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Insights

SBA's Certified Development Company/504 Loan Program: Small Businesses' Window to Wall Street

Abstract

The Small Business Administration (SBA) developed the Certified Development Company/504 Loan Program[1] (504 loan program) to promote economic development, create and retain jobs, and meet certain additional public policy goals.[2] The program helps lenders, such as national banks and federal savings associations (collectively, banks), provide eligible small businesses with long-term financing to acquire and improve major fixed assets, such as owner-occupied commercial real estate and heavy machinery. The program helps businesses by giving them access to long-term, fixed-rate financing with as little as 10 percent owner equity.

Under the program, a bank partners with a certified development company (CDC), which is a specialized SBA-certified nonprofit corporation. Each partner makes a loan to a qualifying small business. Typically, the bank's loan covers 50 percent or more of the project's cost and is secured by a first lien. The CDC's loan covers up to 40 percent of the project's cost and is secured by a second lien. The CDC loan is backed by a 100 percent SBA-guaranteed debenture.

The program helps banks attract and serve small business borrowers that need financing for plant and major-equipment acquisition that may not meet conventional underwriting criteria. Participating with a CDC can help reduce risk for the bank. Banks may also receive Community Reinvestment Act (CRA) consideration for 504 loans.

This *Insights* report presents information collected from a variety of sources, including the SBA, banks participating in the 504 loan program, and CDCs. Appendix A provides a sample term sheet for a 504 project. Appendix B has examples of such projects. Appendix C provides sources of additional information on 504 loans.

I. What Is the SBA 504 Loan Program?

Eligible Borrowers and Uses of Loans

The 504 loan program helps small businesses obtain long-term financing to acquire and improve major fixed assets, such as owner-occupied real estate or equipment. The

[1] This *Insights* report highlights the SBA's Certified Development Company/504 Loan Program. This program and the 7(a) Loan Program are two of the SBA's flagship efforts to expand access to capital. Together, they encourage banks and other lenders to help small businesses and entrepreneurs start and grow their businesses.

[2] The 504 loan program requirements are set forth in 13 CFR 120 and the SBA's Standard Operating Procedures (SOP).

program helps eligible businesses with loan requests that might not otherwise qualify for credit without SBA participation. For real estate, existing buildings financed by a 504 loan must be at least 51 percent owner-occupied, and new construction must be at least 60 percent owner-occupied. Examples of eligible businesses include manufacturers, hotels and motels, nursing homes, gas stations, and restaurants.[3]

The loans must be used for fixed assets, such as land, buildings, machinery, and equipment, acquired or improved by a small business for use in its business operations.

Loans cannot be used for working capital or inventory. Existing debt may be refinanced in some circumstances, as explained in the following section. Additional restrictions on the use of loan funds may also apply.

To be eligible, businesses must operate as for-profit entities and meet the SBA's size requirements. A business qualifies under the SBA requirements if it has a tangible net worth of $15 million or less and it has an average net income after federal income taxes for the previous two fiscal years of less than $5 million. Loans cannot be made to a business engaged in real estate speculation or rental investments. Additional restrictions may also apply.

The business must also meet certain economic development objectives. Generally, the business must create or retain one job for every $65,000 guaranteed by the SBA debenture (for small manufacturers, one job for every $100,000 guaranteed) or meet certain community development or public policy goals, as explained later in this report.

Refinancing Existing Debt

The 504 loan program offers eligible small business borrowers the ability to refinance existing debt with or without business expansion.

Refinancing With Business Expansion

The 504 loan program can be used to refinance existing debt under limited circumstances. Any eligible small business planning an expansion may refinance existing, eligible debt as long as the amount being refinanced does not exceed 50 percent of the cost of expansion. Because the debt being refinanced plus the expansion cost must equal the project cost, the amount being refinanced must be one-third or less of the project's total cost.[4]

Expansion of the small business includes acquisition, construction, or improvement of land, building, or equipment for use by the small business. Eligible debt includes debt that was used to finance fixed assets such as land, buildings, building expansions, or equipment. The existing debt being refinanced must have been used to purchase assets eligible for financing under the 504 loan program, must be collateralized by 504-eligible fixed assets, and must have been incurred for the benefit of the small business.

