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Small Business Administration 504/CDC Loan Guaranty Program

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Summary

The Small Business Administration (SBA) administers programs to support small businesses, including several loan guaranty programs designed to encourage lenders to provide loans to small businesses "that might not otherwise obtain financing on reasonable terms and conditions." The SBA's 504 Certified Development Company (504/CDC) loan guaranty program is administered through non-profit Certified Development Companies (CDC). It provides long-term fixed rate financing for major fixed assets, such as land, buildings, equipment, and machinery. Of the total project costs, a third-party lender must provide at least 50% of the financing, the CDC provides up to 40% of the financing through a 100% SBA-guaranteed debenture, and the applicant provides at least 10% of the financing. It is named from Section 504 of the Small Business Investment Act of 1958 (P.L. 85-699, as amended), which authorized the program. In FY2009, the SBA funded 6,293 504/CDC loans amounting to about $3.8 billion.

Congressional interest in the 504/CDC program has increased in recent years because of increased concern that small businesses might be prevented from accessing sufficient capital to assist in the economic recovery. Congress considered several Obama Administration proposals and bills during the 111th Congress that would have amended the 504/CDC program in an effort to increase the number, and amount, of 504/CDC loans before adopting the Small Business Jobs Act of 2010. President Obama signed the bill into law (P.L. 111-240) on September 27, 2010. It increased the 504/CDC program's loan guaranty limits from $1.5 million to $5 million for "regular" borrowers, from $2 million to $5 million if the loan proceeds are directed toward one or more specified public policy goals, and from $4 million to $5.5 million for manufacturers. It also temporarily expands the ability of 504/CDC borrowers to use the program for the refinancing of existing debt, and provides $505 million to extend through December 31, 2010, the temporary subsidization of 504/CDC and 7(a) loan guaranty program fees and the temporary increase in the 7(a) program's maximum loan guaranty percentage from up to 85% of loans of $150,000 or less and up to 75% of loans exceeding $150,000 to 90% for all standard 7(a) loans. The fee subsidies and 90% loan guaranty percentage were initially funded under P.L. 111-5, the American Recovery and Reinvestment Act of 2009 (ARRA), and had expired on May 31, 2010.

This report opens with a discussion of the rationale provided for the 504/CDC program, the program's borrower and lender eligibility standards, program requirements, and program statistics, including loan volume, loss rates, use of the proceeds, borrower satisfaction, and borrower demographics.

It then examines congressional action taken during the 111th Congress to assist small businesses gain greater access to capital, including the enactment of P.L. 111-5, the American Recovery and Reinvestment Act of 2009 (ARRA) and P.L. 111-240, the Small Business Jobs Act of 2010. It also examines issues raised concerning the SBA's administration of the program, including the oversight of 504/CDC lenders.

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Small Business Administration Loan Guaranty Programs

The Small Business Administration (SBA) administers programs to support small businesses, including several loan guaranty programs designed to encourage lenders to provide loans to small businesses "that might not otherwise obtain financing on reasonable terms and conditions."[1] The SBA's 504 Certified Development Company (504/CDC) loan guaranty program provides long-term fixed rate financing for major fixed assets, such as land, buildings, equipment, and machinery. It is named from Section 504 of the Small Business Investment Act of 1958 (P.L. 85-699, as amended), which authorized the program.[2] It is administered through non-profit Certified Development Companies (CDCs). Of the total project costs, a third-party lender must provide at least 50% of the financing, the CDC provides up to 40% of the financing backed by a 100% SBA-guaranteed debenture, and the applicant provides at least 10% of the financing.

The SBA's debenture is backed with the full faith and credit of the United States and is sold to underwriters who form debenture pools. Investors purchase interests in the debenture pools and receive certificates representing ownership of all or part of the pool. The SBA and CDCs use various agents to facilitate the sale and service of the certificates and the orderly flow of funds among the parties.[3] After a 504/CDC loan is approved and disbursed, accounting for the loan is set up at the Central Servicing Agent (CSA, currently Colson Services Corporation), not the SBA. The SBA guarantees the timely payment of the debenture. If the small business is behind in its loan payments, the SBA pays the difference to the investor on every semi-annual due date.[4] In FY2009, the SBA guaranteed 6,293 504/CDC loans amounting to about $3.8 billion.[5]

Historically, one of the justifications presented for funding the SBA's loan guaranty programs has been that small businesses can be at a disadvantage, compared with other businesses, when trying to obtain access to sufficient capital and credit.[6] Congressional interest in small business access to

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[1] U.S. Small Business Administration, *Fiscal Year 2010 Congressional Budget Justification* (Washington, DC: GPO, 2009), p. 30.

[2] The 504/CDC program was preceded by a 501 state development company program (1958-1982), a 502 local development company program (1958-1995), and a 503/CDC program (1980-1986). The 504/CDC program started in 1986. There are a small number of for-profit CDCs that participated in these predecessor programs that have been grandfathered into the current 504/CDC program. See U.S. Small Business Administration, "SOP 50 10 5(B): Lender and Development Company Loan Programs," Washington, DC (effective October 1, 2009), p. 51, http://www.sba.gov/idc/groups/public/documents/sba_homepage/serv_sops_50105b.pdf; and U.S. Small Business Administration, "2008 Loss Report," Washington, DC, p. 3, http://www.sba.gov/idc/groups/public/documents/sba_program_office/cfo_2008_loss_report.pdf.

[3] 13 C.F.R. § 120.801. 504/CDC debentures are normally sold and proceeds disbursed on the Wednesday after the second Sunday of each month. See U.S. Small Business Administration, "SOP 50 10 5(B): Lender and Development Company Loan Programs," Washington, DC (effective October 1, 2009), p. 315, http://www.sba.gov/idc/groups/public/documents/sba_homepage/serv_sops_50105b.pdf.

[4] U.S. Small Business Administration, "Monthly Purchase of 504 Debentures for Accelerated Loans," Washington, DC, http://www.sba.gov/aboutsba/sbaprograms/elending/notices/BANK_5000_602_MONTHLY_PURC_504.html.

[5] U.S. Small Business Administration, *Fiscal Year 2011 Congressional Budget Justification and FY 2009 Annual Performance Report* (Washington, DC: GPO, 2010), pp. 39, 125.

[6] U.S. Government Accountability Office, *Small Business Administration: 7(a) Loan Program Needs Additional Performance Measures*, GAO-08-226T, November 1, 2007, pp. 3, 9-11, http://www.gao.gov/new.items/d08226t.pdf; and Veronique de Rugy, *Why the Small Business Administration's Loan Programs Should Be Abolished*, American Enterprise Institute for Public Policy Research, AEI Working Paper #126, April 13, 2006, http://www.aei.org/docLib/ (continued...)

capital, in general, and the 504/CDC program, in particular, has increased in recent years for three reasons.

First, private lenders have tightened small business lending standards, making it more difficult than in the past for small businesses to access capital.[7] Second, some research suggests that small business has led job formation during previous economic recoveries.[8] Third, the number of 504/CDC loans funded declined 27.1% from FY2008 to FY2009 (8,630 to 6,293), and the total amount of 504/CDC loans declined 27.5% from FY2008 to FY2009 ($5,289,790 to $3,834,263).[9] The decline in 504/CDC lending, coupled with the tightening of private lending standards, has led to increased concern in Congress that small businesses might be prevented from accessing sufficient capital to enable small businesses to assist in the economic recovery.

Congress considered several Obama Administration proposals and bills during the 111th Congress that would have amended the 504/CDC program in an effort to increase the number, and amount, of 504/CDC loans before adopting the Small Business Jobs Act of 2010. President Obama signed bill into law (P.L. 111-240) on September 27, 2010. It increases the 504/CDC program's loan guaranty limits from $1.5 million to $5 million for "regular" borrowers, from $2 million to $5 million if the loan proceeds are directed toward one or more specified public policy goals, and from $4 million to $5.5 million for manufacturers. It also expands the ability of 504/CDC borrowers to use the program for refinancing existing debt, and provides $505 million to continue through December 31, 2010, the temporary subsidization of fees in the 504/CDC program and the 7(a) loan guaranty program and a temporary increase in the 7(a) program's maximum loan guaranty percentage from up to 85% of loans of $150,000 or less and up to 75% of loans exceeding $150,000 to 90% for all standard 7(a) loans. The fee subsidies and 90% loan guaranty percentage were initially funded under P.L. 111-5, the American Recovery and Reinvestment Act of 2009 (ARRA), and had expired on May 31, 2010.

