USDA’s Business and Industry Guaranteed Loan Program

Abstract
This Insights report provides an overview of the U.S. Department of Agriculture (USDA), Rural Business Programs, Business and Industry (B&I) Guaranteed Loan Program. In fiscal year (FY) 2011, the B&I Guaranteed Loan Program provided federal loan guarantees on 511 commercial loans (totaling $1.4 billion) to rural businesses. The program helps lenders and borrowers improve, develop, or finance business, industry, and employment and improve the economic and environmental climate in rural communities. The program provides guarantees of 60, 70, or 80 percent, depending on loan size, with loans over $10 million guaranteed on an exception basis. Originating lenders benefit from loan guarantees that protect against much of the credit risk associated with lending in rural areas. Loans that meet the Community Reinvestment Act (CRA) criteria of small business loans or community development loans may be considered in an institution’s CRA examination.

I. What Is the B&I Guaranteed Loan Program?
The B&I Guaranteed Loan Program is administered by the Rural Business and Cooperative Program, an agency of the USDA Rural Development. USDA can guarantee loans made by eligible lenders to businesses located in rural areas. The purpose of the B&I Guaranteed Loan Program is to improve, develop, or finance business, industry, and employment and improve the economic and environmental climate in rural communities. The program pursues this mission by enhancing the existing private credit structure through loan guarantees for transactions that support the mission. The guarantee authority is not intended to be used for loans that would not pass credit-risk underwriting standards absent the guarantee. USDA Rural Development is engaged in efforts to increase the number of lenders that are actively participating in the B&I Guaranteed Loan Program. Figure 1 indicates the

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1 Data provided by USDA staff on February 28, 2012.
3 Loans up to and including $5 million have a maximum guarantee of 80 percent; loans between $5 million and $10 million have a maximum guarantee of 70 percent. The Administrator of Rural Business and Cooperative Programs at USDA Rural Development may, at the Administrator’s discretion, grant an exception to the $10 million limit for loans up to $25 million under certain circumstances. The USDA Secretary may approve guaranteed loans in excess of $25 million, up to $40 million, for rural cooperative organizations that process value-added agricultural commodities. Loans over $10 million are very rare in the B&I Guaranteed Loan Program and are subject to a maximum guarantee of 60 percent.
number of lenders with outstanding loans in the program at the end of each fiscal year. The large increase indicated in FY 2010 is likely the result of additional funding from American Recovery and Reinvestment Act of 2009 appropriated for the B&I Guaranteed Loan Program.\(^4\) Even aside from that large increase, figure 1 indicates that the number of participating lenders has grown each year since FY 2007.

**Figure 1: Number of Lenders With Outstanding Loans in the B&I Program, FY 2007–2011**

![Bar chart showing number of lenders with outstanding loans in the B&I program from FY 2007 to FY 2011.](chart)

Source: USDA

Note: Data provided by USDA staff on February 14, 2011, and February 28, 2012.

Figure 2 indicates the number of new loans guaranteed through the B&I Guaranteed Loan Program each fiscal year. The large increase in FY 2010 is due to additional Recovery Act funding appropriated for the B&I program. But typically over the last several years, between 400 and 600 loans have been guaranteed each year. In FY 2011, the average guaranteed loan was for $2.7 million and loans were guaranteed in each of the 47 USDA state and multi-state offices that are the key gatekeepers for the program. The state with the largest number of guaranteed loans in FY 2011 was California, as has been the case each year since 2003, with the exception of 2009 when it came in second to Wisconsin. This is a geographically diverse program, funding businesses across much of rural America, though clearly some states and areas have better program penetration than others. Figure 3 indicates the different levels of guarantee issuance across the 50 states from FY 2004 through FY 2011.

\(^4\) The American Recovery and Reinvestment Act of 2009 provided a supplemental appropriation of $1.7 billion for the B&I Guaranteed Loan Program; provided up to a 90 percent federal guarantee for loans guaranteed under this supplemental funding, compared with the normal 60–80 percent federal guarantee that is available through the standard program; halved the normal guarantee fee to 1 percent of the guaranteed loan amount; and eliminated the annual renewal fee. This supplemental funding and special terms expired on September 30, 2010. Loans guaranteed using the regular authority for FY 2010 received the standard guarantee levels and were assessed the standard 2 percent guarantee fee and \(\frac{3}{4}\) percent annual renewal fee.
Figure 2: Number of New Loans Guaranteed Through the B&I Program, FY 2007–2011

Source: USDA

Note: Data provided by USDA staff on February 14, 2011, and February 27, 2012.

Figure 3: B&I Loan Guarantees, Obligations per Rural Population, FY 2004–2011

Guarantee obligations, in millions of dollars, per rural population (U.S. average = $120)

Source: USDA and U.S. Census Bureau

II. Why Is the B&I Guaranteed Loan Program of Interest to Banks?

The B&I Guaranteed Loan Program enables lenders to provide better terms than they might otherwise offer on loans to customers who meet conventional underwriting criteria. Such improved terms might include fully amortizing loans with longer repayment terms and fixed interest rates on the guaranteed portion of the loan. And, when business lending risk increases through stages of a credit cycle, the B&I program may be a useful tool for risk mitigation.

Legal Lending Limits

Some community banks with smaller legal lending limits may find the B&I Guaranteed Loan Program useful for expanding their commercial lending business. The federally guaranteed portion of a B&I loan does not count toward a bank’s legal lending limit. The amount applied against the bank’s legal lending limit is the unguaranteed portion of the loan. For instance, if a bank’s legal lending limit is $1 million, the bank may make up to a $5 million B&I loan if it has an 80 percent guarantee, because the guaranteed portion (80 percent, or up to $4 million) is not included in the limit. Nevertheless, banks should use careful risk management regardless of the level of the guarantee.