The new financing must provide a substantial benefit to the business—after accounting for any prepayment penalties, financing fees, and other financing costs. The terms or interest rate must be better for the borrower than those on the existing debt, and, as with the standard 504 loan program, the business must create or retain one job for

[3] The Government Accountability Office (GAO) reported that from fiscal year (FY) 2003 through March 31, 2013, the top four types of small businesses funded by 504 loans were hotels (12 percent), restaurants (5 percent), doctors' offices (4 percent), and dentists' offices (3 percent). The GAO also reported that 85 percent of approved 504 loans and dollars went to existing small businesses, and 15 percent went to new small businesses. See GAO, *Small Business Administration: Actions Needed to Ensure Planned Improvements Address Key Requirements of the Development Company (504) Loan Program,* GAO-14-233, March 2014.

[4] See 13 CFR 120.882(e).

every $65,000 guaranteed (in the debenture) by the SBA (one job for every $100,000 guaranteed for small manufacturers).

Refinancing Without Business Expansion

The SBA's 504 Debt Refinancing Program allows small businesses to refinance fixed assets and eligible business expenses through the 504 loan program without the business expansion requirement.[5]

Loans made through the debt refinancing program are structured like a traditional SBA 504 loan. Borrowers may refinance up to 90 percent of the current appraised property value. The refinancing may also include a limited amount of eligible business expenses.

The business must have been in operation for at least two years before submitting the application.[6] The debt to be refinanced must be a commercial loan that

- was incurred for the benefit of the small business not less than two years before the date of the 504 Debt Refinancing Program application.
- was used to acquire a 504-eligible fixed asset (i.e., owner-occupied real estate, land, equipment, etc.).
- is secured by 504-eligible fixed assets.
- has been current on all payments for at least the last 12 months before the application.

Existing SBA 504 loans, SBA guaranteed loans, and other government-guaranteed loans are not eligible to be refinanced.

Public Benefit Requirements

To be eligible for a loan through the 504 loan program, small business projects must either create or maintain jobs, or meet one of 15 community development or public policy goals.[7] In fiscal year (FY) 2010 through FY 2015, approximately 50,000 jobs were supported with 504 financing.[8]

Financing Structure

A 504 project is financed by three parties: (1) a bank loan, secured with a first lien, typically covering 50 percent of the project's cost; (2) a CDC loan secured with a second

[5] The Small Business Jobs Act of 2010, Public Law 111-240, temporarily expanded the ability of a small business to use the 504 loan program to refinance certain qualifying debt; that authority, however, expired on September 27, 2012. See SBA Policy Notice 5000-1382, May 26, 2016. On December 18, 2015, section 521 of division E of the Consolidated Appropriations Act of 2016, Public Law 114-113, reauthorized the Debt Refinancing Program with certain modifications. See SBA Policy Notice 5000-1939, November 17, 2016.

[6] If the ownership of the borrower has changed during this two-year period, the CDC must follow the new business guidance in SOP 50 10 5 (H), determine whether the borrower is considered a new business, and document the justification for its determination in its credit memorandum.

[7] Community development goals include (1) improving, diversifying, or stabilizing the economy of the locality; (2) stimulating other business development; (3) bringing new income into the community; (4) assisting manufacturing firms; and (5) assisting businesses in Labor Surplus Areas as defined by the U.S. Department of Labor. See 13 CFR 120.862(a). Public policy goals include (1) revitalizing a business district of a community with a written revitalization or redevelopment plan; (2) expanding exports; (3) expanding small businesses owned and controlled by women; (4) expanding small businesses owned and controlled by veterans; (5) expanding minority enterprise development; (6) aiding rural development; (7) increasing productivity and competitiveness; (8) modernizing or upgrading facilities to meet health, safety, and environmental requirements; (9) assisting businesses in or moving to areas affected by federal budget reductions; and (10) reducing rates of unemployment in labor surplus areas. See 13 CFR 120.862(b).

[8] SBA, *FY 2017 Congressional Budget Justification* and *FY 2015 Annual Performance Report.*

lien and backed by a 100 percent SBA-guaranteed debenture[9] covering a maximum of 40 percent of the cost; and (3) a contribution by the borrower of at least 10 percent of the project cost. The bank loan can be fixed or variable rate and is typically amortized over a minimum term of seven years.[10] The rate, term, and fees are negotiable between the borrower and the bank.[11] The CDC loan's rate is fixed, and its term is 20 years for real estate and 10 years for equipment. The interest rate on the CDC loan is determined when the SBA sells the debenture to fund the loan. The borrower makes two loan payments each month, one to the bank and one to the CDC. The SBA does not provide a loan guarantee for the bank-funded portion of the financing.

Table 1 shows the uses and sources for a sample 504 loan.

Table 1: Sample Building and Equipment Acquisition: 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	
Bank—first lien	$ 500,000
CDC/SBA—second lien (debentures)	400,000
Borrower equity	100,000
Total	$ 1,000,000

Tables 2 and 3 show the uses and sources when using the 504 loan program to refinance existing debt with and without a business expansion.

