

STATEMENT

by

The National Association of Development Companies

on

The Small Business Administration

**Condition of Small Business and
Commercial Real Estate Lending
In Local Markets**

Submitted to the

COMMITTEE ON SMALL BUSINESS

COMMITTEE ON FINANCIAL SERVICES

UNITED STATES

HOUSE OF REPRESENTATIVES

by

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The National Association of Development Companies (NADCO) is pleased to testify before the House of Representatives Committee on Small Business and Committee on Financial Services about the condition of commercial real estate lending and the related need to improve access to capital by small businesses.

NADCO is a membership organization representing the Certified Development Companies (CDCs) responsible for the delivery of the SBA 504 program. We represent more than 260 CDCs and more than 250 affiliate members, who provided more than 95% of all SBA 504 financing to small businesses during 2009, as well as many other small business programs and services in their communities. CDCs are for the most part not-for-profit intermediaries with a statutory mission to provide community and economic development through the delivery of the SBA 504 loan program and other economic development programs and services customized to the needs of their respective communities.

NADCO would like to thank Chairman Barney Frank, Ranking Member Spencer Bachus, Chairperson Nydia Velazquez, Ranking Member Sam Graves, and the two Committees, for continued support of small business and small business lending in America, and for your focus on the critical need for access to capital in order to restore growth to our economy. We would like to especially thank Chairperson Velazquez for her leadership in gaining passage in the House of H. R. 3854, the Small Business Financing and Investment Act of 2009, late last year. This bill contains many program enhancements our industry has long advocated, and we have urged the Senate to carefully consider passage of many of these program changes.

NADCO's member CDCs work closely with SBA and our lending partners (generally banks and federal credit unions) to deliver what is certainly the largest and most successful federal economic development finance program in history (since 1986, over two million jobs have been created via the authorization of \$50 billion in 504 loans that leveraged over \$90 billion in private investment).

How the Small Business Commercial Real Estate Sector is Different

Commercial real estate financing is different from residential financing in several key ways. First, commercial real estate financing for small business is part of a much larger market of overall commercial real estate, which includes investor-owned hotels, office buildings and even multi unit residential properties. For small businesses that own their own properties, these commercial properties are the "homes for their businesses", so the fate of the financing on these properties has serious ramifications, not only on the businesses that own them, but also on the lenders that loan on them, and on the employees whose jobs are provided by these companies.

Second, unlike SBA loans, conventional loans to small businesses for commercial real estate, are structured very differently from residential financing. While the typical residential home loan is a 30 year loan, these loans typically have long amortizations, but drastically shorter due dates—essentially balloon note financing. Whether fixed or variable rate, these loans are generally written with 5, 7 or 10 year terms, at which time a balloon payment comes due. The historic assumption is that at loan maturity, a lender will renew or re-write the loan for another 5 or 10

years. However, this will not be the case for many small businesses seeking to renew their conventional commercial real estate loans over the next several years.

What the Experts Say

Experts have been raising significant concern about the condition of the commercial real estate market in this country for over a year now.

► In April of 2009 Deutsche Bank issued a study titled “The Potential Refinancing Crisis in Commercial Real Estate”. In this report Deutsche Bank identified that over the next 4 years, there would be approximately \$1.2 Trillion of commercial real estate financing coming due from commercial mortgage backed securities (“CMBS”), insurance companies and banks. They point out that many of these loans, whether performing on payments or not, may not be renewed. The report indicates that...”To date, most market participants have dismissed the seriousness of the future refinance issue claiming that lenders will simply extend maturities for loans that fail to qualify. Such an approach might prove fruitful where non-qualifying loans were a small portion of the total. However, our analysis suggests that the percentage (of non-qualifying) loans is likely to be 60 to 70% or more [of those loans coming up for renewal].”

► In October of 2009 at the request of our industry, Credit Suisse conducted a study titled “What About Small Loans?” In order to estimate the effect of the crisis predicted by the Deutsche Bank study on small business commercial real estate loans, the Credit Suisse study looked at commercial loans made prior to 2008 using commercial mortgage backed securities or “CMBS”. Their analysis concludes that “...Almost 10,000 CMBS loans will mature prior to 2014.” This study did not include the number of or amount of other conventional commercial real estate loans to small businesses that would be added to that total.

