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Small Business Administration 504 Loan Program: Small Businesses' Window to Wall Street

Abstract

The Small Business Administration (SBA) 504 Loan Program (504 loan program) is a long-term financing tool that promotes economic development in communities. The program encourages banks and other lenders to partner with a certified development company (CDC), a private, nonprofit corporation to help small businesses. Each partner makes a loan to a qualifying small business. Typically, the bank loan is secured by a first lien covering 50 percent of a project's cost. By offering 504 loans, banks can attract small business borrowers needing financing for plant and major equipment acquisition. Banks also may receive positive Community Reinvestment Act (CRA) consideration for participation in the 504 program.

This *Insights* report explains how the 504 loan program is working now—one year after the American Recovery and Reinvestment Act (ARRA) was enacted. It updates our February 2006 *Insights* report on the program.

Congress enacted ARRA on February 17, 2009, to stimulate the U.S. economy and increase credit to small businesses. The changes authorized in ARRA, and subsequent legislation, temporarily reduced certain 504 up-front program fees and expanded the program to allow refinancing under certain circumstances.¹

This report presents information collected from a variety of sources, including Web sites published by the SBA, banks, CDCs, and other sources. Appendix A provides a sample term sheet for a 504 project. Appendix B has examples of 504 loan projects. Appendix C provides sources of additional information on 504 loans.

I. What Is the SBA 504 Loan Program?

The 504 loan program provides financing for major fixed assets, such as owner-occupied real estate and long-term machinery and equipment. A 504 project is funded by a loan from a bank secured with a first lien typically covering 50 percent of the project's cost, a loan from a CDC

¹ The original funding for 504 fee relief has been exhausted. Several temporary extensions have been approved providing additional funding for this purpose. Lenders can obtain current information on the status of fee relief from their local SBA field office at <http://www.sba.gov/localresources/>.

secured with a second lien (backed by a 100 percent SBA-guaranteed debenture²) covering a maximum of 40 percent of the cost, and a contribution of at least 10 percent of the project cost from the small business being financed. The SBA promotes the 504 program as an economic development tool because it is a small-business financing product that generates jobs.

Proceeds from 504 loans must be used for purchasing land and improvements, constructing new facilities, converting or renovating existing facilities, purchasing long-term machinery and equipment, or limited refinancing of existing eligible 504 debts.³ ARRA permanently allows 504 proceeds to be used for limited refinancing of existing loans that were used for 504-eligible fixed assets. Refinancing is permitted when there is a business expansion, the refinanced debt does not exceed 50 percent of the projected expansion cost, and the refinancing provides a substantial benefit to the borrower. The 504 program cannot be used to fund working capital or inventory.

Generally, a business must create or retain one job for every \$65,000 guaranteed by the SBA, except for small manufacturers, which must create or retain one job for every \$100,000 guaranteed by the SBA. Borrowers must include projections for meeting these requirements in their applications for CDC loans; the projections are not part of the bank loan process. In addition, projects funded by the 504 program must meet one of three goals, each of which has a different maximum SBA debenture size. The three goals address community development, public policy, and small manufacturer assistance.⁴

What Are CDCs?

Typically, CDCs are nonprofit organizations certified by the SBA to provide funding for small businesses under the SBA 504 program.⁵ Most have a 501(c)(4) or 501(c)(6) nonprofit designation from the Internal Revenue Service, although some have a 501(c)(3) designation. There are approximately 290 CDCs nationwide, some of which have as their sole product the 504 loan, while others offer a range of small business programs in addition to the 504 loans.⁶

CDCs receive certification to operate statewide and, with approval from the SBA, can offer the 504 product in contiguous states. A CDC operates under the leadership of a board of directors drawn from the service area.⁷

CDCs are supervised by the SBA and must submit annual reports to the SBA. The SBA's Office of Lender Oversight oversees CDCs' compliance with all applicable rules and regulations. To retain its certification, a CDC must provide at least four 504 loan approvals during two consecutive fiscal years. As part of its oversight process, the SBA assigns a CDC to one of eight tiers based on annual loan approval volume and provides every CDC with financial data and ratios, including

² The CDC debenture has a 100 percent guarantee from the SBA. Each debenture is packaged with other CDC debentures into a national pool and is sold on a monthly basis to underwriters. Investors purchase interests in debenture pools and receive certificates representing ownership of all or part of a debenture pool. SBA uses various agents to facilitate the sale and service of the certificates and the orderly flow of funds among the parties involved.

³ See www.sba.gov/idc/groups/public/documents/sba_homepage/sba_rcvry_act_borrowers504.pdf.

⁴ See www.sba.gov/financing/sbaloan/cdc504.html and 13 CFR 120.862.

⁵ They are different entities than community development corporations, also known as CDCs, which are nonprofit organizations that typically develop residential and/or commercial property in a targeted area.

⁶ For a listing of CDCs by state, see www.nadco.org/i4a/member_directory/feSearchForm.cfm?directory_id=12&pageid=3378&showTitle=1.

