Congress of the United States
U.S. House of Representatives
Committee on Small Business
2361 Rayburn House Office Building
Washington, DC 20515–6315

MEMORANDUM

To:	Members, Subcommittee on Investigations, Oversight, and Regulations
From:	Judy Chu, Chairwoman
Date:	December 10, 2019
Re:	Subcommittee hearing entitled: "Review of the SBA's 504/CDC Loan Program"

The Committee on Small Business Subcommittee on Investigations, Oversight, & Regulations will hold a hearing titled, "Review of the SBA's 504/CDC Loan Program." The hearing is scheduled to begin at **10:00 A.M. on Tuesday, December 10, 2019 in Room 2360 of the Rayburn House Office Building.** The hearing will review the United States Small Business Administration's (SBA) 504/CDC Loan Program, examining all aspects of the program from the role of Certified Development Companies (CDCs) to its economic development requirements. The hearing will provide Members of the Subcommittee the opportunity to hear from program participants about current issues. The witnesses will be:

Panel:

- Ms. Mary Katherine Mansfield, President & CEO, Bay Colony Development Corp., Waltham, MA
- Mr. Wayne Williams, Senior Vice President, Business Finance Group Inc., Fairfax, VA
- Ms. Elaine Fairman, Executive Director, Business Expansion Funding Corp., Charlotte, NC
- Ms. Brooke Mirenda, President & CEO, Sunshine State Economic Development Corp., Clearwater, FL

Background

The SBA administers an array of programs to support small businesses, including several government guaranteed loan programs designed to encourage lenders to provide loans to small businesses that might not otherwise obtain financing on reasonable terms and conditions. Authorized by the Small Business Investment Act of 1958, the 504/CDC Loan Guaranty program (the "504 program") backs long-term fixed-rate loans up to $5.5 million to support investment in major fixed assets, such as land, buildings, heavy equipment, and machinery.[1]

The program is delivered by local CDCs, which are private, nonprofit corporations established to promote economic development within their communities. CDCs are certified and regulated by SBA, and they must be in good standing and in compliance with all laws and tax requirements in the state they have been incorporated in and in any state they do business. CDCs work in

[1] Robert J. Dilger, Cong. Res. Serv., R41184, Small Business Administration 504/CDC Loan Guaranty Program (2019) [hereinafter R41184].

partnership with SBA and participating private-sector lenders (typically banks) to provide affordable financing to small businesses. Currently, there are 242 CDCs nationwide, each with its own geographically-defined area of operations.[2]

Program Overview

504 loans generally have three parties: 1) a third-party lender who provides 50 percent or more of the financing; 2) a CDC that provides up to 40 percent of the financing via a 504/CDC debenture; and 3) a small business borrower who contributes at least 10 percent of the financing.

It should be noted that contribution requirements may differ if the loan is a New Business and/or Limited-Market/Special-Purpose Property Loan, with the small business borrower potentially responsible for up to 20 percent of financing costs.[3]

The table below outlines the three typical loan structures and their respective contribution requirements.

Typical 504/CDC Loan Structures and Contribution Requirements

Participant	Standard loan	New business OR limited or special-purpose property loan	New business AND limited and special-purpose property loan
Third-Party Lender	50%	50%	50%
CDC/SBA	40%	35%	30%
Small business borrower	10%	15%	20%

Source: SBA SOP 50 10 5(K), p. 265.

Eligibility Standards

In order to qualify for a 504 loan, a business must:

- be located in the United States;
- qualify as small;
- operate for profit and, with limited exceptions, not be in a passive industry such as real estate investing;
- demonstrate the need for the desired credit and that the funds are not available from alternative sources, including personal resources of the principals; and
- be certified by a lender that the desired credit is unavailable to the applicant on reasonable terms and conditions from nonfederal sources without SBA assistance.[4]

[2] U.S. Small Bus. Admin. website CDC locator.
[3] SBA SOP 50 10 5(K), p. 270-71.
[4] 13 CFR §§120.100, 120.101.

