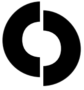
Comptroller of the Currency
Administrator of National Banks

Community Developments

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Insights

Community Affairs Department

SBA 504 Loan Program:

Small Businesses' Window to Wall Street

Abstract:

The Small Business Administration (SBA) 504 loan program is a co-lending product for long-term assets that involves a collaboration between a private sector lender, such as a bank, and a certified development company (CDC). Each party makes a separate loan to a qualifying small business. Typically, the bank portion consists of a loan secured by a first lien, covering 50 percent of the project cost. Offering 504 loans may help banks attract small business borrowers that would benefit from long-term financing for plant and major equipment acquisition.

The information presented here was obtained from a variety of sources including financial institutions, CDCs, and the SBA. Appendix A contains a sample term sheet for a 504 project. Appendix B provides examples of 504 loan projects. Appendix C contains sources of additional information on 504 loans.

I. What Is the SBA 504 Loan Program?

The SBA Certified Development Company (504) loan program provides financing for major fixed assets, such as owner-occupied real estate and long-term machinery and equipment. A 504 project includes a loan from a bank secured with a first lien typically covering 50 percent of the project cost, a loan from the CDC secured with a second lien (backed by a 100 percent SBA-guaranteed debenture[1]) covering a maximum of 40 percent of the cost, and a contribution of at least 10 percent of the project cost from the small business being financed. The SBA promotes this product as an economic development tool and because it is a self-supporting program funded by program fees rather than by appropriations from the federal budget.

Proceeds from 504 loans must be used for fixed assets such as purchasing land and improvements, construction of new facilities, converting or renovating existing facilities, or purchasing long-term machinery and equipment. The 504 program cannot be used to fund working capital or inventory or to refinance or consolidate existing debt.

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

Generally, a business must create or retain one job for every $50,000 guaranteed by the SBA, except for small manufacturers who must create or retain one job for every $100,000 guaranteed by the SBA. Borrowers include these projections in their applications for the CDC loan; the projections are not part of the bank loan process. In addition, projects funded by the 504 program must meet one of three goals, each of which has a different maximum SBA debenture size.[2]

What Are CDCs?

CDCs are typically nonprofit organizations that have been certified by the SBA to provide funding for small businesses under the SBA 504 program.[3] Most have a 501(c)(4) or 501(c)(6) nonprofit designation from the Internal Revenue Service, although some have a 501(c)(3) designation. There are 268 CDCs nationwide, some of which have as their sole product the 504 loan, while others offer a range of small business programs in addition to the 504 loans.[4]

CDCs receive a certification to operate statewide, and with approval from the SBA, can offer the 504 product in contiguous states. CDCs operate under the leadership of a board of directors drawn from the service area.[5]

CDCs are supervised by the SBA and must submit annual reports to SBA. The SBA's Office of Lender Oversight oversees CDCs' compliance with all applicable rules and regulations. To retain its certification, a CDC must provide at least four 504 loan approvals during two consecutive fiscal years. As part of its oversight process, the SBA assigns a CDC to one of seven tiers, based on annual loan approval volume, and provides CDCs with financial data and ratios, including loan loss rate, for their tier average. Under the Premier Certified Lenders Program (PCLP), CDCs receive the authority to approve loans for the SBA, thereby expediting loan processing.[6]

II. Why Are 504 Loans of Interest to Banks?

504 loans are attractive to banks because these loans can retain and attract customers, assist in risk and liquidity management, and provide fee and interest income. The program enables banks to collaborate in a co-lending product that provides long-term financing to small business customers who would not otherwise be able to find the type of financing product that would allow them to preserve capital for long-term growth. (The CDC loan has a fixed interest rate for the term of the loan. The bank loan may have either a fixed or floating rate.) The 504 loan program provides risk management advantages to participating banks, such as limiting their credit exposure to a single customer, providing good collateral coverage for their retained portion of the loan, and facilitating liquidity management through an active secondary market.

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[2] The three goals are community development goals, public policy goals, and small manufacturer assistance. See www.sba.gov/financing/sbaloan/cdc504.html and 13 CFR 120.862.

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

[4] For a state listing of CDCs, see http://www.sba.gov/gopher/Local-Information/Certified-Development-Companies/.

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

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

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

Banks can earn fees and interest income on interim loans related to the project.[7] Separately, a bank providing the permanent 504 loan may also offer a construction loan for projects requiring either new construction, rehabilitation, or reconfiguration of an existing structure. These construction loans typically generate origination, documentation, and inspection fees.