This report examines the program's borrower and lender eligibility standards, program requirements, and program statistics, including loan volume, loss rates, use of the proceeds, borrower satisfaction, and borrower demographics.

It then examines congressional action taken during the 111th Congress to assist small businesses gain greater access to capital, including the enactment of P.L. 111-5, the American Recovery and Reinvestment Act of 2009 (ARRA) and P.L. 111-240, the Small Business Jobs Act of 2010. It also examines issues raised concerning the SBA's administration of the program, including the oversight of 504/CDC lenders.

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20060414_wp126.pdf. Proponents of federal funding for the SBA's loan guarantee programs also argue that small business can promote competitive markets. See, P.L. 83-163, § 2(a), as amended; and 15 U.S.C. § 631a.

[7] Federal Reserve Board, "Senior Loan Officer Opinion Survey on Bank Lending Practices," Washington, DC, http://www.federalreserve.gov/boarddocs/SnLoanSurvey/, cited in Brian Headd, "Forum Seeks Solutions To Thaw Frozen Small Business Credit," *The Small Business Advocate*, vol. 28, no. 10 (December 2009), p. 3, http://www.sba.gov/advo/dec09.pdf.

[8] U.S. Small Business Administration, Office of Advocacy, *Small Business Economic Indicators for 2003*, August 2004, p. 3, http://www.sba.gov/advo/stats/sbei03.pdf; and Brian Headd, "Small Businesses Most Likely to Lead Economic Recovery," *The Small Business Advocate*, vol. 28, no. 6 (July 2009), pp. 1, 2, http://www.sba.gov/advo/july_09.pdf.

[9] U.S. Small Business Administration, *Fiscal Year 2011 Congressional Budget Justification and FY 2009 Annual Performance Report* (Washington, DC: GPO, 2010), pp. 39, 125.

Program Participants and Financing Contribution

As shown in **Table 1**, 504/CDC projects generally have three main participants: a third-party lender provides 50% or more of the financing; a CDC provides up to 40% of the financing through a 504/CDC debenture, which is guaranteed 100% by the SBA; and the borrower contributes at least 10% of the financing. No more than 50% of eligible costs can be from federal sources.

The CDC's contribution, and the amount of the SBA's 100% guaranteed debenture, cannot exceed 40% of the financing for standard 504/CDC loans and 35% of the financing for new businesses (defined as "a business that is two years old or less at the time the loan is approved") or if the loan is for a limited-market property (defined as "a property with a unique physical design, special construction materials, or a layout that restricts its utility to the use for which it is designed") or for a special purpose property. The SBA lists 27 limited or special purpose properties (e.g., dormitories, golf courses, hospitals, and bowling alleys).[10] The CDC's contribution cannot exceed 30% of the financing when the borrower is both a new businesses and the loan is for either a limited-market property or a special purpose property.

Table 1. 504/CDC Loan Structures and Contribution Requirements

Participant	Standard Loan	New Business or Limited or Special Purpose Property Loan	Both New Business and Limited or Special Purpose Property Loan
Third Party Lender	at least 50%	at least 50%	at least 50%
CDC/SBA	maximum 40%	maximum 35%	maximum 30%
Borrower	at least 10%	at least 15%	at least 20%

Source: U.S. Small Business Administration, "SOP 50 10 5(B): Lender and Development Company Loan Programs," Washington, DC (effective October 1, 2009), p. 242, http://www.sba.gov/idc/groups/public/documents/sba_homepage/serv_sops_50105b.pdf.

Borrowers must contribute at least 10% of the financing for standard 504/CDC loans and at least 15% of the financing if they are a new business or if the loan is for a limited-market property or for a special purpose property. They must contribute at least 20% of the financing if they are both a new businesses and the loan is for either a limited-market property or a special purpose property.

[10] The SBA considers the following as a limited or special purpose property: dormitories; cold storage facilities where more than 50% of total square footage is equipped for refrigeration; tennis clubs; golf courses; swimming pools; amusement parks; sports arenas; bowling alleys; theaters; marinas; gas stations; service centers (e.g., oil and lube, brake or transmission centers) with pits and in ground lifts; car wash properties; hospitals, surgery centers, urgent care centers and other health or medical facilities; nursing homes, including assisted living facilities; funeral homes with crematoriums; cemeteries; sanitary landfills; museums; clubhouses; hotels and motels; wineries; railroads; farms, including dairy facilities; oil wells; mines; and quarries, including gravel pits. See U.S. Small Business Administration, "SOP 50 10 5(B): Lender and Development Company Loan Programs," Washington, DC (effective October 1, 2009), pp. 244, 245, http://www.sba.gov/idc/groups/public/documents/sba_homepage/serv_sops_50105b.pdf.

Borrower Eligibility Standards and Program Requirements

Borrower Eligibility Standards

To be eligible for an SBA business loan, a small business applicant must

- be located in the United States,
- be a for-profit operating business (except for loans to eligible passive companies),
- qualify as small,[11]
- demonstrate a need for the desired credit and that the funds are not available from alternative sources, including personal resources of the principals, and
- be certified by a lender that the desired credit is unavailable to the applicant on reasonable terms and conditions from non-federal sources without SBA assistance.[12]

Several types of businesses are prohibited from participating in the program. For example, financial businesses primarily engaged in the business of lending, such as banks and finance companies; life insurance companies; businesses located in a foreign country; businesses deriving more than one-third of gross annual revenue from legal gambling activities; businesses that present live performances of a prurient sexual nature; and businesses with an associate who is incarcerated, on probation, on parole, or has been indicted for a felony or a crime of moral turpitude are ineligible.[13]

To qualify for a SBA business loan, applicants must be creditworthy and able to reasonably assure repayment. The SBA requires lenders to consider the applicant's

- character, reputation, and credit history;
- experience and depth of management;
- strength of the business;
- past earnings, projected cash flow, and future prospects;
- ability to repay the loan with earnings from the business;

[11] Under the 504/CDC program, the business qualifies as small if it does not have a tangible net worth in excess of $8.5 million and does not have an average net income in excess of $3 million after taxes for the preceding two years. For further analysis concerning SBA size standards see CRS Report R40860, *Defining Small Business: An Historical Analysis of Contemporary Issues*, by Robert Jay Dilger.

[12] 13 C.F.R. § 120.100; and 13 C.F.R. § 120.101.

[13] 13 C.F.R. § 120.110. Nineteen types of businesses are ineligible for 504/CDC loans. Also, an Associate is an officer, director, owner of more than 20% of the equity, or key employee of the small business; any entity in which one or more individuals referred to above owns or controls at least 20% of the equity; and any individual or entity in control of or controlled by the small business, except a Small Business Investment Company licensed by the SBA. See 13 C.F.R. § 120.10.

- sufficient invested equity to operate on a sound financial basis;
- potential for long-term success;
- nature and value of collateral (although inadequate collateral will not be the sole reason for denial of a loan request); and
- affiliates' effect on the applicant's repayment ability.[14]

Borrower Program Requirements

Use of Proceeds

A 504/CDC loan can be used to

- purchase land and make necessary improvements to the land, such as adding streets, curbs, gutters, parking lots, utilities, and landscaping;
- finance short-term debt ("bridge financing") on the land as long as there is no building currently on the land and the financing term is three years or less;
- purchase buildings and make improvements to the buildings, such as altering the building's facade and updating its heating and electrical systems, plumbing, and roofing;
- purchase, transport, dismantle, or install machinery and equipment, provided the machinery and equipment have a useful life of at least 10 years;
- purchase essential furniture and fixtures;
- pay professional fees that are directly attributable and essential to the project, such as title insurance, title searches and abstract costs, surveys and zoning matters;
- pay interim financing costs, including points, fees, and interest;
- create a contingency fund, provided that the fund does not exceed 10% of the project's construction costs; and
- finance permissible debt refinancing related to business expansion.[15]

It cannot be used for working capital or inventory. In addition, as will be discussed later, P.L. 111-240, the Small Business Jobs Act of 2010, temporarily expands the ability of 504/CDC borrowers to use the program for the refinancing of existing debt.

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[14] 13 C.F.R. § 120.150.

[15] U.S. Small Business Administration, "SOP 50 10 5(B): Lender and Development Company Loan Programs," Washington, DC (effective October 1, 2009), pp. 279, 280, http://www.sba.gov/idc/groups/public/documents/sba_homepage/serv_sops_50105b.pdf. If the project "involves expansion of a small business applicant" 504/CDC loans can be used to refinance "any amount of existing indebtedness that does not exceed 50 percent of the cost of the expansion.... that involves the acquisition, construction or improvement of land, building or equipment for use by the small business applicant." See Ibid., p. 280.

