatives.	Funding for early–stage technology companies for capital investments including land, buildings, and intellectual property.
Priority Funding Areas	No location restrictions	Sustainable communities; priority funding areas; eligible opportunity zones	Priority funding areas	No location restrictions
$17 million Awarded in fiscal 2021	$15 million Awarded in fiscal 2021	$13 million Awarded in fiscal 2021	$10 million Awarded in fiscal 2021	$8 million Awarded in fiscal 2021

TEDCO: Technology Development Corporation

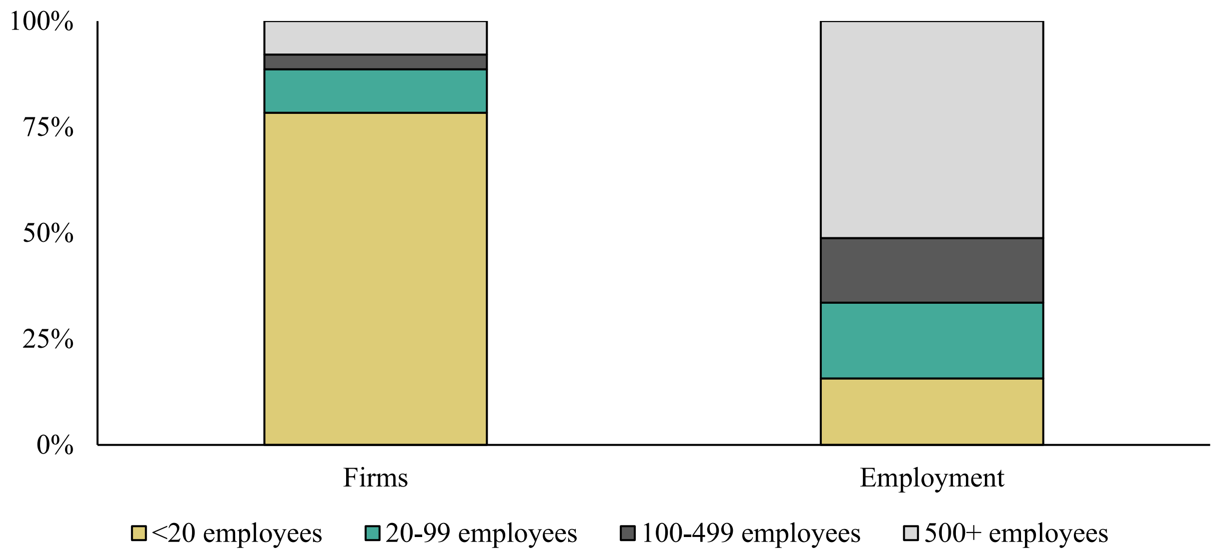
Source: Department of Commerce; Department of Housing and Community Development; Department of Budget and Management; Maryland Technology Development Corporation; Department of Legislative Services

NBW and Small Businesses

Maryland's small businesses[5] often struggle to access the financing they need to operate and expand.

- Most firms operating in Maryland are classified as small businesses. As shown in **Exhibit 5**, 92% of firms in Maryland have fewer than 500 employees. Additionally, firms with fewer than 500 employees employ around half of the State's workforce.

Exhibit 5
Small Businesses in Maryland's Economy

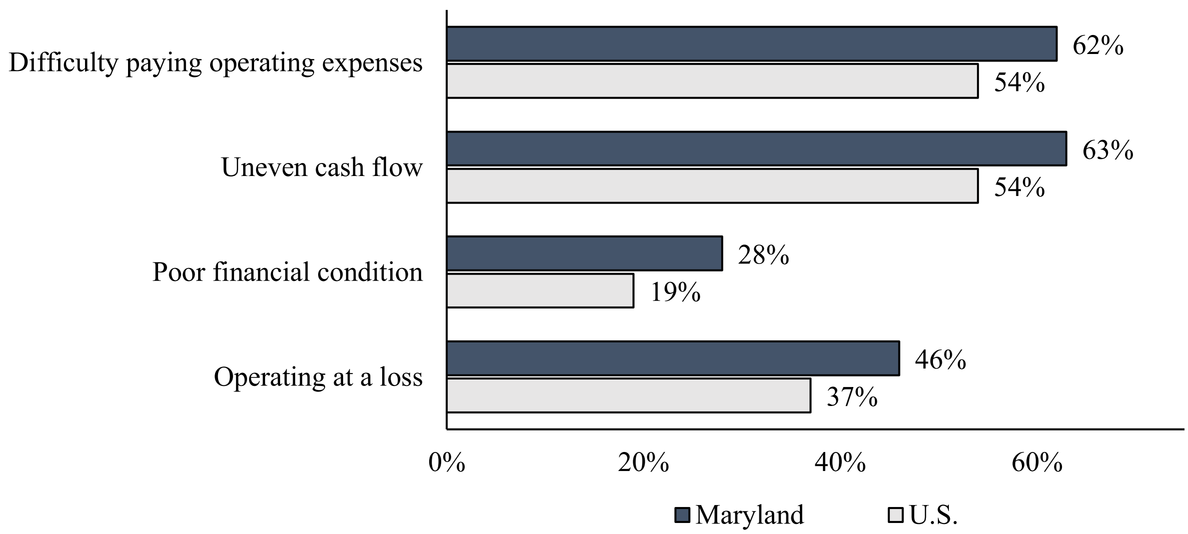


Source: Census Bureau 2020 Statistics of U.S. Businesses

- Small businesses in Maryland are more likely to face financial, operational, and performance challenges than small businesses in the rest of the country. Maryland's small businesses are more likely to operate at a loss, report being in poor financial condition, have uneven cash flow, and have difficulty paying operating expenses than firms in other states, as shown in **Exhibit 6**.

[5] Statute defines "small business" as a business that meets SBA established industry size standards. Size standards vary widely by industry. SBA defines small business by firm revenue (ranging from $1 million to over $40 million) and by employment (from 100 to over 1,500 employees).

Exhibit 6
Challenges Facing Small Businesses
Maryland and U.S. Employer Firms



Source: Federal Reserve *2022 Small Business Credit Survey*

- In 2022, 49% of Maryland small business had unmet financing needs. Stakeholders shared that there are several reasons for this gap, including:

  - Traditional lenders view small businesses as higher risk, so they offer loans with inflexible repayment terms and comparatively high interest rates.

  - Small businesses are deterred by difficult application processes and long waits for credit decisions.

  - Traditional lenders are often unwilling to lend to businesses located in less-developed areas or to emerging markets without established supply chains, market access, or profit history.

NBW lending addresses several of the key challenges facing small businesses seeking financing.

- **NBW can offer larger loan amounts, longer repayment terms, lower interest rates, and more individualized repayment plans than many private lenders**, as demonstrated in **Exhibit 7**. Private banks have a fiduciary duty to act in the best interest of their clients and shareholders, which can translate into lending terms that are disadvantageous for smaller borrowers. The NBW program prioritizes a project's potential financial return on investment in conjunction with the community development benefits a project could have.

Exhibit 7
Comparison of NBW and Commercial Lending Terms

	Sample Industry Standard Lender	SBA 7(a) Small Loans	NBW Business Lending
Loan Amounts	\$10,000 to \$5 million	Up to \$5 million	Up to \$5 million
Repayment Timeframe	Up to 5 years for unsecured term loans Up to 20 years for real estate	Up to 10 years for equipment, working capital, or inventory Up to 25 years for real estate	Up to 30 years
Maximum Loan–to–Value Ratio	80%	85%	90%
Interest Rates	Market rate	Capped at base prime lending rate plus 4.75%	Interest rate based on assessment of community impact, profitability, and other factors
Prepayment Penalties	Allowed	Allowed	Not allowed

NBW: Neighborhood BusinessWorks

Source: U.S. Small Business Administration; Department of Housing and Community Development

- **DHCD staff have the flexibility to structure NBW loans to meet the needs of a wide range of potential borrowers.** Whereas banks may have minimum requirements to consider offering a loan at all, NBW underwriters are encouraged to develop the best possible package for a loan application given the borrower's strengths and weaknesses. **Exhibit 8** summarizes the main criterion that go into the NBW program's ultimate decision to extend a loan offer and how that loan offer should be constructed.