Table 2: Sample 504 Refinance With Business Expansion

Initial	Dollars
Outstanding value of existing debt	$ 300,000
Proposed expansion costs	600,000
Total	$ 900,000
Financing sources	
Bank—first lien	$ 450,000
CDC/SBA—second lien (debentures)	360,000
Borrower equity	90,000
Total	**$ 900,000**

[9] 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. The SBA uses various agents to facilitate the sale and service of the certificates and the orderly flow of funds among the parties involved.

[10] The minimum term for a bank loan is seven years if the CDC loan is 10 years. When the CDC loan is 20 years, the minimum term for the bank loan is 10 years. See 13 CFR 120.921(a).

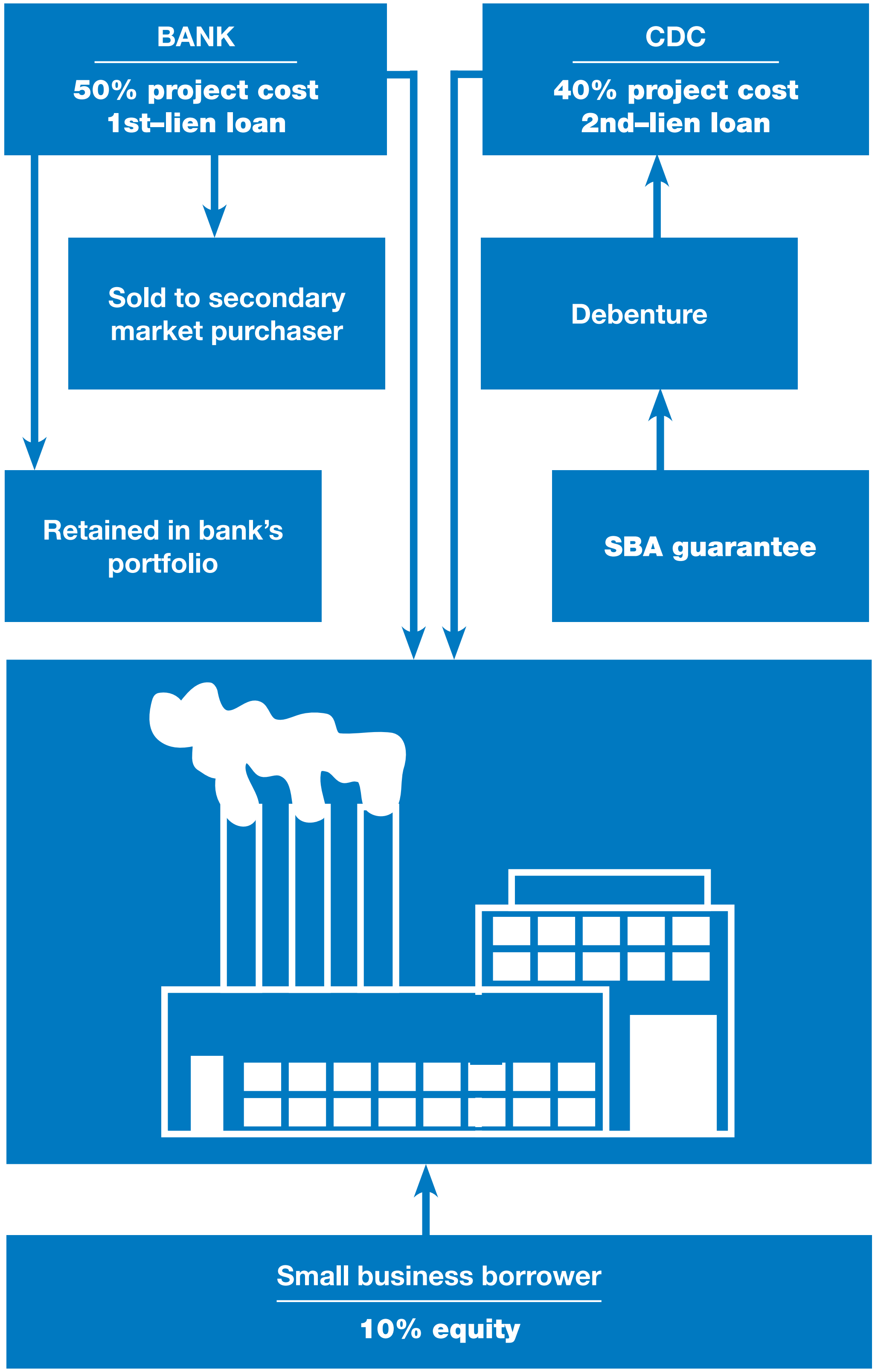
[11] The rate, term, and fees of the bank loan must meet SBA guidelines. See 13 CFR 120.921.