► Also in October of 2009, Mark Zandi, Chief Economist at Moody’s Economy.com testified before the Joint Economic Committee on the state of the economy, one aspect of which he referred to as the “commercial real estate bust”. In his testimony on this issue he indicated that...”More disconcerting is that even commercial property owners with substantial equity, solid tenants and positive cash flow are unable to refinance mortgages as they come due...Unfortunately, the CMBS market remains closed and traditional portfolio lenders such as banks, insurance companies and pension funds are not offering to refinance...”

The Effects of the Economy on Small Business Real Estate Lending:

504 financing traditionally provides long term fixed rate financing to companies that are established and ready to implement a program of substantial growth. A CDC’s 504 loan clients are those small firms that are successfully growing their companies, expanding their businesses, locations and plants, and hiring new workers. These firms have historically created an average of one new job for every \$65,000 in 504 loan amount (historical job creation average exceeds this requirement).

Although a record number of 504 borrowers have been adversely affected by the recession, it is not 504 or SBA borrowers that are at risk from losing their performing loans because of a

balloon payment or a commercial property valuation. The companies that will be most effected by this commercial real estate financing crisis are those with conventional loans—loans with balloon payments coming due over the next several years. In addition to the challenges summarized above, these companies, and as a result their lenders are faced with a “perfect storm” which includes the following.

For business financing in general a combination of the recession (resulting in lower sales) and the credit crisis (resulting in a near-collapse of credit availability) have severely restricted access to capital for small businesses for all types of uses, including commercial real estate. The downturn in sales and business revenues has resulted in declining net income and weaker financial statements making it harder for companies in every business sector to qualify for the financing they need.

The credit crisis and what is deemed by regulators to be a significant concentration of commercial real estate lending has forced banks to focus on rebuilding of their capital, rather than lending it out. This is particularly true for small and regional community banks that tend to traditionally hold a larger share of commercial real estate on their books compared to large money center banks. Additionally the credit crisis has effectively destroyed the secondary market for conventional bank loans. This is a market that many large and virtually all community banks have relied on for decades for a source of funds and liquidity through sales of their loans.

As a reaction to the above, it is no surprise that lenders of all types have become far more cautious in granting loans to static, or even shrinking, small businesses. Historically it is a natural response to an economic downturn for lenders to become more conservative. However in this combination of a severe recession and major capital markets crisis, CDCs are experiencing banks of all types tightening their credit boxes to unprecedented levels.

Solutions for Providing More Small Business Loans:

To get America out of this recession, we must help small business stabilize and then get small businesses growing again and creating new jobs. It is well recognized that it is small business that is the perennial job creating segment of our business infrastructure. Yet, the focus of so many federal stimulus efforts has been on large businesses that often create few, if any, new jobs for our economy. This approach is not optimal policy and leaves America’s most dynamic sector, small business, out in the cold.

The “grease” that gets the small business jobs engine going is capital: both short term and long term funding to pay for business plant and store expansions and for inventory, raw materials, and labor costs. Without funding, businesses cannot grow. With funding, businesses can finance their growth and hire new workers. The fact that the unemployment and under-employment rates are so high is an indicator that many small businesses are not yet growing again.

SBA has existing loan guarantee programs that meet the needs of small business with both short and long term capital. The 504 program provides long term funds to businesses to finance fixed assets by accessing the low cost funds provided by investors through the public markets. This program is delivered by a low cost industry of non-profit Certified Development Companies,

which has historically delivered billions in long term capital to thousands of growing small businesses each year.

Today, that CDC industry is providing loans to businesses in every state, but due to lack of demand during this very severe recession, the industry is working at less than its capacity. In both the Senate and the House, bills have been introduced that would enable our CDC industry to provide capital to more small businesses and to meet their long term financing needs.

Reach Out to More Small Businesses With New Capital:

Congress and the Obama administration have worked hard to put more fixed asset and working capital funding in the hands of small businesses hard pressed by this recession. Our industry thanks both the Congressional Small Business Committees for taking a leadership role by adding key programs to the stimulus bill earlier this year that are beginning to impact capital access and job creation.

We also recognize the House Small Business Committee for passing H. R. 3854, an SBA programs reauthorization bill with numerous beneficial program changes. Foremost among these changes is the proposal to increase the maximum 504 loan size from \$1.5 million to \$3 million, and the limit for critical public policy loans would increase from \$2.0 million to \$4.0 million.