Exhibit 8
Loan Evaluation Matrix

High Risk ⟵		⟶ Low Risk
Start-Up	**Stage of Business**	5+ Years in Business
No Sales Record & Poor Market Conditions	**Market Conditions**	Strong Sales Record & Good Market Conditions
No Experience	**Management Experience in Industry**	5+ Years Experience
No Financial Records	**Financial Record-Keeping**	Accurate & Timely Financial Records
No Financial Plan	**Financial Planning**	Strong Financial Planning
Historic Net Losses & No Future Expected Profit	**Profitability**	Historic Profits & Projected Continued Profitability
No Income History	**Debt Service Coverage Ratio (DSCR)**	DSCR at or above 1.2 *DSCR = Net Income ÷ Debt Service Payment*
No Borrower Equity	**Borrower Equity in Transaction**	At least 20% owner cash contribution
Unsecured Loan	**Loan to Value Ratio (LTV)**	LTV less than 85% *LTV = Loan Amount ÷ Appraised Value of Assets Securing the Loan*
Serious Derogatory Items	**Credit History**	No Derogatory Items
Debt payments are 70% + of gross monthly income	**Debt-to-Income Ratio (DTI)**	Debt payments are less than 30% of gross monthly income
No Expected Community Benefits	**Expected Community Benefits**	Job Creation/Retention, Revitalization & Expanded Public Services

Source: Department of Housing and Community Development

- **NBW business loans largely go to jurisdictions with high poverty, unemployment, and vacancy rates that are least likely to attract private sources of financing.** Nearly three-quarters of NBW business loan funds disbursed between fiscal 2017 and 2021 went to projects in Baltimore City and Prince George's County. As shown in **Exhibit 9**, together those two jurisdictions are home to 33% of the State's unemployed workers, 33% of families in poverty, and 31% of vacant housing units.

Exhibit 9
NBW Business Loans by Jurisdiction
Fiscal 2017-2022

Jurisdiction	NBW Funds Awarded	Award Funds	Unemployed Workers	Families in Poverty	Vacant Housing Units
Baltimore City	$19,404,729	56%	14%	20%	22%
Prince George's	5,740,000	16%	20%	13%	8%
Cecil	1,819,617	5%	2%	2%	2%
Baltimore	1,786,955	5%	13%	14%	10%
Washington	1,248,583	4%	2%	4%	2%
Allegany	1,150,000	3%	1%	2%	2%
Dorchester	1,000,000	3%	1%	1%	1%
Frederick	938,744	3%	3%	3%	2%
Howard	905,000	3%	4%	3%	2%
Talbot	350,000	1%	0%	1%	2%
Queen Anne's	258,661	1%	0%	0%	1%
St. Mary's	91,607	0%	1%	2%	2%
Worcester	60,000	0%	1%	1%	15%
Somerset	50,000	0%	1%	1%	1%
Other Jurisdictions	0	0%	36%	32%	27%
Total	**$34,803,896**	**100%**	**100%**	**100%**	**100%**

Source: Department of Housing and Community Development; Maryland Department of Planning; Department of Legislative Services

- **DHCD awards NBW loans to a diverse range of projects, with a particular emphasis on commercial and mixed-use projects in downtown areas.** Examples of previous NBW business loans are outlined in **Exhibit 10**.

Exhibit 10
Example NBW Business Loans

Project	Description
Baltimore City $750,000 Loan	Redevelopment of a former church into a brewpub and apartment complex in the Washington Hill neighborhood of Baltimore City.
Talbot County $350,000 Loan	Provide gap funding for the purchase of commercial property in Easton, MD already functioning as a medical suite and previously leased by the borrower.
Frederick County $545,000 Loan	Assist with the construction costs associated with the relocation and new construction of a new funeral home. The business chose to relocate when the county offered to purchase their existing property to develop affordable housing in the area.
Prince George's County $2,720,000 Loan	Funding for renovations, startup costs, working capital, furniture, fixtures, and equipment for a Maryland company expanding in a priority funding area and qualified opportunity zone.
Cecil County $828,998 Loan	Refinance of a short-term commercial acquisition loan from a private bank and assistance to renovate the previously vacant commercial property into a music venue.
Charles County $805,000	Redevelop a vacant property into a mixed-use commercial space with residential units and a small grocery store.

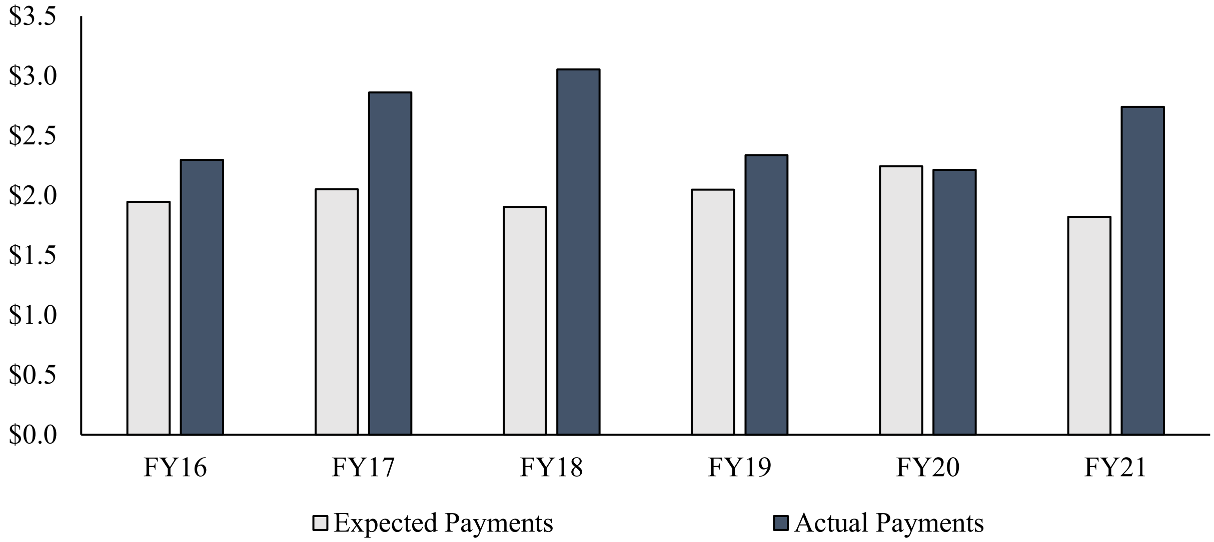
NBW: Neighborhood BusinessWorks

Source: Department of Housing and Community Development

- **Actual loan repayments are generally above expected repayments based on monthly repayment schedules**. **Exhibit 11** shows the expected payments on NBW loans based on their set repayment schedules compared to actual payments made on NBW loans by fiscal year. Between fiscal 2016 and 2021, actual repayments exceeded expected repayments every year, apart from fiscal 2020.[6] DHCD does not penalize early repayment on loans, so businesses that are able to pay above the required amount often do so.

[6] Loan repayments were paused at the beginning of the COVID–19 State of Emergency.