Job Creation and Retention Requirement

All 504/CDC borrowers must meet one of two specified economic development objectives. First, except small manufacturers, they must create or retain at least one job for every $65,000 of project debenture. Borrowers who are small manufacturers (defined as a small business with its primary North American Industry Classification System Code in Sectors 31, 32, and 33, and all of its production facilities are located in the United States) must create or retain one job per $100,000 of project debenture. The jobs created do not have to be at the project facility, but 75% of the jobs must be created in the community where the project is located. Using job retention to satisfy this requirement is allowed only if the CDC "can reasonably show that jobs would be lost to the community if the project was not done."[16]

Second, if the borrower does not meet the job creation or retention requirement, the borrower can retain eligibility by meeting any one of five community development goals or nine public policy goals, provided the CDC meets its required job opportunity average of at least one job opportunity created or retained for every $65,000 in project debenture, or for every $75,000 in project debenture for projects located in special geographic areas (Alaska, Hawaii, state-designated enterprise zones, empowerment zones, enterprise communities, and labor surplus areas). Loans to small manufacturers are excluded from the calculation of this average.[17]

The five community development goals are

- improving, diversifying or stabilizing the economy of the locality;
- stimulating other business development;
- bringing new income into the community;
- assisting manufacturing firms; or
- assisting businesses in labor surplus areas as defined by the U.S. Department of Labor.

The nine public policy goals are

- revitalizing a business district of a community with a written revitalization or redevelopment plan;
- expansion of exports;
- expansion of small businesses owned and controlled by women;
- expansion of small businesses owned and controlled by veterans (especially service-disabled veterans);
- expansion of minority enterprise development;
- aiding rural development;

[16] Ibid., p. 277.

[17] A job opportunity is defined as a full time (or equivalent) permanent job created within two years of receipt of 504/CDC funds, or retained in the community because of a 504/CDC loan. See Ibid., pp. 58, 241, 278.

- increasing productivity and competitiveness (e.g., retooling, robotics, modernization, and competition with imports);
- modernizing or upgrading facilities to meet health, safety, and environmental requirements; or
- assisting businesses in or moving to areas affected by federal budget reductions, including base closings, either because of the loss of federal contracts or the reduction in revenues in the area due to a decreased federal presence.[18]

Loan Amounts

The minimum 504/CDC debenture is $25,000. P.L. 111-240, the Small Business Jobs Act of 2010, increased the gross debenture amount

- from $1.5 million for regular 504/CDC loans to $5 million,
- from $2 million if the loan proceeds are directed toward one or more of the public policy goals described above to $5 million,
- from $4 million for small manufacturers to $5.5 million,
- from $4 million for projects that reduce the borrower's energy consumption by at least 10% to $5.5 million, and
- from $4 million for projects for plant, equipment, and process upgrades of renewable energy sources, such as the small-scale production of energy for individual buildings or communities consumption (commonly known as micropower), or renewable fuel producers, including biodiesel and ethanol producers to $5.5 million.[19]

Loan Terms, Interest Rate, and Collateral

Loan Terms

The SBA determines the 504/CDC program's loan terms and publishes those terms in the *Federal Register*.[20] The current maturities for 504/CDC loans are

- 20 years for real estate,
- 10 years for machinery and equipment, and
- 10 or 20 years based upon a weighted average of the useful life of the assets being financed.[21]

[18] 13 C.F.R. § 120.862.

[19] P.L. 111-240, the Small Business Jobs Act of 2010, Sec. 1112. Maximum Loan Amounts Under 504 Program

[20] 13 C.F.R. § 120.933.

[21] U.S. Small Business Administration, "SOP 50 10 5(B): Lender and Development Company Loan Programs," Washington, DC (effective October 1, 2009), p. 301, http://www.sba.gov/idc/groups/public/documents/sba_homepage/serv_sops_50105b.pdf.

The maturities for the first mortgage issued by the third-party lender must be at least seven years when the CDC/504 loan is for a term of 10 years, and 10 years when the loan is for 20 years.[22]

Interest Rate

The interest rate for 504/CDC debentures is set by the SBA and approved by the Secretary of the Treasury.[23] It is based on market conditions for long-term government debt at the time of sale, and pegged to an increment above the current market rate for 5-year and 10-year U.S. Treasury issues. The rate for September 2010 is 4.62%.[24] In addition, the SBA sets the maximum interest rate that can be charged by any third party lender for a commercial loan which funds any portion of the cost of a 504/CDC project. That rate "must be reasonable" and published in the *Federal Register*. The current maximum interest rate that a third-party lender is allowed to charge for a commercial loan that funds any portion of the cost of a 504/CDC project is 6% over the New York prime rate or the maximum interest rate permitted in that state, whichever is less.[25]

Collateral

The SBA usually takes a second lien position on the project property to secure the loan. The SBA's second lien position is considered adequate when the applicant meets all of the following criteria:

- strong, consistent cash flow that is sufficient to cover the debt;
- demonstrated, proven management;
- the applicant's business has been in operation for more than two years; and
- the proposed project is a logical extension of the applicant's current operations.[26]

If one or more of the above factors is not met, additional collateral or increased equity contributions may be required. All collateral must be insured against such hazards and risks as the SBA may require, with provisions for notice to the SBA and the CDC in the event of impending lapse of coverage.[27] However, for 504/CDC loans, the applicant's cash flow is the primary source of repayment, not the liquidation of collateral. Thus, "if the lender's financial analysis demonstrates that the applicant lacks reasonable assurance of repayment in a timely manner from the cash flow of the business, the loan request must be declined, regardless of the collateral available."[28]

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[22] 13 C.F.R. § 120.921.

[23] 13 C.F.R. § 120.932.

[24] Capital Certified Development Corporation, "504/CDC Program Interest Rates," Austin, Texas, http://www.capitalcdc.com/interest.php.

[25] 13 C.F.R. § 120.921; and U.S. Small Business Administration, "Interest Rates," 75 *Federal Register* 17454, April 6, 2010.

[26] U.S. Small Business Administration, "SOP 50 10 5(B): Lender and Development Company Loan Programs," Washington, DC (effective October 1, 2009), p. 286, http://www.sba.gov/idc/groups/public/documents/sba_homepage/serv_sops_50105b.pdf.

[27] 13 C.F.R. § 120.934.

[28] U.S. Small Business Administration, "SOP 50 10 5(B): Lender and Development Company Loan Programs," Washington, DC (effective October 1, 2009), p. 313, http://www.sba.gov/idc/groups/public/documents/sba_homepage/ (continued...)

Lender Eligibility Standards, Operating Requirements and Program Requirements

Lender Eligibility Standards

CDCs apply to the SBA for certification to participate in the 504/CDC program. A CDC must be a non-profit corporation and

- be in good standing in the state in which it is incorporated;
- be in compliance with all laws, including taxation requirements, in the state in which it is incorporated and any other state in which it conducts business;
- have satisfactory performance as determined by the SBA in its discretion. Examples of the factors that may be considered in determining satisfactory performance include the CDC's risk rating, on-site review and examination assessments, historical performance measures (like default rate, purchase rate and loss rate), loan volume to the extent that it impacts performance measures, and other performance related measurements and information (such as contribution toward SBA's mission); and
- provide the SBA a copy of its IRS tax exempt status.[29]

In addition, when applying for certification a CDC must

- indicate its area of operations, which is the state of the CDC's incorporation;[30]
- report its membership, which must include at least 25 members who actively support economic development in their area of operations and represent (1) government organizations, (2) financial institutions (lenders), (3) community organizations, such as chambers of commerce, trade associations, colleges, or small business development centers, and (4) businesses in the area of operations;
- meet other specified membership requirements, such as meeting at least annually, requiring a quorum to transact business, and prohibiting any person or entity from owning or controlling more than 10% of the CDC's voting membership; and
- have a board of directors which meet specified requirements, such as being chosen from the membership by the members and representing at least three of the four membership groups.[31]

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[29] Ibid., p. 51.

[30] A CDC can apply to be a multi-state CDC "provided the State the CDC seeks to expand into is contiguous to the State of the CDC's incorporation; the CDC demonstrates that its membership meets the requirements in 13 CFR § 120.822 separately for its State of incorporation and for each additional State in which it seeks to operate as a Multi-State CDC; and the CDC has a loan committee meeting the requirements of 13 CFR § 120.823." See Ibid., p. 76.

