Comptroller of the Currency
Administrator of National Banks

Executive Summary

Web and Telephone Seminar
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SBA 504 Certified Development Company Loan Program: Small Businesses' Window to Wall Street

Speakers:

John C. Dugan
Barry Wides
Peter J. Morgan
Jean Wojtowicz
Randy Christiansen

Following is an executive summary of this OCC Web/Telephone seminar covering:

- What the SBA 504 loan program is.
- How this program works and why it is beneficial for banks.
- The role that CDCs play in the 504 program.

SBA 504 Certified Development Company Loan Program: Small Businesses' Window to Wall Street

OCC Speakers: **John C. Dugan,** Comptroller of the Currency
Barry Wides, Deputy Comptroller, OCC Community Affairs
Peter J. Morgan, Executive Vice President, Zions Bank, N.A.
Jean Wojtowicz, President, Cambridge Capital Management Corp.
Randy Christiansen, National Bank Examiner

Overview

The Small Business Administration's (SBA) 504 loan program enables small businesses to finance assets, such as real estate, at appealing terms. For participating lenders, its benefits can be measured in credit quality, income, risk management, loan structure flexibility, and regulatory compliance terms. While 504 loans are an effective tool used by many banks, many are not taking advantage of this vehicle, which makes education to create greater awareness important.

Context

This web and telephone seminar explained the SBA 504 loan program from three perspectives—a bank active in 504 lending; a Certified Development Company (CDC), which helps facilitate such loans; and a bank regulator. A brisk Q&A session followed.

Key Learnings

- **SBA 504 lending offers ample benefits for banks, small businesses, and local economies—a win/win/win.**

  The SBA's 504 loan program provides small businesses a way to finance major assets, as large companies do, at appealing terms—most prominently, a relatively small (typically 10%) down payment. It's a co-lending product: banks partner with CDCs, which are nonprofit entities certified by the SBA to provide funding under the 504 program. The two split the lending, with the CDC's portion backed by a 100% guaranteed debenture. The bank typically finances 50%, holds the first lien on the asset, can structure its portion as it sees fit—with fixed or variable terms, prepayment penalties or none—and can sell the loan into a secondary market. The CDC typically puts up 40% of the loan amount, and its portion carries prepayment penalties as well as a fixed rate. This portion of the financing comes from debentures sold to institutional investors.

  Importantly, by making long-term financing accessible to small growing businesses, the 504 program promotes local economic development—helping create and retain jobs. Participating in 504 lending can also help banks meet regulatory requirements under the Community Reinvestment Act (CRA).

  > *"The SBA 504 program . . . allows a lender to control . . . the origination process. The loans are readily salable into the secondary market, and may allow your bank to earn CRA credit. What's not to like?"*
  > - Barry Wides

- **504 loans offer multiple benefits for banks, at relatively low risk.**

  Peter Morgan of Zions Bank shared a banker's perspective. Over the past 12 years, Zions has underwritten, closed, securitized, and sold 3,000 SBA 504 first-mortgage loans, exceeding $2.5 billion (700 during 2006 alone, worth $600 million), in all 50 states, for businesses in over 100 industries. Thus, Zions knows this product well. Mr. Morgan shared his insights about how it works, how best to market it, its advantages and drawbacks, and what banks considering providing the product can expect:

  > *"This government-sponsored program . . . can be an excellent supplement to your bank's income statement and/or increase your loan portfolio while mitigating your credit risk."*
  > - Peter J. Morgan

  - *Portfolio snapshot.* In 2006, Zion's average 504 loan was $750,000, and its loan-to-value (LTV) ratio averaged 54%. Offices and warehouses were the most common asset funded, followed by hotels with several other property types represented.
  - *Terms and structure.* The bank generally provides a loan equal to 50% of a project's costs; the loan amount cannot be less than what the SBA provides. The term of the bank's loan must be at least half that of the SBA's. There is no dollar limit on loan amounts. These are long-term loans, with 20- and 25-year maturities common. Amounts and rates can be modified with the SBA's consent. Importantly, the bank initially must provide the entire loan amount for a few months until the SBA's funds become available through the debenture issuance process. In the case of a construction loan this interim period is longer.
  - *Prospecting and marketing.* Good prospects for SBA 504 loans include small companies that are growing rapidly. When evaluating a prospect, banks should be aware that: 1) a rapidly growing business may show ability to service the proposed debt only in the past 12-18 months; 2) in the case of start-ups, principals should have prior industry experience (crucial to lowering the default rate); and 3) in some instances, greater-than-usual borrower leverage can work—banks need to consider the financial strength of the total package.
  - *To market SBA loans, Zions*: 1) trains branch managers and loan officers in SBA loan programs; 2) has a network of small business contacts that help it identify SBA loan opportunities; 3) maintains excellent relationships with CDCs in its multi-state market footprint, referring transactions back and forth; and 4) has SBA 504 goals and incentives for its loan officers.
  - *Advantages.* Many of the benefits to banks stem from the SBA 504's low (50%) LTV ratio, which lowers the risk in the event of