Exhibit 11
Expected and Actual Repayments by Fiscal Year
($ in Millions)

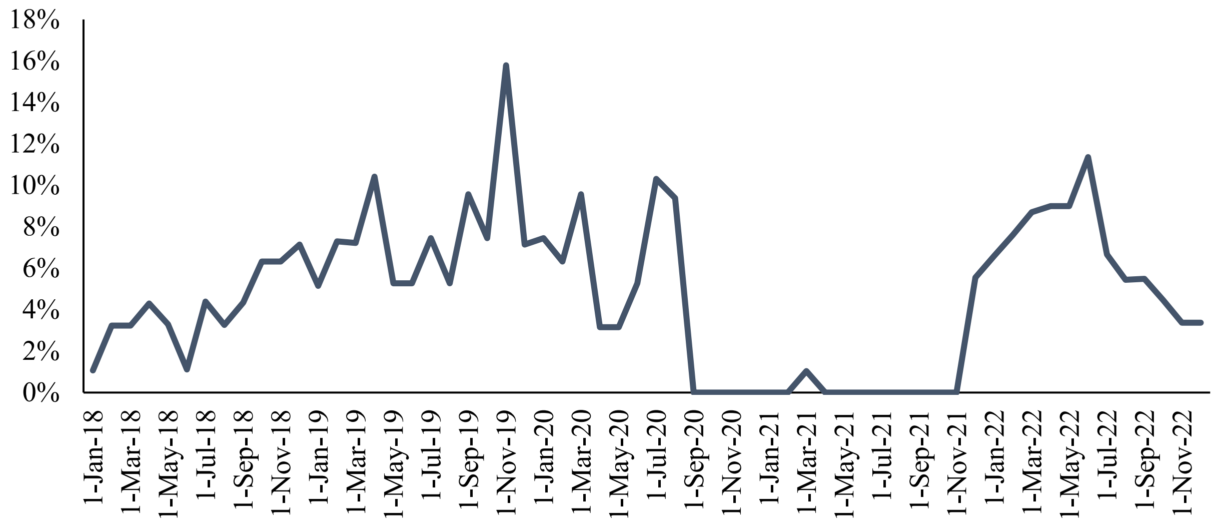


Source: Department of Housing and Community Development; Department of Legislative Services

- **An average of 94% of NBW borrowers repaid their loans on time each month from 2018 to 2022.** DHCD receives monthly repayment reports from their external loan servicer. Accounts that are 30 or more days behind on repayment are categorized as "delinquent." **Exhibit 12** shows the percent of borrowers in repayment who were delinquent each month from January 2018 through December 2022. Delinquency rates rose from 1% to around 10% of borrowers in repayment between January 2018 and March 2020.

- In response to the COVID-19 pandemic in April 2020, DHCD offered temporary deferment of monthly loan payments to NBW borrowers. Borrowers were required to submit a deferment request to the DHCD Asset Management team and certify that their business was impacted by the State of Emergency. Per the NBW loan agreement, forbearance allowed borrowers to defer payments for up to six months.

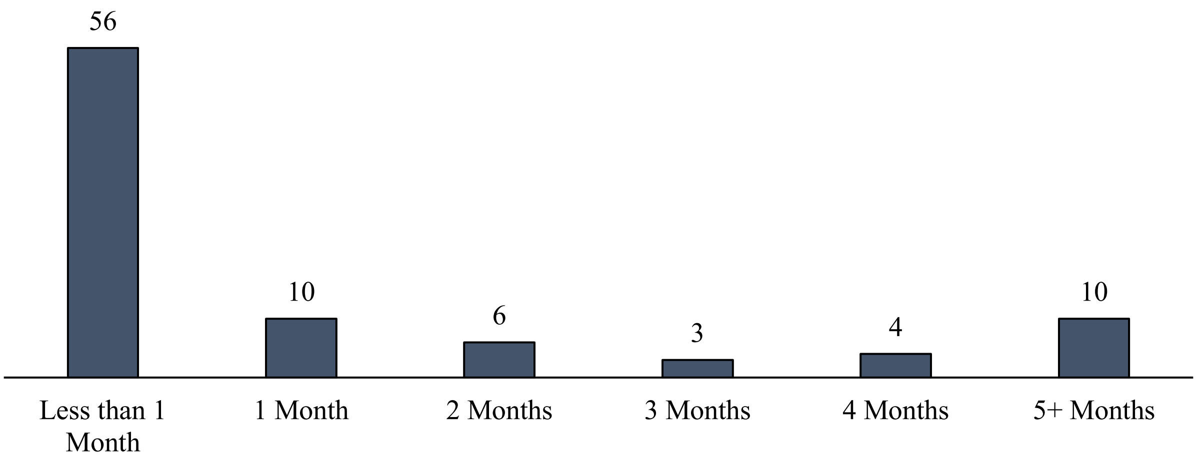
Exhibit 12
Percent of Loans 30+ Days Delinquent
2018-2022



Source: Loan Servicer; Department of Legislative Services

- **DHCD actively supports NBW borrowers when they struggle to make payments on business loans.** The NBW team prioritizes early identification of repayment issues and works with borrowers to get their projects back on track through technical support or alterations to the loan agreement when deemed necessary. As shown in **Exhibit 13**, NBW business loans do not tend to remain in delinquent status for extended periods of time. Nearly half of loans classified as delinquent at some point during their repayment period spend less than two months in delinquency.

Exhibit 13
Total Months in Delinquency
NBW Business Loans Originated 2016-2022

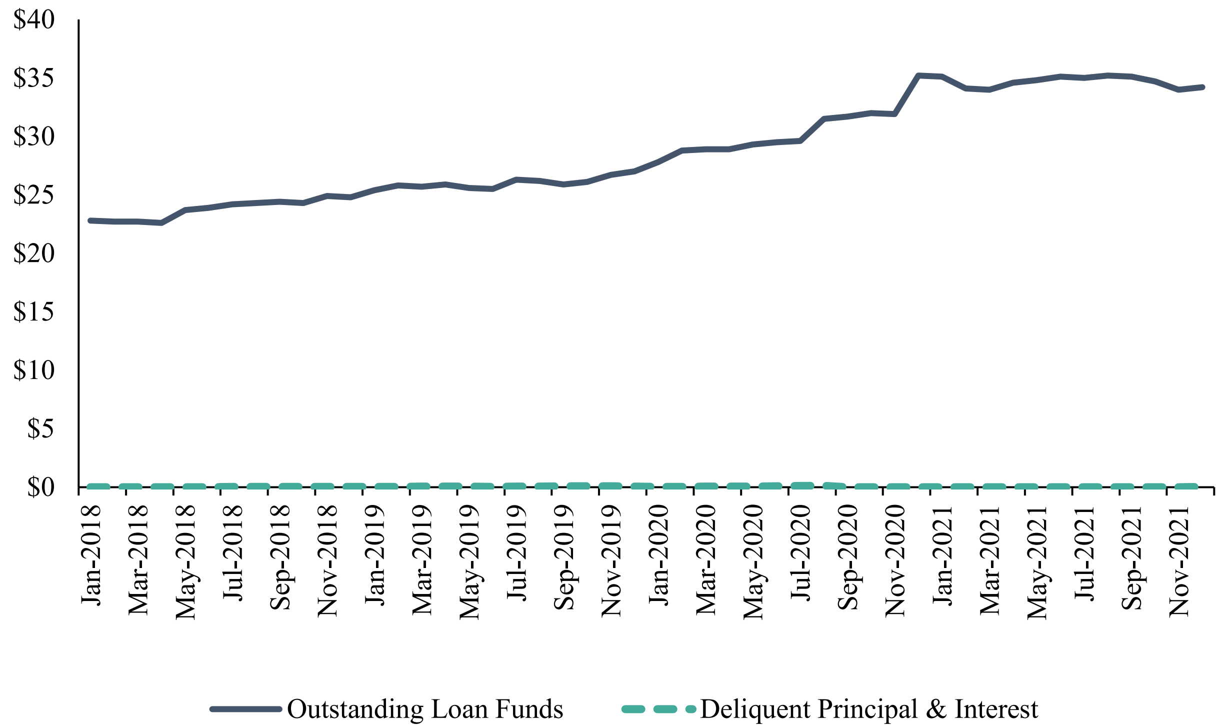


NBW: Neighborhood BusinessWorks

Source: Loan Servicer; Department of Legislative Services

- **Delinquent payments generally accounted for less than 1% of NBW loan funds each month from 2018 to 2021.** The total value of outstanding NBW loans and the total value of delinquent principal and interest payments for that period are shown in **Exhibit 14**.