Table 3: Sample 504 Refinance Without Expansion

Initial	Dollars
Appraised value of property	$ 600,000
Outstanding value of debt	500,000
Financing sources	
Bank—first lien	$ 250,000
CDC/SBA—second lien (debentures)	250,000
Borrower equity	100,000
Total	$ 600,000
Payoff of outstanding balance	**$ 500,000**

Note: The refinance funds (bank loan plus CDC/SBA) cannot exceed 90 percent of the property's current appraised value.

Typical 504 Project Structure



Eligible Lenders

Participating lenders include national banks and federal savings associations. The SBA recommends that lenders interested in participating in the 504 loan program contact their local SBA district offices. As part of the loan closing documents, lenders are required to execute a third-party lender certification confirming that 504 loan program requirements have been met.

Certified Development Companies

A CDC is a nonprofit organization certified by the SBA to provide 504 loans to small businesses.[12] Most have a 501(c)(4) or 501(c)(6) nonprofit designation from the Internal Revenue Service; some have a 501(c)(3) designation. In 2016, there were 252 active CDCs nationally.[13] Some make only 504 loans; others offer a range of programs to help small businesses.

A CDC receives certification to operate statewide and, with approval from the SBA, can offer the 504 product in contiguous states.[14] A CDC operates under the leadership of a board of directors.[15]

The SBA's Office of Lender Oversight oversees CDCs' compliance with all applicable rules and regulations. CDCs must submit annual reports to the SBA and meet certain performance requirements in order to retain their certification.

Priority CDC status provides for expedited 504 loan closings. Accredited Lenders Program (ALP) CDCs are eligible for an expedited process for approving loan applications and servicing actions. Approximately one-third of CDCs have ALP status.[16] Under the Premier Certified Lenders Program (PCLP), CDCs have increased authority to process, close, service, and liquidate 504 loans. As of October 27, 2014, 18 CDCs had PCLP status.[17]

II. Why Are 504 Loans of Interest to Banks?

Participation in the 504 loan program is attractive to banks because it can help them draw and retain customers they might not otherwise be able to serve. The program also helps banks manage risk and liquidity.

Through the program, banks can offer long-term financing to small business customers who otherwise might not qualify for the necessary financing to grow. The low down payment and fixed interest rate on the CDC portion of the financing are particularly attractive to new and growing businesses.

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[12] Certified development companies are different entities from community development corporations, also known as CDCs, which are typically nonprofit organizations that undertake housing and community economic development activities in distressed communities.

[13] SBA, *FY 2017 Congressional Budget Justification* and *FY 2015 Annual Performance Report*.

[14] The SBA provides a listing of CDCs by state.

[15] 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 organizations, (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 two voting members of the board—other than the CDC manager—must have commercial lending experience. In addition, none of the entities represented in the membership or on the board of directors may control the CDC; the CDC must remain independent of banks, governmental agencies, and other institutions.

[16] Robert Jay Dilger, *Small Business Administration 504/CDC Loan Guaranty Program,* Congressional Research Service, 7-5700, January 7, 2016.

[17] Ibid.

Partnering with a CDC on a 504 loan can limit a bank's credit exposure. The loan-to-value (LTV) ratio for the bank loan typically does not exceed 50 percent. In addition, 504 loans are collateralized by real estate or other fixed assets, and the risk exposure is tiered. The bank loan is in the first-lien position, and the CDC loan is subordinate to the bank's position.

Selling 504 first-lien loans in the secondary market can help a bank manage its lending limits.[18] In addition, loans used for owner-occupied real estate are not counted when determining a bank's commercial real estate concentrations.[19]

A small business that is investing in plant and equipment is often entering into its largest business-related loan. In many cases, a 504 loan becomes the basis for an entire banking relationship.[20]

Banks can earn fees and interest income on interim/bridge loans related to the project.[21] Because 504 loans may be used for permanent financing only, banks making 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. Banks are reminded, however, that the CDC portion of the lending package will not be available until construction is completed. As with all real estate secured loans, the construction loans should conform to applicable laws and regulations, including lending limits and appraisal guidelines.