With that said, several types of businesses are prohibited from participating in the 504 program. These include, but are not limited to:

- businesses engaged primarily in lending (i.e., banks and finance companies);
- life insurance companies;
- businesses located in a foreign country;
- business deriving more than one-third of their gross annual revenue from gambling activities;
- businesses that present live performances of a prurient, sexual nature; and
- businesses with an associate who is incarcerated, on probation, on parole, or has been indicted for a felony or a crime of moral turpitude.[5]

<u>Job Creation and Retention Requirement</u>

One of the primary purposes of the SBA 504 loan program is job creation. To ensure that lenders are financing projects for borrowers who plan to create jobs, the SBA includes a job creation or retention requirement. Under this requirement, borrowers (other than small manufacturers) must create or retain at least one job for every $75,000 of SBA funds received, and small manufacturers must create or retain at least one job per $120,000 of SBA funds received.[6] If the borrower does not meet the job creation or retention requirement, he/she can retain eligibility by meeting certain community development, public policy, or energy reduction goals.[7]

<u>Loan Amounts, Terms, Rates, and Collateral</u>

The minimum 504 loan amount is $25,000. Currently, the maximum loans sizes are:

- From $1.5 million to $5 million for regular 504 loans;
- From $2 million to $5 million if the loan proceeds are directed toward one or more of the public policy goals;
- From $4 million to $5.5 million for small manufacturers and for projects that reduce the borrower's energy consumption by at least 10 percent; and
- From $4 million to $5.5 million for projects for plants, equipment, and process upgrades of renewable energy sources, such as the small-scale production of energy for individual buildings or community consumption, or renewable fuel producers, including biodiesel and ethanol producers.[8]

SBA determines the 504 program's loan terms and publishes them in the *Federal Register*. Loans for equipment and machinery generally mature in 10 years, while loans for real estate purchases mature in 20 or 25 years.[9] Maturities for the first mortgage issued by the third-party lender must be at least 7 years when the 504 loan is for a term of 10 years and at least 10 years when the loan is for 20 or 25 years.[10]

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[5] 13 C.F.R. §120.110.
[6] U.S. Small Bus. Admin., Office of Fin. Assistance, SBA SOP 50 10 5(K), p. 309.
[7] 13 C.F.R. §120.862; *see also* U.S. Small Bus. Admin., Office of Fin. Assistance, SBA SOP 50 10 5(K), p. 309.
[8] P.L. 111-240 §1112; and 15 U.S.C. §696(2)(a)
[9] R41184.
[10] 13 C.F.R. §120.921; *see also* U.S. Small Bus. Admin., "504 Loans and Debentures With 25 Year Maturity," 83 *Federal Register* 14536, April 4, 2018.

Accredited Lender Program (ALP)

CDCs that have a good partnership with their SBA field office and have demonstrated a strong track record for processing and servicing sound loans may apply to the SBA to be designated an Accredited Lender. An ALP status is beneficial because it expedites the process for approving loan applications and servicing.[11] A CDC's designation as an ALP is based on several factors, including experience as a CDC, number of 504 loans approved, size of the CDC's portfolio, compliance record, and record of cooperation with all SBA offices.[12] About one-third of CDCs have ALP status, and they account for about 60-70 percent of all 504 lending each year.[13]

Loan Closing Process

SBA approved 504 loans are not closed until after project-related construction is complete, which can often take one to two years. All loans must be disbursed within 48 months of approval. SBA District Counsels generally review the closing package and notify the Central Servicing Agency (CSA) and the CDC if the loan is approved for funding. If the loan is approved, the CDC forwards documents needed for the funding directly to the CSA. Because the 504 program provides permanent or *take-out* financing, an interim lender (either the third-party lender or another lender) typically provides financing to cover the period between SBA approval and debenture sale.[14] Proceeds from the debenture sale are used to repay the interim lender for the amount of the project costs that it advanced.[15]

Fees

Borrowers are charged fees amounting to about 3.5 percent of net debenture proceeds plus annual servicing and guarantee fees of about 1 percent of the unpaid balance. Some of these fees are charged by the SBA to the CDC, and others are charged by the CDC to the borrower.[16] SBA is authorized to charge CDCs five fees to help recover expenses: a guaranty fee, servicing fee, funding fee, development company fee, and participation fee. CDCs may charge borrowers five additional fees: processing fee, closing fee, servicing fee, late fee, and assumption fee. CSAs and underwriters are also authorized to charge fees.