default. This may enable a bank to tolerate higher default risk, finance larger and more projects, and diversify project-financing risk. Moreover, the ability to sell the loan into the secondary market presents liquidity opportunities as well as premium and/or fee income, giving the bank more means to pursue other business goals (expansion, etc.). Finally, these loans often qualify the bank for CRA credit.

- *Managing default risk*. SBA 504 loans carry slightly higher probability of default than usual (the delinquency rate approximates 1%), but the bank experiences lower losses in default situations. Zion's principal loss rate on these loans has averaged just 3 to 5 basis points. In the event of default, the SBA usually protects its second-lien position and buys out the bank lender (it will not do this, however, in the case of special-use properties or if equity is insufficient).
- *Secondary market*. When selling the loans into the secondary market, the referring lender keeps all applicable loan fees including the premium. This secondary market opportunity can mean a bank is better able to: 1) expand geographically into new markets; 2) manage its real estate or industry portfolio concentrations—perhaps taking on higher-risk projects or making multiple loans to the same borrower; 3) generate more income; 4) manage credit risk; and 5) manage liquidity.

- **CDCs work closely with banks and customers to coordinate and facilitate the lending process.**

Jean Wojtowicz explained CDCs' role in the lending process. She described that the SBA started its 504 loan program in 1981 to promote economic development, create/retain jobs, and meet other public policy goals. It has licensed 275 CDCs nationwide, which serve as banks' conduits to processing, closing, and servicing the SBA-guaranteed second-lien loan. Since its inception, the program has funded about 70,000 loans, totaling almost $28 billion. In terms of number of loans and total dollar amount, volume has doubled from 2002 to 2006. Every $50,000 a CDC loans out must create one new job (unless a project meets other public policy goals).

Some program specifics: 1) eligible businesses must be for-profit, with net worth of less than $7 million and no more than $2.5 million average net income for the past two years; 2) eligible projects are those that involve the purchase of fixed assets with a useful life of at least ten years; 3) the minimum project size is $125,000, with a minimum SBA loan portion of $50,000; no project maximum exists, though the SBA's loan maximum is $1.5 million; 4) business principals must pass the SBA's personal resource test determining need; 5) predefined prepayment penalties apply to the SBA's portion of the loan; 6) the bank pays a fee to the CDC amounting to 0.5% of the first mortgage amount; and 7) the typical 50/40/10 bank/SBA/borrower loan breakdown does not apply for single-purpose facilities or start-ups.

In terms of process, the bank and CDC discuss the proposed loan structure before the bank seeks internal approval. Next, the bank approves its portion—both the 50% it will loan and the 90% it will put up until SBA funds come through. With a centralized SBA approval process, the CDC's internal approval takes only days. The CDC is responsible for monitoring and servicing its loan.

The debenture sales that generate the SBA's financing occur once a month for 20-year debentures, and once every other month for 10-year instruments. Loans must close 45-60 days prior to a debenture sale, as the closing documents are due to the SBA approximately 30 days before the sale. The interest rate is set at the time of the sale. Proceeds are wired to the bank after the sale to pay down the interim loan.

To best utilize this program, Jean Wojtowicz advised banks to: 1) use 504s for their best, most credit-worthy customers; 2) provide 504 loans—with their advantageous structuring—before competition does; 3) use them to build customer loyalty; 4) be sure that incentive programs reward loan officers equally for selling 504s as for conventional loans; and 5) be a value-added banker—knowing, for instance, when a prospect's lease expires prior to presenting a loan proposition.

> *"Look at this as a product for your best customers. You should know that if you don't provide this option . . . your competition will."*
> - Jean Wojtowicz

- **SBA 504 loans result in a favorable risk structure for a bank—when underwritten properly.**

Bank regulator Randy Christiansen offered his perspective on banks' prudent use of the product's features, providing several caveats for 504 lenders to keep in mind.