⁷ A CDC must have at least 25 members, who elect a board of directors from among themselves. The membership must include representatives from each of four groups: (1) government, (2) financial institutions, (3) community organizations, and (4) businesses. At least three of the four groups must be represented on the board of directors, and at least one member of the board other than the CDC manager must have commercial lending experience. In addition, none of the entities represented on the membership or board of directors may control the CDC; the CDC must remain independent of banks, governmental agencies, and other institutions.

loan loss rate for its tier average. Under the Preferred Certified Lenders Program (PCLP), CDCs receive the authority to approve loans for the SBA, thereby expediting loan processing.⁸

II. Why Are 504 Loans of Interest to Banks?

The 504 loans are attractive to banks because these loans can retain and attract customers, assist in risk and liquidity management, and provide fee and interest income. The program enables banks to collaborate with CDCs to provide long-term financing to small business customers who might otherwise be unable to find long-term financing to grow. (A CDC loan has a fixed interest rate for the term of the loan. The bank loan may have either a fixed or variable rate.) The 504 loan program provides risk management advantages to participating banks, such as limiting their credit exposure to a single customer, providing good collateral coverage for their retained portion of the loan, and facilitating liquidity management through an available secondary market.

Credit risk is partially mitigated by a low loan-to-value (LTV) ratio, which typically does not exceed 50 percent. Banks' 504 loans are collateralized by real estate or other fixed assets and, most importantly, the exposure on 504 loans is tiered with banks having the first-lien position. The CDC loans are subordinate to the banks' first position on the debt. In addition, 504 loans may help banks manage their lending limits, industry exposure, and liquidity because a secondary market for 504 first-lien loans exists. With the help of the newly created SBA 504 first-loan pool guarantee, secondary market transactions are likely to increase.⁹

Banks can earn fees and interest income on interim loans related to the project.¹⁰ Separately, banks providing the permanent 504 loans may also offer construction loans for projects requiring new construction, rehabilitation, or reconfiguration of an existing structure. These construction loans typically generate origination, documentation, and inspection fees. However, banks are reminded that these interim loans are not guaranteed and, as with all real estate-secured loans, they should conform to applicable laws and regulations including lending limits and appraisal guidelines.

Banks also can earn income by selling first-lien loans in the secondary market and may be able to cross-sell a variety of other financial products and services as the borrowers' businesses grow. In addition, banks may purchase 504 loans from originating banks, securitize the loans, and generate income from the retained servicing activities of the portfolio.

Originated loans of \$1 million or less represent approximately 55 percent of the total outstanding commercial and industrial (C&I) loans made by national community banks. Therefore, loans to small businesses are likely to form a significant part of their lending business.¹¹ SBA 504 loans

⁸ This reduces time needed for SBA review of various documents because the lenders in the PCLP submit materials to SBA for after-the-fact approvals. CDCs must apply to the SBA to become PCLP lenders. Because the SBA gives these CDCs sign-off authority, PCLP CDCs assume some of the risk. PCLP lenders must reimburse SBA for 10 percent of any loss as the result of a default by a borrower, and PCLP lenders must also maintain a loan loss reserve of 1 percent of their outstanding loans.

⁹ On October 28, 2009, the SBA announced that it created a secondary market guarantee program to provide greater liquidity for lenders and expand access to capital for small businesses. The new program, a provision within ARRA, is expected to encourage sales into the secondary market of the first mortgage portion of small business financing made possible through the 504 program. Under the new program, portions of eligible 504 first mortgages pooled by originators or broker-dealers can be sold with an SBA guarantee to third-party investors in the secondary market. Lenders retain at least 15 percent of each individual loan, pool originators assume 5 percent of the risk, and the SBA guarantees the remaining 80 percent. To be eligible to be included in a pool, the first mortgage must be associated with a 504 loan disbursed on or after February 17, 2009. The program is in place until February 16, 2011, or until \$3 billion in new pools are created, whichever occurs first. The SBA expects the first of these pools to close in 2010. See SBA News Release, "SBA Creates Secondary Market Guarantee Program for 504 First Mortgage Loan Pools," October 28, 2009.

¹⁰ Because the debentures funding the CDC loan are not commonly sold until 30 to 60 days after closing, projects usually require interim financing from a bank.

¹¹ Data on national community banks are derived from the reports of condition and income (call report) as of June 30, 2009. National community banks are those institutions with less than \$10 billion in total assets as of the call report date.

may help banks with their mission of local economic development by enabling them to assist small businesses to grow and produce jobs.

A 2008 economic impact study, funded by the National Association of Development Companies, the CDC trade association, indicated that direct, indirect, and multiplier effects of the 504 program were significant. The report indicated that within two years of receiving a 504 loan, 62 percent of all 504 borrowers showed job growth. Additionally, it reported that there was \$37.50 of increased federal revenue for every dollar spent on program costs.¹²

CRA Consideration for SBA 504 Program Loans

Loan size determines how 504 loans receive consideration in CRA examinations. In most cases, loans of \$1 million or less qualify as small business loans and may be considered under the lending test for banks of all sizes.¹³ Intermediate-small banks may choose to have small business loans of \$1 million or less, which meet the regulatory definition of community development, evaluated as community development loans.¹⁴ Loans of greater than \$1 million made under the 504 program are considered community development loans¹⁵ either under the lending test¹⁶ or community development test,¹⁷ depending on the bank's size.

