Comptroller of the Currency
Administrator of National Banks
US Department of the Treasury

Community Developments

MARCH 2012 COMMUNITY AFFAIRS DEPARTMENT

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 to promote economic development and create and retain jobs. The program helps lenders provide 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 financing backed with as little as 10 percent owner equity.

Under the program, a bank partners with a certified development company (CDC), a specialized SBA-certified nonprofit corporation, to finance small businesses looking to expand. Each partner makes a loan to a qualifying small business. Typically the lender's loan is secured by a first lien covering 50 percent of a project's cost. The CDC's loan is secured by a second lien for up to 40 percent of the project's cost. The CDC loan is also 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 also may receive positive 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 program helps businesses grow by acquiring and improving major fixed assets, such as owner-occupied real estate or heavy equipment. The program helps businesses with eligible 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.

The loans must be used for fixed assets, such as the purchase of land and buildings, site and building improvements, newly constructed facilities, and long-term machinery and equipment.

Loans cannot be used for working capital or inventory, except when refinancing into the 504 program through a temporary provision of the Small Business Jobs Act (SBJA)[1] that ends September 27, 2012. Existing debt may be refinanced under the permanent 504 refinancing program and the temporary SBJA refinancing program, as explained in the following section.

Eligible businesses must operate as for-profit entities and meet the SBA's requirements. A business qualifies if its net worth is less than $15 million and it has an average net income for the previous two years of less than $5 million. Loans cannot be made to a business engaged in real estate speculation or rental investments. Additional restrictions may apply. The business must create or retain one job for every $65,000 guaranteed by the SBA debenture ($100,000 per job for small manufacturers).

Refinancing Is an Option Under Permanent and Temporary Provisions of the Program

The 504 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 is one-third or less of the total project cost. 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 debt being refinanced must be related to the expansion with fixed assets as collateral.

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 and interest rate must be better for the borrower than those on the existing debt, and, as with the standard 504 program, the refinance must create or retain a job for every $65,000 guaranteed (in the debenture) by the SBA ($100,000 per job for small manufacturers).

A temporary provision in the SBJA allows small businesses to refinance fixed assets and eligible business expenses through the SBA's 504 program without the usual business expansion requirement.[2] This pilot program is scheduled to end September 27, 2012.

[1] Small Business Jobs Act of 2010, Pub. L. No. 111-240, 124 Stat. 2504 (2010).

[2] This pilot program is targeted at those small businesses that are performing well and making their payments on time but, because of the downturn in real estate values, may have difficulty refinancing their loans. In addition, businesses with excess equity (more than 10 percent) that are having problems accessing working capital can use this program to help restructure their balance sheets, lock in long-term fixed rates, and improve their cash flow.

The program is structured like the SBA's traditional 504 program, with a bank, a CDC, and a borrower all contributing to the total project cost. The amount of total financing cannot exceed 90 percent of the fair market value of the fixed assets securing the loan. The borrower's 10 percent contribution may be satisfied by its equity in the eligible fixed asset serving as collateral or by the equity in any other fixed assets that are acceptable to the SBA as collateral (e.g., other commercial or residential property and fixed assets).

The debt must have been incurred at least two years before the date of application. Loans with an existing federal guarantee (including 7(a), 504, and U.S. Department of Agriculture loans) cannot be refinanced through this temporary provision.

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**

Table 2 shows the uses and sources for a sample Refinance 504 loan.

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**

Table 3 shows a loan refinance without business expansion.

Table 3: Sample Loan Refinance Without Business Expansion (Temporary Authority)

Initial	Dollars
Appraised value of property	$ 600,000
Outstanding value of debt	500,000
Financing sources	
Bank—first lien	$ 300,000
CDC/SBA—second lien (debentures)	240,000
Borrower equity	60,000
Total	**$ 600,000**
Payoff of outstanding balance	$ 500,000
Amount available for working capital	40,000

Note: The refinance funds (bank loan + SBA debenture) cannot exceed 90 percent of the appraised value.

Public Benefit Requirements

The SBA created the 504 program to help stimulate economic development and create jobs. Since its inception, more than 2 million jobs have been created or retained nationwide as a direct result of SBA 504 loans.[3]

In most cases, a business must create or retain one job for every $65,000 guaranteed by the SBA. Small manufacturers must create or retain one job for every $100,000 guaranteed by the SBA. Borrowers must include projections for meeting these requirements in their applications for CDC loans. The projections are not part of the bank loan process.

