SBA 504 Loans: An Underused Program That Helps Community Banks

by Thomas Wallace

Community banks not taking advantage of the Small Business Administration 504 Loan are invited to learn more about this very useful lending product that can help address some of their biggest challenges.

Despite its role in financing more than $6 billion in projects and the creating up to 50,000 jobs in the past year, the SBA 504 Loan program remains a less well-known SBA financing vehicle. It shouldn't be. Benefits offered to community banks by the SBA 504 include mitigation of credit risk, liquidity management, managing overall lending limits, and strengthening core earnings through a highly marketable commercial lending product.

The focus of the 504 is economic development through the purchase or construction of capital assets while requiring minimal equity from borrowers. Its financing structure derives from a broadly defined *project cost*, which can include an array of soft costs (such as architect/engineering fees, interim interest, and appraisal/feasibility studies). It cannot include working capital and is limited as to the financing of short-lived assets.

The borrower will be required to inject 10-20% of the cost into the project. This can be accomplished through actual cash injections or the contribution of acceptable assets, such as land for construction-related projects. Equity requirements begin at 10% of the defined project cost and increase by 5% increments, depending on whether the project involves special or single-purpose construction and whether or not the borrower is a start-up venture. During construction or, as regards equipment, delivery and installation, the bank will fund the entire balance, net of the borrower's required equity, of the project cost. Within 30 to 60 days of completion, the SBA-sponsored financing will provide take-out financing reducing the bank's exposure to approximately 50% of the project cost, with an upper-dollar limit to the takeout of $1 million to $1.3 million, depending on specific circumstances. The bank's financing will be in a first security position with the SBA-supported financing junior to the bank in security interest. At no time in the process does the bank enjoy a guarantee from the SBA—the program simply commits to an end takeout, reducing the final exposure to a very low loan-to-cost ratio. Collateral is, with rare

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exception, project specific, leaving working assets available to support other credit extensions.

There are virtually no restrictions on the bank's senior debt, in terms of either structure or pricing, other than it must be for a term of at least seven to 10 years, depending on the term of the SBA-supported junior debt. The bank remits to the SBA a one-time fee of 0.5% of the first-position permanent loan's balance as a program participation fee. While this cannot be explicitly passed onto the borrower, it obviously factors into the pricing of the bank's first position permanent loan. The SBA-sponsored financing is by definition a term loan, fully amortizing for either 10 or 20 years, at a fixed rate of interest. The rate is fixed for the full term of the loan. Historically, these rates have averaged at or below the Wall Street Journal Prime prime rate although, as indicated in Figure 1, there are significant fluctuations.

The vehicle used by the SBA to deliver this program is the Certified Development Company (CDC). There are approximately 250 CDCs around the country, the majority of which are not-for-profit, locally organized corporations charged with a range of economic development tasks but licensed specifically for the delivery of the 504 loan program by the SBA. the CDC gathers the requisite information for a standardized credit application. Subsequent to approval by a lender, the application is approved by the CDC's local board of directors and then submitted to the appropriate SBA district office for approval. The SBA approval process and requisite paperwork is handled entirely by the CDC, making the process less burdensome, if somewhat more redundant, than the better-known SBA 7(a) program. If approved by the SBA, the bank receives a commitment, subject to specified conditions, to provide the takeout loan described above.

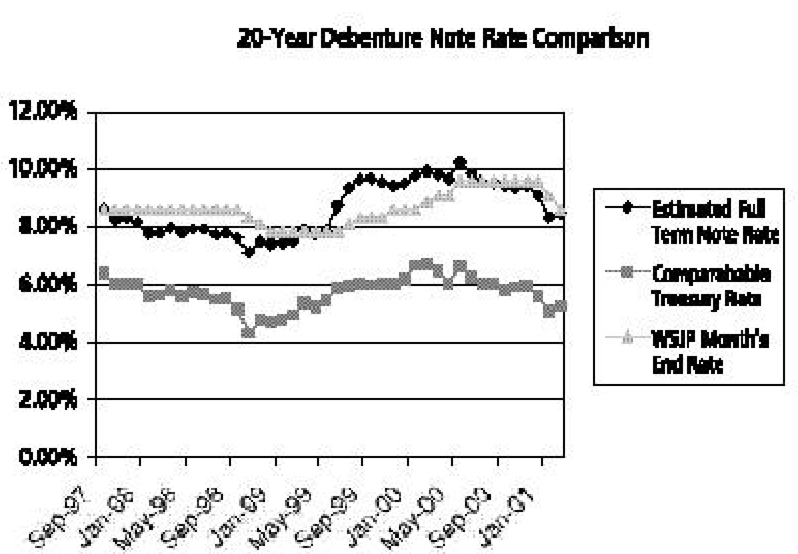
Eligibility for borrower participation in the program is dramatically more straightforward than in other SBA programs. As regards financial considerations, eligibility essentially comes down to being a for-profit corporation with a tangible net worth of less than $6 million and average annual net income for the preceding two years of less than $2 million. Concurrent with this is a job creation requirement. While fundamental to the program, this requirement is of less importance in an individual situation owing to the specifics of the calculation.