III. How Do SBA 504 Loans Work?

Reaching Customers

There are several ways banks connect with borrowers receiving 504 loans. The connection mechanism depends on a number of factors, including the condition of local real estate markets, the capacity of and competition among CDCs operating in the state or states, and the receptiveness of banks to offer 504 loans.

Typically, bank customers looking to purchase either a facility to house their company's operations or heavy equipment for their business discuss financing needs with their bankers. Depending on bankers' knowledge of, and comfort with, SBA 504 loans, banks may either present 504 loans as a financing option or refer customers to CDCs that can explain 504 loans to customers.

In some areas of the country, borrowers are referred to banks by commercial real estate brokers who advertise properties as potentially qualifying for 504 financing. In these areas, competitive markets for 504 loans exist among banks. Borrowers may be referred either to banks or CDCs by local professionals (accountants and lawyers, for example) with whom they do business.

Banks that have dedicated government lending departments generally undertake specialized marketing of the 504 program. Some banks have sales personnel dedicated to SBA products and are actively engaged in marketing 504 loans to commercial customers as well as to CDCs, commercial real estate brokers, and other professionals, including professional associations

¹² See "SBA 504 Growing Small Businesses, Jobs, Communities, 2008, Economic Impact Statement," National Association of Development Companies (February 2008) at http://www.nadco.org/files/public/Economic%20Impact%20Study%20-%20Feb_2008.pdf.

¹³ See 12 CFR 25.12(v).

¹⁴ See Vol. 75, Fed. Reg. 11642, Section __.12(h)—3 (March 11, 2010).

¹⁵ See Vol. 75, Fed. Reg. 11642, Section __.12(h)—1 (March 11, 2010).

¹⁶ See 12 CFR 25.22 (large banks) and 12 CFR 25.26(b) (small banks).

¹⁷ See 12 CFR 25.25 (wholesale or limited-purpose banks) and 12 CFR 25.26(c) (intermediate-small banks).

through which potential borrowers may have contacts. Other banks have SBA divisions that serve as advisors to relationship managers throughout the banks and are brought in to provide SBA product expertise if the banks' in-house products do not fit the particular project. Generally, banks with specialized SBA departments obtain about 80 to 90 percent of their 504 borrowers from their marketing and outreach or from referrals from bank relationship managers, with the remainder referred by CDCs.

Many community banks that engage in a limited number of 504 deals annually may benefit from the outreach and marketing conducted by CDCs to promote 504 loans. When these banks have customers who may benefit from 504 loans, banks may contact CDCs operating in their market to assist in describing the 504 product to customers. CDCs often conduct joint marketing calls with these banks on potential borrowers, serving as the product expert in these discussions. Smaller banks, in particular, may value the role of CDCs in enabling the bank to provide SBA products that the banks may not otherwise be able to offer.¹⁸

Banks may also use secondary-market purchases of 504 loans to build their 504 portfolios. For example, one large bank may partner with community banks that refer customers who would benefit from 504 loans. In these transactions, the large bank makes the 504 loan to the borrower and pays a community bank a placement fee.

Loan Presentation, Underwriting, and Processing

Banks differ in how they present 504 loans as an option to borrowers. Some banks present borrowers with cost and term sheets comparing the 504 loan with other loan products, such as the SBA 7(a) loan or a bank's conventional commercial loan products. Others first look to fit the borrowers' needs into conventional loan products and offer the 504 loan to borrowers if they do not qualify.