Banks also can earn income if they sell the first lien loan in the secondary market and may be able to cross-sell a variety of other financial products and services as the business continues to 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.

As loans of less than $1 million represent more than 60 percent of the commercial and industrial (C&I) loans made by national community banks, loans to small businesses are likely to form a significant part of their lending business.[8] SBA 504 loans may help banks with their mission of local economic development by enabling them to assist small businesses to grow and produce jobs.

Community Reinvestment Act (CRA)

The size of the loan determines how 504 loans receive consideration in CRA examinations. Loans of $1 million or less qualify as small business loans and may be considered under the lending test for banks of all sizes.[9] Loans of greater than $1 million that meet the definition of community development (CD)[10] may receive consideration as CD loans either under the lending test[11] or community development test[12], depending on the bank's size.

III. How Do SBA 504 Loans Work?

Reaching Customers

There are a variety of ways through which a bank connects a borrower with a 504 loan. The connection mechanism depends on a number of factors, including the condition of the local real estate market, the capacity of CDCs operating in the state, competition among CDCs operating in the state, and the receptiveness of banks to offering 504 loans.

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[7] As 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. If substantial improvements to property are needed, banks also may provide construction loans, generally with terms of 6 to 18 months.

[8] Data taken from Reports of Condition and Income ("Call Report"), June 30, 2005.

[9] See 12 CFR 25.22.

[10] A community development loan means a loan that: has as its primary purpose community development, generally has not been reported as a small business loan, and benefits the bank's assessment area or a broader statewide or regional area. See 12 CFR 25.12(h).

[11] See 12 CFR 25.22 (large banks), 12 CFR 25.26(b) (small banks).

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

Typically, bank customers looking to purchase either a facility to house the company's operations or heavy equipment for their businesses will discuss financing needs with their bank. Depending on the bank's knowledge of, and comfort with, SBA 504 loans, its staff may either present the 504 loan as one financing option or refer the customer to a CDC that would explain a 504 loan to the customer.

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

Banks that have dedicated government lending departments generally undertake specialized marketing of the 504 program. Some of these banks have sales personnel dedicated to SBA products and are engaged in active marketing of 504 loans to commercial customers as well as CDCs, commercial real estate brokers, and other professionals, including professional associations, where potential borrowers may have contacts. Other banks have SBA divisions that serve as advisors to relationship managers throughout the bank and are brought in to provide SBA product expertise if the bank's in-house products do not fit a particular project. Generally, banks with specialized SBA departments obtain about 80 to 90 percent of their 504 borrowers from their marketing and outreach or from referrals from bank relationship managers, with the remainder referred by CDCs.

Many community banks that engage in a limited number of 504 deals annually, typically benefit from the outreach and marketing conducted by CDCs to promote 504 loans. When these banks have a customer who would benefit from a 504 loan, the bank may contact a CDC operating in the bank's state to assist it in describing the 504 product to the customer. CDCs often will conduct joint marketing calls with these banks on potential borrowers, serving as the product expert in these discussions. Smaller banks, in particular, may value the role of CDCs in enabling the bank to provide SBA products that the bank might not otherwise be able to offer.[13]

A bank may also use the secondary market purchases of 504 loans to build its 504 portfolio. For example, one larger bank partners with community banks across the country that refer customers who would benefit from 504 loans. In these transactions, the larger bank makes the 504 loan to the borrower and pays the community bank a placement fee.