However, as the Deutsche Bank and Credit Suisse studies show, the on-going financial crisis has increased the demands for capital beyond the House-passed new 504 program loan limits. As President Obama has advocated, and many banking and industry groups have endorsed, we now support the urgent need to provide even greater levels of capital access to healthy, growing small businesses. As stated in H. R. 4302, we urge support for a total credit limit to a single borrower of \$5 million for regular 504 projects and public policy projects, and \$5.5 million for small manufacturers and energy-efficient projects.

While such limits would not often be used for a single 504 project, they would be most applicable to the provision of added capital to those successful small businesses that are already “maxed out” on their 504/ 7(a) eligibility at the current loan levels. History demonstrates that successful small businesses that can expand further are those that will create the most new jobs in new locations, while minimizing risk of default and potential losses for the 504 program.

Refinance Conventional Maturing & High Cost Debt:

Our industry strongly recommends that the Committees support the H. R. 4302 proposals to assist small businesses by including a temporary expansion of refinancing provisions. There are three distinct needs for this program enhancement:

1. Maturing debt: Studies have shown that substantial small business real estate debt now held by commercial banks, or in the public markets through CMBS pools, will mature in the next several years. With pressure from regulators, and deteriorating loan portfolios, many banks have either tightened their credit standards, or completely withdrawn from small business financing. Small businesses, especially those in rural areas, may have no

sources of funding to roll over their loans for their business real estate, which can lead to lender foreclosures. This occurs for even good firms that can pay their debt costs, but just cannot locate sources of funds.

2. High cost debt: Many small businesses have owned their real estate for years. These loans were done when rates were very high, compared to the record low interest rates available today. These firms need to conserve cash for working capital and job creation, rather than paying high debt costs. By enabling access to today's lower interest rates, debt costs can be decreased and firms can use the savings to pay salaries, expand inventory, and hire more workers, rather than pay interest costs.
3. Access locked up real estate equity: In spite of the decline in real estate values, many small firms still have significant equity in their business real estate. They simply have no way to access it if they cannot refinance their existing mortgage debt. Enabling these companies to both refinance their real estate while providing them with more operating cash is a double win for these companies and our economy and will enable them to re-invest it in their business operations, expand, and increase job creation and retention for their communities.

We believe that through the benefits offered by H. R. 4302, SBA, the banking industry, and our own industry can work together to craft means to assist in these situations and provide fresh capital to these small businesses, while retaining sufficient real estate collateral to protect both the banks and the taxpayer. We urge Congress to pass legislation to make regulations more flexible, especially during this recession in which businesses are collapsing due to lack of working capital, even as they sit on substantial real estate equity that they cannot access due to a crisis in the nation's capital markets.

We also believe that the downside of not taking this action is too great. The Congressional Oversight Panel in their February report, Commercial Real Estate Losses and the Risk to Financial Stability, "...expresses concern that a wave of commercial real estate loan losses over the next four years could jeopardize the stability of many banks, particularly community banks." And that "...a significant wave of commercial mortgage defaults would trigger economic damage that could touch the lives of nearly every American. Because community banks play a critical role in financing the small businesses that could help the American economy create new jobs, their widespread failure could disrupt local communities, undermine the recovery and extend the already painful recession."

CONCLUSIONS:

For many years, 504 has been an extremely cost effective capital access program for thousands of growing small businesses that are the core job creators of the American economy. The program was in such demand that for several years its growth rate exceeded 20% each year. As the country slid into this deep recession, many small business owners decided they could not take a risk of continued growth of their firms, so they stopped borrowing all but the necessary working capital to maintain their existing operations.

It is the sense of both SBA and NADCO that many small businesses are beginning to experience an economic turnaround. We can see it in the calls that CDCs are getting about 504. Our “pipeline” of loan projects is coming back. Certainly the stimulus enacted by this Congress is working, beginning a slow but steady upturn of the American business cycle and the economy is beginning to move forward.

The proposed program changes we have discussed will dramatically improve 504 as a more flexible and effective source of capital at just the right time for our economy, as small businesses begin to ask for long term fixed asset and plant expansion funding. With rapid implementation by SBA, 504 will be the right program at just the critical time for small businesses. We ask Congress to pass H. R. 4302 to provide immediate access to capital for small businesses, and work with the Senate to finalize a comprehensive small business bill to help restore the American dream of having a job and establishing and owning your own business.

Thank you for your support of this legislation, and of small businesses across America.