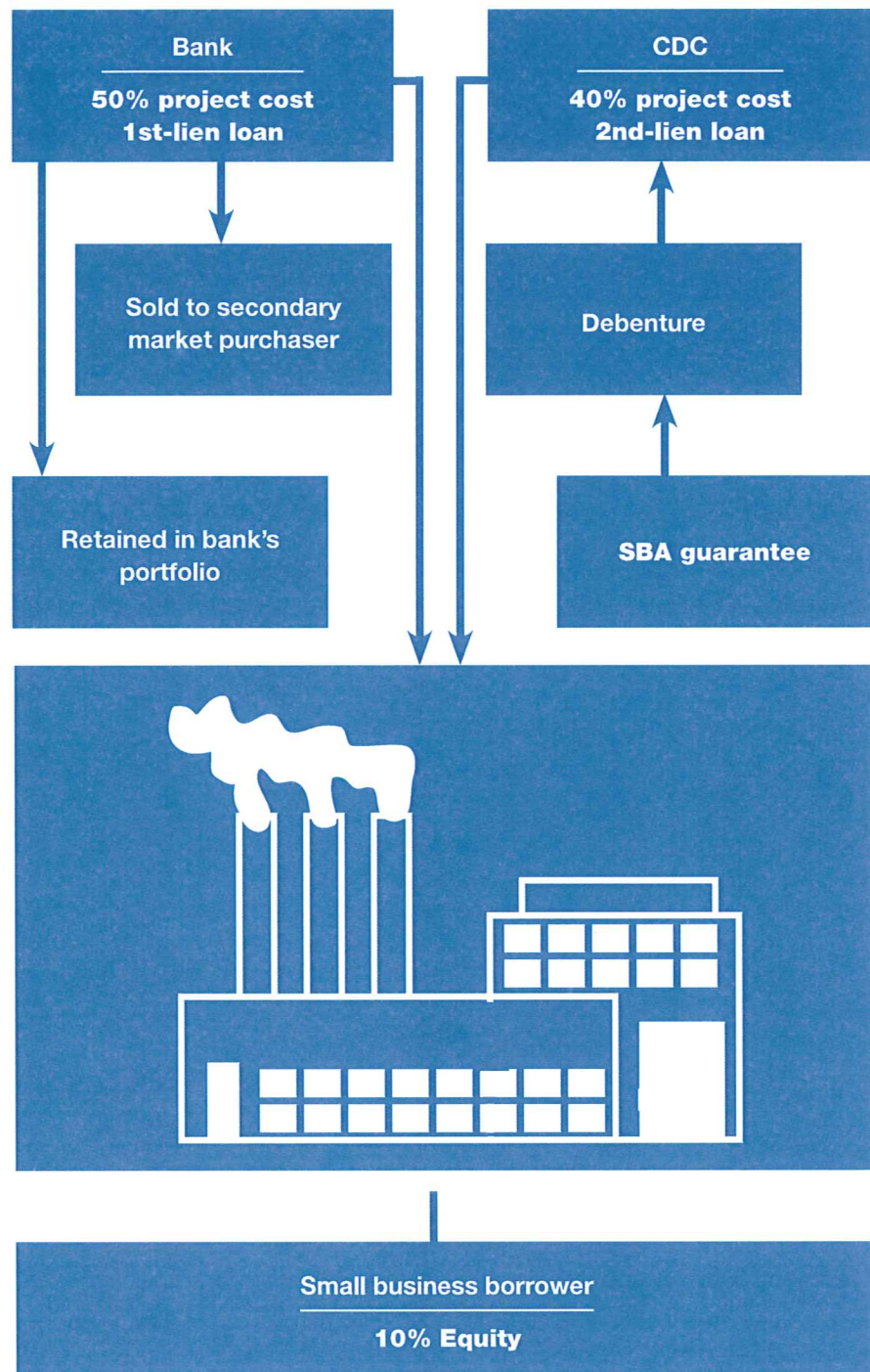
Typically, banks and CDCs perform simultaneous underwriting for the loans they provide, although banks will contact CDCs after they have conducted their underwriting. In analyzing potential loans, banks and CDCs look at traditional underwriting criteria, including management and cash flow. Banks and CDCs may contact each other during the underwriting period to discuss any concerns they may have with projects.

Some banks maintain separate credit policies for 504 loans, with differing requirements for 504 loans than other small business loans, because of the lower credit risk afforded by a lower LTV ratio on 504 loans. For example, a policy may relax cash flow requirements for a 504 loan, reducing the typical debt service coverage ratio from 1.25 to 1.15 (cash flow/debt service). The policy also may allow borrowers to use projections, instead of historical cash flows, to justify repayment.

Although closing documents may be signed for bank loans and CDC loans simultaneously, CDC loans do not get funded until the SBA debentures guaranteeing the loans are sold. (See footnote 2 for a discussion of how SBA debentures support the 504 program.) Therefore, for example, although the interest rate on a bank loan is set at closing, a borrower does not know the interest rate on the CDC loan until the debenture is sold. Closing documents for CDC loans are signed, leaving space for the interest rates to be added when they are available. CDCs can provide historical rates to borrowers as a guide to what the final rates may be. Because debentures are not commonly sold until 30 to 60 days after closing, projects usually require interim financing from banks. Traditionally, interim financing is offered by the bank providing the first-lien loan.

¹⁸ Kurt Chilcott, "SBA 504 Certified Development Companies: The Nation's Leading Economic Development Lenders," *Community Developments*, OCC, Winter 2003.

Figure 1: Typical 504 Project Structure



Source: OCC

Please see Figure 1 illustrating how a 504 project financing generally consists of:

- (1) an equity contribution by the small business of at least 10 percent of the project costs;
- (2) a loan made with the proceeds of a CDC debenture for up to 40 percent of project costs and certain administrative costs, collateralized by a second lien on the property; and
- (3) a loan from a bank for the balance (usually 50 percent) of the financing, collateralized by a first lien on the property. The term of the bank loan must be at least half as long as the term of the CDC loan.

Table 1 displays the funding sources for a sample 504 loan:

Table 1: Sample 504 Loan:

Project Uses	Dollars
Acquisition of building	800,000
Renovations	100,000
Machinery	50,000
Soft costs	50,000
Total	1,000,000

Financing Sources	Dollars
Bank – first lien	500,000
CDC/SBA – second lien (debentures)	400,000
Borrower equity	100,000
Total	1,000,000

IV. What Are the Key Risks and Regulatory Considerations Presented by SBA 504 Loans?

As with all loans, banks face credit risk from 504 loans. Many of the loans are for special purpose facilities, such as gas stations, bowling alleys, and agricultural structures, which can limit the resale value of the collateral properties. The 504 loan program, however, limits an institution’s exposure because of its 50 percent LTV ratio and a first lien on the property. In addition, banks underwrite their 504 loans with business cash flows that serve as the primary source of repayment and the collateral serving as the secondary repayment source.