Capital Requirements

The federal guarantee lowers a lender’s risk-weighting for capital purposes. Under the B&I program, the capital risk weight is “preferred”—much lower than for unguaranteed loans.6

CRA

B&I loans have the potential to receive CRA consideration as either loans to small businesses or as community development loans, depending on the amount and purpose of the loans, the type and size of the institutions being examined, and whether the loans benefit the institutions’ CRA assessment area or broader statewide or regional area. For example, the CRA examination for institutions evaluated under the large bank test includes a review of small business loans that meet the definition of “loans to small business” on the Consolidated Report of Condition and Income (call report).7 Loans of over $1 million may qualify as community development loans if they meet the CRA definition of community development.

In contrast, institutions evaluated under the small and intermediate small bank tests may receive CRA consideration for business loans of any amount that finance small businesses, which are loans to businesses with gross annual revenues of $1 million or less. Intermediate small banks may opt to have business loans of any amount that meet the definition of community development considered as either business loans under the lending test or community development loans under the community development test.

5 This report uses “banks” to refer collectively to national banks and federal savings associations.

6 The B&I loan guarantees to the lender are “conditional,” based on the lender following certain program requirements. Thus, the guaranteed portion of a loan receives a 20 percent capital risk weighting and the unguaranteed portion receives a 100 percent risk weight. For more information on capital requirements for guaranteed loans per 12 CFR 3, see Appendix A to Part 3–Risk-Based Capital Guidelines, http://ecfr.gpoaccess.gov/cgi/t/text/text-idx?c=ecfr&sid=e801422230c9c4484be778c7eb36094d&rgn=div5&view=text&node=12:1.0.1.1.3.5.4.9.1 (accessed May 30, 2011).

7 Loans to small business are defined as those with original amounts of $1 million or less and that are reported as “loans secured by nonfarm or nonresidential real estate” or “commercial and industrial loans” in Part I of the call report.
For all national banks and federal savings associations (collectively, banks), providing technical assistance on financial matters to small businesses may also qualify as a community development service. For example, banks may receive consideration for providing assistance to small businesses in preparing loan application packages for submission to local, state, or federal government agencies.

For additional information and guidance on CRA, refer to the regulations and the Interagency Questions and Answers on CRA.\(^8\)

**New Business Development Opportunities**

Because of the B&I loan guarantee, lenders can offer borrowers more flexible terms, such as longer loan maturity or larger loan sizes. This flexibility can open doors to expanding customer relationships. Businesses receiving B&I loans may become repeat customers. Furthermore, B&I borrowers may open additional accounts with their lending institution, establishing full banking relationships, such as checking and payroll accounts.

**Profitability**

There are several ways that the B&I program can help increase bank profitability. By helping to mitigate credit risk and expand the universe of business loans that they can originate, this product allows banks to earn fees and interest on loans they might not have otherwise made.

Additionally, the guaranteed and, to a lesser extent, the unguaranteed portion of a B&I loan can be sold into the secondary market. This process can generate fees, and loans may be sold for a premium, depending on rate, maturity, and market conditions. For instance, if a bank makes a B&I guaranteed loan (20-year maturity at 2 percent over prime) with a principal balance of $5 million, which is 80 percent guaranteed, and a secondary market investor offers a 6 percent premium, the originating bank can earn approximately $240,000 for selling the guaranteed portion.

When banks sell their B&I loans to the secondary market, USDA requires them to retain servicing. This typically generates a 1 percent annual servicing fee on the guaranteed loan portion—which is sold—for the lender. Additionally, the banks earn interest income on the unguaranteed portion of the loans.

**Liquidity Management**

Liquidity management policies direct banks to have sufficient assets on their books that can be easily converted to cash, if needed.\(^9\) There is a secondary market for the guaranteed portion of B&I loans. By selling these loan portions, banks can help manage liquidity issues, which can enable them to recycle funds for new loans or use the proceeds for other purposes.\(^10\) Essentially, the secondary market enables lenders to enhance liquidity and increase profitability while limiting financial exposure.

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\(^10\) Banks should underwrite these loans so they are prepared to hold them on their books if secondary market conditions change.
Many lenders sell loans on the secondary market directly to investors. The typically large loan amounts involved in the B&I Guaranteed Loan Program enable servicers to negotiate servicing spreads and to sell loans at a premium.

B&I loans are eligible to be sold or exchanged for securities to Farmer Mac. Farmer Mac is a federally chartered secondary market entity, much like Fannie Mae for single-family residential mortgage loans, but specifically geared to USDA (including B&I) guaranteed loans.\textsuperscript{11}

**Mitigating Risk**

The B&I program generally provides a 60 to 80 percent federal guarantee on business loans depending on the size of the loan. Table 1 illustrates how the B&I program decreases a bank’s exposure when lending to businesses. If a loan defaults, the bank, after the liquidation of collateral, receives from USDA the remaining unpaid principal and interest of the guaranteed loan portion on a pro-rata basis. In this hypothetical example, a $5 million loan with an 80 percent guarantee exposes the bank to a maximum of 20 percent of the loss on the loan.

**Table 1: Hypothetical Small Business Expansion Plan**

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Total project cost:</strong></td>
<td>$5 million</td>
</tr>
<tr>
<td>Less owner equity injection:</td>
<td>$0</td>
</tr>
<tr>
<td>\hspace{1cm} tangible balance sheet equity requirement without additional equity injection\textsuperscript{a}</td>
<td></td>
</tr>
<tr>
<td><strong>Loan amount:</strong></td>
<td>$5,000,000</td>
</tr>
<tr>
<td>Less B&amp;I guarantee (80%):</td>
<td>$4 million</td>
</tr>
<tr>
<td><strong>Bank exposure/unguaranteed (20%):</strong></td>
<td>$1 million</td>
</tr>
<tr>
<td><strong>Loan interest rate:</strong></td>
<td>5%</td>
</tr>
<tr>
<td><strong>Guaranteed portion sold at premium:</strong></td>
<td>6%</td>
</tr>
<tr>
<td><strong>Lender’s servicing spread:</strong></td>
<td>1%</td>
</tr>
<tr>
<td><strong>Premium (6% of $4 million):</strong></td>
<td>$240,000</td>
</tr>
<tr>
<td>Servicing spread on the guaranteed portion (1% of $4 million):</td>
<td>$40,000</td>
</tr>
<tr>
<td>Lender’s interest income on the unguaranteed portion (5% of $1 million):</td>
<td>$50,000</td>
</tr>
<tr>
<td>Lender’s earnings in year 1 of the loan:</td>
<td>$390,000</td>
</tr>
</tbody>
</table>

Source: OCC analysis.