[31] Ibid., p. 52.

If approved by the SBA, newly certified CDCs are on probation for two years. At the end of this time, the CDC must petition for either permanent CDC status or a single, one-year extension of probation. Currently, there are 267 CDCs actively participating in the program.[32]

Lender Operating Requirements

The CDC's board of directors is allowed to establish a loan committee composed of members of the CDC who may or may not be on its board of directors. The loan committee reports to the board, and must meet specified requirements, such as having at least one member with commercial lending experience acceptable to the SBA, having all of its members live or work in the area of operations of the state where the 504/CDC project they are voting on is located, allowing CDC staff to serve on the committee, and requiring a quorum of at least five committee members authorized to vote in order to hold a meeting.[33] In addition, multi-state CDCs are required to have a separate loan committee "for each state into which the CDC expands."[34]

The SBA also has a number of requirements concerning CDC staff, such as requiring CDCs to "have qualified full-time professional staff to market, package, process, close and service loans" and "directly employ full-time professional management," typically including an executive director (or the equivalent) to manage daily operations.[35]

CDCs are also required to operate "in accordance with all SBA loan program requirements" and provide the SBA "current and accurate information about all certification and operational requirements."[36] CDCs with 504/CDC loan portfolio balances of $20 million or more are required to submit financial statements audited in accordance with Generally Accepted Accounting Principles (GAAP) by an independent Certified Public Accountant (CPA). CDCs with 504/CDC loan portfolio balances of less than $20 million must, at a minimum, submit a review of their loan portfolio balances by an independent CPA or independent accountant in accordance with GAAP. The auditor's opinion must state that the financial statements are in conformity with GAAP.[37]

Lender Program Requirements

The Application Process

CDCs must analyze each application in a commercially reasonable manner, consistent with prudent lending standards. The CDC's analysis must include

- a financial analysis of the applicant's pro forma balance sheet. The pro forma balance sheet must reflect the loan proceeds, use of the loan proceeds, and any other adjustments such as required equity injection or stand-by debt;

[32] U.S. Small Business Administration, Office of Legislative Affairs, correspondence with the author, April 7, 2010.

[33] U.S. Small Business Administration, "SOP 50 10 5(B): Lender and Development Company Loan Programs," Washington, DC (effective October 1, 2009), p. 53, http://www.sba.gov/idc/groups/public/documents/sba_homepage/serv_sops_50105b.pdf.

[34] Ibid.

[35] Ibid.

[36] Ibid., p. 55.

[37] Ibid.

- a financial analysis of repayment ability based on historical income statements, tax returns (if an existing business) and projections, including the reasonableness of the supporting assumptions;
- a ratio analysis of the financial statements including comments on any trends and a comparison with industry averages;
- a discussion of the owners' and managers' relevant experience in the type of business, as well as their personal credit histories;
- an analysis of collateral adequacy, including an evaluation of the collateral and lien position offered as well as the liquidation value;
- a discussion of the applicant's credit experience, including a review of business credit reports and any experience the CDC may have with the applicant; and
- other relevant information (e.g., if the application involves a franchise and the success of the franchise).[38]

Lenders submit this information, using required SBA forms, to the Sacramento, CA, Loan Processing Center. The SBA's goal is to process all 504/CDC regular loans within six business days and all loans submitted by members of the Accredited Lender Program (ALP) within three business days.[39]

Accredited Lender Program Status

CDCs may apply to the SBA for Accredited Lender Program (ALP) status. Selection is based on several factors, including the CDC's experience as a CDC, the number of 504/CDC loans approved, the size of their portfolio, their record of compliance with SBA loan program requirements, and their record of cooperation with all SBA offices.[40] The SBA is able to process loan requests from ALP-CDCs more quickly than from regular CDCs because it relies on their credit analysis when making the decision to guarantee the debenture. About one-third of CDCs (88 of 267, or 32.9%) have ALP status.[41]

Premier Certified Lenders Program Status

The SBA also has a Premier Certified Lenders Program (PCLP).[42] ALP-CDCs may apply to the SBA for PCLP status. CDCs provided PCLP status have increased authority to process, close, service and liquidate 504/CDC loans. The loans are subject to the same terms and conditions as other 504/CDC loans, but the SBA delegates to the PCLP-CDC all loan approval decisions, except eligibility. Selection is based on several factors, including all of the factors used to assess ALP status plus evidence that the CDC is "in compliance with its Loan Loss Reserve Fund

[38] Ibid., p. 240.

[39] Ibid., pp. 297, 298.

[40] Ibid., p. 68.

[41] U.S. Small Business Administration, Office of Legislative Affairs, correspondence with the author, April 7, 2010.

[42] The PCLP was authorized by P.L. 103-403, the Small Business Administration Reauthorization and Amendments Act of 1994.

(LLRF) requirements [described below], has established a PCLP processing goal of 50%, and has a demonstrated ability to process, close, service and liquidate 504 and/or PCLP loans."[43]

PCLP-CDCs are required to establish and maintain a Loan Loss Reserve Fund (LLRF) for its financings under the program. The LLRF is used to reimburse the SBA for 10% of any loss sustained by the SBA resulting from a default in the payment of principal or interest on a PCLP debenture. Each LLRF must equal 1% of the original principal amount of each PCLP debenture.[44]

About one out of every 10 CDCs (26 out of 267, or 9.7%) have PCLP status.[45] In FY2009, they processed about 7% of 504/CDC loan applications amounting to about 6% of the total amount guaranteed.[46]

Real Estate Appraisals

As part of its analysis of each application, CDCs are required to have an independent appraisal conducted of the real estate if the estimated value of the project property is greater than $250,000, or $250,000 or less "if such appraisal is necessary for appropriate evaluation of creditworthiness."[47] The appraiser must have no appearance of a conflict of interest and be either state-licensed or state-certified. When the project property's estimated value is over $1 million, the appraiser must be state-certified.[48]

Closing

The CDC closes the loan in time to meet a specific debenture funding date. At the time of closing, the project must be complete (except funds put into a construction escrow account to complete a minor portion of the project). The SBA's district counsel reviews the closing package and notifies the CSA (currently Colson Services Corporation) and the CDC via e-mail if the loan is approved for debenture funding. If the loan is approved, the CDC forwards specified documents needed for the debenture funding directly to the CSA using a transmittal letter or spreadsheet. Because the 504/CDC program provides permanent or "take-out" financing, an interim lender (either the third party lender or another lender) typically provides financing to cover the period between SBA approval of the project and the debenture sale. Proceeds from the debenture sale are used to repay the interim lender for the amount of the project costs that it advanced on an interim basis.[49]

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[43] U.S. Small Business Administration, "SOP 50 10 5(B): Lender and Development Company Loan Programs," Washington, DC (effective October 1, 2009), p. 70, http://www.sba.gov/idc/groups/public/documents/sba_homepage/serv_sops_50105b.pdf.

[44] Ibid., p. 71.

[45] U.S. Small Business Administration, Office of Legislative Affairs, correspondence with the author, April 7, 2010. All PCLP-CDCS have ALP status as that is a requirement for being provided PCLP authority.

[46] U.S. Small Business Administration, "CDC Loan Program Approval Activity," Washington, DC, http://www.sba.gov/loans/business/regionaw.html.

[47] U.S. Small Business Administration, "SOP 50 10 5(B): Lender and Development Company Loan Programs," Washington, DC (effective October 1, 2009), p. 288, http://www.sba.gov/idc/groups/public/documents/sba_homepage/serv_sops_50105b.pdf.

[48] Ibid.

[49] Ibid., pp. 16, 243.

Loan Guaranty and Servicing Fees

Borrowers are currently charged fees amounting to about 2.25% of the net debenture proceeds plus annual servicing and guaranty fees of generally less than 1% of the unpaid debenture balance. Some of these fees are charged by the SBA to the CDC and others are charged by the CDC directly to the borrower.