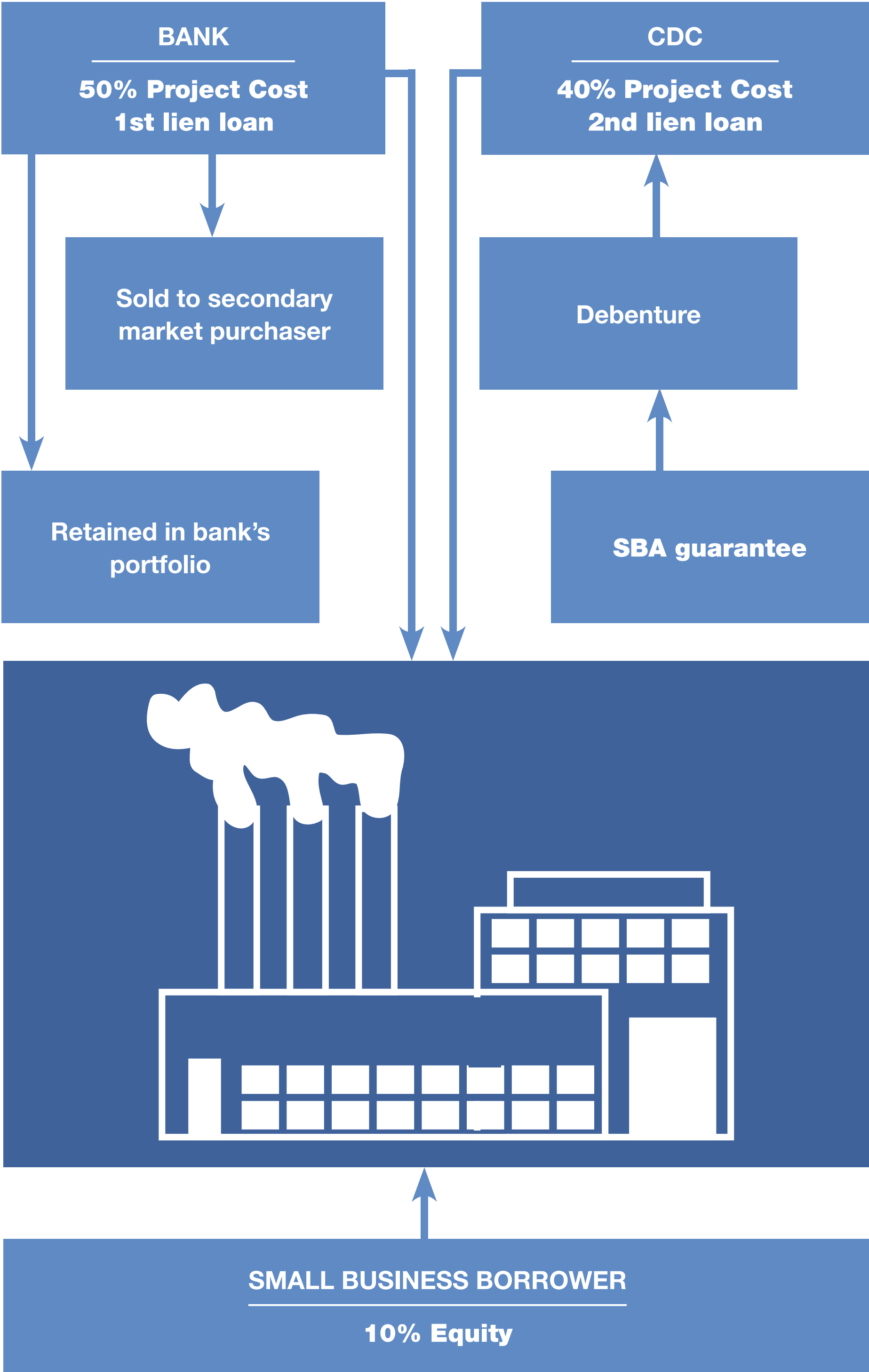
Loan Presentation, Underwriting, and Processing

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

Typically, the bank and CDC perform simultaneous underwriting for the credit each provides, although sometimes a bank will contact a CDC after it has conducted its own underwriting. In analyzing a potential loan, banks and CDCs look at traditional underwriting criteria, including management and cash flow. The bank and CDC may contact each other during the underwriting period to discuss any concerns that each may have with the project.

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

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



Although closing documents may be signed for both the bank loan and the CDC loan simultaneously, the CDC loan does not get funded until the SBA debentures guaranteeing the loan are sold. (See footnote 1 for a discussion of how SBA debentures support the 504 program.) Therefore, although the interest rate on the bank loan is set at closing, the borrower will not know the interest rate on the CDC loan until the debenture is sold. The closing documents for the CDC loan are signed, leaving space for the interest rate to be added when it is available. The CDC can provide historical rates to borrowers for guidance on the final rate. As debentures are not commonly sold until 30 to 60 days after closing, projects usually require interim financing from a bank. Traditionally, this is the same bank that provides the first lien loan.

The project financing generally consists of :

(1) a contribution by the small business of at least 10 percent of the project costs;

(2) a loan made with the proceeds of a CDC debenture for up to 40 percent of project costs and certain administrative costs, collateralized by a second lien on the property; and

(3) a loan from a bank for the balance (usually 50 percent) of the financing, collateralized by a first lien on the property. The term of the bank loan must be at least half as long as the term of the CDC loan.