The delay between funding of a bank loan and funding of a CDC loan leaves the bank facing another risk. During this period, a bank typically provides an interim loan, which means that the bank temporarily has a loan with a 90 percent LTV ratio. This interim loan is separate from any construction loan that might be needed. If a bank’s loan to the project exceeds the supervisory LTV limits contained in 12 CFR 34, the bank must include them in the aggregate amount of all loans in excess of the limits and report them accordingly.¹⁹ This aggregate amount should not exceed 100 percent of capital for the institution.

Banks interviewed did not express concern about holding a 90 percent exposure for a relatively short period of time—an average of 45 days. Potential concerns are mitigated primarily because the interim period is short, and a firm takeout source is in place through the SBA-guaranteed debenture. The banks interviewed indicated they would become concerned if they were too heavily invested in one region or one industry.²⁰

¹⁹ See 12 CFR 34, Subpart D, Appendix A, “Interagency Guidelines for Real Estate Lending.”

²⁰ See Concentrations in Commercial Real Estate Lending, Sound Risk Management Practices, 71 Fed. Reg. 74,580 (Dec. 12, 2006).

Banks providing permanent 504 loans may also offer construction loan financing, if needed. For construction loans, banks generally require additional collateral from the borrower beyond the real estate or equipment being financed. Some banks cross-collateralize with other business assets, and some require a personal guarantee from the business owner. Again, the construction loan risk is partially offset by the firm CDC takeout upon completion, leaving the bank with a 50 percent LTV first-lien loan.

When a bank makes a 504 first-mortgage loan, it enters into a third-party lender agreement with a CDC.²¹ Among other things, this document sets forth how a bank is expected to work with a CDC and the SBA in the event of a loan default. The SBA and CDC have specific methods they can use to, in some cases, bring the loan current or acquire it from the third-party lender. A 504 lender is required to notify the SBA and CDC when a borrower is 30 days late on a payment.²² Typically, a 504 lender also checks with the CDC to learn of its experience with the borrower. The SBA hopes that the bank will work with 504 small business borrowers and the CDC they collaborate with to restructure debt, when appropriate. Recently issued guidance by the Federal Financial Institutions Examination Council (FFIEC) regarding prudent commercial real estate loan workouts reinforces this option for banks.²³ Additionally, the bank and thrift regulatory agencies recently issued a statement on how financial institutions can work to meet the credit needs of small business borrowers.²⁴

V. Who Is in the SBA 504 Loan Business Today?

The SBA budget for fiscal year 2010 allocates \$7.5 billion for CDC debentures. If that amount were to be fully subscribed, it would lead to approximately \$9.4 billion in associated 504 first-lien loans by lenders.

As shown in Table 2, in fiscal year 2008, 504 lending was spread among a wide number of financial institutions. In fact, over 4,000 lenders made 504 loans in fiscal year 2008, with nearly 95 percent of these lenders closing between one and five loans during the year. These numbers show that there is broad knowledge of the product across the banking spectrum, with many community banks closing at least one 504 loan.

Table 2: SBA 504 Loans in 2008

Number of Loans	Number of Lenders	Percent of Total
1 to 5	3,818	94.5
6 to 15	176	4.4
16 to 49	45	1.1
50-100	1	*
101 -500	2	*

* less than 1 percent

Source: SBA data.

Nationally, use of 504 loan products is concentrated in certain areas of the country. SBA 504 lending is especially active in California, which accounts for nearly 20 percent of all 504 loans originated in 2008. The CDC industry is especially competitive in California, which has led

²¹ See 13 CFR 120.921, Terms of Third Party Loans.

²² See 13 CFR 120.921 (c).

²³ On October 30, 2009, the FFIEC released guidance for examiners and financial institutions on prudent commercial real estate loan workouts. See www.occ.gov/ftp/release/2009-128.htm.

²⁴ See "Interagency Statement on Meeting the Credit Needs of Creditworthy Small Business Borrowers," <http://www.occ.gov/ftp/bulletin/2010-6a.pdf>.

to a high level of publicity for the product there. According to the banks interviewed, there is active use of 504 loans in a number of other states, including Florida (7.3 percent), Illinois (3.9 percent), Minnesota (3.9 percent), New York (4.0 percent), and Texas (5.4 percent). The product is represented in all 50 states, albeit at lower volumes than those previously cited.

VI. How Does the Cost and Pricing Structure Operate?

Bankers we interviewed tell us that, in general, making larger loans is more cost effective, given the costs involved in originating loans in conjunction with the 504 program. However, banks make loans of all sizes under the program as is indicated in Table 3. In 2008, 44.6 percent of all bank first mortgages originated in conjunction with the 504 program were less than \$500,000 in size. Additionally, the CDCs interviewed indicated that smaller size loans are common because the 504 program allows small businesses with limited capitalization to leverage assets in order to grow.