A 2007 economic impact study, funded by the National Association of Development Companies, the CDC trade association, reported that of the 15,000 businesses that received 504 loans during the two-year study period (2003–2005), the program supported a net growth of 54,000 jobs and $4.6 billion in added labor income. Approximately two-thirds of all 504 borrowers reported job growth within two years of receiving the loan. Businesses with job growth, not counting business start-ups, averaged nearly 12 new jobs per business and about $41,600 in 504 loan dollars per new job.[4]

Financing Structure

A 504 project is funded by a bank loan, secured with a first lien, typically covering 50 percent of the project's cost; a loan from a CDC, secured with a second lien and backed by a 100 percent SBA-guaranteed debenture,[5] covering a maximum of 40 percent of the cost; and 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.[6] Bank rate, term, and fees are negotiable between the borrower and the bank. The CDC loan is fixed rate, and its term is 20 years for real estate and 10 years for equipment. The rate on the CDC loan is determined when the SBA sells the debenture to fund the loan. The borrower makes two loan payments, 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.

---

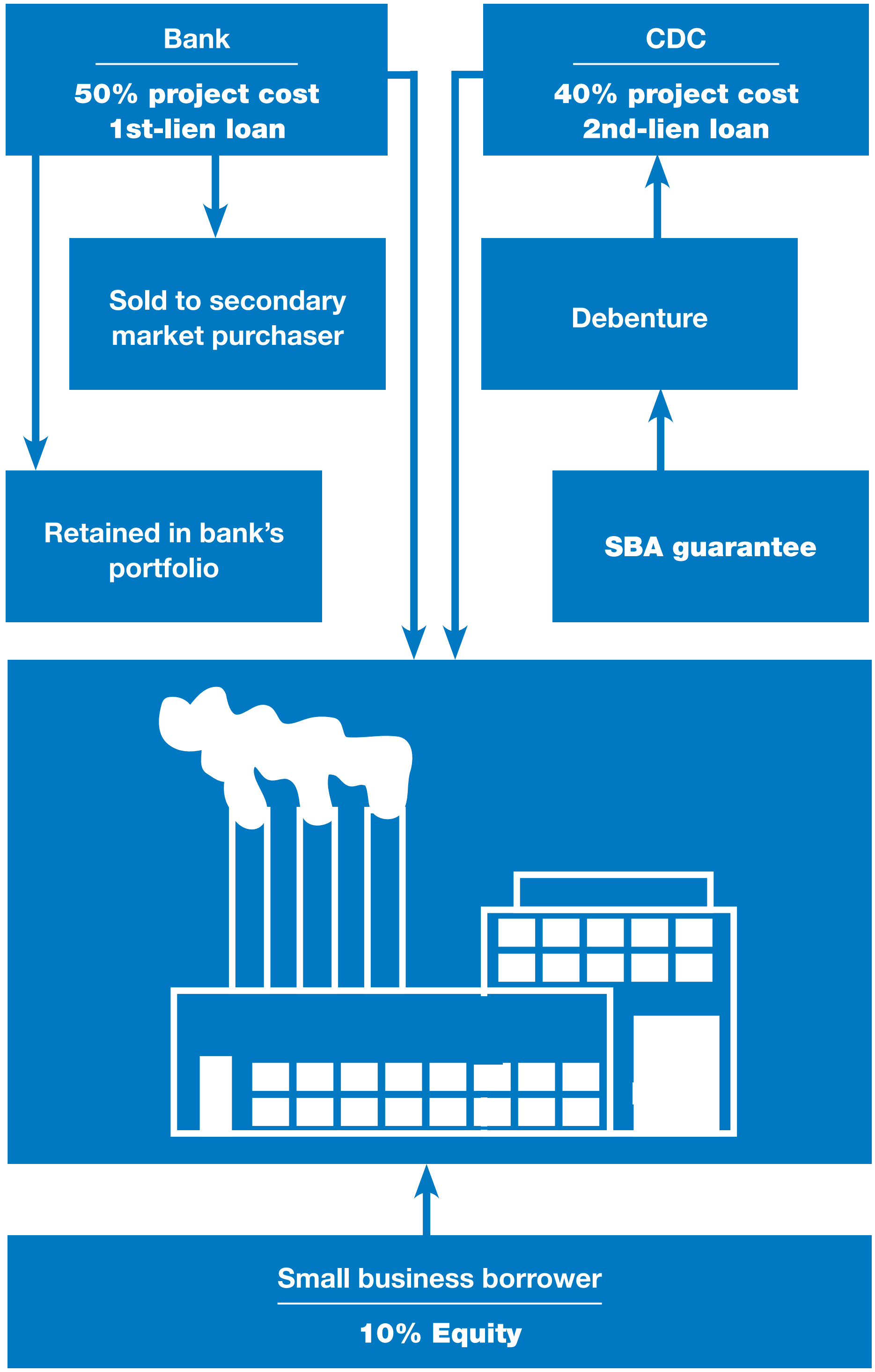
[3] 2010 Certified Development Company Industry Capability Study, National Association of Development Companies, 2011, www.nadco.org/files/public/2010%28Final%29IndustryCapabilityStudy.pdf.