\textsuperscript{a} Tangible balance sheet equity is discussed under “Borrower Equity Requirements” on page 7.

**III. How Does the B&I Guaranteed Loan Program Work?**

Typically lenders use the B&I Guaranteed Loan Program to originate loans that they might otherwise be unable to originate because of loan size limitations, which are mitigated by the federal guarantee, or because of the loan characteristics facilitated by the program.

**Program Requirements**

The B&I Guaranteed Loan Program is not narrowly focused with regard to participant borrowers or lenders. Its most stringent requirement is that businesses need to be located in rural areas. That said, there are a number of program requirements, including the following.

**Eligible lenders.** Most banks under the supervision or subject to review of a federal or state agency—including national- and state-chartered banks, Farm Credit System banks, and federally and state-chartered thrifts—are eligible to participate in the B&I program. Other non-supervised lenders, such as non-depository Community Development Financial Institutions (CDFI), community development corporations, insurance companies, and mortgage companies with successful commercial lending experience, may apply to USDA for eligibility.

**Eligible borrowers.** Loans are made to businesses that save or create jobs in rural areas. Borrowers may be individuals, partnerships, cooperatives, for-profit or non-profit corporations including publicly traded companies, Indian Tribes, or public bodies. There is no size restriction on the businesses. Local economic development organizations and non-owner–occupied facilities may be considered.

**Eligible areas.** Loans must be to businesses in rural areas. If a business has multiple locations, the loan proceeds must be used for the portion of the business located in rural areas.

For the B&I program, rural areas are defined as any areas other than

- a city or town that has a population of greater than 50,000 inhabitants; and
- the urbanized area contiguous and adjacent to such a city or town, as defined by the U.S. Census Bureau using the latest decennial census of the United States.\(^\text{12}\)

**Borrower equity requirements.** To ensure that the business itself is solvent, USDA requires that the borrower demonstrate minimum levels of tangible balance sheet equity.\(^\text{13}\) Specifically, a minimum of 10 percent tangible balance sheet equity is required for existing businesses with full personal or corporate guarantees at the time the Loan Note Guarantee is issued. Twenty percent tangible balance sheet equity is required for new businesses. Unconditional personal and/or corporate guarantees for the full term of the loan are required from those owning at least 20 percent interest in the borrower. The B&I loan may be for an amount to finance 100 percent of the borrower’s capital needs, if the business can meet the minimum tangible balance sheet equity based on existing equity. The loan guarantee, however, is still capped at 80 percent of the loan amount.

**Eligible loan purposes.** Loan proceeds may be used for a wide variety of business purposes, including but not limited to the following:

- Business and industrial acquisitions, construction, conversion, expansion, repair, modernization, or development costs.
- Purchase equipment, machinery or supplies.
- Start-up costs and working capital.
- Processing and marketing facilities.
- Pollution control and abatement.
- Refinancing for sound projects under certain conditions.
- Projects involving forestry, hydroponics, and aquaculture, purchase of stock in a cooperative, tourism, renewable energy, and non-owner–occupied facilities.

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\(^\text{12}\) Maps of urbanized areas as defined by the 2000 U.S. Census are at www.census.gov/geo/www/maps/ua2kmaps.htm. The 2010 Census definitions are likely to be published in 2012.

\(^\text{13}\) Tangible balance sheet equity is required to demonstrate the solvency of the business itself, not the borrower’s exposure to loss in the particular transaction(s) being financed by the B&I loan. Tangible balance sheet equity should not be confused with a down payment or other borrower equity contribution to the particular transaction(s) being financed by the B&I loan.
Ineligible loan purposes. There are categories of business activities that are ineligible for B&I guaranteed loans. B&I guaranteed loans may not be used to finance the following:

- Owner-occupied and rental housing projects (housing site development may be eligible).
- Golf courses, racetracks, and gambling facilities.
- Lending, investment, and insurance companies.
- Agricultural production (with some exceptions).
- Projects involving more than $1 million and the relocation of 50 or more jobs.
- Businesses not at least 51 percent owned and controlled by U.S. citizens.
- Charitable institutions, churches, organizations affiliated with or sponsored by a church, or fraternal organizations.

Additionally, loan guarantees cannot be made on a line of credit.

Maximum loan amount. B&I loans are generally limited to a maximum of $10 million per borrower. The Administrator of Rural Business and Cooperative Programs may approve loans up to $25 million and the USDA Secretary may approve loans up to $40 million for rural cooperative organizations that process value-added agricultural commodities.\(^\text{14}\)

Loan guarantee limits. The B&I loan guarantee, a guarantee against loss, may be up to 80 percent on loans of $5 million or less, 70 percent on loans of $5 million to $10 million, and 60 percent on loans exceeding $10 million. The maximum percentage applies to the entire amount of loan.

Loan-to-appraised market value ratios. The maximum loan-to-appraised market value ratios shall not exceed 80 percent for real estate, 60 percent for accounts receivable (less than 90 days), 60 percent for inventory, and 70 percent for certain project-specific machinery and equipment.

Interest rate. Interest rates for loans may be fixed or variable, or a combination of fixed and variable. The rate is negotiated between the lender and the borrower and may not be more than those rates customarily charged to other borrowers in similar circumstances. Variable rates cannot be adjusted more frequently than quarterly. Interest rates are subject to agency review and approval.

Maximum repayment terms. Loan terms are negotiated between the lender and borrower but are subject to program maximums that vary with the purpose of the loan:

- Working capital, seven years.
- Machinery and equipment, 15 years or useful life, whichever is less.
- Real estate, 30 years.