Table 3: Bank 504 Loan Sizes (Fiscal Year 2008)

Loan Size	Number of Loans	Percent of Total
Less than \$500,000	3,938	44.6
From \$500,000 to \$999,999	2,497	28.3
From \$1,000,000 to \$1,999,999	1,591	18.0
More than \$2,000,000	800	9.1

Source: SBA data.

Bankers generally agreed that SBA 504 loans were better products for real estate acquisition than SBA 7(a) loans. But for loans below \$500,000, bankers said borrowers preferred 7(a) loans. One bank indicated that for real estate purchases of \$400,000 or less, most borrowers opt to use 7(a) loans due to the higher fees and the prepayment penalty on 504 loans.²⁵ For loans between \$500,000 and \$900,000 at that bank, borrowers use both 504 and 7(a) loans, while for loans of \$900,000 and above, most use 504 loans.

A comparison of the 504 and 7(a) loan programs is illustrated in Table 4.

²⁵ There is a prepayment penalty charged if the CDC loan is prepaid during the first half of its term. The penalty for prepayment of a 20-year debenture is 100 percent of one year's interest if the prepayment occurs in the first year of the loan, declining by 10 percent per year to zero after 10 years. The penalty for prepayment of a 10-year debenture is 100 percent of one year's interest if the prepayment occurs in the first year of the loan, declining by 20 percent per year to zero after five years. Partial prepayments are not permitted.

Table 4: Comparison of the SBA 504 and 7(a) Loan Programs

Issue	504 Loan Program	7(a) Loan Program
Purpose of loan	Fixed assets such as owner-occupied real estate and heavy equipment or limited refinancing of existing eligible 504 debts No working capital loans	Any business purpose
Goal of program	Job creation and retention; economic development	Capital access – access to capital for businesses that would not qualify elsewhere
Rates and Terms	Bank loan: Variable or fixed rate; must be at least half as long as term of CDC loan CDC loan: Fixed rate, 10- or 20-year maturity	Variable or fixed rate; term of up to 25 years depending on use of proceeds
Maximum amounts	Bank loan size is unlimited; generally used for projects of \$3.75 million to \$5 million;	\$2.0 million loan with a \$1.5 million guaranteed amount
Fees	Bank loan: Application fee and construction loan fee (if applicable) vary by bank; one-time SBA participation fee of 50 basis points paid by bank (participation fee temporarily eliminated by ARRA and subsequent legislation) CDC loan: Upfront fees of approximately 2.75%, which are financed. (CDC application fee of 1.5% temporarily eliminated by ARRA and subsequent legislation)	Upfront guarantee fee of approximately 3% on guaranteed portion (temporarily eliminated by ARRA and subsequent legislation) Ongoing fee: 54.5 basis points paid by lender
Bank lien position	Bank has exclusive first lien	Bank holds the first lien; with a typical 75% guarantee, the lender receives 75% of any proceeds from liquidation and the SBA receives 25% ²⁶
Loan-to-Value	Bank loan: Typically 50% CDC loan: Maximum of 40%	Maximum of 90%
Qualification	Business net worth not to exceed \$8.5 million; average net profit for two consecutive years not to exceed \$3 million after taxes	Same as 504 program
Prepayment penalties	CDC loan: Penalty is 100% of one year's interest in the first year, declining to zero at the midpoint of the loan	Low; no penalty for up to 25% prepayment in first three years

Source: OCC, based on SBA loan program information.

²⁶ ARRA and subsequent legislation have temporarily increased the maximum 7(a) guaranty up to 90 percent.

The potential for leverage and the long-term nature of the 504 loan product make it attractive. To obtain 504 loans, businesses generally provide a downpayment of 10 to 15 percent and receive 85 to 90 percent financing.²⁷ Loans from CDCs (40 percent of eligible project costs) have 10- or 20-year terms, depending on the asset financed, and a fixed interest rate. Loans from banks (50 percent of eligible project costs) may have fixed or variable interest rates and are often structured with 20- or 25-year amortizations, enabling long-term repayment. Conventional commercial loans, on the other hand, generally require higher down payments and typically have shorter repayment terms.

The fees on 504 transactions can reduce the program's attractiveness to some borrowers. Fees of 1 to 1.5 percent are typically charged by lenders for the first-mortgage loan under the 504 program. Additionally, a 2.75 percent fee is assessed by the SBA (through the CDC) for costs related to the debenture sale. Both of these fees are still in effect. The SBA/CDC fee can be financed as part of the debenture-funded loan. However, ARRA has temporarily eliminated the 1.5 percent application fee typically charged to borrowers by CDCs, as well as the 0.5 percent participation fee charged to lenders by the SBA (again through the CDC).²⁸

Banks use various benchmarks to set the rates on their 504 loans. Secondary market purchasers may focus on loans tied to particular benchmarks. Many banks use Treasury rates or other common indices as benchmarks. Generally there are spreads of 1.5 to 3.5 percent attached to any benchmark rate, but the rates and fees are set by local market conditions and a bank's asset/liability management strategy. Larger rate concessions may be given in areas of the country where there are more competitive markets for 504 loans, such as California and other states previously referenced. The interest rate spread is also determined by the creditworthiness of the borrower.