A hypothetical 504 loan sources and uses proforma is illustrated as follows.

Project Uses	
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 permanent loan
CDC/SBA – second lien	$400,000 permanent loan
Borrower equity	$100,000
Total	$1,000,000

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

As with any loan product, 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 property. However, the 504 loan program limits the institution's exposure because of its 50 percent LTV and a first lien on the property. In addition, banks underwrite their 504 loans with business cash flow serving as the primary source of repayment and the collateral serving as the secondary repayment source.

The delay between funding of the bank loan and funding of the CDC loan presents another risk to the bank. During this period, the bank typically provides an interim loan, which means that the bank temporarily has a loan with a 90 percent LTV. (This interim loan is separate from any construction loan that might be needed.) If these loans exceed the supervisory LTV limits contained in 12 CFR 34, the institution must include them in the aggregate amount of all loans in excess of the limits, and report them accordingly.[14] This aggregate amount should not exceed 100 percent of capital for the institution.

Banks interviewed did not express concern about holding a 90 percent exposure for a relatively short period of time – an average of approximately 45 days. Potential concerns are mitigated primarily because the interim period is short, and a firm takeout source is in place through the SBA-guaranteed debenture. The banks interviewed indicated they would become concerned, however, if they were too heavily invested in one region or one industry.[15]

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

All of the banks interviewed were pleased with the low loss rates they have experienced on 504 loans. They also noted that there were no difficulties with the liquidation procedures for the few 504 loans that had turned into problem assets. They reported that the liquidation process was straightforward, beginning with a requirement that the bank notify SBA when the borrower is 60 days late on a payment. Typically, the bank will also check with the CDC to learn of its experience with the borrower.

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

The SBA budget for FY 2006 allocates $5.5 billion for CDC debentures. If that amount were to be fully subscribed, it would lead to approximately $6.9 billion in associated 504 first lien loans by lenders.

Table 1
Bank 504 Loan Sizes (FY 2005)

Loan Size	Number of Loans
Less than $500,000	4,340
Between $500,000 and $999,999	2,546
Between $1,000,000 and $1,999,999	1,654
More than $2,000,000	652

[Data provided by SBA]

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

[15] In January 2006, the federal banking agencies published for a comment proposed guidance for concentrations in commercial real estate lending and sound risk management practices. See 71 Fed. Reg. 2302 (January 13, 2006).

As shown in Table 2, in FY 2004, 504 lending was spread among a wide number of financial institutions, with about 20 percent of the volume concentrated in the top five lenders. 1,625 lenders made 504 loans in FY 2004, with nearly 85 percent of these lenders closing between one and five loans during the year. These numbers show that although major 504 lending volume is concentrated among a few lenders, there is broad knowledge of the product across the banking spectrum, with many smaller, community banks closing one or two financings annually.

Table 2
SBA 504 Loans in 2004

Number of Loans	Number of Lenders
1 to 5	1378
6 to 15	175
16 to 49	51
50 to 100	14
101 to 500	5

Nationally, use of the 504 product is concentrated in certain areas of the country. SBA 504 lending is especially active in California, which accounts for nearly half of all 504 loans nationwide. The CDC industry is especially competitive in California, which has led to a high level of publicity for the product there. According to the banks interviewed, there is active use of 504 loans in a number of other western states including Nevada, Arizona, Washington, and Oregon. The product is also well known in Illinois, Ohio, Minnesota, Florida, and a number of states in the northeast.

VI. How Does the Cost/Pricing Structure Operate?

All of the banks interviewed indicated that a bank loan size of $500,000 was necessary to make the fees associated with the product worthwhile for borrowers, but the banks will do smaller loans if requested. The CDCs interviewed indicated that smaller size loans are common and beneficial because the 504 product allows small businesses with limited capitalization to leverage assets in order to grow.

The bankers generally agreed that the SBA 504 loan was a better product for real estate acquisition than the SBA 7(a) loan, but that for loans below the $500,000 threshold, borrowers preferred the 7(a) loan. One bank indicated that for real estate purchases of $400,000 or less, most borrowers opted to use a 7(a) loan due to the higher fees and the prepayment penalty on 504 loans.[16] For loans between $500,000 and $900,000 at that bank, borrowers used both 504 and 7(a) loans, while for loans of $900,000 and above, most used 504 loans.