[4] "SBA 504: Growing Small Businesses, Jobs, Communities," 2008 Economic Impact Study, National Association of Development Companies, www.nadco.org/files/public/Economic%20Impact%20Study%20-%20Feb_2008.pdf.

[5] 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.

[6] 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.

Typical 504 Project Structure



Eligible Lenders

Participating lenders include banks, federal savings associations, and credit unions. Lenders interested in participating should contact their local SBA District Office. Lenders must meet SBA program requirements. A lender is required to execute a third-party lender certification as part of the loan closing.

Certified Development Companies

A CDC is a nonprofit organization certified by the SBA to provide 504 loans to small businesses.[7] Most have a 501(c)(4) or 501(c)(6) nonprofit designation from the Internal Revenue Service; some have a 501(c)(3) designation. Nationwide, there are approximately 270 CDCs. Some make only 504 loans; others offer a range of programs to help small businesses.[8]

A CDC receives certification to operate statewide and, with approval from the SBA, can offer the 504 product in contiguous states. A CDC operates under the leadership of a board of directors drawn from the service area.[9]

The SBA's Office of Lender Oversight oversees CDCs' compliance with all applicable rules and regulations. CDCs must submit annual reports to the SBA. To retain its certification, a CDC must provide at least four 504 loan approvals during two consecutive fiscal years. As part of its oversight process, the SBA assigns a CDC to one of eight tiers based on the number of debentures issued by the CDC and provides every CDC with financial data and ratios, including loan-loss rate for its tier average. Under the Premier Certified Lenders Program (PCLP), CDCs receive the authority to approve loans for the SBA, thereby expediting loan processing.[10]

II. Why Are 504 Loans of Interest to Banks?

Participation in the SBA 504 program is attractive to banks because it can help them draw and retain customers, manage risk and liquidity, and generate additional cross-selling opportunities for bank products.

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

---

[7] They 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.

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

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

[10] Under the PCLP, the SBA designates qualified CDCs as PCLP CDCs and delegates to them increased authority to process, close, service, and liquidate 504 loans. This ability reduces the time needed for SBA review of various documents because PCLP lenders submit materials to the SBA for after-the-fact approvals. CDCs must apply to the SBA to become PCLP lenders. Because the SBA gives these CDCs sign-off authority, PCLP CDCs assume some of the risk. PCLP lenders must reimburse the SBA for 10 percent of any loss as the result of a default by a borrower, and PCLP lenders must also maintain a loan-loss reserve of 1 percent of its outstanding loans.

By partnering with a CDC, a bank can limit its 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 CDC loans are subordinate to the bank's position.

By using a secondary market for 504 first-lien loans,[11] a bank can manage its lending limits,[12] industry exposure, and liquidity. The lender's first lien loans are salable on the secondary market, providing the lender with greater liquidity. In addition, 504 loans used for owner-occupied real estate are not counted in commercial real estate concentrations.[13]

Banks can earn fees and interest income on interim loans related to the project.[14] Cross-selling opportunities are also available. For example, banks making 504 loans may 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 these interim loans are not guaranteed, and, as with all real estate secured loans, they should conform to applicable laws and regulations, including lending limits and appraisal guidelines.

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

CRA Consideration for SBA 504 Program Loans

Banks making 504 loans may qualify for CRA consideration. 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.[15] 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.[16] Loans of greater than $1 million made under the 504 program are considered community development loans[17] either under the lending test[18] or the community development test,[19] depending on the bank's size.

---

[11] On October 28, 2009, the SBA announced that it had created a secondary-market guarantee program to provide lenders with greater liquidity and to expand access to capital for small businesses. The new program, a provision within the American Recovery and Reinvestment Act of 2009, is designed to encourage sales into the secondary market of the first mortgage portion of small business financing made possible through the 504 program. Under this program, portions of eligible 504 first mortgages pooled by originators or broker dealers can be sold with an SBA guarantee to third-party investors in the secondary market. Lenders retain at least 15 percent of each individual loan, pool originators assume 5 percent of the risk, and the SBA guarantees the remaining 80 percent. The SBJA extended the program to September 27, 2012.