With this product, above-average obligor (or default) risk is mitigated by below-average collateral and structural risk. Although the probability of default is higher than for conventional lending, less is lost in the event of default. This is a low credit loss type of lending. It provides some credit and liquidity risk management tools, such as the second lien take-out and selling loans into the secondary market.

> *"When underwritten properly, 504 lending results in a favorable risk structure for your bank."*
> - Randy Christiansen

There are some traps to avoid:

- *Focus on repayment ability*. Owing to the higher obligor risk, lenders' primary underwriting focus should be on the repayment ability of borrowers, with additional focus/due diligence on principals/guarantors. Due diligence is critical; a small business's success is tied to its principal's character and experience.
- *No collateral-based lending*. Given these loans' structures and collateral protection, it may be tempting for banks to engage in collateral-based lending. Don't. Cash flow is the primary method of repaying; collateral is backup.

Appraisal regulations still apply in these relatively secured 504 transactions. Since poor appraisals can cause credit losses in the event of default, even if the bank appears fully protected at loan inception, regulators want to see high standards for appraiser independence and qualifications. Regulators also expect banks to monitor and report their temporary Supervisory LTV exceptions during the interim period prior to the bank receiving the SBA financing. The 504 product offers banks latitude in rate structuring and an ability to sell loans into the secondary market to help manage interest rate and liquidity risks. Regulators expect banks to effectively manage the liquidity and interest rate risks associated with these credits, particularly given their long-term nature. Banks should not approve interim financings that exceed their lending limits, but a bank does have some options to manage larger transactions, such as participating with other lenders, and referring transactions to a larger secondary market lender.

In considering 504 loans for CRA credit, loan size plays a role: loans of $1 million or less may qualify as small business loans and those greater than $1 million as community development (CD) loans.

Other Important Points

- **Domestic Use Only.** Assets located in foreign countries do not qualify for SBA 504 transactions.

Additional Resources:

- **SBA 504 Loan Program: Small Businesses' Window to Wall Street**
  www.occ.treas.gov/cdd/Insights_2-06.pdf
- **State listing of CDCs**
  www.nadco.org/search_advanced.asp?mode=org
- **SBA information on the 504 product**
  www.sba.gov/services/financialassistance/sbaloantopics/cdc504/index.html
- **SBA regulations**
  www.sba.gov/tools/resourcelibrary/lawsandregulations/index.html
- **Lending limits**
  www.occ.treas.gov/fr/cfrparts/12CFR32.htm
- **Real estate lending and appraisals (see subpart C)**
  www.occ.treas.gov/fr/cfrparts/12CFR34.htm
- **Supervisory Loan-to-Value limits (see Appendix A to Subpart D)**
  www.occ.treas.gov/fr/cfrparts/12CFR34.htm
- **Commercial Real Estate Risk Management Guidance**
  www.occ.treas.gov/ftp/release/2006-131a.pdf
- **Community Reinvestment Act**
  www.occ.treas.gov/fr/cfrparts/12CFR25.htm

Speaker Biographies

John C. Dugan
Comptroller of the Currency

John C. Dugan was sworn in as the 29th Comptroller of the Currency on August 4, 2005. The Comptroller of the Currency is the administrator of national banks and chief officer of the Office of the Comptroller of the Currency (OCC). The OCC supervises 1,900 federally chartered commercial banks and about 50 federal branches and agencies of foreign banks in the United States, comprising more than half the assets of the commercial banking system. The Comptroller also serves as a director of the Federal Deposit Insurance Corporation, the Federal Financial Institutions Examination Council, and the Neighborhood Reinvestment Corporation. Prior to his appointment as Comptroller, Mr. Dugan was a partner at the law firm of Covington & Burling, where he chaired the firm's Financial Institutions Group. He specialized in banking and financial institution regulation. He also served as outside counsel to the ABA Securities Association. He served at the Department of Treasury from 1989 to 1993 and was appointed assistant secretary for domestic finance in 1992. While at Treasury, Mr. Dugan had extensive responsibility for policy initiatives involving banks and financial institutions, including the savings and loan cleanup, Glass-Steagall and banking reform, and regulation of government-sponsored enterprises. In 1991, he oversaw a comprehensive study of the banking industry that formed the basis for the financial modernization legislation proposed by the administration of the first President Bush.