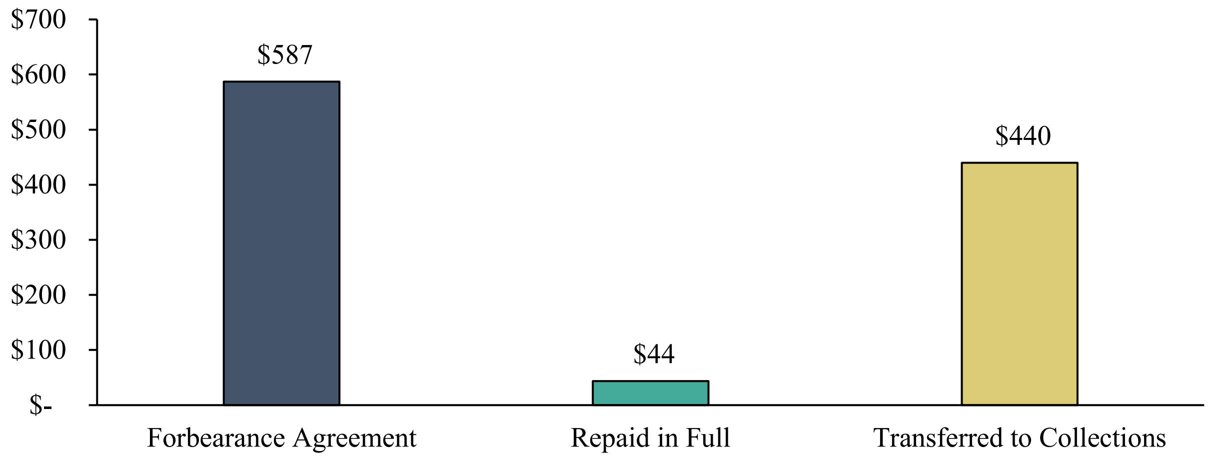
Exhibit 14
Outstanding Loan Funds and Delinquent Funds
2018-2022
($ in Millions)



Source: Loan Servicer; Department of Legislative Services

- **Around 1 in 15 NBW business loans end in default.** Between fiscal 2018 and 2021, NBW awarded around 225 business loans. During that same period, 15 borrowers with a total balance of just over $1 million defaulted on their NBW loans. As shown in **Exhibit 15**, $44,000 from one borrower has been repaid in full, $587,000 from another borrower is being repaid under a forbearance agreement, and $440,000 across 13 borrowers has been transferred to the Central Collections Unit (CCU). According to CCU, a total of $3,845 had been recouped as of March 2023.

Exhibit 15
Status of Defaulted Loans
Loan Defaults Occurring 2018-2021
($ in Thousands)



Source: Department of Housing and Community Development; Department of Legislative Services

NBW and Targeted Communities

DHCD collects limited information about the community benefits of projects supported by NBW business loans.

- **Underwriting documentation related to a project's expected community benefits is sparse compared to the documentation associated with financial underwriting criteria.** NBW's underwriting for business loans is most flexible for proposed projects that expect to have a large positive impact on the local community. NBW underwriters can move forward with developing a loan package for higher risk borrowers when the expected community benefits of the project outweigh the credit risk. However, DHCD's analysis of a project's expected community benefit is based on unsubstantiated information from the borrower.

  Exhibit 16 compares the documentation requirements outlined in the NBW Underwriting Manual related to the borrower's financial capacity and the project's expected community benefits. Underwriting of a borrower's financial capacity requires extensive documentation from third-party sources, including tax returns, bank statements, and credit reports. Underwriting of a project's expected community impact is primarily based on information reported by the borrowers themselves that is not independently verified.

Exhibit 16
Documentation Requirements for Underwriting

Documentation Related to Borrower's Financial Capacity	Documentation Related to Project's Expected Community Benefits
1. Balance sheet for the past 3 years	1. Application form
2. Income and expense statements for the past 3 years	2. Application cover letter
3. Statement of cash flows	3. Detailed business plan
4. Contingent liabilities and a statement concerning their amount, nature, and path toward resolution	
5. Detailed schedule of other real estate holdings	
6. Tax returns for the past 3 years	
7. Bank statements for the past 3 months	
8. Authorization to pull credit reports	
9. Any notes that can provide explanation and/or rationale for any information that underwriter may perceive as a credit and/or capacity issue	

Source: Department of Housing and Community Development

- **DHCD staff do not collect follow-up information on the impact of projects funded through NBW.** According to data provided by DHCD, every $1 in NBW financial assistance is associated with $6 in external project funding from the private sector, other State programs, or federal programs.[7] Additionally, every $100,000 in NBW financial assistance is associated with the creation of an estimated eight additional full-time jobs.[8] However, this impact data is based on the information provided by borrowers during the loan application process and is not independently verified by DHCD staff.

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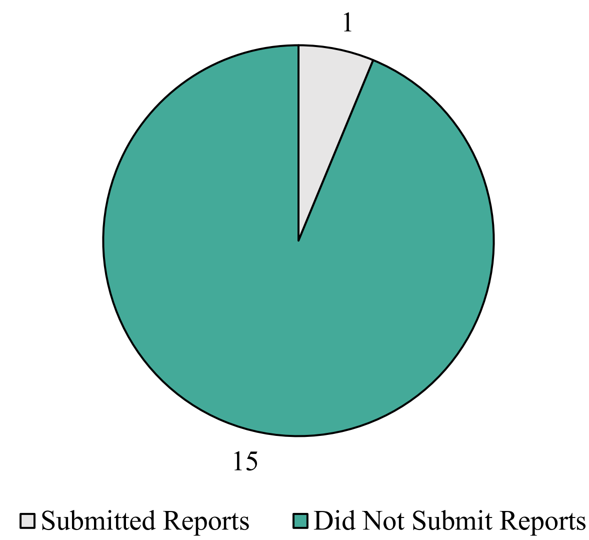
[7] Information provided by DHCD to the Department of Budget and Management and obtained by Office of Program Evaluation and Government Accountability (OPEGA). External financing could not be verified by OPEGA using available information sources.

[8] Estimates for job creation based on information provided by borrower in application and have not been verified by DHCD or OPEGA.

- **DHCD does not enforce their own minority business enterprise (MBE) reporting requirements for NBW borrowers.** DHCD requires borrowers to submit an MBE agreement for all construction projects that receive at least $250,000 in NBW funding and provide a monthly report of all MBE vendor and subcontractor payments to DHCD's Office of Fair Practices. Of the awards made from fiscal 2019 through 2023, 16 were required to submit an MBE plan under DHCD policy. As shown in **Exhibit 17**, only one borrower submitted the required monthly reports.

Exhibit 17
Submission of MBE Monthly Reports by Borrowers



MBE: minority business enterprise

Source: Department of Housing and Community Development

NBW Lending Process

NBW business loans may be inaccessible to small businesses in targeted areas who do not have the time or resources to complete the application process.