[12] 12 CFR 32. See also "Concentrations of Credit," *Comptroller's Handbook,* December 2011.

[13] "Concentrations in Commercial Real Estate Lending, Sound Risk Management Practices: Interagency Guidance on CRE Concentration Risk Management," OCC Bulletin 2006-46, December 6, 2006.

[14] 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.

[15] See 12 CFR 25.12(v).

[16] See 75 Fed. Reg. 11642, Section __.12(h)—3 (March 11, 2010).

[17] See 75 Fed. Reg. 11642, Section __.12(h)—1 (March 11, 2010).

[18] See 12 CFR 25.22 (large banks) and 12 CFR 25.26(b) (small banks).

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

III. How Do 504 Loans Work?

Reaching Customers

The connection between banks and borrowers regarding SBA 504 loans depends on a number of factors, including local real estate professionals' familiarity with the 504 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 program to the customer.

In some areas of the country, real estate professionals are very familiar with the 504 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 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 about 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.[20] When banks have customers who may benefit from 504 loans, banks may contact CDCs operating in their market to assist in describing the 504 product to customers. CDCs often conduct joint marketing calls with 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.[21]

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

Loan Presentation, Underwriting, and Processing

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

---

[20] The marketing efforts for the temporary refinance program under the Small Business Jobs Act of 2010 (set to expire September 27, 2012) may help a new set of potential borrowers become more familiar with the program.

[21] Chilcott, Kurt. "SBA 504 Certified Development Companies: The Nation's Leading Economic Development Lenders." *Community Developments*, Office of the Comptroller of the Currency, Winter 2003.

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 potential loans, banks and CDCs look at traditional underwriting criteria, including management, cash flow, operating trends, and the quality 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 borrower.

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). The policy also may allow borrowers to use projections, instead of historical cash flows, to justify repayment.

Although closing documents may be signed for bank loans and CDC loans simultaneously, CDC loans do not get funded until the SBA debentures guaranteeing the loans are sold.[22] 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 rates to borrowers as a guide for potential rates. 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.[23] 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 loan current or acquire it from the third-party lender. A 504 lender is required to notify the SBA and the CDC when a borrower is 30 days late on a payment.[24] 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 (FFIEC) has issued guidance regarding prudent commercial real estate loan workouts.[25] The "Interagency Statement on Meeting the Credit Needs of Creditworthy Small Business Borrowers" discusses principles of sound underwriting and risk management practices.[26]

---

[22] 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.

[23] See 13 CFR 120.921.

[24] See 13 CFR 120.921(c).

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

[26] "Small Business Lending: Meeting the Credit Needs of Creditworthy Small Business Borrowers," OCC Bulletin 2010-06, February 5, 2010.

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

As with all loans, banks face credit risk from 504 loans. Many of the loans are for special purpose facilities, such as gas stations, bowling alleys, and agricultural structures, which can limit the resale value of the collateral properties.[27] The 504 loan program, however, limits a lender's exposure because of the bank loan's typical 50 percent LTV ratio and its first lien on the property. In addition, in the underwriting process, business cash flows serve as the primary source of repayment, and collateral serves as the secondary source. Interestingly, the SBA reports that the credit scores[28] for 504 borrowers tend to trend higher than for 7(a) borrowers.

The delay between the funding of the bank loan and the funding of the CDC loan leaves the bank facing another type of credit risk. Lenders typically provide an interim loan to cover the period until the CDC loan comes in, which means that the bank will temporarily have a loan with a 90 percent LTV ratio. This interim loan is separate from any construction loan that might be needed. If a bank's loan to the project exceeds the supervisory LTV limits contained in 12 CFR 34, the bank must include them in the aggregate amount of all loans in excess of the limits and report them accordingly.[29] This aggregate amount should not exceed 100 percent of capital for the institution.

Bankers interviewed for this publication did not express concern about holding a 90 percent exposure for a relatively short period of time—an average of 45 days. Potential concerns are mitigated because the interim period is short, and a firm takeout source is in place through the SBA-guaranteed debenture. Those banks, however, indicated they would become more concerned if they were heavily invested in one region or one industry.[30]

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

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

In 2010, nearly 3,500 bank lenders made more than 7,840 loans through the 504 program. Two-thirds made only one 504 loan during the year, and 99 percent made fewer than 10 loans. The average (mean) bank loan was $741,000, while the average (mean) CDC loan was $593,000.