Typically, rates on the interim loans float but generally start out no higher than rates on first-lien loans. There may be documentation fees for interim loans, and, if there is a construction loan, there is generally a construction loan fee, as well as typical inspection fees.

The CDC loan is pegged to the 10-year Treasury note as a benchmark and is amortized over 10 years for capital equipment loans and 20 years for real estate loans. If projects include real estate and significant portions of capital equipment, the weighted maturity is calculated and rounded to either a 10-year or 20-year maturity. Projects can also be separated into two loans if they are collateralized by real estate and equipment.

Internal Costs and Performance

Most of the banks interviewed indicated that their internal costs are higher for processing SBA loans compared with conventional loans. Factors contributing to the increased costs include the necessity of interacting with the CDC, the post-closing procedures particular to the product, and costs involved with selling the loans in the secondary market.

The banks we interviewed indicated that the 504 loan product had performed well relative to their non-owner-occupied commercial real estate portfolio, which typically had higher loan-to-value

²⁷ If the business is a start-up or the project is funding a single-purpose facility with limited re-use value, SBA regulations require a contribution of 15 to 20 percent by the small business. See 13 CFR 120.910.

²⁸ The original funding in ARRA for fee relief has been exhausted. However, several temporary extensions have been approved providing additional funding for this purpose. Additional information can be obtained by contacting local SBA field offices at www.sba.gov/localresources.

ratios. The banks indicated that when liquidation was required, the process coordinated by SBA was timely and effective.²⁹ Some banks also noted that the SBA does not impose a great burden on banks offering this product.

A few banks indicated that the 504 loan product, like other loan products, must meet internal yield requirements. To achieve these requirements, banks generally use pricing models to net out a combination of an interest rate and fees to meet performance targets.

VII. What Barriers Have Constrained the Growth of SBA 504 Loans?

Areas of the country characterized by competitive pricing for loans by banks and CDCs make extensive use of 504 loans, but their use remains low in other regions. CDC interviews indicate that in certain states banks and small business owners are not aware of 504 loans, and, as a result, product use has not grown. In a limited number of states, according to the CDCs interviewed, banks and small business owners are reluctant to use government lending products. Reportedly, some banks in these areas find the 504 paperwork requirements onerous.

Many banks agreed that the 504 product needs to be better publicized. Referring to the 504 program as “small businesses’ window to Wall Street,” one CDC noted that large businesses have long been able to use long-term financial products to finance long-term assets and that the 504 product provides that same option to small businesses. Many banks and CDCs also agreed that use of the 504 product largely depends on how effective CDCs have been in marketing and publicizing the product in a state.

A number of banks and CDCs indicated that while the SBA has streamlined the 504 loan application process and reduced processing time since the agency centralized 504 processing, much closing documentation and paperwork are unnecessary. However, the bankers commented that because the CDC generally handles the additional paperwork, it does not affect the bank.

Some community banks are constrained on the size of the loans they can make because of legal lending limits, and this constraint limits their lending in areas with high real estate values. However, these banks can still make 504 loans to their customers by selling these loans to other banks through secondary markets.

At many banks, 504 loans must compete with other internal bank products. Depending in part on how a bank’s compensation policies are structured, loan officers may have greater incentives to sell in-house products. In addition, the bankers interviewed indicated that SBA has firm loan documentation requirements for 504 loans that are less flexible than bank products outside the 504 program.

²⁹ See SBA SOP 50-50-4, Loan Servicing. If a borrower is 65 days late on payments, the bank and CDC must develop a workout plan or the SBA must purchase the debenture. After purchase, if the bank and CDC determine that the loan can be restructured, they may allow for a deferment as part of the restructured payment arrangement. If they determine that the loan cannot be restructured, or if the workout plan fails, the SBA will determine if the loan needs to be liquidated. If this determination is made, the agency and the CDC will develop a liquidation plan as soon as possible. On a case-by-case basis, the SBA determines if the agency will enter a protective bid at the foreclosure sale if there is recoverable value for the SBA/CDC second-lien position. For example, SBA may decide that bidding at the foreclosure sale is necessary to take ownership of the collateral in order to sell it, or it may decide that property-specific considerations (e.g., contamination of the facility or decline in property value) make it unwise for SBA to bid at the sale. If SBA acquires the property through the foreclosure proceeding, the agency tries to sell the collateral as soon as practicable to realize maximize recovery. SBA pays off any expenses related to the sale of the asset, such as realtor fees, mechanics’ liens, and prior bank liens, with the balance treated as a loan recovery.

A few banks indicate that while SBA approves credit quickly, generally within 48 hours of loan submissions, a project can be delayed by significant lags in SBA approvals of appraisals and environmental reports.

Most of the banks and CDCs indicate that the perception of an SBA loan has changed dramatically from several years ago when the SBA had a reputation of being a lender of last resort. According to one CDC, the 504 loan is now viewed as a structuring advantage. Banks look favorably on companies that have 504 loans because it means that they have structured their long-term financing to match long-term assets.

As stated previously, many lenders and CDCs acknowledge that fees associated with the 504 program can be high. To lessen this disincentive, ARRA and subsequent legislation temporarily eliminated some of the programs' fees to help stimulate volume.