SBA Fees

The SBA is authorized to charge fees that are sufficient to cover the estimated costs of the 504/CDC program. To meet this goal, the SBA charges CDCs an ongoing, annual servicing fee, not to exceed 0.9375% on the unpaid principal balance of the loan, that is adjusted annually based on the date the loan was approved. The annual servicing fee for FY2010 is 0.389% of the unpaid principal balance. The SBA also charges CDCs a funding fee, not to exceed 0.25% of the debenture, to cover costs incurred by the trustee, fiscal agent, and transfer agent.[50]

The SBA charges third-party lenders a one time participation fee of 0.5% of the senior mortgage loan if in a senior lien position to the SBA.[51] The fee may be paid by the third party lender, CDC, or borrower. For SBA loans approved after September 30, 1996, the SBA also charges the CDC an annual fee of 0.125% of the debenture's outstanding principal balance. The fee must be paid from the servicing fees collected by the CDC and cannot be paid from any additional fees imposed on the borrower.[52]

As will be discussed later, P.L. 111-5, ARRA provided an additional $375 million to reduce fees in the 7(a) and 504/CDC loan guaranty programs and to increase the 7(a) program's maximum guaranty percentage from up to 85% of loans of $150,000 or less and up to 75% of loans exceeding $150,000 to 90% for all standard 7(a) loans. Congress subsequently approved an additional $305 million to extend the fee reductions and 90% loan guaranty percentage for the 7(a) program through May 31, 2010.[53] Congress later adopted the Small Business Jobs Act of 2010, which was signed into law (P.L. 111-240) by President Obama on September 27, 2010. It provides $505 million to continue the fee subsidies and 7(a) program's 90% loan guaranty through December 31, 2010.

[50] Ibid., p. 318; 13 C.F.R. § 120.971(d); and 13 C.F.R. § 120.971(e). The SBA previously also charged a one time, up front 0.5% guaranty fee on the debenture. The SBA elected not to charge the fee in FY2009 and FY2010.

[51] When there are different liens on a property, the senior lien must be satisfied before junior liens in the event of a default.

[52] U.S. Small Business Administration, "SOP 50 10 5(B): Lender and Development Company Loan Programs," Washington, DC (effective October 1, 2009), p. 318, http://www.sba.gov/idc/groups/public/documents/sba_homepage/serv_sops_50105b.pdf; and 13 C.F.R. § 120.972.

[53] P.L. 111-118, the Department of Defense Appropriations Act, 2010, enacted on December 19, 2009, provided $125 million to extend ARRA's "fee reductions and eliminations" for the SBA's 7(a) and 504/CDC programs and 90% loan guarantee limit for the SBA's 7(a) program through February 28, 2010. P.L. 111-144, the Temporary Extension Act of 2010, enacted on March 2, 2010, provided $60 million to extend those fee reductions and loan modifications through March 28, 2010. P.L. 111-150, an act to extend the Small Business Loan Guarantee Program, enacted on March 26, 2010, authorized the use of $40 million in SBA appropriated funds to extend those fee reductions and loan modifications through April 30, 2010. P.L. 111-157, the Continuing Extension Act of 2010, enacted on April 15, 2010, provided $80 million to extend those fee reductions and loan modifications through May 31, 2010.

CDC Fees

CDCs are allowed to charge borrowers a processing (or packaging) fee, closing fee, servicing fee, late fee, assumption fee, Central Servicing Agent (CSA) fee, other agent fees, and an underwriters' fee.

Processing (or Packaging) Fee

The CDC is allowed to charge borrowers a processing (or packaging) fee of up to 1.5% of the net debenture proceeds. Two-thirds of this fee is considered earned and may be collected by the CDC when the SBA issues a "Authorization for the Debenture." The portion of the processing fee paid by the borrower may be reimbursed from the debenture proceeds.[54] As mentioned previously, legislation was enacted that provided additional funding to eliminate this fee through May 31, 2010.

Closing Fee

The CDC is also allowed to charge "a reasonable closing fee sufficient to reimburse it for the expenses of its in-house or outside legal counsel, and other miscellaneous closing costs."[55] Up to $2,500 in closing costs may be financed out of the debenture proceeds.[56]

Servicing Fee

CDCs can also charge a monthly servicing fee of at least 0.625% per annum and no more than 2% per annum on the unpaid balance of the loan as determined at five-year anniversary intervals. A servicing fee greater than 1.5% for rural areas and 1% elsewhere requires the SBA's prior written approval, based on evidence of substantial need. The servicing fee may be paid only from loan payments received. The fees may be accrued without interest and collected from the CSA when the payments are made. CSAs are entities that receive and disburse funds among the various parties involved in 504/CDC financing under a master servicing agent agreement with the SBA.[57]

Late Fee and Assumption Fee

Loan payments received after the 15th of each month may be subject to a late payment fee of 5% of the late payment or $100, whichever is greater. Late fees will be collected by the CSA on

[54] Ibid.; and 13 C.F.R. § 120.971(a)(1).

[55] 13 C.F.R. § 120.971(a)(2).

[56] U.S. Small Business Administration, "SOP 50 10 5(B): Lender and Development Company Loan Programs," Washington, DC (effective October 1, 2009), p. 317, http://www.sba.gov/idc/groups/public/documents/sba_homepage/serv_sops_50105b.pdf.; and 13 C.F.R. § 120.883(e).

[57] 13 C.F.R. § 120.971(a)(3); and U.S. Small Business Administration, "SOP 50 10 5(B): Lender and Development Company Loan Programs," Washington, DC (effective October 1, 2009), pp. 241, 317, http://www.sba.gov/idc/groups/public/documents/sba_homepage/serv_sops_50105b.pdf.

behalf of the CDC. Also, with the SBA's written approval, CDCs may charge an assumption fee not to exceed 1% of the outstanding principal balance of the loan being assumed.[58]

Central Servicing Agent (CSA) Fee

CSAs are allowed to charge an initiation fee on each loan and an ongoing monthly servicing fee of 0.1% under the terms of the master servicing agreement (with the CSA receiving three sixty-fourths of the servicing fee and the remainder going to the SBA). Also, "agent fees and charges necessary to market and service debentures and certificates may be assessed to the borrower or the investor."[59] CDCs must review the agent's services and related fees "to determine if the fees are necessary and reasonable when there is an indication from a third party that an agent's fees might be excessive, or when an applicant complains about the fees charged by an agent."[60] In cases where fees appear to be unreasonable, CDCs "should contact the SBA" which, after conducting an investigation, can "reduce the fee to an amount SBA deems reasonable, refund any sum in excess of that amount to the applicant, and refrain from charging or collecting from the applicant any funds in excess of the amount SBA deems reasonable."[61]

Underwriters' Fee

Borrowers are also charged an up front underwriters' fee of 0.4% for 20-year loans and 0.375% for 10-year loans. The underwriters' fee is paid by the borrower to the underwriter.[62] As mentioned previously, underwriters are approved by the SBA to form debenture pools and arrange for the sale of certificates.

Program Statistics

Loan Volume

As shown in **Table 2**, in FY2007, the SBA guaranteed 10,405 504/CDC loans amounting to $6.3 billion. Loan applications fell during FY2008 and FY2009, primarily due to decreased small business demand for capital during the recession, difficulties in secondary credit markets, especially from October 2008 to February 2009, and a tightening of credit lending standards. In FY2008, the SBA guaranteed 8,630 504/CDC loans amounting to approximately $5.3 billion. In FY2009, it guaranteed 6,293 504/CDC loans amounting to about $3.8 billion. The SBA's goal for FY2010 is to approve at least $4 billion in 504/CDC program guaranties.[63]

[58] 13 C.F.R. § 120.971(a)(4); 13 C.F.R. § 120.971(a)(5); and U.S. Small Business Administration, "SOP 50 10 5(B): Lender and Development Company Loan Programs," Washington, DC (effective October 1, 2009), p. 317, http://www.sba.gov/idc/groups/public/documents/sba_homepage/serv_sops_50105b.pdf.

[59] 13 C.F.R. § 120.971(c).

[60] U.S. Small Business Administration, "SOP 50 10 5(B): Lender and Development Company Loan Programs," Washington, DC (effective October 1, 2009), pp. 321, 322, http://www.sba.gov/idc/groups/public/documents/sba_homepage/serv_sops_50105b.pdf.

[61] Ibid.

[62] Ibid., p. 318.

[63] U.S. Small Business Administration, *Fiscal Year 2011 Congressional Budget Justification and FY 2009 Annual* (continued...)

Table 2. 504/CDC Loans and Amounts, FY2007 - FY2009

($ amounts in billions)

Fiscal Year	Number of Loans	Amount of the Debentures
2007	10,405	$6.3
2008	8,630	$5.3
2009	6,293	$3.8

Source: U.S. Small Business Administration, *Fiscal Year 2011 Congressional Budget Justification and FY 2009 Annual Performance Report* (Washington, DC: GPO, 2010), pp. 39, 125.