- **The NBW loan application package, which was paper based prior to January 2023, requires extensive documentation from potential borrowers.** The NBW Underwriting Manual explains that a complete application generally contains the items listed in **Exhibit 18**. However, the manual also notes that "each loan application will be assessed individually" and "some items may not be available due to the age[9]/type/structure of the potential Borrower." Members of the small business community indicated that compared to loan programs offered through other State agencies, the application requirements for NBW business loans are challenging for new and emerging businesses to meet.

Exhibit 18
NBW Business Loan Application Materials

1. A completed NBW application form with all required exhibits.
2. Historical annual financial statements for the past 3 years.
3. Business tax returns for the past 3 years.
4. Interim financial statement not greater than 6 months old.
5. A personal financial statement for any individuals holding greater than 20% ownership.
6. Three years tax returns for any individuals holding greater than 20% ownership.
7. Projected financial statements for 2 years.
8. A business plan for entities operating for less than one year.
9. Supplemental information requested by NBW staff for certain programs or specific loans.

NBW: Neighborhood BusinessWorks

Source: Department of Housing and Community Development

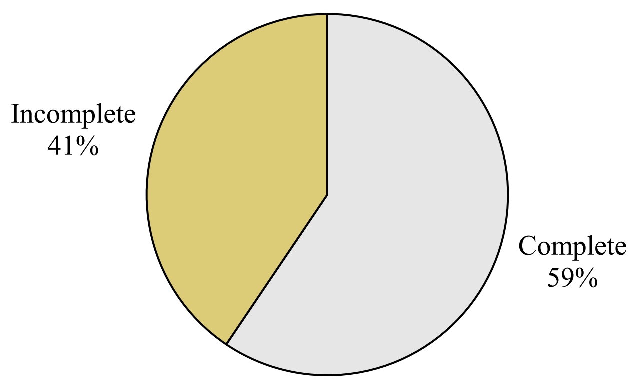
- **Almost half of potential borrowers who start an NBW business loan application do not complete the process.**

As shown in **Exhibit 19**, of the NBW program received a total of 180 loan applications between 2018 and 2021, 73 (41%) were incomplete and 107 (59%) were complete. Of the 73 incomplete NBW applications reviewed, more than half were missing documentation required as

[9] Age refers to the amount of time a borrower has been in business.

part of the NBW application package and applicants did not respond to requests from DHCD to submit the missing materials.

Exhibit 19
NBW Business Loan Applications



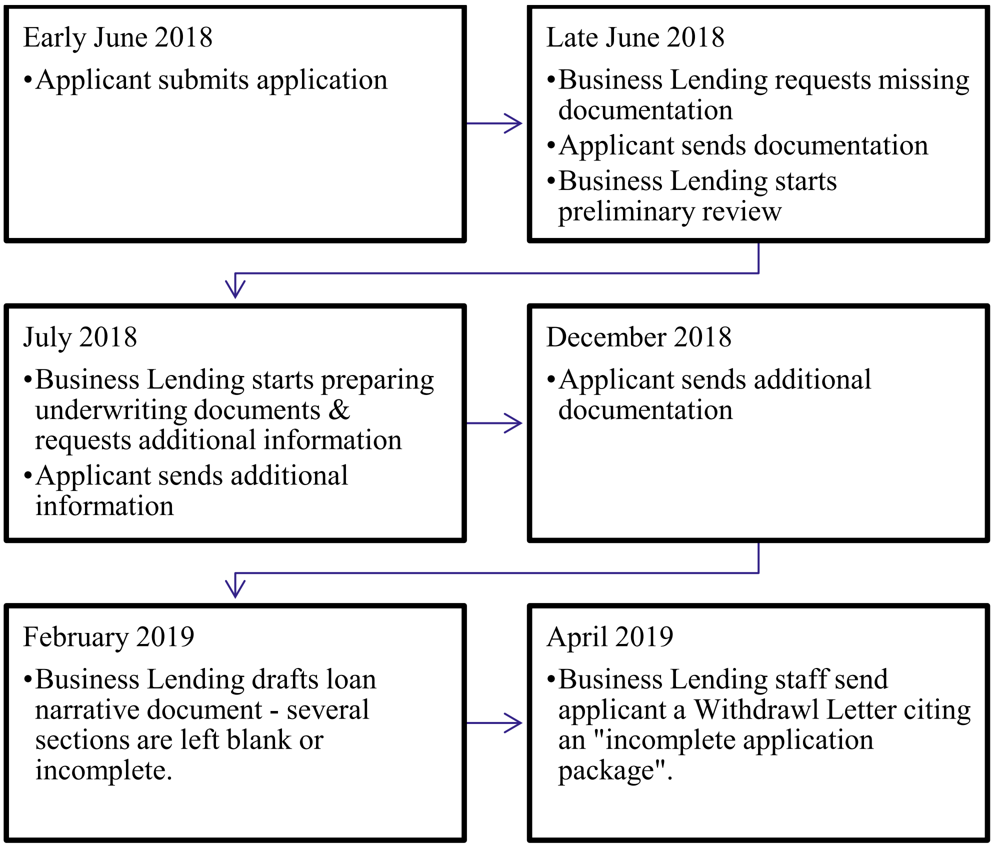
NBW: Neighborhood BusinessWorks

Source: Department of Housing and Community Development; Department of Legislative Services

- **Several applicants were in communication with DHCD staff for more than six months before their applications were determined to be complete.** At least 20 applications categorized as incomplete appear to have the required documentation on file, but applicants did not provide supplemental information requested by the NBW team.[10] In many of these cases, applicants appear to "drop out" of the application process after extensive correspondence with the NBW team. An example of this is outlined in **Exhibit 20**. In this case, it took nearly a full year for NBW to withdraw an application because it was incomplete.

[10] The definition of an "incomplete application" is broad. The federal Equal Credit Opportunity Act defines an application as incomplete if the applicant has not provided all relevant information to the creditor and the credit lacks sufficient data for a credit decision. This does not mean that an applicant did not submit all the documentation listed on a credit application. If a creditor asks for supplemental information and the applicant does not provide that information, they can be denied for incompleteness.

Exhibit 20
Case Study of Application Dropout



Source: Department of Housing and Community Development; Department of Legislative Services

NBW's application, approval, and loan management procedures may expose the State to operational risk[11] and limit the program's ability to meet small business financing needs in targeted areas.

- **The direct authority of the Secretary of Housing and Community Development over the NBW Program may undermine the checks and balances built into the lending process.** The NBW Policy and Procedures Manual states that the NBW Director reviews the final underwriting package for every loan before recommending it for approval.

[11] Operational risk is the possibility of loss resulting from breakdowns in internal procedures, policies, or systems. Operational risk can be mitigated by effective control systems, including regular internal and external audits, regular risk review of individual transactions, effective management information systems, clear lines of reporting and authority, and the presence of an independent oversight function with sufficient resources and stature within the organization.

According to DHCD staff, loans are only recommended for approval if the underwriter and NBW Director agree that they are fiscally responsible projects that meet the mission of the NBW Program. However, DHDC staff familiar with NBW business lending shared that the Secretary can bring projects to staff members and direct them to work with potential borrowers to develop an application. Referring to one of these projects, one DHCD staff member wrote, “I know the Secretary is keen to proceed and it is, therefore, a done deal.” **Exhibit 21** outlines a case where the Secretary of Housing and Community Development had influence over NBW lending decisions.

Exhibit 21

NBW Support to a Biopharmaceutical Company

A biopharmaceutical company (“The Company”) based in Utah has manufacturing operations across two sites in Cecil County’s Opportunity Zones. The Company is currently seeking FDA approval for several drugs with the hope to expand their manufacturing operations to 500 jobs by fiscal 2025.