Banks may purchase 504 loans from originating banks, securitize the loans, and generate income from the retained servicing activities of the portfolio.[22]

CRA Consideration for 504 Loan Program Loans

Bank financing through the 504 loan program may qualify for CRA consideration, depending on loan amounts. In most cases, loans of $1 million or less qualify as small business loans and may be considered under the CRA lending test for banks of all sizes.[23] 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.[24] Loans of greater than $1 million made under the 504 loan program are considered community development loans[25] under the lending test[26] or the community development test,[27] depending on the bank's size. In order for a 504 loan to qualify for CRA consideration as a community development loan, it must meet the geographic requirements in the regulation.[28]

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[18] See 12 CFR 32. See also the "Concentrations of Credit" booklet of the *Comptroller's Handbook*.

[19] OCC, "Concentrations in Commercial Real Estate Lending, Sound Risk Management Practices: Interagency Guidance on CRE Concentration Risk Management," bulletin 2006-46 (December 6, 2006). See also 71 Fed. Reg. 74585 (December 12, 2006).

[20] Ferber, Merril, "SBA 504 Loan Program More Attractive Then (sic) Ever for Banks and Borrowers," National Association of Development Companies.

[21] 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.

[22] See OCC, Banking Circular 181, "Purchases of Loans in Whole or In Part–Participations" (August 2, 1984).

[23] See 12 CFR 25.12(v) and 195.12(v).

[24] See "Community Reinvestment Act; Interagency Questions and Answers Regarding Community Reinvestment; Guidance," __.12(h) – 3, 81 Fed. Reg. 48506 and 48529 (July 25, 2016).

[25] Ibid., __.12(h) – 1, 81 Fed. Reg. 48529.

[26] See 12 CFR 25.22 and 195.22 (large banks), and 12 CFR 25.26(b) and 195.26(b) (small banks).

[27] See 12 CFR 25.25 and 195.25 (wholesale or limited-purpose banks), and 12 CFR 25.26(c) and 195.26(c) (intermediate small banks).

[28] See "Community Reinvestment Act; Interagency Questions and Answers Regarding Community Reinvestment; Guidance," __.12(h) – 1 and __.25(e) – 1, 81 Fed. Reg. 48528, 48529, and 48544.

III. How Do 504 Loans Work?

Reaching Customers

Opportunities for banks to make SBA 504 loans depend on a number of factors, including local real estate professionals' familiarity with the 504 loan program, outreach efforts of CDCs operating in the area, and the capacity of banks to offer 504 loans and complementary bank products.

Typically, a bank customer interested in expanding a business contacts a lender to discuss financing options. Depending on the lender's knowledge of, and comfort with, 504 loans, the lender may suggest a 504 loan as a financing option or refer the customer to a CDC that can explain the 504 loan program to the customer.

In some areas of the country, real estate professionals are very familiar with the 504 loan program. Potential borrowers may be referred to banks by commercial real estate brokers who advertise properties as potentially qualifying for 504 financing. Borrowers may also be referred to banks or CDCs by local professionals, such as accountants and lawyers, with whom they do business.

Banks that have dedicated government lending departments generally undertake specialized marketing of the 504 loan 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 and professional associations. Other banks have SBA divisions that serve as advisers to relationship managers. These advisers are brought in to provide SBA product expertise if the banks' in-house products do not fit a particular project. Generally, banks with specialized SBA departments obtain approximately 80 percent 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.

Community banks that engage in a limited number of 504 deals annually may benefit from the outreach and marketing conducted by CDCs. When banks have customers who may benefit from 504 loans, banks may ask CDCs operating in their market to assist in describing the 504 loan product to customers. CDCs often conduct joint marketing calls with banks, serving as the product expert in these discussions with potential borrowers. Smaller banks in particular may value the role of CDCs in enabling the banks to provide SBA products that the banks may not otherwise be able to offer.[29]

Community banks may also refer customers who would benefit from 504 loans to larger banks. In these transactions, the large bank originates the 504 loan to the borrower and may pay a community bank a placement fee.

Loan Presentation, Underwriting, and Processing

Lenders have different preferences 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 then offer the 504 loans to borrowers if they do not qualify for conventional loans.

Typically, banks and CDCs perform separate but simultaneous underwriting for the loans that each provide. In analyzing loan requests, banks and CDCs look at traditional underwriting criteria, including management, cash flow, operating trends, and the quality

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

of the collateral. Banks and CDCs may contact each other during the underwriting period to discuss any concerns they may have with projects. The bank and CDC loans may have different terms and conditions, but they are coordinated to meet the needs of borrowers.

Some banks maintain separate credit policies for 504 loans because of the lower credit risk afforded by a lower LTV ratio. For example, such 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).[30] The policy also may allow borrowers to use reasonable and adequately supported 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.[31] While 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 interest rate information to borrowers as a guide regarding the interest rate they will ultimately pay on their CDC loan. 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.