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[11] R41184.
[12] U.S. Small Bus. Admin., Office of Fin. Assistance, SBA SOP 50 10 5(K), p. 76.
[13] R41184.
[14] R41184.
[15] U.S. Small Bus. Admin., Office of Fin. Assistance, SBA SOP 50 10 5(K), p. 267.
[16] R41184.

Program Statistics

The table below shows the number and amount of 504 loans and 504 refinance loans that the SBA approved, and the number and amount of 504 loans and 504 refinance loans after cancellations and modifications are considered from FY16-FY20.[17]

504 loan, refinance loan volume for FY16-FY19					
Fiscal Year		Loans Approved	Loans (after full cancellations)	$Millions in Debentures	$Millions in Debentures (after mods & cancellations)
2016	Loans	5,938	5,557	$4,740	$4,940
	Refinancings	45	41	$41.4	$38.9
2017	Loans	6,218	5,925	$5,010	$4,230
	Refinancings	266	244	$287.4	$262.4
2018	Loans	5,874	5,774	$4,750	$4,380
	Refinancings	181	174	$154.1	$149.8
2019	Loans	6,099	6,006	$4,960	$4,890
	Refinancings	166	161	$154.8	$149.7

Appropriations for Subsidy Costs

SBA's goal is to achieve a zero-subsidy rate for its loan guarantee programs, which occurs when those programs generate enough revenue through fee collection and recoveries of collateral on purchased (defaulted) loans to not require appropriations to issue new loan guarantees. Fees and recoveries did not generate enough revenue to cover 504 loan losses from FY12 through FY15; however, since FY16, the 504 program has operated on zero-subsidy.[18]

Borrower Demographics

In FY19, 28.1 percent of 504 approved loans went to minority-owned businesses (18.9 percent Asian, 7.6 percent Hispanic, 1.5 percent African American, and 0.1 percent Native American) and 10.4 percent went to women-owned businesses.[19] Based on a comparative analysis of private-sector small business loans and the SBA's loan guarantee programs, the Urban Institute concluded that:

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[17] R41184.

[18] R41184.

[19] U.S. Small Bus. Admin, "SBA Lending Statistics for Major Programs (as of September 30, 2019),".

> Overall, loans under the 7(a) and 504 programs are more likely to be made to minority-owned, women-owned, and start-up businesses (firms that have historically faced capital gaps) as compared to conventional small business loans. Moreover, the average amounts for loans made under the 7(a) and 504 programs to these types of firms are substantially greater than conventional small business loans to such firms. These findings suggest that the 7(a) and 504 programs are being used by lenders in a manner that is consistent with SBA's objective of making credit available to firms that face a capital opportunity gap.[20]

Current Issues

Government Shutdown

During the partial government shutdown of 2018-19, the SBA stopped processing loans for 35 days. Moreover, SBA's lending partners, including CDCs, couldn't make any new SBA-backed loans or make minor corrections to loan paperwork. This prevented many 504 loans from closing in a timely manner. In response, CDCs and industry stakeholders advocated that CDCs who are Accredited Lenders should have increased delegated authority to make *de minimis* changes to loan closing packages.[21]