Amortization. Loans must be fully amortizing. Balloon payments are not permitted.

\(^{14}\) USDA Rural Development defines a value-added agricultural commodity as any agricultural commodity that:

- has undergone a change in physical state;
- was produced in a manner that enhances the value of the agricultural commodity or product, as demonstrated through a business plan that shows the enhanced value;
- is physically segregated in a manner that results in the enhancement of the value of the agricultural commodity or product;
- is a source of farm- or ranch-based renewable energy, including E–85 fuel; or
- is aggregated and marketed as a locally-produced agricultural food product.

Prepayment penalties. Prepayment penalties are permitted by the B&I program.

Fees and costs. There is a one-time guarantee fee currently set at 3 percent of the guaranteed principal amount and an annual renewal fee. The rate of the annual renewal fee is established in an annual notice published in the Federal Register and in FY 2012 was set at 0.25 percent. This renewal fee is assessed on the outstanding principal loan balance as of December 31 of each year and is due on January 31 each year. All program fees are the responsibility of the lender but are typically passed on to the borrower. Other typical lender costs may also be assessed by the lender.

Feasibility studies. USDA may require a feasibility study by a qualified independent consultant for start-up businesses or existing businesses when the project significantly affects the borrower’s operations. Additionally, the program requires a business plan as a component of all loan applications.

Appraisals. An appraisal report prepared by an independent, qualified fee appraiser is required on the property that will serve as collateral. Real property appraisals must be in accordance with standards 1 and 2 of the Uniform Standards of Professional Appraisal Practice. Chattel appraisals are made in accordance with the accepted format and standards of the industry.

Collateral. All collateral must secure the entire loan. Repayment of the loan must be reasonably assured. Personal and corporate guarantees are usually required.

How Do Lenders Participate?

Lenders are not required to undergo a training or certification process to participate in the B&I Guaranteed Loan Program. Lenders are encouraged to contact their local USDA Rural Development office to learn more about the program and about any program nuances that may apply to that particular office and personnel. The OCC also encourages regulated financial institutions to discuss the program and its appropriateness for their institution with their OCC supervisory office.

The B&I program is a lender-driven program. Banks use their own documents, security instruments, and commercial underwriting requirements. Subject to the limitations discussed previously, banks set their own interest rates and terms and service their own loans. Local USDA Rural Development personnel can assist through the entire process, enabling banks to focus on and enhance customer relationships.

Certified Lender Program

The Certified Lenders Program’s (CLP) objectives are to expedite approval of loan guarantees and loan servicing action. Lenders with a successful commercial loan portfolio and experience in federal guaranteed commercial loan programs may apply for the B&I CLP. To be eligible for the CLP a lender must be recognized throughout the state as a commercial lender and have a track record of successfully making at least five commercial loans per year for at least the most recent five calendar years. Additionally


16 A list of offices, contact information, as well as state office Web sites can be obtained at www.rurdev.usda.gov/StateOfficeAddresses.html (accessed March 14, 2012).

17 USDA Form 4279-8, at http://forms.sc.egov.usda.gov/eCommon/eFileServices/eForms/RD4279-8.PDF (accessed March 14, 2012), is required to request certified lender status, as well as documentation for CLP eligibility.
their portfolio must be maintained such that delinquent commercial loans outstanding do not exceed 6 percent of commercial loans outstanding and historic losses do not exceed 6 percent of dollars loaned. A bank without the five-year track record noted above must demonstrate that it has personnel with equivalent previous experience where the commercial loan portfolio was of a similar quantity and quality. The lender must provide a written certification to this effect along with a statistical analysis of its commercial loan portfolio for the last three of its fiscal years. If the lender is a bank or thrift, it must have a safety and soundness rating in the upper half of possible ratings as reported by a lender rating service selected by USDA Rural Development.18

CLP lenders may request USDA to reserve guarantee authority up to 30 days in advance of submitting an application for loan guarantee. CLP lenders may submit an abbreviated application for loan guarantee.

**Application Processing**

Applications are submitted to USDA Rural Development’s network of state and area offices. Applications are received and processed in the appropriate USDA Rural Development state or area office based on the location of the project to be financed. Most state office B&I program directors have the authority to approve guarantees for loans up to $5 million to $10 million. Loan approval and loan servicing authority is located in field offices. Applications for loans exceeding the authority of the state office B&I program director are also received and processed by the field office, which then submits the underwritten package with recommendation for approval to the national office loan committee for approval.

Generally, the application process includes the following:

- Lender’s pre-application (optional).
- Lender submits completed application USDA state office.
- USDA issues approval and conditional commitment.
- Lender and borrower complete loan closing. Lender submits lender’s certifications to the conditional commitment, the closing report and the lenders agreement to the USDA.19
- USDA issues loan note guarantee.20

**Pre-application.** Although this step is not required, USDA recommends that lenders submit a pre-application for each loan considered for the B&I Guaranteed Loan Program. Pre-application has a dual purpose: (1) prescreen the loan for program eligibility and (2) reduce the amount of time needed to process a formal application. Lenders may request a pre-application guide from their local USDA office. A letter signed by the lender and borrower containing necessary information included in the pre-application guide can also serve as a pre-application. Alternatively, lenders may provide their standard preliminary

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18 USDA uses the safety and soundness rating system at www.bankrate.com/rates/safe-sound/bank-ratings-search.aspx (accessed March 8, 2012). Lending institutions must have safety and soundness rating of at least three stars (out of five) to be eligible for the CLP.


credit analysis or preliminary loan committee presentation in lieu of the preliminary application. Generally, the pre-application includes sufficient information for the USDA field staff to make an initial determination of project eligibility for the B&I program.

**USDA evaluation of pre-application.** USDA Rural Development makes a preliminary eligibility determination within 10 days upon receipt of a completed pre-application. The determination is based on information provided in the pre-application regarding

- borrower eligibility.
- eligible loan purpose.
- reasonable assurance of repayment ability.
- sufficient collateral.
- sufficient equity.
- compliance with all applicable statutes and regulations.