Formalizing Bank/CDC Partnerships

When a bank makes a 504 first-mortgage loan, it enters into a third-party lender agreement with a CDC.[32] Among other considerations, this agreement sets forth how the bank is expected to work with the CDC and the SBA in the event of a loan default. The SBA and the CDC have specific methods they can use to bring the bank's loan current or acquire it from the third-party lender (bank). The bank is required to notify the SBA and the CDC within 30 days of the event of default and at least 60 days prior to foreclosure.[33] The SBA expects that the bank will work with small business borrowers and the CDC to restructure debt, when appropriate. The Federal Financial Institutions Examination Council has issued guidance regarding prudent commercial real estate loan workouts.[34] The "Interagency Statement on Meeting the Credit Needs of Creditworthy Small Business Borrowers" discusses principles of sound underwriting and risk management practices.[35]

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

In the underwriting process, business cash flows serve as the primary source of repayment and collateral serves as the secondary source. While the bank loan is not guaranteed, the 504 loan program limits a bank's exposure because the bank loan is typically 50 percent of the total financing on the property and the bank holds a first lien on the property.

[30] This ratio includes both the bank and CDC loans.

[31] 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. The SBA uses various agents to facilitate the sale and service of the certificates and the orderly flow of funds among the parties involved.

[32] See 13 CFR 120.921.

[33] See 13 CFR 120.921(c).

[34] OCC, "Commercial Real Estate (CRE) Loans: Guidance on Prudent CRE Loan Workouts," bulletin 2009-32, (October 30, 2009).

[35] OCC, "Small Business Lending: Meeting the Credit Needs of Creditworthy Small Business Borrowers," bulletin 2010-6 (February 5, 2010).

The 504 loan program provides "take out" financing that requires a private lender[36] to provide interim financing for the full amount of project funds before the sale of the debenture and, if applicable, during the construction and acquisition period. If the bank providing the first–lien loan provides an interim and/or construction loan to cover the period until the CDC loan comes in, the bank will temporarily have a loan that may exceed supervisory LTV limits. Interim loans financing the project before the sale of the debenture can be relatively short—an average of 45 days. Acquisition, construction, and development loans can be of longer duration, depending on the project. If a bank's loan to the project exceeds the supervisory LTV limits contained in 12 CFR 34, the bank must identify the loan in the institution's records and report to the board of directors, at least quarterly, the aggregate amount of these loans.[37] The aggregate amount of all loans in excess of the supervisory LTV limits should not exceed 100 percent of total capital for the institution.

The construction loan may meet the definition of high volatility commercial real estate (HVCRE). It is anticipated that, given the public benefits of 504 projects, most construction loans to projects with 504 financing will meet the community development exemption for HVCRE.[38]

V. Who Participates in the SBA 504 Loan Program?

In 2015, nearly 1,520 bank lenders made more than 5,725 loans through the 504 loan program. One-half made only one 504 loan during the year, and 95 percent made fewer than 10 loans. The average bank loan was $1,003,727 while the average CDC loan was $738,412.[39]

SBA 504 loans are made throughout the United States and U.S. territories. The use of the 504 loan program, however, tends to be concentrated in specific areas of the country. In 2016, the regions that included California, Great Lakes states such as Illinois and Ohio, southeastern states such as Florida and Georgia, and Gulf Coast states such as Texas accounted for over two-thirds of all 504 loan program originations.[40]

The SBA budget for FY 2017 allocates $7.5 billion at the program level and an additional $7.5 billion for the 504 Debt Refinancing program.[41] If that amount were to be fully subscribed, it would lead to approximately $9.4 billion in associated 504 first-lien loans being originated by lenders.

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[36] Any experienced, independent source including a CDC may supply interim financing provided it meets the conditions described in 13 CFR 120.890. A CDC may provide interim financing but only for a project financed by another CDC. As stated in the regulation, neither the borrower nor an associate of the borrower may supply interim financing. SBA SOP 50 10 5 (H), p. 238.

[37] See 12 CFR 34, subpart D, appendix A, "Interagency Guidelines for Real Estate Lending."

[38] See "Regulatory Capital Rules: Regulatory Capital, Implementation of Basel III, Capital Adequacy, Transition Provisions, Prompt Corrective Action, Standardized Approach for Risk-Weighted Assets, Market Discipline and Disclosure Requirements, Advanced Approaches Risk-Based Capital Rule, and Market Risk Capital Rule," final rule, 78 Fed. Reg. 62018 (October 11, 2013).