[16] 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 3
Comparison of 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; no refinancing or working capital	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; must be at least half as long as term of CDC loan **CDC loan:** Fixed rate, 10- or 20-year maturity	Variable or fixed; term of up to 25 years depending on use of proceeds
Maximum amounts	Bank loan size is unlimited; generally used for projects of $3.75 million to $5 million; $10 million for manufacturing	$2.0 million loan with a $1.5 million guaranteed amount
Fees	**Bank loan:** Application fee and construction loan fee (if applicable) vary by bank; one-time SBA participation fee of 50 basis points paid by bank **CDC loan:** Upfront fees of approximately 2.75 percent which are financed	Upfront guarantee fee of approximately 3% on guaranteed portion; ongoing fee of 54.5 basis points paid by lender
Bank lien position	Bank has exclusive first lien	Bank holds the first lien; with typical 75% guarantee, the lender receives 75% of any proceeds from a liquidation and SBA receives 25%
Loan-to-Value	**Bank loan:** Typically 50% **CDC loan:** Maximum of 40%	Maximum of 90%
Qualification	Business net worth not to exceed $7 million; average net profit for 2 consecutive years not to exceed $2.5 million after taxes	Depending on the type of business, annual sales of less than $5 million or manufacturing firm of less than 500 employees
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 3 years

The key factors that make the 504 loan attractive for borrowers are the potential for leverage and the long-term nature of the product. With a 504 loan, a business generally provides 10 to 15 percent down payment and receives 85 to 90 percent financing.[17] The loan from the CDC (40 percent of eligible project costs) has a 10- or 20-year term, depending on the asset financed, and a fixed interest rate. The loan from the bank (50 percent of eligible project costs) may have a fixed or floating interest rate, but is often structured with a 20- or 25-year amortization, enabling long-term repayment. Conventional commercial loans, on the other hand, generally require a higher down payment, and typically have a shorter repricing term.

The fees on 504 loans reduce their attractiveness to some borrowers. There is a 1 to 1.5 percent loan fee typically charged by a bank for the first lien loan under the 504 program, and a 2.75 percent fee charged by SBA for costs related to the debenture sale on the second lien loan. The SBA fee is typically financed as part of the debenture.

Banks vary in the benchmarks used to set the rates on their 504 loans and are not limited to which index they can use, although some secondary market purchasers may focus on loans tied to a particular benchmark. Many banks use Treasury rates or some other common index as a benchmark. Generally there are spreads of 1.5 to 3.5 percent attached to any benchmark rate, but the rates and fees are set by local market conditions and a bank's asset/liability management strategy. There are larger rate concessions in areas of the country where there is a more competitive market for 504 loans, such as California and western states, and fewer rate concessions in central and southeastern states. The spread is also affected by the creditworthiness of the borrower.

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

The loan by the CDC uses the 10-year Treasury note as a benchmark, and is amortized over 10 years for capital equipment loans and 20 years for real estate loans. If a project includes real estate and a significant portion of capital equipment, the weighted maturity is calculated and rounded to either a 10-year or 20-year maturity. The project can also be separated into two loans if it involves both types of collateral (real estate and equipment).

Internal Costs and Performance

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

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

All of the banks interviewed indicated that the product had performed well, with a small number of loans turning into problem assets and requiring liquidation. The banks indicated that when liquidation was required, the process coordinated by SBA was timely and effective.[18] Some of the banks also noted that there is not much burden imposed on banks by the SBA for offering this product.

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

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

While use of 504 loans is high in some areas of the country, characterized by competitive pricing for loans by banks and CDCs, use of the product remains low in other regions. Interviews with CDCs indicated that in certain states the product simply is not well-known either by banks or small business owners, and as a result, product use has not grown. In a more limited number of states, according to the CDCs interviewed, there is a reluctance by both banks and small business owners to use government lending products. Reportedly, some banks in these areas view the 504 paperwork requirements as onerous.

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

A number of banks and CDCs indicated that while the 504 loan application process has been streamlined and processing time by SBA has been reduced since SBA centralized 504 processing, there is still more closing documentation and paperwork required than what these banks and CDCs believe is necessary. The bankers commented that generally the CDC handles this extra paperwork so that it does not affect the bank.

Some community banks have constraints on the size of the loans they can make due to legal lending limits. This can be a problem especially in areas with high real estate values. However, these banks can still make 504 loans to their customers by partnering with other banks that are active secondary market purchasers of 504 loans to actually fund the loan.