SBA 504 loans are made throughout the United States and U.S. territories. However, the use of the 504 program tends to be concentrated in specific areas of the country. California originated 23 percent of 504 loans in 2010. Seven states—California, Florida, Texas, Illinois, New York, Georgia, and Wisconsin—accounted for more than half of the loans approved in 2010.

---

[27] The SBA does require additional borrower equity for special-purpose real estate such as hotels and bowling alleys.

[28] Dunn and Bradstreet.

[29] See 12 CFR 34, Subpart D, Appendix A, "Interagency Guidelines for Real Estate Lending."

[30] "Concentrations in Commercial Real Estate Lending, Sound Risk Management Practices: Interagency Guidance on CRE Concentration Risk Management," OCC Bulletin 2006-46, December 6, 2006.

The SBA budget for fiscal year 2012 allocates $7.5 billion for CDC debentures. If that amount were to be fully subscribed, it would lead to approximately $9.4 billion in associated 504 first-lien loans by lenders.

VI. How Does the Cost and Pricing Structure Operate?

The low down-payment requirement and the long-term nature of the 504 loan product make the program attractive to small business borrowers. To obtain 504 loans, businesses generally provide a down payment of 10 percent to 15 percent and receive 85 percent to 90 percent financing.[31] Loans from CDCs (40 percent of eligible project costs) have 10- or 20-year terms, depending on the asset financed, and a fixed interest rate. Loans from banks (50 percent of eligible project costs) may have fixed or variable interest rates and are often structured with 20- or 25-year amortizations, enabling long-term repayment. Conventional commercial loans, on the other hand, generally require higher down payments and typically have shorter repayment terms.

The fees on 504 transactions, however, may reduce the program's attractiveness to some borrowers. Fees of 1 percent to 1.5 percent are typically charged by lenders for the first-mortgage loan. An additional 2.75 percent fee is assessed by the SBA (through the CDC) for costs related to the debenture sale. The SBA/CDC fee can be financed as part of the debenture-funded loan.

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 set by local market conditions and a bank's asset/liability management strategy. Larger rate concessions may be given in areas of the country where there are more competitive markets for 504 loans, such as California.

Typically, rates on the interim loans float but start out no higher than rates on first-lien loans. There may be documentation fees for interim loans, and, if there is a construction loan, there 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 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 portfolios, which typically had

---

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

higher loan-to-value ratios. The bankers indicated that when liquidation was required, the process coordinated by the SBA was timely and effective.[32] Some bankers also commented that the SBA does not impose a great burden on banks offering this product.

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) Program

Both the SBA 504 and the SBA 7(a) programs can be used by borrowers to purchase, construct, or renovate owner-occupied real estate and purchase equipment. The 504 program can be used to finance larger deals (only the CDC portion has size limitations). The CDC loan rate is fixed, and the bank rate can be fixed as well, allowing borrowers to lock in low interest rates for relatively long terms (up to 20 years). However, some lenders interviewed for this publication said that for loan amounts under $500,000, many borrowers preferred the 7(a) program because of the higher fee and prepayment penalty on 504 loans.[33]

---

[32] See SBA SOP 50-50-4, "Loan Servicing," and SBA SOP 50-51-3, "Liquidation Plans" and "Protective Bids." 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 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.

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

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

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

Issue	504 loan program	7(a) loan program
Purpose of loan	Fixed assets such as owner-occupied real estate and heavy equipment or limited refinancing of existing eligible 504 debts. No working capital loans; however, working capital may be a portion of the temporary SBJA 504 refinancing program.	Any business purpose.
Goal of program	Job creation and retention; economic development.	Capital access: access to capital for businesses that would not qualify elsewhere.
Rates and terms	Bank loan: Variable or fixed rate; must be at least seven-year term for 10-year CDC loan, at least 10-year term for 20-year CDC loan. CDC loan: Fixed rate, 10- or 20-year maturity.	Variable or fixed rate; term of up to 25 years, depending on use of proceeds.
Maximum amounts	Bank loan size is unlimited; CDC loans are capped at $5 million for most projects, $5.5 million for manufacturing.	$5 million for most projects, $5.5 million for manufacturing.
Fees	Bank loan: Application fee and construction loan fee (if applicable) vary by bank; one-time SBA participation fee of 50 basis points paid by bank. CDC loan: Upfront fees of approximately 2.75%, which are financed.	Upfront guarantee fee of approximately 3% on guaranteed portion. Ongoing fee: 54.5 basis points paid by lender.
Bank lien position	Bank has exclusive first lien.	Bank holds the first lien; with a typical 75% guarantee, the lender receives 75% of any proceeds from liquidation and the SBA receives 25%.[34]
Loan-to-value	Bank loan: Typically 50%. CDC loan: Maximum of 40%.	Maximum of 90%.
Qualification	Business net worth not to exceed $15 million; average net profit for two consecutive years not to exceed $5 million.	Same as 504 program.
Prepayment penalties	CDC loan: Penalty is 100% of one year's interest in the first year, declining to zero at the midpoint of the loan.	Low; no penalty for up to 25% prepayment in first three years.