**Submission of a full application.** The submission of a full application for the B&I loan guarantee is the next step—or it is the first step for lenders and borrowers that have decided not to submit a pre-application. There are two forms for the full application, depending on the size of the loan.

1) **Abbreviated application.** Lenders may submit an abbreviated application for loans not exceeding $600,000. This type of application packet requires more limited information and forms than the standard application. The packet includes

- short application Form RD 4279-1-A, “Application for Loan Guarantee (Business and Industry Short Form – One-Doc).” 21
- Form RD 1940-20, “Request for Environmental Information,” and attachments, unless the project is categorically excluded under agency environmental regulations pursuant to the National Environmental Protection Act.
- supporting documentation including the lender’s risk underwriting documentation and a proposed loan agreement (using the lender’s own form(s)). Lenders should consult with the relevant USDA Rural Development field office regarding what information would be required in an abbreviated application for a particular project.

2) **Standard application.** Lenders must submit a standard application package for loans exceeding $600,000. This type of application packet comprises

- a completed Form RD 4279-1, “Application for Loan Guarantee (Business and Industry).” 22
- Form RD 1940-20, “Request for Environmental Information,” and attachments, unless the project is categorically excluded under the USDA’s environmental regulations pursuant to the National Environmental Protection Act.
- supporting documentation, including the information required in the pre-application (if not previously submitted), appraisals, and the lender’s risk underwriting documentation. Lenders should consult with the relevant USDA Rural Development field office regarding what information would be required in a standard application.

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21 The abbreviated application form is available at http://forms.sc.egov.usda.gov/efcommon/eFileServices/eForms/RD4279-1-A.PDF.

22 The standard Application for Loan Guarantee is at http://forms.sc.egov.usda.gov/efcommon/eFileServices/eForms/RD4279-1.PDF.
Forms. Lenders should use their own standard loan documents for loans guaranteed under the B&I Guaranteed Loan Program. As previous noted, USDA Rural Development has additional forms relating to the loan guarantee application and other items to comply with program requirements.

Application approval timeline. USDA Rural Development guidelines explain that loan guarantee applications are processed and dedicated within 60 days. Most loan guarantee applications for working capital, equipment, refinancing, or other non-construction projects are processed and approved within 30 days if the lender submits a preliminary application. In practice, we have heard from lenders that timelines can vary depending on size, location, and project complexity. Construction projects and projects with potential environmental impacts may require in-depth review in accordance with the National Environmental Protection Act.

Application review. Ideally, when an application for loan guarantee is submitted to a USDA Rural Development state office, this is not the first time that the office becomes aware of the project. Reviews and guarantee decisions are expedited by using the pre-application and by maintaining an open line of communication between the lender and USDA Rural Development staff. The timeline for processing applications might also be affected by the size of a loan.

USDA Rural Development state program directors have different levels of loan guarantee approval authority, depending on their experience. This ranges from zero authority for state program directors who have not yet processed loans under the B&I program to $10 million for more experienced ones. When a loan is for an amount larger than the relevant state program director’s guarantee approval authority, the state USDA Rural Development staff initially performs the review, and the package is then submitted, along with a recommendation, to the national office in Washington, D.C., for the final decision. This may add several weeks to the review and decision process.

Each state receives a certain allocation of guarantee authority each year, with the national office maintaining a reserve fund, which is used to fund loan guarantees for states that exceed their guarantee authority. Loans requiring access to the reserve fund receive guarantees on a competitive basis. When a state receives a loan guarantee application that would require guarantee authority from the reserve fund, the state submits the loan package with recommendation to the national office; the loan package is accompanied by a scoring sheet that indicates how the loan performs on particular priorities (for example, job creation). Each loan in this category is then reviewed by a national loan committee, with loan guarantees offered to the most competitive loan applications. Again, this additional process may add several weeks to the review and decision process.

Loan guarantee applications for amounts below $10 million (or less, if necessary, to fall under the relevant state program director’s guarantee approval authority) that are submitted early in the year (before that state has exceeded its annual allocation) can, in theory, be expected to more expeditiously navigate the review and approval decision process.

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23 This reserve fund is generally 10 percent of the annual allocation. Additional funds are added to the fund in June of each program year when individual state allocations that have not been committed are reallocated to other states with outstanding loan guarantee applications.
Stages of B&I Loan Guarantee Issuance

**Conditional loan guarantee commitment.** If a loan guarantee application meets the qualifications required by the USDA Rural Development state office (and national office, where relevant), a conditional loan guarantee commitment is issued. This conditional commitment includes a list of conditions that must be met by the lender and borrower for the guarantee to be issued. These conditions generally include standard financial performance requirements (for example, placement of liens on collateral, successful USDA staff inspections of project site, and occupancy permits), but some loans may require additional conditions. These conditions must be met prior to loan closing, so that the guarantee can be issued at the closing.

In cases where the project being funded involves construction, the conditional loan guarantee commitment typically includes the requirement that the facility be operational. For these projects, the lender might provide interim construction financing, which would not be guaranteed under the B&I program. Once the facility is operational and other conditions included in the conditional loan guarantee commitment are met, typically, the lender would offer permanent financing, which would receive the USDA guarantee under the B&I program.

In some situations, lenders may negotiate with the USDA to receive the B&I guarantee on a loan closed prior to the facility becoming operational. This negotiation might result in a lower B&I guarantee on the loan and a higher equity investment requirement from the borrower—shifting more of the risk on the loan from the USDA to the lender and borrower. More typically, however, the lender would fund the construction phase of the program separately so as to maximize the B&I guarantee on the permanent project financing.

**Issuance of the loan note guarantee.** When conditions have been met, the lender certifies this to be the case and the local USDA staff typically confirms that the conditions have been met. At this point, the state USDA Rural Development office issues the loan note guarantee. When conditions are not met for the loan note guarantee, the USDA’s role ends.

It is important to stress that, until the loan note guarantee is issued, the loan is not guaranteed. This means that the loan does not receive preferred capital risk weighting and that the full loan amount counts toward legal lending limits until the loan note is guaranteed.