The result is a loan program which has elements of economic development combined with the fundamentals of sound credit underwriting.

Program Benefits to Community Banks

Credit risk management. From the perspective of credit risk management, the 504 program is unquestionably positive for the bank. The program results in an institutional exposure of approximately 50% to cost at the beginning of the permanent financing. The bank must manage the risks inherent in the interim period and ensure that the closing is properly coordinated to address security positions and related concerns. However, short of truly adverse conditions, it is difficult to imagine incurring a loss in a transaction with a loan-to-cost basis of 50% and a willing second position security interest. The SBA's basic philosophy is that it will pursue a reasonable expectation of recovery and is thus willing to purchase the first secured position's interest with minimal difficulty. This also carries

Figure 1



the potentially substantial benefit of minimizing, in a best-case environment, the normal expenses incurred in a workout situation.

The program can be particularly beneficial to a community bank in managing portfolio concentration risk. The overall credit needs of a large customer could be served, while, in effect, participating the risk via the CDC/SBA-supported second-position loan. This would also allow the institution to retain the capacity to supply crucial lending relationships for working capital, thereby supporting a sounder and more controlled credit exposure. The program's structure and implementation encourage this by not seeking collateral beyond the project being financed.

The main credit risk comes during the time when the interim loan is partially funded. The full panoply of "Murphy's Law," can be summoned to detail what could go wrong at this juncture. The CDC/SBA are under no obligation to fund in the event of material adverse changes or in the event of cost overruns and again, it bears repeating that the bank is not operating under a guarantee of its loan at any point. The greatest care should be taken to manage the funding process with all due consideration and deliberation, since errors here can be catastrophic in terms of the overall credit risk. While the risks inherent in a construction lending environment immediately come to mind, these are often well addressed by the normally extremely structured circumstances of a construction loan. The risks of financing an equipment purchase should not be lightly regarded or underestimated.

Earnings management. The primary benefit of the 504 program to a community bank, from the perspective of earnings, may be its contribution to core earnings as a long-term portfolio asset. The counter to this position is the ability to more effectively utilize capital because of a growing secondary market for the first position loans.

As previously mentioned, the permanent loan is profoundly well secured against most imaginable contingencies. However, the pricing in this situation is totally at the discretion of the institution. The only restriction is that the maturity of the first-position loan cannot be less than seven or 10 years, depending on the term of the debenture. Within this limitation, pricing can be fixed or floating on whatever basis suits the institution's needs. In addition, the pricing during the interim period can be adjusted to reflect the greater risk at this time, yet remain well within the disciplines of the market, because of the overall pricing and structural advantages obtained by the borrower after the permanent loan is placed. At the funding of the permanent loan, the first-position lender is so well secured, an argument can be legitimately made to adjust the normal portfolio loan loss reserve requirement.

The result is a pricing model that is more like a normal or, perhaps, preferred borrower with a fraction of the risk. Unless the bank in question is operating at a relatively high loan-to-deposit ratio or the growth in the local community affords it the opportunity to pursue multiple transactions, the ability to hold well-priced, high-quality assets in the portfolio seems intuitively persuasive. This contention is, however, based on a range of situation-specific factors and bears consideration. Based on the funding decisions of the bank, it may also be prudent to make pricing and structuring decisions with an eye toward the requirements of the secondary market.

There are options in the secondary market to securitize the bank's first-position loan. Loan sales are structured to sell the entire first position on a servicing-released basis. This affects the conversion of a stream of earnings into a single point fee. The key benefits here are the ability to enhance fee income while managing loan portfolio balances, thereby producing better performance under such profitability ratios as ROE and ROA.

Most secondary market sources require that bankers choosing this option price the transaction with significant prepayment penalties. The more substantial these can be made, the higher the likely premium. Loans with prepayment penalties exceeding five years have achieved premiums as high as 5-6%. Options frequently seen include an annually declining penalty of 5%, 4%, 3%, 2%, and 1%; and a flat 5% penalty for five to 10 years. In situations where a 10-year prepayment penalty is written into a note, the borrower can be allowed a 90-day window within which to prepay the loan after the fifth anniversary. This same timeframe can also accommodate a pricing call. Either of two pricing models suffer markedly less acceptance in the market without prepayment penalty requirements—fixed-rate loans without at least a five-year prepayment penalty or floating rate loans with relatively higher rates (for example, exceeding *Wall Street Journal* Prime prime plus 1.25%). This is due to the refinancing risk potential in these situations.