Loss Rate

Since the program's inception in 1958, the SBA has experienced a 2.36% loss rate (ratio of actual losses to disbursements) on its CDC business loans. The loss rate for CDC guaranteed loans is 1.9% and 26.9% for direct loans (last issued in 1988).[64]

Use of Proceeds and Borrower Satisfaction

In 2008, the Urban Institute released the results of a SBA-commissioned study of the SBA's loan guaranty programs. As part of its analysis, the Urban Institute surveyed a random sample of SBA loan guaranty borrowers. The survey indicated that borrowers used 504/CDC loan proceeds to

- build a new building (36%),
- purchase a new building (33%),
- purchase new land (16%),
- purchase or install new equipment (15%),
- acquire original business (8%),
- expand or renovate current building (7%),
- other (7%),
- improve land (6%),
- finance working capital (4%),
- refinance existing debt (3%), or
- hire additional staff (2%).[65]

(...continued)

Performance Report (Washington, DC: GPO, 2010), p. 39.

[64] U.S. Small Business Administration, "2008 Loss Report," Washington, DC, p. 8, http://www.sba.gov/idc/groups/public/documents/sba_program_office/cfo_2008_loss_report.pdf.

[65] Christopher Hayes, *An Assessment of Small Business Administration Loan and Investment Performance: Survey of Assisted Businesses* (Washington, DC: The Urban Institute, 2008), p. 3, http://www.urban.org/UploadedPDF/411599_assisted_business_survey.pdf. The percentage total exceeds 100 because recipients were allowed to name more (continued...)

The Urban Institute also reported that two-thirds the 504/CDC borrowers responding to their survey rated their overall satisfaction with their loan and loan terms as either excellent (21%) or good (45%). About one out of every four borrowers (23%) rated their overall satisfaction with their loan and loan terms as fair, 8% rated their overall satisfaction as poor, and 4% reported that they don't know or did not respond.[66] In addition, 87% of the survey's respondents reported that the 504/CDC loan was either very important (53%) or somewhat important (34%) to their business success (4% reported somewhat unimportant, 4% reported very unimportant, and 6% reported that they don't know or did not respond).[67]

Borrower Demographics

The Urban Institute found that about 9.9% of private sector small business loans are issued to minority-owned small businesses and about 16% of those loans are issued to women-owned businesses.[68] In FY2009, 30% of 504/CDC loan recipients were minority-owned businesses (21% Asian, 7% Hispanic, and 2% African American) and 15% were women-owned businesses.[69] Based on its comparative analysis of private sector small business loans and the SBA's loan guaranty programs, the Urban Institute concluded

> Overall, loans under the 7(a) and 504 programs were more likely to be made to minority-owned, women-owned, and start-up businesses (firms that have historically faced capital gaps) as compared to conventional small business loans. Moreover, the average amounts for loans made under the 7(a) and 504 programs to these types of firms were substantially greater than conventional small business loans to such firms. These findings suggest that the 7(a) and 504 programs are being used by lenders in a manner that is consistent with SBA's objective of making credit available to firms that face a capital opportunity gap.[70]

Congressional Issues

Fee Subsidies and the 7(a) Program's 90% Loan Guaranty

Congress included provisions in P.L. 111-5, the American Recovery and Reinvestment Act of 2009, to encourage both lenders and small businesses to use the SBA's loan guaranty programs. For example, it provides an additional $730 million for SBA programs. Included in that amount is $375 million to subsidize the 504/CDC program's third party participation fee and CDC processing fee, subsidize the SBA's 7(a) program's guaranty fee, and increase the 7(a) program's

(...continued)

than one use for the loan proceeds.

[66] Ibid., p. 5.

[67] Ibid.

[68] Kenneth Temkin, Brett Theodos, with Kerstin Gentsch, *Competitive and Special Competitive Opportunity Gap Analysis of the 7(A) and 504 Programs* (Washington, DC: The Urban Institute, 2008), p. 13, http://www.urban.org/UploadedPDF/411596_504_gap_analysis.pdf.

[69] U.S. Small Business Administration, "Business Loan Approval (Gross $) Ytd Activity," Washington, DC, March 27, 2010, http://www.sba.gov/idc/groups/public/documents/sba_homepage/serv_fa_weekly_lending_report.pdf.

[70] Kenneth Temkin, Brett Theodos, with Kerstin Gentsch, *Competitive and Special Competitive Opportunity Gap Analysis of the 7(A) and 504 Programs* (Washington, DC: The Urban Institute, 2008), p. 21, http://www.urban.org/UploadedPDF/411596_504_gap_analysis.pdf.

maximum loan guaranty percentage from up to 85% of loans of $150,000 or less and up to 75% of loans exceeding $150,000 to 90% for all standard 7(a) loans.[71] ARRA's funding for the 7(a) program was exhausted in November 2009. ARRA's funding for the 504/CDC program was about to expire in December 2009 when Congress acted to extend the subsidies and loan modification. Congress subsequently provided another $305 million to extend the fee subsides and the 7(a) program's 90% loan guaranty percentage through May 31, 2010, and P.L. 111-240, the Small Business Jobs Act of 2010, provides another $505 million to extend the fee subsides and 90% loan guaranty percentage from September 27, 2010, through December 31, 2010.[72]

The Obama Administration argued that additional funding for the SBA's loan guaranty programs, including the 504/CDC program, improved the small business lending environment, increased both the number and amount of SBA guaranteed loans, and supported "the retention and creation of hundreds of thousands of jobs."[73] Critics argued that small business tax reduction, reform of financial credit market regulation, and federal fiscal restraint are a better means to assist small business economic growth and job creation.[74]

Program Administration

The SBA's Office of Inspector General (OIG) and the U.S. Government Accountability Office (GAO) have independently reviewed the administration of SBA's loan guaranty programs. Both agencies have reported deficiencies that need to be addressed, including issues involving the oversight of 504/CDC lenders.

On March 23, 2010, the SBA's OIG released the results of an audit of "25 of 100 statistically selected CDC/504 loans approved under Premier Certified Lender (PCL) authority that were disbursed during fiscal year (FY) 2008."[75] The loans "had been approved by 3 of the most active of the 24 PCLs" operating in 2008.[76]

[71] P.L. 111-5, the American Recovery and Reinvestment Act of 2009.

[72] P.L. 111-240, the Small Business Jobs Act of 2010, Sec. 1111. Section 7(A) Business Loans. The Senate had adopted H.R. 4213, the American Workers, State, and Business Relief Act of 2010, on March 10, 2010, by a 62-36 vote. It would have provided $560 million to extend the fee reductions and 90% loan guarantee limit through December 31, 2010. The House approved an amended version of the bill, renamed the American Jobs and Closing Tax Loopholes Act of 2010, on May 28, 2010, by a 245-171 vote. It would have provided $505 million to extend the fee reductions and 90% loan guarantee limit through December 31, 2010. The extension provision was subsequently removed from the bill, which became P.L. 111-205, the Unemployment Compensation Extension Act of 2010.

[73] U.S. Small Business Administration, "Administration Announces New Small Business Commercial Real Estate and Working Capital Programs," Washington, DC, February 5, 2010, http://www.sba.gov/idc/groups/public/documents/sba_homepage/sba_rcvry_factsheet_cre_refi.pdf; and U.S. Small Business Administration, "SBA Recovery Lending Extended Through April 30," Washington DC, March 29, 2010, http://www.sba.gov/idc/groups/public/documents/sba_homepage/news_release_10-08.pdf.

[74] Susan Eckerly, "NFIB Responds to President's Small Business Lending Initiatives," Washington, DC, October 21, 2009, http://www.nfib.com/newsroom/newsroom-item/cmsid/50080/; and NFIB, "Government Spending," Washington, DC, http://www.nfib.com/issues-elections/issues-elections-item/cmsid/49051/.

[75] U.S. Small Business Administration, Office of the Inspector General, "Report on Audit of Premier Certified Lenders in the Section 504 Loan Program," Washington, DC, March 23, 2010, p. 20, http://www.sba.gov/idc/groups/public/documents/sba_homepage/oig_report_10-10.pdf.

[76] Ibid.