[39] Statistics provided by the SBA for this report.

[40] National Association of Development Companies, Regional Rankings of CDCs.

[41] SBA, *FY 2017 Congressional Budget Justification* and *FY 2015 Annual Performance Report*.

VI. What Are the Cost and Pricing Considerations of 504 Loans?

The SBA sets the allowable fees that borrowers may be charged.[42] For 504 loans approved in FY 2017, the upfront guaranty fee will continue to be zero. The annual service fee[43] is 0.697 percent (69.7 basis points) of the outstanding balance of the loan. For 504 debt refinance loans, the annual service fee in FY 2017 is 0.697 percent plus 0.034 percent, for a total of 0.731 percent (69.7 basis points plus 3.4 basis points) of the outstanding balance of the loan.[44]

The bank portion of 504 loans may be fixed or variable. Banks use various benchmarks to set interest rates on 504 loans. Many banks use Treasury rates or other common indexes as benchmarks. Generally, spreads of 1.5 percent to 3.5 percent are attached to any benchmark rate. The creditworthiness of the borrower also affects the interest rate spread. The rates and fees are also affected by local market conditions and a bank's asset/liability management strategy.[45]

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

The CDC loan is pegged to the 10-year Treasury note and is amortized over 10 years for capital equipment loans and over 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 bankers interviewed for this report indicated that their internal costs are higher for processing SBA loans than conventional loans. Factors contributing to 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 bankers interviewed indicated that the 504 loan product had performed well relative to their non-owner-occupied commercial real estate portfolio, which typically had higher LTV ratios. The bankers indicated that when liquidation was required, the process coordinated by the SBA was timely and effective.[46] Some bankers also commented that the SBA does not impose a great burden on banks offering this product.

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[42] SBA SOP 50 10 5 (H), p. 316–318.

[43] The service fee is paid to the CDC and is based on the amount of the CDC loan.

[44] SBA Information Notice 5000-1389 (September 16, 2016).

[45] The interest rate on the bank loan must be reasonable and not exceed the maximum interest rate for third-party loans from commercial financial institutions as published periodically by the SBA in the *Federal Register*.

[46] See SBA SOP 50 50 4, "Loan Servicing," and SBA SOP 50 51 3, "Loan Liquidation." If a borrower is 65 days late on payments, the bank and the CDC must develop a workout plan or the SBA must purchase the debenture. After purchase, if the bank and the 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, the 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 the SBA to bid at the sale. If the SBA acquires the property through the foreclosure proceeding, the agency tries to sell the collateral as soon as practicable to maximize its recovery. The 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 bankers noted 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.

Comparisons With the SBA 7(a) Loan Program

Borrowers can use both the SBA 504 and the SBA 7(a) loan programs to purchase, construct, or renovate owner-occupied real estate and purchase equipment. The 504 loan program can be used to finance larger deals (only the CDC portion has size limitations). The CDC loan rate is fixed, allowing borrowers to lock in low interest rates for relatively long terms (up to 20 years on the CDC portion).

Table 4 compares the SBA's 504 and 7(a) loan programs.

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

Measures	504 loan program	7(a) loan program[a]
Loan structure	Two loans: Private lender loan secured by first lien typically 50 percent of eligible project costs; SBA/CDC loan secured by second lien for up to 40 percent of eligible project costs.	Single loan: Private lender loan secured by first lien and partially (typically 75 percent to 85 percent) guaranteed by the SBA.
Use of loan proceeds	Long-term fixed assets such as owner-occupied real estate, building improvements, and equipment.	In addition to fixed assets, loan proceeds may applied to a wider range of uses including working capital and inventory.
Maximum loan amount	Bank loan size is unlimited; CDC loans are capped at $5 million for most projects, $5.5 million for energy efficiency and manufacturing (per project).	$5 million.
Rate and terms	CDC loan: 10- or 20-year term fixed interest rate. Private lender: Variable or fixed interest rate, which may have shorter term than CDC loan.	Interest rate can be variable or fixed; maturity depends on ability to repay. Generally, working capital and machinery and equipment (not to exceed the life of equipment) is 5 to 10 years; real estate is 25 years.
Economic impact	Must create or retain one job for every $65,000 guaranteed by the SBA debenture (for small manufacturers, one job for every $100,000 guaranteed) or meet certain community development or public policy goals.	No economic impact requirement.

Source: OCC, based on SBA loan program information.

[a] The SBA 7(a) loan program includes several specialty programs with various loan size limits, guarantee amounts, allowable use of proceeds, allowable lenders, and methods of applying for guarantee. This chart refers to the regular 7(a) program.