In 2018, The Company approached the Secretary of Housing and Community Development about financial assistance under the Opportunity Zone Program. Over the course of a year, the NBW team crafted a loan package that would make it possible for The Company to obtain Series C venture funding to expand their manufacturing footprint in Cecil County. In 2019, NBW closed a $500,000 loan to The Company to provide working capital for their manufacturing expansion in Maryland. Between 2019 and 2023, DHCD provided a total of $8.5 million in financial assistance to The Company through the Opportunity Zone Program.

The initial loan to The Company is unique from other NBW business loans for several reasons, including:

1. The business did not submit an application for a business loan. Instead, the business approached the Secretary and requested financing support after which the staff helped craft a loan package.

2. At the direction of the Secretary, the NBW team developed a new “leveraged loan” product for the Opportunity Zone Program. Loan review and approval for this product went through a newly established Opportunity Zone Committee rather than the NBW Loan Approval Committee.

3. The new lending product had less-stringent requirements. Specifically, the borrower was not required to provide any collateral to cover the loan and did not have to demonstrate historic cash flow or sufficient income to cover loan payments.

4. The Company is not required to make any repayments until the loan matures in February 2034.

NBW: Neighborhood BusinessWorks

Source: Department of Housing and Community Development; Department of Legislative Services

- **Staff who are particularly knowledgeable about loan underwriting processes and procedures may be able to manipulate the loan application package to hide shortcomings of the borrower or the project.** Lending decisions are heavily dependent on the information compiled and presented by NBW underwriters. Many of the DHCD staff members consulted for this evaluation described underwriting as "an art, not a science." While the qualitative nature of the review process allows DHCD staff a great deal of flexibility in designing a loan package that meets the needs of potential borrowers, it also makes it possible for staff to manipulate the information they include in their underwriting analysis. The Office of Program Evaluation and Government Accountability (OPEGA) identified one example of this occurring in 2013, as described in **Exhibit 22**. This application was initially approved by the Loan Review Committee.

Exhibit 22

NBW Loan Application

In 2013, an NBW underwriter intentionally withheld derogatory information about one of the key personnel of a project to ensure the loan application would make it to committee review. In an email from March 13, 2013, the underwriter wrote to the applicant, "If I followed the proper procedures the request would have been decline[d] upfront…by keep putting the loan request in front of the decision makers is making them look at the request and the underwriting more closely. That puts me in a bad spot by not underwriting (disclosing the negative findings) the key person that will be responsible…"

The loan was initially approved by the NBW Loan Review Committee, but the applicant did not provide the documentation required for closing. The loan did not go to closing, and the application was ultimately denied on March 19, 2013. However, it is not clear that DHCD took any steps to address the underwriter's deliberate misrepresentation of the loan application.

This case, while dated, raises concerns about the reliability of the information in all underwriting documentation created by this specific underwriter who remained on staff until 2017. While policies and procedures have been updated since this time, it does not appear that there are additional checks in place to prevent underwriters from manipulating their analysis.

DHCD: Department of Housing and Community Development
NBW: Neighborhood BusinessWorks

Source: Department of Housing and Community Development; Department of Legislative Services

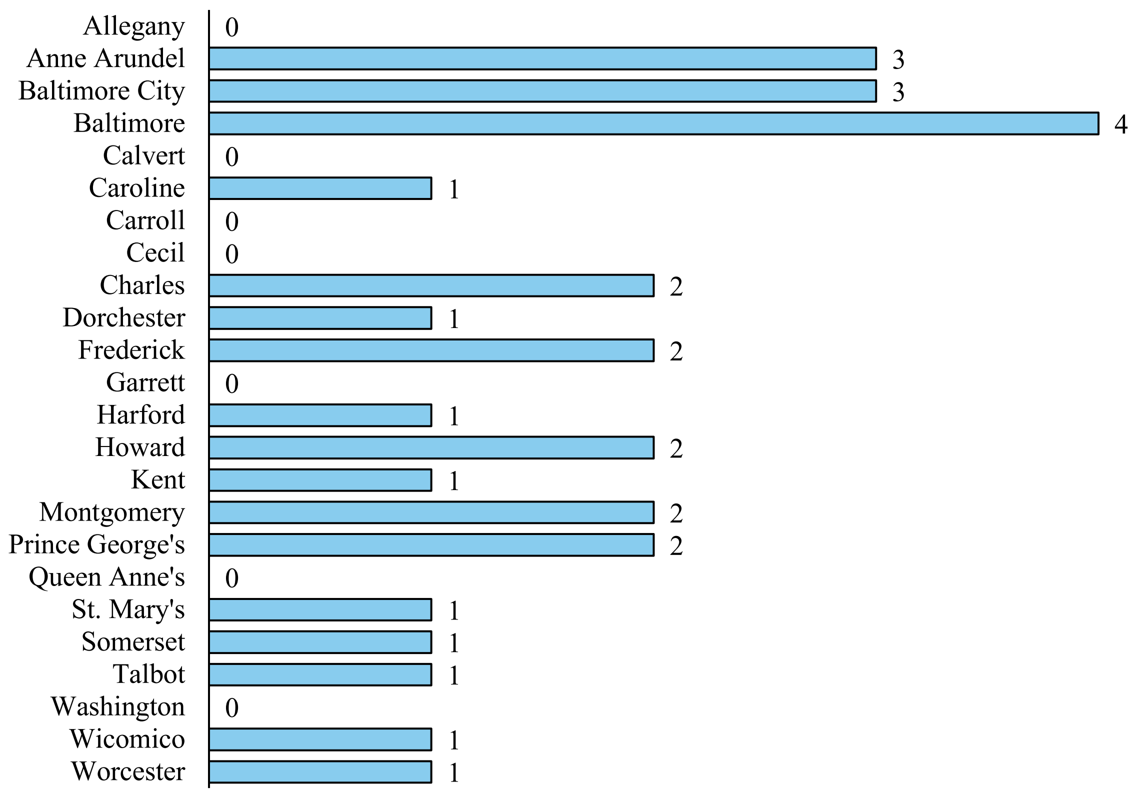
- **Between 2018 and 2021, every loan presented to Loan Approval Committee or the Secretary was approved.** OPEGA reviewed documentation from 65 loans that were approved by the Director of Business Lending between 2018 and 2021 and found no cases in which a loan presented to the Loan Approval Committee or the Secretary were ultimately denied. Committee members shared that they place a lot of faith in the NBW underwriting team's analysis. Thus, they approach the committee review as an opportunity to fine-tune the lending terms, and not as an opportunity to challenge the underwriter's recommendation to provide the loan. Documentation provided by NBW shows that the Loan Approval Committee review often results in adjustments to the proposed interest rate, the repayment schedule of the loan, or alterations to loan requirements related to closing documentation, funding disbursements, or reporting.

- **The information systems used by DHCD to manage NBW business lending are insufficient for the complexity of the application, review, and management processes.** There is no central management information system in place for the NBW program. Each unit within DHCD that interacts with the NBW program collects and stores information through separate systems that do not communicate with one another. The U.S. Department of the Treasury, which is responsible for examining the lending practices of commercial banks, notes that the effectiveness of a bank's loan portfolio management heavily depends on the quality of management information systems. Inadequate management information systems limit the ability of lenders to identify and respond to challenges when they arise. According to DHCD staff, having access to an internal management information system "would allow for better record-keeping and save a considerable amount of time in tracking the portfolio activity."

Other NBW Programs

- **DHCD works with community-based microlenders to administer the Microenterprise Loan Program, but there are no intermediary lenders serving microenterprises in Allegany, Carrol, Cecil, Garrett, and Washington counties.** Interested microlenders apply for NBW financing and go through a similar underwriting and approval process as small business loan applicants. Microlenders use their borrowed funds to originate and administer microenterprise loans and provide technical assistance to their borrowers. As of January 2023, five microlenders were participating in the Microenterprise Loan Program as intermediaries. **Exhibit 23** shows the areas served by participating microlenders. Counties with no microlenders are not able to participate in the NBW Microenterprise Program.