VIII. Conclusion

The SBA designed the 504 loan program to promote economic development by allowing small businesses to obtain 90 percent financing for fixed assets. This enables businesses to retain needed capital for expansion. The 504 loans help create economic development benefits through job creation or retention and increasing the local tax base. In addition, the 504 structure allows borrowers to obtain long-term fixed rates on their CDC loans while providing banks with the flexibility to use fixed- or variable-rate products for their portion of the loans.

The 504 program allows banks to make 50 percent LTV loans to qualifying small businesses, while retaining a first lien on the collateral. The 504 loans may also receive positive CRA consideration. The banks interviewed for this report indicate that good overall performance and a low default rate characterized these loans. Further, one CDC notes that as use and knowledge of the product grows, more banks may find it necessary to add the 504 loan to their product offerings to remain competitive in the small business lending market.

Appendix A

Sample Term Sheet

Loan amount	Bank first lien No maximum, but typically up to \$2.5 million, varies by bank.
	SBA second lien Up to \$1.5 or \$2 million, depending on project goal For small manufacturers, up to \$4 million
Maximum financing available	90% Bank first lien 50% (can be higher) SBA second lien 40% (maximum)
Borrower Equity	10% minimum
Interest Rates	Bank first lien – variable or fixed Variable – Typically based on five-year Seattle Federal Home Loan Bank Rate Fixed – Typically based on Treasury notes SBA second lien – fixed Typically based on Treasury notes
Term	Bank first lien Any term, must be at least half the term of SBA loan SBA second lien 10 years (machinery); 20 years (real estate)
Fees	Bank loan Application fee and construction loan fee (if applicable) vary by bank; one-time participation fee of 50 basis points paid by lender (temporarily eliminated by ARRA and subsequent legislation) CDC loan Upfront fees of approximately 2.75 % (temporarily eliminated by ARRA and subsequent legislation); 1% of fees added to annual interest rate
Eligible assets	Long-term fixed assets only (such as owner-occupied real estate and heavy equipment)
Eligible borrowers	Most businesses
Debt service coverage	Typically at least 1.15%

Appendix B

Financing Examples

Case Study 1 – Urban Redevelopment

One small business that produces custom-made wood furniture for offices, hospitals, and lobbies purchased a plant that had previously manufactured metal housings for car starters and alternators. The plant needs to be clean and relatively dust-free for the construction and finishing of high-end furniture. The old industrial plant had open spaces and good electrical connections, but oil lines for cooling old machinery needed to be removed and the air conditioning and heating equipment needed replacement. The 504 loans from the CDC and bank financed plant renovation and new equipment. The bank and CDC worked together to assemble the financing to help the business buy the building, purchase and install the equipment it needed, and retain enough working capital to get going in the new location.

Case Study 2 – Small Business Growth and Employment

A manufacturer of injection-molded plastic parts used a \$1 million 504 project (\$500,000 of which was a loan from a national bank) to add a 750-ton press, allowing the company to compete for bigger jobs. Among the company's products are cases for medical equipment, such as kidney dialysis, blood analyzer, and bone density machines; handheld equipment; shelving; and highway guard rails. The new press will enable the company to produce large plastic molded parts for a backyard tool shed measuring 4 x 6 feet. The company plans to add eight to 10 employees in the next year, creating jobs in a rural area. The banker on the project remarked that "SBA 504 financing was the most viable option for arranging this financing. It allowed the borrower to put up less upfront and retain cash for operating expenses."

Case Study 3 – Innovative Products

A company that converts vans, enabling disabled people to drive, used 504 funding to expand into a new facility where all of the conversion work and the showroom could be housed under one roof. The company's products include a joystick that allows driving by one-handed individuals and persons with impaired dexterity or limited strength and range of motion. The 504 loans from a national bank and the CDC helped the company purchase its new 16,500-square-foot building and equipment, including computer-controlled machinery to increase production.

Appendix C

Resource Directory

State listing of CDCs

www.sba.gov/localresources/district/id/financing/index.html

SBA information for banks

www.sba.gov/banking/

SBA information on the 504 product

www.sba.gov/financing/sbaloan/cdc504.html

SBA regulations

http://www.nadco.org/files/public/Economic%20Impact%20Study%20-%20Feb_2008.pdf

OCC Community Developments newsletter on bank financing for small businesses

www.occ.treas.gov/cdd/CD_winter03/cd_header.html

National Association of Development Companies

www.nadco.org

SBA 504 Growing Small Businesses, Jobs, Communities

2008 Economic Impact Study

http://www.nadco.org/files/public/Economic%20Impact%20Study%20-%20Feb_2008.pdf

Derek Hyra, Sherrie Rhine, and William Reeves were the primary authors of the updates to the original version of this report. Samuel Frumkin was the primary author of the original report. Also contributing were Barry Wides and Julie Williams. *Community Developments Insights* reports differ from OCC advisory letters, bulletins, and regulations in that they do not reflect agency policy and should not be considered as definitive regulatory or supervisory guidance. Some of the information used in the preparation of this paper was obtained from publicly available sources that are considered reliable. However, the use of this information does not constitute an endorsement of its accuracy by the OCC.