**Post-Closing Lender Responsibilities**

**Loan servicing.** The lender is responsible for servicing the entire B&I loan (guaranteed and unguaranteed portions) in a prudent manner. These responsibilities are more fully set forth in the lender’s agreement governing the B&I guarantee and in RD Instruction 4287-B.\(^{24}\) Generally, the B&I loan servicing requirements are fairly standard, but lenders should be sure to review this document and discuss requirements with the relevant USDA Rural Development field office staff.

\(^{24}\) These instructions are at www.rurdev.usda.gov/mo/Bf%204287%20servng%20guar%20loans.pdf (accessed March 8, 2012).
**Reports and communications to USDA Rural Development.** In addition to servicing the loan, lenders must meet all the reporting and other communications required by the B&I Guaranteed Loan Program. These include the following:

- At the USDA’s request, the lender meets with USDA staff to ascertain how the guaranteed loan is being serviced and that the conditions and covenants of the loan agreement are being enforced. The USDA holds meetings with the lender at least annually.
- The lender must submit the borrower’s annual financial statements to USDA within 120 days of the end of the borrower’s fiscal year (which borrowers must provide under the loan agreement). The lender must analyze the financial statements and provide USDA with a written summary of the lender’s analysis and conclusions, including trends, strengths, weaknesses, extraordinary transactions, and other indications of the financial condition of the borrower. Spreadsheets of the new financial statements must be included. Lenders are required to provide an annual report of the number of workers employed by the borrower.
- USDA coordinates with the lender to make periodic visits to the borrower. Borrower visits are scheduled during the first year of operation after issuance of the loan note guarantee. For all current borrowers, a joint borrower visit should be done at least once every three years.

Complementing the above broad guidelines, the following time frames are the specific reporting requirements from the lender to USDA:

- Semiannually—by June 30 and December 31—on the loan’s status and remaining balance (use Form RD 1980-41).
- Annually—120 days after the borrower’s fiscal year-end—provide financial statements and analysis.
- If the loan is sold on the secondary market (provide USDA with copy of executed Form RD 4279-6, “Assignment”).
- Whenever the lender’s risk rating of the loan is changed.
- Whenever the loan is more than 30 days delinquent (use Form RD 1980-44).
- Whenever the borrower is in violation of any loan covenant or security agreement.

In executing the servicing responsibilities, lenders should be aware that the USDA’s prior written concurrence is needed for certain activities:

- Before advancing any additional loans to the borrower (even if they are unguaranteed loans).
- For any subordination of lien position.
- For the modification of any loan instruments.
- If a release of collateral is proposed whose value is more than 20 percent of the original loan amount.
- For any restructuring of rates, term, or debt repayment.
- To release any borrower or guarantor from liability.
- When cumulative protective advances exceed $5,000.
- Before any liquidation action.

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25 Protective advances are lender advances to preserve and protect the collateral, necessary in situations where the borrower is unable or unwilling to meet its obligations in this regard. This definition was provided by USDA staff on February 22, 2012.
Default by borrower. The lender must notify the USDA when a borrower is 30 days past due on a payment or is otherwise in default of the loan agreement. If a monetary default exceeds 60 days, the lender must arrange a meeting with USDA Rural Development and the borrower to attempt to resolve the problem.

In considering options, the prospects for providing a permanent cure without adversely affecting the risk to USDA and the lender are the B&I program’s paramount objectives. Curative actions may include but are not limited to

- deferment of principal (subject to rights of any holder).
- an additional unguaranteed temporary loan by the lender to bring the account current.
- reamortization of or rescheduling the payments on the loan (subject to rights of any holder).
- transfer and assumption of the loan.
- reorganization.
- liquidation.
- changes in interest rates with USDA’s, the lender’s, and the holder’s approval, with the requirement that the interest rate is adjusted proportionately between the guaranteed and unguaranteed portions of the loan and the type of rate remains the same.

In the event of default or third party actions that the borrower cannot or will not cure or eliminate within a reasonable period of time, liquidation may be considered. If the lender concludes that liquidation is necessary, it must request USDA’s concurrence. The lender liquidates the loan. The lender, within 30 days after a decision to liquidate, submits to USDA in writing its proposed detailed method of liquidation. Upon approval by the USDA of the liquidation plan, the lender commences liquidation. Instructions for loan liquidation are included in the B&I Loan Guarantee Program Servicing Instructions (RD Instruction 4287-B).

IV. What Are the Key Risks and Regulatory Issues With the Program?

Although the loan guarantee significantly reduces credit risk by guaranteeing up to 80 percent of a loan, the lender remains exposed to credit risk on the nonguaranteed portion. Lenders must exercise appropriate due diligence and maintain appropriate controls and ongoing monitoring to protect against this credit risk and the operational risks associated with the administration of these programs. Financial institutions should underwrite loans made under these programs using sound underwriting procedures. Lenders using the B&I program may use their own credit review and financial analysis, so long as they meet the requirements for the lenders’ complete written analysis in the USDA Instructions.26 Lenders must also take appropriate measures for the monitoring and prevention of fraud. This includes executing necessary verification procedures, including verification of borrower equity and business site inspections. Such measures are necessary to comply with program requirements as well as to comply with prudent lending practices.

Financial institutions must comply with the operational requirements of the B&I program to ensure that guarantees are honored in the event of defaults. Failure to comply with program rules can result in guarantee claims being partially or fully denied. For example, USDA must be notified anytime a loan exceeds 30 days delinquency. Ultimately, the quality of the lender’s management of operational risk (adherence to USDA operational requirements)

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and legal compliance risk associated with the B&I program may have a direct impact on the integrity of the loan guarantees and therefore on the lender’s credit risk profile.