Expedite Low-Dollar Loans

Banks participating in the 504 loan program across the nation is very uneven. In many cases, the fixed costs associated with 504 financed projects lead banks to believe that the value the 504 program is not worth the effort and expense for small projects.[22] For this reason, many small business owners may not even be made aware of the 504 program.[23] Oftentimes, and particularly with smaller projects, banks recommend small business owners take more expedient options.[24] In light of this trend, and given the increasing popularity of predatory online small business loans, some CDCs have called for ways to expedite the deployment of low-dollar, low-risk loans to small businesses, including the creation of an Express program for 504 loans of $500,000 or less, and the harmonization of the role of SBA District Counsels, who currently play inconsistent roles in the closing process across the SBA District Offices, creating confusion for lenders and slowdowns for small businesses.[25]

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[20] Kenneth Tomkins, Brett Theodos, with Kerstin Gensch, *Competitive and Special Competitive Opportunity Gap Analysis of the 7(A) and 504 Programs* (Washington, DC: The Urban Institute, 2008), p. 21.

[21] Letter from Patrick J. MacKrell, Board Chair, National Association of Development Companies, to William Manger, Associate Administrator, Office of Capital Access, U.S. Small Business Administration (Apr. 27, 2018).

[22] *Reauthorization of the SBA's Access to Capital Programs: Hearing Before the S. Comm. on Small Bus. and Entrepreneurship*., 116th Cong. (2019) (statement of Patricia "Patti" Kibbe, President & CEO, Evergreen Business Capital).

[23] *Reauthorization of the SBA's Access to Capital Programs: Hearing Before the S. Comm. on Small Bus. and Entrepreneurship*., 116th Cong. (2019) (statement of Patricia "Patti" Kibbe, President & CEO, Evergreen Business Capital).

[24] *Reauthorization of the SBA's Access to Capital Programs: Hearing Before the S. Comm. on Small Bus. and Entrepreneurship*., 116th Cong. (2019) (statement of Patricia "Patti" Kibbe, President & CEO, Evergreen Business Capital).

[25] *Reauthorization of the SBA's Access to Capital Programs: Hearing Before the S. Comm. on Small Bus. and Entrepreneurship*., 116th Cong. (2019) (statement of Patricia "Patti" Kibbe, President & CEO, Evergreen Business Capital); *see also* Letter from Patrick J. MacKrell, Board Chair, National Association of Development Companies, to William Manger, Associate Administrator, Office of Capital Access, U.S. Small Business Administration (Apr. 27, 2018).

Increase in Loan Amount
In the Congressional Budget Justification for FY2020, SBA requested an increase ($5.5 million to $6.5 million) in the total maximum amount that a small manufacturer may borrow in 504 loans. SBA noted that since the mid-2000s the manufacturing sector has lost nearly 1.8 million jobs and increasing the loan amount would help small manufactures re-enter the marketplace.[26]

Leasing Limitations
Additionally, some CDCs are concerned that the requirement that 504 borrowers occupy at least 51 percent of a building acquired with the proceeds of the 504 loan is outdated and should be updated to be consistent with current occupancy and leasing practices (50-50 split use for business purposes and other purposes). Specifically, some have advocated changing the rule from 51-49 to 50-50, which would expand the pool of buildings eligible for 504 financing.[27]

Conclusion
SBA's 504/CDC program is designed to promote economic development, job creation and retention, and meet public policy goals. The program helps small businesses to expand by securing affordable financing for investments for land, buildings, and fixed assets. However, as with most government programs, periodic oversight and review is necessary to determine whether there are areas for continued improvement in program performance and deployment. Accordingly, this hearing will allow Members to gain valuable insights about the working of the 504 Loan Program. Specifically, witnesses from the CDC community will be able to provide first-hand information on their experiences with the program that can guide potential legislation and oversight for the committee going forward.

[26]U.S. Small Bus. Admin., *FY2020 Congressional Budget Justification and FY2018 Annual Performance Report*, p. 35 (2019).
[27] *Reauthorization of the SBA's Access to Capital Programs: Hearing Before the S. Comm. on Small Bus. and Entrepreneurship*., 116th Cong. (2019) (statement of Patricia "Patti" Kibbe, President & CEO, Evergreen Business Capital).