It is critical to note that the definition of prepayment accepted by the secondary market is liberal. The borrower can prepay a loan by up to 20% of the original note amount annually without penalty. Various market participants have accepted this definition of repayment on both floating and fixed-rate loans.

Likewise, and for obvious reasons, the market rewards greater frequency in pricing adjustments. There are several choices of a rate index, including *Wall Street Journal* Prime, Federal Home Loan Bank—Seattle, and LIBOR. These can be used for either fixed or floating-rate structures. Treasury-based spreads are becoming less common as the declining Federal debt has begun to shape the yield curve independently of other factors.

The issue between these two positions—hold versus sell—is more than a question of the effective use of capital. It also goes to fundamental issues of funding and portfolio management. The questions of what loans are held in portfolio and locally managed through to repayment as well as the funding sources of these loans define not only the bank's role in the community, but its very identity as a community bank.

Balance sheet management. While the marketability of the first-position loan can have income implications, it can also provide the institution with greater ability to access liquidity. As long as loans are structured as indicated earlier in this article, they are readily marketable with credible and known sources in the industry, such as Zions Bank or Bank of the West. Sales can be arranged within a matter of days and settlement normally occurs within a like timeframe.

Both seasoned and unseasoned loans are actively sought by the secondary market. With a modicum of foresight, a community bank can add an additional layer of liquidity reserves to its funding considerations.

The structure of the program allows for the leveraging of short-term earnings, whether in the form of recognized fees or conventionally accrued interest. Situations can be managed so that the takeout facilitated by the CDC/SBA second-position loan occurs before the closing of major reporting periods. In fact, it is possible to arrange table funding by secondary-market participants. The result would be that the earnings from loan fees would be taken in against a lower loan portfolio base, as reflected in the period-ending reports. This can affect small but positive changes in capital adequacy ratios and in loan loss reserve ratios.

Marketing management. Compared to other SBA programs, the 504 loan is readily marketable to a range of borrowers because of the relatively limited list of eligibility considerations. The product provides several significant advantages to the borrowing clients of community banks, which immediately makes it more attractive.

The primary marketing aspects of the program are the low down payment requirements and the attractive long-term fixed rate. As mentioned above, the required level of borrower equity in a transaction can range 10-20%. To most borrowers, the ability to retain cash in a business operation as working capital is intuitively appealing. However, if needed, a quick set of pencil calculations on the nearest envelope should demonstrate that the return on funds kept in the business operation should exceed that of most real estate investments. By allowing most borrowers to remain at equity levels below the 20-25% demanded by conventional lending, the 504 has a definite marketing edge.

Figure 1 also illustrate the very positive rate structure afforded by this program. Fixed rates for 20 years are not particularly commonplace in the commercial arena. The ability to control a key cost component is of particular benefit and interest to many borrowers and is well worth the issue of prepayment penalties. Should prepayment penalties be a significant issue on the second-position loan, a significant counterpoint is the ability to prepay up to 20% of the first-position loan, even when structured with penalties that render it more saleable in the secondary market.

Rate structure is also a potentially strong selling point of the product, because it is possible to combine fixed and floating-rate products. This inherently creates a hedge against rate movement, which is not often a product afforded by community banks to their smaller borrowers.

These same factors can help overcome borrower objections to program fees that, on the second-position loan, can exceed 3% of the loan amount fairly easily. Since the costs are funded through the second-position loan, these are not out-of-pocket expenses, again preserving working capital in the business. Furthermore, the overall rate structure can produce an all-in cost of financing below that of the conventional market.

From the bank's perspective, the marketing advantages of the program are threefold:

1. The pricing advantage of the debenture rate for the second position loan. This can go a long way to countering more aggressive fixed rate pricing sometimes offered by larger banks with promotional programs managed through greater treasury capability and capacity.
2. The relatively liberal nature of credit extension terms for down payment requirements and the 20-year fully amortizing term.
3. The ability to introduce additional flexibility in the management of a credit relationship with a borrower. By allowing a community bank to manage its legal lending limits and internal portfolio guidelines, the bank retains relationships with larger and rapidly growing customers. Furthermore, it does so in a way that promotes the ability of the bank to retain more of and more control over the overall credit relationship, while limiting its exposure and overall risk.

The art of running a successful community bank is frequently in the ability to wear, with integrity, many hats at once while serving a customer base. The utility of the program can be seen across a range of management areas, such as credit risk, profitability, and liquidity. Its ultimate benefit, however, is helping a local bank retain an active role in the sound management and delivery of local long-term credit needs. In this role, the 504 program helps to fulfill the nature of a community bank. ❒