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

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[18] If a borrower is 65 days late on payments, the bank and CDC must develop a workout plan or the SBA must repurchase the debenture. If the bank and CDC determine that the loan can be restructured, they may allow 6 to 9 months for the borrower to catch up on payments. 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 will develop a liquidation plan over a 1- to 2-week period. On a case-by-case basis, the SBA determines if the agency will outbid other bidders for the first lien loan at the foreclosure sale. For example, SBA may decide that bidding at the foreclosure sale is necessary to take ownership of the collateral in order to sell it, or it may decide that property specific considerations (e.g., contamination of the facility, decline in property value) make it unwise for SBA to bid at the sale. If SBA makes a successful bid on the first lien loan, the agency tries to sell the collateral as soon as possible, preferably within 30 days. After the asset has been sold, SBA tries to recoup any losses from loan guarantors. SBA then pays off any expenses related to the sale of the asset, such as realtor fees, mechanics' liens, and prior bank liens, with the balance treated as a loan recovery.

A few banks indicated that while turnaround on credit approvals is completed quickly by SBA, generally within 48 hours of submission, a project can be delayed by significant lags in SBA approvals of appraisals and environmental reports.

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

Many banks and CDCs acknowledged that SBA fees for the 504 loan program are high. There are upfront fees of approximately 2.75 percent on the CDC loan. Typical servicing fees also apply. These fees are paid by the borrower. Separately, the bank pays an upfront per loan participation fee of 50 basis points to the SBA, which the bank may pass on to the borrower. However, these fees enable the 504 program to be self-funding, with program revenues covering losses and expenses.

VIII. Conclusion

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

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

Appendix A

Sample Term Sheet

Loan amount	**Bank first lien** Typically up to $2.5 million, varies by bank For small manufacturers, up to $5 million **SBA second lien** Up to $1.5 or $2.0 million, depending on project goal For small manufacturers, up to $4.0 million
Maximum financing available	**90%** Bank first lien 50% (can be higher) SBA second lien 40% (maximum)
Borrower Equity	**10% minimum**
Interest Rates	**Bank first lien – floating or fixed** Floating – Typically based on 5-year Seattle FHLB rate Fixed –Typically based on Treasury notes **SBA second lien – fixed** Typically based on Treasury notes
Term	**Bank first lien** Any term, must be at least ½ the term of SBA loan **SBA second lien** 10 years (machinery); 20 years (real estate)
Fees	**Bank loan** Application fee and construction loan fee (if applicable) vary by bank; one-time participation fee of 50 basis points paid by lender **CDC loan** Upfront fees of approximately 2.75 percent (financed); 1 percent of fees added to annual interest rate
Eligible assets	**Long-term fixed assets only** (such as owner-occupied real estate and heavy equipment)
Eligible borrowers	**Most businesses**
Debt service coverage	**Typically at least 1.15%**

Appendix B

Financing Examples

Case Study 1 – Urban Redevelopment

One small business that produces custom-made wood furniture for offices, hospitals, and lobbies purchased a plant that had previously manufactured metal housings for car starters and alternators. It 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 replacement. The 504 loans from the CDC and bank financed plant renovation and new equipment. The bank and CDC worked together to assemble the financing to help the business buy the building, purchase and install the equipment they needed, and retain enough working capital to get going in the new location.

Case study 2 – Small Business Growth and Employment

A manufacturer of injection molded plastic parts used a $1 million 504 project ($500,000 of which was a loan from a national bank) to add a 750-ton press, allowing the company to compete for bigger jobs. Among the company's products are: cases for medical equipment, such as kidney dialysis, blood analyzer and bone density machines; hand held equipment, shelving and highway guard rails. The new press will enable the company to produce large injection plastic molded parts for a backyard tool shed measuring 4 x 6 feet. The company plans to add 8-10 employees in the next year, creating jobs in a rural area. The banker on the project remarked that "SBA 504 financing was the most viable option for arranging this financing. It allowed the borrower to put up less upfront and retain cash for operating expenses."

Case study 3 – Innovative Products

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

Appendix C

Resource Directory

State listing of CDCs

http://www.sba.gov/gopher/Local-Information/Certified-Development-Companies/

SBA information for banks

http://www.sba.gov/banking/

SBA information on the 504 product

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

SBA regulations

http://www.sba.gov/library/lawroom.html

OCC Community Developments newsletter on bank financing for small businesses

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

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