Source: OCC, based on SBA loan program information.

[34] Some programs under the 7(a) umbrella may offer higher guarantees. For instance, many 7(a) programs offer 85 percent guarantees for loans up to $150,000. The Export Express program offers 90 percent guarantees for loan amounts up to $350,000.

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

Bank participation in the 504 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 publication agreed that the 504 product needs to be better publicized. Referring to the 504 program as "small businesses' window to Wall Street," one CDC executive noted that the 504 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. However, the lenders commented that because the CDC generally handles the additional paperwork, it does not affect the bank.

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 through secondary markets.

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

Most of the bankers and the CDC executives indicate 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, job creation, and job retention. The program helps small businesses obtain long-term capital for fixed assets with as little as 10 percent equity. The CDC loans are available at long-term fixed rates, while banks have the flexibility of using fixed- or variable-rate products for their portion of the loans.

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 positive 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** No maximum, but typically up to $2.5 million, varies by bank **CDC second lien** 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—variable or fixed** Variable—typically based on five-year Seattle Federal Home Loan Bank Rate Fixed—typically based on Treasury notes **CDC second lien—fixed** Typically based on Treasury notes
Term	**Bank first lien** At least seven years with a 10-year CDC loan; at least 10 years with a 20-year CDC loan **CDC second lien** 10 years (machinery); 20 years (real estate)
Fees	**Bank loan** Application fee and construction loan fee (if applicable) vary by bank; one-time participation fee of 50 basis points paid by lender **CDC loan** Upfront fees of approximately 2.75%; 1% of fees added to annual interest rate
Eligible assets	**Long-term fixed assets only** (such as owner-occupied real estate and heavy equipment)
Eligible borrowers	The business must operate as a for-profit entity and meet the SBA's size requirements. Loans cannot be made to businesses engaged in real estate speculation or rental investments. Additional restrictions may apply.
Debt service coverage	**Typically at least 1.15%**

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 4-by-6 feet. The company plans to add eight to 10 employees in the next year, creating jobs in a rural area. The banker on the project remarked that "SBA 504 financing was the most viable option for arranging this financing. It allowed the borrower to put up less 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 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 art works. 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
www.sba.gov/content/cdc504-loan-program

Temporary 504 Loan Refinancing Program without business expansion
www.sba.gov/content/504-loan-refinancing-program

SBA Standard Operating Procedures
www.sba.gov/category/lender-navigation/forms-notices-sops/standard-operating-procedures-sops-and-guides

State listing of CDCs
www.nadco.org/i4a/member_directory/feSearchForm.cfm?directory_id=12&pageid=3378&showTitle=1.

National Association of Development Companies
www.nadco.org

"SBA 504: Growing Small Businesses, Jobs, Communities," 2008 Economic Impact Study
www.nadco.org/files/public/Economic%20Impact%20Study%20-%20Feb_2008.pdf

***Small Business Resource Directory,* Office of the Comptroller of the Currency**
http://interimoccgovstg.dev.occ.treas.gov/topics/community-affairs/resource-directories/small-business/index-small-business.html?submenuheader=0

David Black was the primary author of the most recent update to this report. Derek Hyra, Sherrie Rhine, and William Reeves contributed to previous updates. Samuel Frumkin was the primary author of the original report published in February 2006. Also contributing were Barry Wides and Julie Williams. Emily Gold edited the most recent update.
Community Developments Insights reports differ from OCC advisory letters, bulletins, and regulations in that they do not reflect agency policy and should not be considered as definitive regulatory or supervisory guidance. Some of the information used in the preparation of this paper was obtained from publicly available sources that are considered reliable. However, the use of this information does not constitute an endorsement of its accuracy by the OCC.