Typically, loans receive a conditional guarantee prior to closing, with the guarantee issued only after the conditions are met. These conditions often include standard financial requirements (such as executing liens on collateral), but may also include borrower performance requirements (such as requiring that a new facility be operational). Loans to borrowers starting new business endeavors or involved in construction activities are most likely to include these performance conditions, as the USDA staff involved with the transaction seeks to ensure that the business is viable before removing the conditions on the guarantee. Lenders should carefully review the conditions on the guarantee with USDA staff before loan closing to ensure that all parties share the same expectations and comfort level with the terms of the guarantee.

Some lenders are apprehensive about whether their loan guarantee claims will be honored if loans go into default. Under the B&I program, lenders can minimize this risk by carefully following procedures for documenting and servicing loans. Table 2 indicates the pattern in FY 2008–2010 with regard to B&I program loan performance and the incidence of B&I guarantee claims not being fully paid by the USDA.

Table 2: B&I Guaranteed Loan Program Performance

<table>
<thead>
<tr>
<th></th>
<th>FY 2008</th>
<th>FY 2009</th>
<th>FY 2010</th>
</tr>
</thead>
<tbody>
<tr>
<td>Number of loans submitted for the B&amp;I program*</td>
<td>803</td>
<td>726</td>
<td>1,263</td>
</tr>
<tr>
<td>Number of loans approved for the B&amp;I program</td>
<td>588</td>
<td>506</td>
<td>1,027</td>
</tr>
<tr>
<td>Number of loans for which banks sought to claim guarantee</td>
<td>50</td>
<td>45</td>
<td>90</td>
</tr>
<tr>
<td>Number of loans for which guarantee was partially denied</td>
<td>0</td>
<td>3</td>
<td>2</td>
</tr>
<tr>
<td>Number of loans for which guarantee was fully denied</td>
<td>1</td>
<td>0</td>
<td>1</td>
</tr>
</tbody>
</table>

Source: Data provided by USDA staff on February 14, 2011.

*Includes preliminary and full loan applications and includes cases withdrawn by the lender.

According to USDA, of the five loss claims that were partially denied in FY 2009 and FY 2010, three were denied for negligent servicing by the lender that caused an increase in the loss amount. One was denied because of lender misrepresentation. Another case was denied because of excessive accrued interest. Of the two loss claims denied in full during FY 2008 and FY 2010, one was because of fraud and misrepresentation by the lender and the second was because the lender failed to maintain its lien position on the collateral.

To provide further context regarding the performance of B&I guaranteed loans, as of the end of July 2011, the delinquency rate on outstanding B&I guaranteed loans was 7.73 percent. The Office of Management and Budget has forecast a 12.7 percent default rate for B&I guaranteed loans originated in FY 2012.

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27 Lenders interviewed about this program indicated that complying with the terms included in the conditional guarantee can be a drawback to the B&I Guaranteed Loan Program.

28 As calculated by the USDA, loans to companies in bankruptcy proceedings are not included in the delinquency rate. So the actual delinquency rate is somewhat higher than 7.73 percent. This delinquency rate was provided by USDA Rural Development staff on August 9, 2011.

Table 3 lists several mistakes that lenders make that might affect the viability of the B&I guarantee.

**Table 3: Common Mistakes by Lenders Making B&I Program Loans**

- Lender failed to disclose in a timely manner a material fact to USDA regarding a guaranteed loan.
- Lender failed to obtain or maintain liens on collateral and protect collateral for the loan.
- Lender did not service the loan in a manner consistent with prudent lending practices.

V. Who Uses These Programs?

**Lenders**

The majority of lenders active in the B&I program are small community lenders that use the program from time to time on loans that exceed their legal lending limit or when they need to use the guarantee as an additional risk management tool. Regional banks, credit unions, and member banks of the Farm Credit System also participate in the program. A minority of lenders active in the program, generally midsize community banks, hold a majority of the portfolio of the B&I guarantee program. These lenders use the B&I program and sale of the guarantee to the secondary market as a key component of their capital and liquidity management strategies. They also use the program to offer the borrower credit enhancements, such as longer repayment terms, fixed interest rates, and fully amortized loans.

**Packagers**

Many lenders work with their USDA Rural Development field office directly to prepare and submit applications for loan guarantees. Lenders needing additional assistance find it useful to work with experienced loan packagers to help them through the application process. In some regions of the country, there are active packagers or brokers who bring complete loan applications to commercial lenders. Lenders should exercise appropriate due diligence before entering a third-party relationship with loan packagers or brokers and throughout any transaction involving these entities.30

**Borrowers**

Any legal entity is eligible to be a borrower under the B&I Guaranteed Loan Program, including individuals, public and private organizations, and federally recognized Indian tribal groups. There is no size restriction regarding business borrowers (the program is not targeted to small businesses). Borrowers must be U.S. citizens or legal residents; public and private organization borrowers must be at least 51 percent owned and controlled by U.S. citizens or legal residents.

A borrower must be engaged in or proposing to engage in a business. Business may include manufacturing, wholesaling, retailing, renewable energy, providing services, or other activities that provide employment or improve the economic or environmental climate of a rural community or rural area.

Secondary Market

There is an active secondary market for the guaranteed portion of loans made through the B&I Guaranteed Loan Program. Many buyers of guaranteed loans under the SBA programs also buy the guaranteed portion of USDA loans, including those guaranteed through the B&I program. Additionally, the Federal Agricultural Mortgage Corporation (Farmer Mac)\(^3\) is a government-sponsored entity whose mission is to provide a secondary market for agricultural real estate and rural housing mortgage loans. Farmer Mac II is a Farmer Mac program with the sole purpose of buying the guaranteed portions of USDA-guaranteed loans, such as those guaranteed through the B&I Guaranteed Loan Program. Farmer Mac guarantees the timely payment of principal and interest on securities backed by qualified loans or guaranteed portions, and either retains those securities in its portfolio or sells them in the secondary capital markets.

VI. How Does the Cost and Pricing Structure Work?

Interest Rates

The interest rates for B&I Guaranteed Loan Program guaranteed loans are negotiated between the lender and the applicant and may be either fixed or variable (or a combination of fixed and variable). Interest rates must not exceed rates customarily charged borrowers in similar circumstances in the ordinary course of business and are subject to USDA review and approval. The variable interest rate may be adjusted at different intervals during the term of the loan, but the adjustments may not be more often than quarterly.