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

Bank participation in the 504 loan program across the nation is very uneven. The CDCs that the OCC interviewed for this publication attributed this to several causes. In some states, bankers and small business owners are not aware of 504 loans. In others, bankers and small business owners are reluctant to use government lending products. Some lenders perceive the 504 paperwork requirements as onerous and not worth the effort.

The bankers interviewed for this report agreed that the 504 product needs to be better publicized. Referring to the 504 loan program as "small businesses' window to Wall

Street," one CDC executive noted that the 504 loan program gave small businesses the same access to long-term financial products for long-term assets that larger firms have had for quite a while. The availability of the 504 product, however, largely depends on how effective CDCs have been in marketing and publicizing the product.

With centralized processing, the SBA streamlined the 504 loan application process and reduced processing time. Still, closing documentation and paperwork can be more burdensome than for conventional loans. The lenders, however, commented that because the CDC generally handles the additional paperwork, it does not affect the bank. Bankers interviewed indicated that the SBA has firm loan documentation requirements for 504 loans that are less flexible than those for conventional bank products.

Community banks can be constrained on the size of the loans they can make because of legal lending limits. These limits can be particularly critical in areas with high real estate values. Community banks, however, can still make 504 loans to their customers by selling these loans to other banks in the secondary market.

At many banks, 504 loans 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 than 504 loans.

Most of the bankers and the CDC executives indicated that their perception of SBA loans has changed dramatically from several years ago when the SBA had a reputation of being a lender of last resort. According to one CDC executive, banks look favorably on companies that have 504 loans because they have structured their long-term financing to match long-term assets.

VIII. Conclusion

The SBA designed the 504 loan program to promote economic development and job creation and retention, and meet other public policy goals. The program helps small businesses obtain long-term capital for fixed assets with as little as 10 percent equity. The CDC financing is available at long-term fixed rates, while banks have the flexibility of using fixed- or variable-rate products for their portion of the financing.

The partnership with CDCs 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 CRA consideration. One CDC notes that as the 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 term loan** No maximum, but typically up to $2.5 million, varies by bank **CDC second-lien term loan** Up to $5 million, depending on project goal For small manufacturers and energy-efficient projects, up to $5.5 million
Maximum financing available	**90%** Bank first lien 50% (can be higher) CDC second lien 40% (maximum)
Borrower equity	**10% minimum**
Interest rates	**Bank first-lien term loan** Variable or fixed rate A reasonable interest rate that does not and will not exceed the maximum allowable interest rate as set by the SBA **CDC second-lien term loan** Fixed rate Rate is set with sale of debenture
Term	**Bank first-lien term loan** At least seven years with a 10-year CDC loan; at least 10 years with a 20-year CDC loan **CDC second-lien term loan** 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 **CDC loan** The fees that a 504 borrower may be charged can be found at 13 CFR 120.971 and 120.972

Appendix B

Examples of 504 Financing

Case Study 1: Urban Redevelopment

A small business that produces custom-made wood furniture for offices, hospitals, and lobbies purchased a plant that previously had manufactured metal housings for car starters and alternators. The plant needed 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 to be replaced. The bank and the CDC worked together to assemble the financing to help the business buy the building and purchase and install the equipment it needed to get going in the new location.

Case Study 2: Small Business Growth and Employment

A manufacturer of injection-molded plastic parts used $1 million in 504 loans to acquire 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 4x6 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 cash or equity upfront and retain cash for operating expenses."

Case Study 3: Innovative Products

A company that converts vans so that disabled people can drive them 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 a CDC helped the company purchase its new 16,500-square-foot building and new equipment, including computer-controlled machinery that allowed the company to increase quality and productivity.

Case Study 4: Refinance With Business Expansion

A small foundry specializing in precision casting was able to land a new contract to reproduce quarter-scale replicas of famous artworks. This required expansion of its facilities. The foundry was able to refinance existing bank debt along with new expansion expenses into a new 504 loan package. This enabled the company to finance its fixed assets with low-cost, long-term debt.

Appendix C

Resource Directory

SBA 504 loan program

SBA Standard Operating Procedures

Local assistance: Find the local SBA district office and resources in your area

National Association of Development Companies

OCC, "Small Business Resource Directory"

David Black was the primary author of this 2017 updated report. Derek Hyra, Sherrie Rhine, and William Reeves contributed to updates made in 2012. Samuel Frumkin was the primary author of the original report published in February 2006. 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 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 and believed to be current as of May 1, 2017. The use of this information, however, does not constitute an endorsement of its accuracy by the OCC.