From 1985 to 1989, Mr. Dugan was minority counsel and minority general counsel for the U.S. Senate Committee on Banking, Housing, and Urban Affairs. There he advised the committee as it debated the Competitive Equality Banking Act of 1987, the Proxmire Financial Modernization Act of 1988, and the Financial Institutions Reform, Recovery, and Enforcement Act of 1989. Among his professional and volunteer activities before becoming Comptroller, he served as a director of Minbanc, a charitable organization whose mission is to enhance professional and educational opportunities for minorities in the banking industry. He was also a member of the American Bar Association's committee on banking law, the Federal Bar Association's section of financial institutions and the economy, and the District of Columbia Bar Association's section of corporations, finance, and securities laws.

A graduate of the University of Michigan in 1977 with an AB in English literature, Mr. Dugan also earned his JD from Harvard Law School in 1981. Born in Washington, DC in 1955, Mr. Dugan lives in Chevy Chase, Maryland, with his wife, Beth, and his two children, Claire and Jack.

Barry Wides
Deputy Comptroller, OCC Community Affairs

Barry Wides is the OCC's deputy comptroller for Community Affairs where he leads a department of community development professionals located in Washington and the four OCC districts. The Community Affairs staff is responsible for outreach to banks and their community partners, the administration of the "Part 24" public welfare investment authority, the development of policy, and the creation and distribution of educational materials on community development issues.

Prior to joining the OCC in 1999, Mr. Wides was director of Affordable Housing Sales at Freddie Mac where he led a nationwide sales team responsible for developing products and strategies to achieve the company's congressionally-mandated affordable housing goals. He previously served as deputy director of the Resolution Trust Corporation's Affordable Housing Program. Mr. Wides began his career in Washington as a presidential management intern and budget examiner at the Office of Management and Budget.

Barry is a Certified Public Accountant and holds a BS in Accounting and an MBA from Indiana University.

Peter J. Morgan
Executive Vice President, Zions Bank, N.A.

Peter Morgan is Executive Vice President, Manager, and founder of Zions Bank's National Real Estate Department. The department provides a nationwide secondary market for real estate loans to small businesses. In 2005, Zions Bancorporation was the nation's largest originator of owner-occupied first mortgage real estate loans done in connection with the SBA 504 loan program. Mr. Morgan has been employed with Zions for 23 years.

Mr. Morgan was graduated from Pacific Coast Banking School, University of Utah, with a BA in finance and holds a Masters in Business Administration from Arizona State University.

Jean Wojtowicz
President, Cambridge Capital Management Corp.

Jean Wojtowicz is president of the consulting firm, Cambridge Capital Management Corp., which she founded in 1983. The corporation has been awarded management contracts for the Indiana Statewide Certified Development Corporation and the Indiana Community Business Credit Corporation. Both corporations are consortiums of financial institutions.

Cambridge also holds the management contract for LYNX Capital Corporation, established to link capital to minority business opportunities, and has assisted loan programs offered by the Indiana Economic Development Corporation and the Indiana Department of Commerce. Ms. Wojtowicz's firm joined with T.M. Englehart Corporation in 1991 to launch a venture capital fund called Cambridge Ventures L.P.

From 1994 to 1998, Cambridge Capital was retained to develop and manage the West Virginia Capital Corporation, which is modeled after the Indiana Community Business Credit Corp. From 1998 to 2002, Cambridge Capital was retained to develop and manage ShoreBridge Capital Ltd. in Cleveland, Ohio, which is a mezzanine fund for growing companies.

Ms. Wojtowicz serves on the following boards: Vectren Corp (NYSE: VVC); Windrose Medical Properties Trust (NYSE: WRS); First Merchants Corp. (NASDAQ: FRME); First Internet Bank of Indiana; Indiana State Chamber; Indianapolis Chamber of Commerce; Greater Indianapolis Progress Committee; OneAmerica Funds, Inc.; Goodwill Industries; Venture Club of Indiana; and national professional organizations including NADCO and NABDC. She is also on the Advisory Council of the Federal Reserve Bank of Chicago.

Ms. Wojtowicz earned a degree in business administration with emphasis on finance, investment, and banking matters from the University of Wisconsin in Madison.

C. Randy Christiansen
National Bank Examiner

Randy Christiansen is a National Bank Examiner and lead credit examiner for Zions Bancorporation. Mr. Christiansen joined the OCC's Salt Lake City office in 1987. In 1997, he became a retail credit team leader at First Security Corporation in the OCC's Large Bank Supervision program. Since 2001, he has been responsible for the regulatory supervision of all commercial and retail credit related functions at Zions Bancorporation. He is also a Team Leader of the Shared National Credit examinations at Wells Fargo Bank in San Francisco.

Mr. Christiansen was graduated from the University of Utah in 1986 with a BS degree in finance.