It is permissible to have one interest rate on the guaranteed portion of the loan and another rate on the unguaranteed portion of the loan, if the rate on the guaranteed portion does not exceed the rate on the unguaranteed portion.

Guarantee Fee

The guarantee fee, which must be paid to USDA before issuance of the guarantee, is 3 percent of the guaranteed portion of the loan. This fee is charged to the lender and may be passed on to the borrower as an eligible loan purpose.

Annual Renewal Fee

The lender pays the annual renewal fee once a year, which is required to maintain the enforceability of the guarantee. The rate of the annual renewal fee (a specified percentage) is established by USDA Rural Development in an annual notice published in the Federal Register, multiplied by the outstanding principal loan balance as of December 31 of each year, multiplied by the percent of guarantee.\(^3\) The rate is the rate in effect at the time the loan is committed and remains in effect for the life of the loan.

Annual renewal fees are due January 31. Payments not received by April 1 are considered delinquent and, at USDA discretion, may result in cancellation of the guarantee to the lender.

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\(^3\) More information about Farmer Mac can be found at www.farmermac.com.

\(^3\) The renewal fee for FY 2012 is 0.25 percent.
Other Fees

Other fees can be negotiated between the borrower and lender.

VII. What Barriers Have Constrained the Growth of This Program?

Guarantee Authority

The capacity of the B&I Guaranteed Loan Program is limited by the amount of guarantee authority appropriated to the program through annual appropriations each fiscal year. The amount of B&I program guarantee authority for FY 2012 was $811 million.

A majority of the guarantee authority is distributed to USDA Rural Development state offices. If a state office fully utilizes its allocation, it may request additional authority from the portion held in national reserve. Some states (for example, California) typically obligate more than their allocation of guarantee authority each year, while other states typically do not obligate their full allocation. This suggests that there may be a considerable opportunity for the program to provide a more even level of financing across the United States (see figure 3 on page 3).

Concern About Inconsistencies in Program Administration

USDA Rural Development’s decentralized organizational structure of field offices has strengths and weaknesses. The B&I Guaranteed Loan Program is primarily administered by these local field offices, under the leadership of 47 state (or multi-state in a few cases) offices. Through its field offices, USDA Rural Development is able to provide lenders local one-on-one assistance for the submittal and processing of applications for loan guarantee, loan servicing, and loan liquidation.

The decentralized structure, however, has led to inconsistencies in program administration and operating procedures at the field office level. Although the program is a national one and has overall guidelines that should be implemented throughout the country, we have heard from lenders that there is a certain level of variation in how the program is run in different areas. Some USDA offices handle multiple B&I loan applications each month. Others may process an application once a year or even less frequently. As a result, lenders report that some USDA personnel are better versed in program guidelines and some offices have better-developed systems for processing loan applications than others.

USDA Rural Development held a series of lender roundtable discussions in 2010 to provide lenders opportunities to provide feedback on strengths and weaknesses and to discover the inconsistencies of the program’s administration.

In response to these discussions, USDA held a series of training sessions for its key B&I program field staff to improve program consistency. Training resources have been increased. USDA Rural Development created a temporary lender advocate position in 2010 at its national office to provide lenders a conduit for additional communication and feedback and to work with field offices to continue to build consistency in program administration. The lender advocate position has been replaced by two regional coordinators who report directly to USDA’s Administrator of Rural Business and Cooperative Programs.
We have heard anecdotally that some lenders are more willing to participate in the B&I Guaranteed Loan Program for loans in certain states than in others, partly in response to assumptions of additional risk or variation in processing times due to the way the program is run in those other states. This targeting results from lenders having established relationships with USDA personnel in some states and not in others.

Compounding this geographic variation, some states receive different levels of annual allocations of guarantee approval authority. When a state exceeds this guarantee approval authority for a given year, any subsequent loan applications have to be submitted to the national office to compete for funds in the B&I fund reserve. This can add significant time to the approval process for affected applications, as well as risk that an application may not be approved because of shortage of funds.

**Concern About Guarantee Claims**

Some lenders express apprehension that their guarantee claims will not be honored if loans go into default. USDA reports that claim denials are unlikely if lenders follow procedures for documenting and servicing loans. Because USDA pre-approves B&I guaranteed loans before the loans can be funded, these risks are additionally reduced.

Table 2 on page 16 indicates the track record with regard to guarantee approvals and guarantee payments during a three-year period. USDA rarely denies guarantee payments in full or in part once the guarantee is in place.

Lenders providing financing for projects involving construction should be vigilant in managing the risk associated with construction financing. The conditional loan guarantee commitment typically includes the requirement that the facility be operational prior to loan closing. Until all conditions in the commitment are met and the permanent loan closing is conducted with the issuance of the B&I guarantee, the lender is not protected by the B&I Guaranteed Loan Program.

**Lack of a Lender Awareness and Familiarity With the Program**

Lenders’ lack of awareness and knowledge of the program is a barrier to program access. USDA Rural Development field office staffs have been charged to conduct additional outreach and lender training. The USDA has expanded its communication and relationships with national and state lender organizations in seeking their assistance to distribute program information.

**VIII. Conclusion**

USDA’s B&I Guaranteed Loan Program is designed to help participating lenders and borrowers improve the economic and environmental climate in rural communities. When properly administered, the program can be important tools for lenders and borrowers involved in rural enterprises. This is especially true for businesses that might otherwise be unable to find loans for rural business activities and for lenders wishing to manage liquidity and to reduce credit risk. Additionally, B&I loans to small businesses that meet applicable CRA requirements may be considered in an institution’s CRA evaluation.
Kristopher Rengert was the primary author of this report. Also contributing were William Reeves, Ted Wartell, and Barry Wides. Community Development Insights reports differ from OCC advisory letters, bulletins, and regulations in that they do not reflect OCC 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. The use of this information, however, does not constitute an endorsement of its accuracy by the OCC.