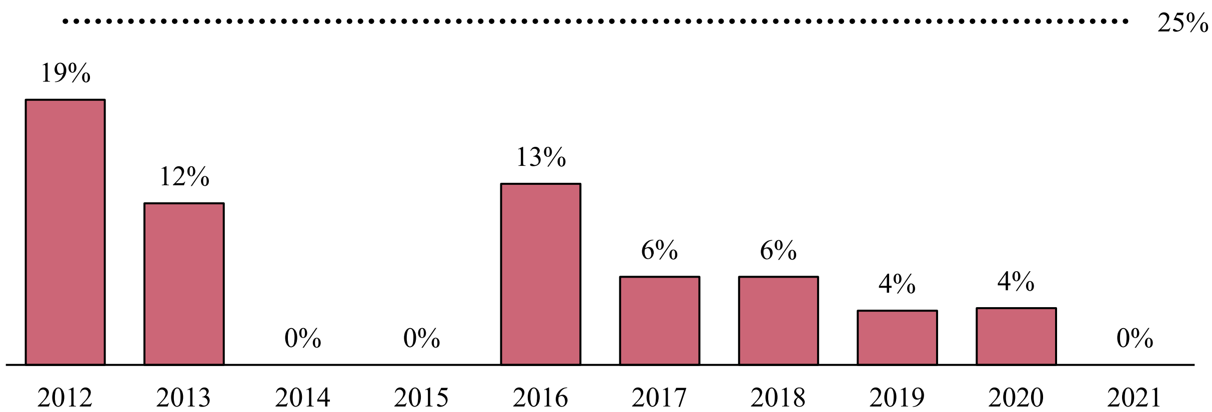
Exhibit 23
NBW Microenterprise Loan Program
Intermediary Lenders by Jurisdiction



Source: Department of Housing and Community Development; Department of Legislative Services

- **DHCD has never met the goal of allocating 25% of grants and loans to microenterprises.** Statute requires DHCD to "make a reasonable, good faith effort" to allocate 25% of NBW grants and loans to microenterprises. As demonstrated in **Exhibit 24**, DHCD did not achieve this goal between fiscal 2012 and 2021. In fiscal 2014, 2015, and 2021, no NBW funding went toward the Microenterprise Loan Program.

Exhibit 24
Percent of Grants and Loans to Microenterprise Intermediary Lenders
Fiscal 2012-2021



Source: Department of Housing and Community Development; Department of Legislative Services

- **No intermediary loans have been made through the Fresh Food Financing Initiative because no jurisdiction has applied for a food desert designation.** Chapter 228 of 2014 established the Fresh Food Financing Initiative to provide up to $100,000 in financing to help create and retain small businesses and other food-related enterprises that provide fresh fruits, vegetables, and other healthy foods to residents in a designated food desert. Local governments must apply to the department to designate a community or a neighborhood as a "Food Desert Area" for local businesses to become eligible for these funds.

  Community-based lenders can apply for financing to act as intermediary lenders under this initiative. Intermediary lenders are expected to provide technical assistance to applicants and borrowers, originate loans, and monitor borrower progress. During fiscal 2015, the NBW team approved a loan an intermediary lender who would be responsible for originating and managing loans made through the Fresh Food Financing Initiative. The NBW team shared that the intermediary lender was unable to make any loans because there were no designated food deserts in the State at that time. Legislation passed in 2016 expanded NBW's business lending portfolio to include priority funding areas.

  In DHCD's fiscal 2017 report on the Fresh Food Financing Initiative, the Secretary stated that the 2016 legislation made the food desert designation "obsolete."[12] The report

[12] Report available here: https://dlslibrary.state.md.us/publications/Exec/DHCD/HS6-308.4(a)_2017.pdf

indicates that DHCD did not anticipate any future applications from local governments for a food desert designation and that the department would continue to make financing available to small businesses that provide fresh food retail through the NBW program. As of January 2023, no local government had applied for the designation.

Recommendations

Recommendations to the Department of Housing and Community Development:

1. DHCD should consider collecting more robust information about community and economic impact from borrowers during the application process and after a loan has been disbursed.

2. DHCD should invest in a management information system for the NBW Program and maintain more robust documentation for all loans, but especially those that fall outside of the usual portfolio of NBW.

3. DHCD should conduct an independent audit of their lending practices to identify potential operational risk factors for and update policies and procedures in accordance with findings.

Recommendations to the Maryland General Assembly:

4. The Maryland General Assembly could consider clarifying the objectives of the NBW Program in statute to define the economic and community impacts that NBW should prioritize in funding decisions.

5. The Maryland General Assembly could consider revising the DHCD statute to align with the current NBW program. Specifically:

    a. The Capital Access Program is no longer part of the Neighborhood Business Development portfolio.

    b. The Fresh Food Financing as it is written is obsolete and the annual mandated report is unnecessary.

Appendix A. Response from the Department of Housing and Community Development

WES MOORE
Governor
ARUNA MILLER
Lt. Governor
JACOB R. DAY
Acting Secretary
JULIA GLANZ
Deputy Secretary

DHCD Response to NBW program evaluation report

The Department of Housing and Community Development has reviewed the NBW program evaluation report. We want to thank our colleagues at DLS for their thorough review, and their collaborative efforts while working on this project. DHCD is pleased to provide our response to the report.

<u>DHCD Response to the Recommendations</u>

1. DHCD should consider collecting more robust information about community and economic impact from borrowers during the application process and after a loan has been disbursed.

<u>DHCD Response</u>: The Department accepts this recommendation.

2. DHCD should invest in a management information system for the NBW Program and maintain more robust documentation for all loans, but especially those that fall outside of the usual portfolio of NBW.

<u>DHCD Response</u>: The Department agrees with this recommendation and will begin the exploratory process to determine how to proceed. There are a few high priority systems being implemented right now that will require DHCD's attention over the next year.

3. DHCD should conduct an independent audit of their lending practices to identify potential operational risk factors for and update policies and procedures in accordance with findings.

<u>DHCD Response</u>: The Department agrees that a review of process and procedures would be beneficial. We will begin the process of determining how to proceed.

<u>DHCD Response to specific findings within the report</u>

In addition to responding to the specific recommendations, the Department would like to offer some additional information regarding the NBW program overall, and then also some additional context to the specific investment that was highlighted in the report.

1. **General comments about NBW: timing, process, and requirements**

There are many aspects to underwriting a business borrowing request and sometimes an applicant is simply just not ready to proceed. This can be due to zoning issues, MHT required approvals, no business plan, no commitment letter(s) from primary lenders to identify the financing gap, etc. Sometimes they apply to DHCD with just an idea, not a business plan that is ready for financing. When dealing with real estate purchase/ construction/renovation contracts, there can be zoning issues, lease agreements or purchase contracts are not in hand, sales contracts expire, etc. The NBW program also has to engage the Office of the Attorney General with the attorneys representing the buyer and seller and it is not uncommon that this process alone, especially when reviewing loan documents and closing requirements, can take many weeks.

The NBW program is primarily a commercial real estate lender. The majority of our projects include real estate purchases and renovations. MHT approval is required on all real estate projects that include construction. In order for MHT to determine no adverse impact, they must have all construction plans and budgets sent to them for review. The MHT project review process can take several weeks or months. If there happens to be an adverse impact on the property or the neighborhood, MHT can take months to come up with a satisfactory remediation plan acceptable to the state, borrower and DHCD.