The audit was initiated "based on concerns that PCLs were engaging in risky underwriting practices and that five PCLs were paying their executives excessive compensation."[77] The OIG determined that

> PCLs may not have used prudent practices in approving and disbursing 68 percent of the sampled loans, totaling nearly $8.9 million, due to poor loan underwriting, and eligibility or loan closing issues. Specifically, 40 percent of the loans had faulty underwriting repayment analyses, and 52 percent of the loans had eligibility and/or loan closing issues.... Projecting our sample results to the universe of CDC/504 loans disbursed in 2008 by these three PCLs, we estimate with 90-percent confidence that at least 572 loans, totaling nearly $254.9 million in CDC/504 loan proceeds, had weaknesses in the underwriting process, eligibility determinations or loan closing. Of this amount, we estimate that a minimum of 183 loans, totaling $56.4 million or more, were made to borrowers based on faulty repayment analyses. We also estimate that lenders disbursed $209 million or more to borrowers who had eligibility and/or loan closing issues.[78]

In terms of dollars paid for CDC executive compensation, the OIG found that

> 4 of the 5 CDCs reviewed were among the top 10 highest for executive compensation.... In terms of percentage of gross receipts spent on executive compensation, 3 of the 5 questioned CDCs ranked among the top 10 highest of the 56 CDCs that had gross receipts over $1 million.[79]

The OIG made several recommendations to address these issues, including changing the SBA's Standard Operating Procedures (SOP) to require lenders to use

> (1) the actual cash flow method to determine borrower repayment ability for businesses using accrual accounting, (2) historical salary levels to estimate salaries of the borrower's officers, and (3) historical sales data to make sales projections.[80]

It also recommended that the SBA develop a process "to ensure that corrective actions are taken in response to the Agency's onsite reviews to ensure these conditions do not continue, and/or guidance for these reviews should be modified, as appropriate, to ensure that reviewers properly assess lender determination of borrower repayment ability and eligibility."[81]

The OIG reported that the SBA

> disagreed that SOP 50 10 should be revised to strengthen lender repayment analyses by requiring the use of the actual cash flow method and historical salary and sales data. The Agency also did not believe an additional process was needed to ensure that corrective actions are taken to improve lender performance, but acknowledged that better use of onsite review results are needed to make more informed lender decisions and programmatic determinations.[82]

[77] Ibid., p. 1.

[78] Ibid., pp. 3, 4.

[79] Ibid., p. 4.

[80] Ibid., pp. 4, 5.

[81] Ibid., p. 5.

[82] Ibid.

In 2009, GAO released an analysis of the SBA's oversight of the lending and risk management activities of lenders that extend 7(a) and 504/CDC loans to small businesses. GAO recommended that the SBA strengthen its oversight of these lenders. GAO argued that although the SBA's "lender risk rating system has enabled the agency to conduct some off-site monitoring of lenders, the agency does not use the system to target lenders for on-site reviews or to inform the scope of the reviews."[83] It also noted that

> the SBA targets for review those lenders with the largest SBA-guaranteed loan portfolios. As a result of this approach, 97 percent of the lenders that SBA's risk rating system identified as high risk in 2008 were not reviewed. Further, GAO found that the scope of the on-site reviews that SBA performs is not informed by the lenders' risk ratings, and the reviews do not include an assessment of lenders' credit decisions.[84]

GAO argued that although the SBA "has made improvements to its off-site monitoring of lenders, the agency will not be able to substantially improve its lender oversight efforts unless it improves its on-site review process."[85]

Presidential Proposals and Legislation

Congress considered several Obama Administration proposals and bills during the 111th Congress that would have authorized changes to the 504/CDC program before it approved the Small Business Jobs Act of 2010.

The Obama Administration's Proposals

The Obama Administration supported congressional efforts to temporarily subsidize fees for the 7(a) and 504/CDC loan guaranty programs and to increase the 7(a) program's loan guaranty percentage from up to 85% of loans of $150,000 or less and up to 75% of loans exceeding $150,000 to 90%. The latest extension of the fee subsidies and 7(a) program's 90% loan guaranty percentage was authorized by P.L. 111-240, the Small Business Jobs Act of 2010, which President Obama signed into law on September 27, 2010. It provides $505 million to extend the fee reductions and 90% loan guaranty percentage from September 27, 2010, through December 31, 2010.[86]

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83 U.S. Government Accountability Office, *Small Business Administration: Actions Needed to Improve the Usefulness of the Agency's Lender Risk Rating System*, GAO-1—53, November 6, 2009, p. i, http://www.gao.gov/new.items/d1053.pdf.

84 Ibid., pp. i, 27-30.

85 Ibid., p. 35.

86 U.S. Small Business Administration, "Administration Announces New Small Business Commercial Real Estate and Working Capital Programs," Washington, DC, February 5, 2010, http://www.sba.gov/idc/groups/public/documents/sba_homepage/sba_rcvry_factsheet_cre_refi.pdf; and P.L. 111-240, the Small Business Jobs Act of 2010, Sec. 1111. Section 7(A) Business Loans. Previously, P.L. 111-118, the Department of Defense Appropriations Act, 2010, enacted on December 19, 2009, provided $125 million to extend ARRA's "fee reductions and eliminations" for the SBA's 7(a) and 504/CDC programs and 90% loan guarantee limit for the SBA's 7(a) program through February 28, 2010. P.L. 111-144, the Temporary Extension Act of 2010, enacted on March 2, 2010, provided $60 million to extend those fee reductions and loan modifications through March 28, 2010. P.L. 111-150, an act to extend the Small Business Loan Guarantee Program, enacted on March 26, 2010, authorized the use of $40 million in SBA appropriated funds to extend those fee reductions and loan modifications through April 30, 2010. P.L. 111-157, the Continuing Extension Act of (continued...)

In an effort to make the SBA's loan guaranty programs more attractive to small businesses, the Obama Administration also proposed the following modifications to several SBA programs, including the 504/CDC program:

- increase the maximum loan size for the 504/CDC program from $2 million to $5 million for regular projects and from $4 million to $5.5 million for manufacturing projects,
- temporarily allow in FY2010 and FY2011, with an option to extend into FY2012, the refinancing of owner-occupied commercial real estate loans within one year of maturity under the SBA's 504/CDC program,
- increase the maximum loan size for standard 7(a) loans from $2 million to $5 million,
- increase the maximum loan size for microloans to small business concerns from $35,000 to $50,000,
- increase the maximum loan limits for lenders in their first year of participation in the Microloan program, from $750,000 to $1 million, and from $3.5 million to $5 million in the subsequent years, and
- temporarily increase the cap on SBAExpress loans from $350,000 to $1 million.[87]

H.R. 3854, the Small Business Financing and Investment Act of 2009

H.R. 3854 would have authorized several new SBA programs and change several existing SBA programs, including the 504/CDC program, in an effort to enhance job creation by increasing the availability of credit to small businesses. The bill was passed by the House, 389-32, on October 29, 2009. The Senate did not take action on the bill.[88]

It would have

- increased the maximum loan size for 504/CDC loans from $1.5 million to $3 million for regular projects, from $2 million to $4 million for projects located in a low-income community, from $4 million to $8 million for manufacturers, and for up to $10 million for projects that constitute "a major source of employment" as determined by the Administration;

(...continued)

2010, enacted on April 15, 2010, provided $80 million to extend those fee reductions and loan modifications through May 31, 2010.

[87] U.S. Small Business Administration, "Administration Announces New Small Business Commercial Real Estate and Working Capital Programs," Washington, DC, February 5, 2010, http://www.sba.gov/idc/groups/public/documents/sba_homepage/sba_rcvry_factsheet_cre_refi.pdf. For an analysis of the pros and cons associated with these actions see CRS Report R41146, *Small Business Administration 7(a) Loan Guaranty Program*, by Robert Jay Dilger.

[88] For further analysis see CRS Report R40985, *Small Business: Access to Capital and Job Creation*, by Robert Jay Dilger and Oscar R. Gonzales.

- extended ARRA's fee reductions and loan modifications through September 30, 2011;
- increased the maximum loan size for 7(a) loans from $2 million to $3 million,
- extended, with modifications, ARRA's America's Recovery Capital Loan Program (ARC), which temporarily provides small businesses loan assistance for debt relief, through the end of FY2011;[89] and
- provided a 100% loan guaranty for small business concerns owned and controlled by veterans, and expanded and made permanent the SBA's secondary market lending authority.[90]

The bill would have also created a temporary SBA direct lending program following enactment that would have been available to creditworthy small business borrowers that were unable to find credit elsewhere.[91]

S. 2869, the Small Business Job Creation and Access to Capital Act of 2009

S. 2869 was ordered to be reported by the Senate Committee on Small Business and Entrepreneurship on December 10, 2009. The Senate did not take further action on the bill, but several of its provisions were later included in P.L. 111-240, the Small Business Jobs Act of 2010. It would have

- increased the maximum loan size for the 504/CDC loans from $1.5 million to $5 million for regular projects, from $2 million to $5 million for projects meeting one of the program's specified public policy goals, and from $4 million to $5.5 million for manufacturers;
- allowed 504/CDC loans to be used to refinance up to $4 billion in short-term commercial real estate debt each fiscal year for two years after enactment into long-term fixed rate loans;
- authorized the SBA to establish an alternative size standard for the 7(a) and 504/CDC programs that uses maximum tangible net worth and average net income as an alternative to the use of industry standards;
- extended ARRA's fee reductions and loan modifications through December 31, 2010;
- increased the maximum loan size for 7(a) loans from $2 million to $5 million; and
- increased the maximum loan size for the Microloan program from $35,000 to $50,000.[92]

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[89] ARC's loan limit would be increased from $35,000 to $50,000, and to $75,000 in areas of high unemployment, and borrowers would be allowed to use ARC loans to refinance existing SBA loan debt.