The NBW program does its very best to work with potential borrowers and assist them throughout the project. We want to assist small businesses who do not have access to capital, not deny their requests. Many times, potential borrowers are simply not ready to undertake a project or they do not have the means either financially or experience wise to move forward with the proposed project. There is a misconception that “state” financing can be provided to all that apply. There are three (3) main reasons that many applications are not completed: 1) The borrower just has an idea with no formal business plan – these borrowers are referred to the local SBDC for technical assistance. 2) Lack of Collateral – the borrower has no assets to secure a loan. 3) Lack of Liquidity – the borrower does not have the means to repay a loan.

We recently implemented more stringent time guidelines to assist with the application process. Most times, the on-line application is not fully completed. When we see an application is in process, our staff reaches out within 24 - 48 hours to provide assistance to the borrower. Sometimes borrowers just do not respond to emails or phone calls which then requires daily follow up on the part of the NBW staff. In the past, we afforded borrowers weeks and even months to complete their application. With our newly implemented processing guidelines and on-line application that went live in November 2022, we allow the borrower 30 days to either contact us or complete their application.

Once we have a completed application, there are many financial and legal documents such as Articles of Incorporation, By-Laws, tax returns etc. that must be submitted. Once we have a complete application including all required submissions, the project goes into the underwriting process. Underwriters must engage on a regular basis with the prospective borrower to ensure a complete understanding of the project, that the project supports DHCD’s mission of revitalization and job creation and that the project is welcome within the local jurisdiction. Local approval by the highest governing body in the city or county where the project resides is also required. The local jurisdiction, by legislation, has 45 days to respond to the request.

The above is a brief summary of the process that can be timely, but we do our best to ensure the needs of our borrowers are being met while balancing the protection and investment of taxpayer dollars.

2. **Specifically, Exhibit -21 NBW Support to a Biopharmaceutical Company**

To put into context the Department's history with the Biopharmaceutical Company ("Company")

The Company has manufacturing operations across two sites in Opportunity Zones in Maryland. In 2018, The Company approached the Secretary of Housing and Community Development about financial assistance under the Opportunity Zone Program. Over the course of a year, the NBW team was tasked to develop an equity-like financial assistance mechanism for companies that have high strategic significance for the State of Maryland but who are smaller in size than the business entities typically handled by the Department of Commerce and which may not fit within the budget or charge of TEDCO. The venture loan product and loan agreements were developed with the assistance of the outside legal counsel specializing in that field. The venture loans are vehicles incorporating typical protections a creditor would receive, i.e. they claim priority over equity investors in the waterfall of repayment rights in the event of an entity default. DHCD also incorporated the right to get repaid in the amount of an equivalent equity value if the company ends up appreciating multifold as a result of the ultimate company success.

The NBW program funded $8.5 million to the Company as follows:

- A $500,000 venture debt loan closing in February 2019 that led to a subsequent Series D investment from private investors of $40,000,000+ into the Company in the summer of 2020. The $500,000 venture debt loan enabled the company to support ongoing clinical trials at the time of the venture debt funding.
- A $3,000,000 loan for equipment closed in May 2022. The loan was secured by the equipment that was purchased.
- A $5,000,000 SSBCI Venture Debt funding closed in Dec 2022 and has been matched with over $40,000,000+ of private funding to support the ongoing clinical trials for the company. These venture debt funds and private equity have enabled the Company to continue its ongoing clinical trials.

Since Feb 2019, the biopharmaceutical company has expanded its manufacturing operations by 15,000 square feet and has subsequently leased another 80,000 square feet of a previously 6-yr vacant building.

Some context to why the "uniqueness" of the venture debt loan. After the statutory change to NBW in 2016-2017, the NBW program tools and resources were expanded to include private market bond issuance, and venture debt, in addition to the traditional lending activity. Steps were taken internally, over several years, to identify what would be required by the Department to do one, or both, of these activities. The department has developed a legal and financial framework to access private capital markets to finance credit eligible mixed use real estate projects with business occupants. The bond markets for business loan programs have changed and the increased interest rates made this NBW program path less attractive to participating businesses. If the market conditions become more favorable, NBW and CDA bond finance teams will revisit this capital formation opportunity..

The venture debt program was finalized after internal leadership vetted the application process and underwriting criteria. The venture debt product is designed to provide the opportunity for small businesses that have funding needs to grow their businesses but do not have the assets (collateral) to secure traditional funding. (i.e biopharmaceutical companies, software companies, service providers, etc.). There were two businesses identified that were early opportunities for the Department. The biopharmaceutical company was one of them.

The initial loan to The Company is unique from other NBW business loans for several reasons and the following provides additional context for the questions posed:

1) **The business did not submit an application for a business loan. Instead, the business approached the Secretary and requested financing support after which the staff helped craft a loan package**. The development of the new venture loan product and program was spurred by the Secretary's vision to grow the NBW program through new loan product offerings, which was further solidified through a statutory change allowing DHCD to enter into convertible note instruments in 2022. The staff followed industry standard best practices for evaluating venture debt opportunities by executing extensive due diligence on the company, its operations, audited financials and proposed plans with clinical partners to progress through concurrent FDA clinical trials. With the opportunity zone debt financing in its infancy, standard due diligence activities were executed over a 9-10 month timeframe to evaluate the potential of making a venture debt investment.
2) **At the direction of the Secretary, the NBW team developed a new "leveraged loan" product for the Opportunity Zone Program. Loan review and approval for this product went through a newly established Opportunity Zone Committee rather than the NBW Loan Approval Committee.** The Opportunity Zone Program loan was later replicated for another high strategic value business entity in the film animation industry which received two awards totaling $1,000,090. Due to complexity in underwriting venture loans and the unique risks and repayment terms associated with high impact and lower probability of success of an enterprise, venture loan review and approval went through a newly established Opportunity Zone Committee, which became the Venture Debt Committee after NBW added the federal State Small Business Credit Initiative venture loan funding to its product offering.
3) **The new lending product had less-stringent requirements. Specifically, the borrower was not required to provide any collateral to cover the loan and did not have to demonstrate historic cash flow or sufficient income to cover loan payments.** Instead, each business is analyzed for its potential to strategically and positively impact the job market and local and state economy and community while simultaneously having the potential to grow in its value due to a probability-weighted commercial success of its operations. These venture loans do have higher interest rates and equity like returns for the increased risk. These venture loans are another financing product that is needed to meet community development needs.
4) **The Company is not required to make any repayments until the loan matures in February 2034** The term of the loan enabled the company and the department to have enough time for the company to meet clinical milestones and financial milestones for each to mutually benefit. The company and the department may mutually agree to have the loan repaid with accrued interest at any time. For qualified trigger liquidity events,

DHCD may exercise its right to get repaid over and beyond the principal and interest owed on the note based on the increased valuation of the company.

In addition, the process and due diligence performed in order to execute these loans allowed DHCD to put forth a strong application to the U.S. Treasury, where this same program is now an approved use under the $198,000,000 SSBCI federal award.

Appendix B. Methodology

Our program evaluation objective was to answer the following questions:

1. Is the Department of Housing and Community Development (DHCD) efficiently and effectively meeting the objectives of the Neighborhood BusinessWorks (NBW) business lending program?

2. What is the financial return to the State from NBW business lending?

3. What are the community impacts of NBW business lending?

To answer the core research questions, this evaluation relied on the following qualitative and quantitative data collection and analysis:

1. Interviews and focus groups with:

   a. DHCD staff members involved with NBW business lending;

   b. representatives of local government responsible for supporting small business development and community revitalization;

   c. small business advocacy organizations in Maryland; and

   d. industry experts on small business finance and concessional lending.

2. Analysis of administrative data provided by DHCD including:

   e. DHCD's NBW loan and grant application files since 2011;

   f. repayment data from the external loan servicer for fiscal 2017-2022;

   g. DHCD's asset management spreadsheets related to NBW;

   h. policies and procedures manuals for the NBW business loan program; and

   i. data on MBE participation in NBW-funded projects.