[90] H.R. 3854, the Small Business Financing and Investment Act of 2009.

[91] Ibid. For further analysis see CRS Report R40985, *Small Business: Access to Capital and Job Creation*, by Robert Jay Dilger and Oscar R. Gonzales.

P.L. 111-240, the Small Business Jobs Act of 2010

P.L. 111-240, the Small Business Jobs Act of 2010, was signed into law by President Obama on September 27, 2010. The act authorizes the Secretary of the Treasury to establish a $30 billion Small Business Lending Fund (SBLF) to encourage community banks to provide small business loans, a $1.5 billion State Small Business Credit Initiative to provide funding to participating states with small business capital access programs, and about $12 billion in tax relief for small businesses.[93] It also contains revenue raising provisions to offset the act's cost, a number of changes to the SBA's loan and contracting programs, and establishes an alternative SBA small business eligibility size standard.[94]

As mentioned previously, P.L. 111-240 also increased the 504/CDC program's loan limits from $1.5 million to $5 million for regular 504/CDC loans, from $2 million to $5 million if the loan proceeds are directed toward one or more of the program's specified public policy goals, from $4 million to $5.5 million for small manufacturers, from $4 million to $5.5 million for projects that reduce the borrower's energy consumption by at least 10%, and from $4 million to $5.5 million for projects for plant, equipment, and process upgrades of renewable energy sources, such as the small-scale production of energy for individual buildings or communities consumption (commonly known as micropower), or renewable fuel producers, including biodiesel and ethanol producers.[95]

P.L. 111-240, also provides $505 million to continue the fee subsidies for the 7(a) and 504/CDC loan guaranty programs and the temporary increase in the 7(a) program's loan guaranty percentage from up to 85% of loans of $150,000 or less and up to 75% of loans exceeding $150,000 to 90% for all standard 7(a) loans from September 27, 2010, through December 31, 2010. The fee subsidies and 90% loan guaranty percentage had expired on May 31, 2010.

In addition, the act temporarily allows, for two years, 504/CDC loans to be used to refinance projects not involving expansions as long as the financing does not exceed 90% of the value of the collateral for the financing, "except that, if the appraised value of the eligible fixed assets serving as collateral for the financing is less than the amount equal to 125% of the amount of the financing, the borrower may provide additional cash or other collateral to eliminate any deficiency."[96] The refinancing can be used only for commercial indebtedness incurred not less than two years before the date of the application for assistance and only for eligible fixed assets (to acquire land, buildings, or equipment, or to construct a building). In addition, the refinancing can not be used for indebtedness subject to a federal guarantee, and it has to be collateralized by eligible fixed assets. The borrower also has to be current on all payments due on the existing debt

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92 S. 2869, the Small Business Job Creation and Access to Capital Act of 2009.

93 For further analysis of P.L. 111-240, the Small Business Jobs Act of 2010, see CRS Report R41385, *Small Business Legislation: H.R. 3854 and H.R. 5297*, by Robert Jay Dilger, Oscar R. Gonzales, and Gary Guenther.

94 For further analysis of the SBA's size standards see CRS Report R40860, *Defining Small Business: An Historical Analysis of Contemporary Issues*, by Robert Jay Dilger.

95 P.L. 111-240, the Small Business Jobs Act of 2010, Sec. 1112. Maximum Loan Amounts Under 504 Program

96 P.L. 111-240, the Small Business Jobs Act of 2010, Sec. 1122. Low-Interest Refinancing Under the Local Development Business Loan Program.

for not less than one year before the date of the application. The act authorizes the SBA to issue up to $7.5 billion in refinancing annually, for two fiscal years. [97]

Concluding Observations

During the 111th Congress, congressional debate concerning proposed changes to the SBA's loan guaranty programs, including the 504/CDC program, centered on the likely impact the changes would have on small business access to capital, job retention, and job creation. As a general proposition, some, including the chairs of the House and Senate Committees on Small Business and President Obama, argued that economic conditions made it imperative that the SBA be provided additional resources to assist small businesses in acquiring capital necessary to start, continue, or expand operations and create jobs.[98] Others worried about the long-term adverse economic effects of spending programs that increase the federal deficit. They advocated business tax reduction, reform of financial credit market regulation, and federal fiscal restraint as the best means to assist small business economic growth and job creation.[99]

In terms of specific program changes, continuing the 504/CDC program's temporary fee subsidies, increasing its loan limits, and temporarily expanding its refinancing options were designed to achieve the same goal: to enhance job creation and retention by increasing the ability of 504/CDC borrowers to obtain credit at affordable rates. For example, the Obama Administration argued that increasing the maximum loan limits for the 504/CDC, 7(a), Microloan, and SBAExpress programs will allow the SBA to "support larger projects" which will "allow the SBA to help America's small businesses drive long-term economic growth and the creation of jobs in communities across the country." [100] The Administration also argued that increasing the maximum loan limits for these programs will be "budget neutral" over the long run and "help improve the availability of smaller loans."[101]

Critics argued that increasing these loan limits might increase the risk of defaults and result in higher guaranty fees or the need to provide the SBA additional funding, especially for the SBAExpress program, which had experienced somewhat higher losses than other SBA loan guaranty programs.[102] Others advocated a more modest increase in the maximum loan limits to

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[97] Ibid.

[98] Representative Nydia Velázquez, "Small Business Financing and Investment Act of 2009," House debate, *Congressional Record*, daily edition, vol. 155, no. 159 (October 29, 2009), pp. H12074, H12075; Senator Mary Landrieu, "Statements on Introduced Bills and Joint Resolutions," remarks in the Senate, *Congressional Record*, daily edition, vol. 155, no. 185 (December 10, 2009), p. S12910; and The White House, "Remarks by the President on Job Creation and Economic Growth," December 8, 2009, http://www.whitehouse.gov/the-press-office/remarks-president-job-creation-and-economic-growth.

[99] Susan Eckerly, "NFIB Responds to President's Small Business Lending Initiatives," Washington, DC, October 21, 2009, http://www.nfib.com/newsroom/newsroom-item/cmsid/50080/; and NFIB, "Government Spending," Washington, DC, http://www.nfib.com/issues-elections/issues-elections-item/cmsid/49051/.

[100] U.S. Small Business Administration, "Administration Announces New Small Business Commercial Real Estate and Working Capital Programs," Washington, DC, February 5, 2010, http://www.sba.gov/idc/groups/public/documents/sba_homepage/sba_rcvry_factsheet_cre_refi.pdf.

[101] Ibid.

[102] Robb Mandelbaum, "Small Business Incentives Face a Hard Road in Congress," *New York Times*, February 12, 2010, http://boss.blogs.nytimes.com/2010/02/12/small-business-incentives-face-a-hard-road-in-congress/; and U.S. Congress, House Committee on Small Business, *House Committee on Small Business Views With Regard to the Fiscal Year (FY) 2010 Budget*, Letter from Nydia Velázquez, Chair, House Committee on Small Business, to John M. Spratt, (continued...)

ensure that the programs focus on start-ups and early-stage small firms, "businesses that have historically encountered the greatest difficulties in accessing credit" and "avoids making small borrowers carry a disproportionate share of the risk associated with larger loans."[103]

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Jr., Chair, House Committee on the Budget, 111th Cong., 2nd sess., March 11, 2009, p. 3, http://www.house.gov/smbiz/democrats/Reports/FY%202010%20Views%20and%20Estimates%20v2.pdf.

[103] U.S. Congress, House Committee on Small Business, *Small Business Financing and Investment Act of 2009*, report to accompany H.R. 3854, 111th Cong., 2nd sess., October 26, 2009, H.Rept. 111-315 (Washington: GPO, 2009), p. 1.