

**STATEMENT**

by

**The National Association of Development Companies**

on

**The Small Business Administration**

**504 Loan Guaranty Program**

**Expanding Small Business Access to Capital**

Submitted to the

**COMMITTEE ON SMALL BUSINESS**

**UNITED STATES**

**HOUSE OF REPRESENTATIVES**

by

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&

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The National Association of Development Companies (NADCO) is pleased to provide a statement to the House of Representatives Committee on Small Business about our concerns on the 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 200 affiliate members, who provided more than 98% of all SBA 504 financing to small businesses during 2008, 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 of community and economic development achieved through the delivery of the SBA 504 and other economic development programs and services customized to the needs of their respective communities.

NADCO's member CDCs work closely with SBA and our lending partners to deliver what is certainly the largest and most successful federal economic development finance program in history (over two million jobs, \$44 billion in authorized 504 loans and the leveraging of over \$50 billion in private investment since 1986).

NADCO would like to thank Chairwoman Velazquez, Ranking Member Graves, and the entire Committee, for continued support of small business in America, the CDC industry and the 504 program. The Committee on Small Business has worked closely with SBA and our industry to ensure the availability of this valuable economic development program to small businesses for more than twenty years.

NADCO will provide comments today on the critical needs of the 504 program as we seek to increase access to long term capital by small businesses during and immediately following this recession.

### **Reduce 504 Program Costs for Small Businesses:**

NADCO has just been informed that the FY 2010 SBA budget increases the cost of access to the 504 program for small businesses by 38.9 basis points per annum. Further, with the nation's unemployment rate being a major factor in the SBA's "econometric" subsidy model, it is a certainty that the borrower fee for FY 2011 will also increase, and likely be a larger figure than for 2010. For the average 504 borrower, this represents an increased interest cost of almost \$50,000 for the life of their loan. For FY 2011, this figure may far more than double. These cost increases will hit our potential new borrowers just at the time our national economy needs these companies to expand, create jobs and help pull the country out of the recession. This seems to negate the benefits of the recently approved benefits through the stimulus bill. We reduced the cost to borrowers in March 2009 and then will significantly increase the cost in October 2009

Since FY 1997, the 504 program has been at zero subsidy; that is to say, fees paid by small business borrowers, CDCs and first mortgage lenders have covered the entire cost of the program. No taxpayer funds have been appropriated for the program in over ten years. While we have requested a more detailed discussion with SBA's subsidy experts, an analysis of the OMB Federal Credit Supplement reveals that SBA is projecting that loan defaults for 504 will increase

from 3.5% for FY 09 to over 7.3% for FY 10. Together with the unemployment rate increase, these two factors may well account for the majority of the fee increases over the next two years.

NADCO is concerned about this forecast of the program default rate. Surveys of our CDC membership and information on bank credit underwriting leads us to a very different conclusion than the SBA has drawn for this critical factor. In fact, both banks AND SBA's own underwriting of 504 loans have become far more conservative during this recession. The "credit box" has become much tighter, and only the strongest small businesses are now qualifying for new loans. Further, with most businesses more carefully husbanding their cash, demand for fixed plant expansion is coming from only the stronger small businesses. Finally, appraisers have become much more conservative in their valuations of commercial real estate, making expansion capital of any kind much more difficult to obtain.

Combining all these factors, it is clear that the FY10 loans we make to small businesses may be among the best and most conservative in the twenty-two year history of 504 lending. NADCO strongly believes that loan defaults for the 2010 loans will substantially decline, not go up, as now forecasted by SBA's subsidy modelers.

The result will be that, just as occurred in FY 1997 when OMB grossly overestimated the defaults and cost thousands of small businesses millions in inflated guarantee fees, for FY 2010 we will see borrowers paying unnecessarily high program fees at the worst time: when they need access to affordable 504 loan capital so they can preserve their cash for working capital to undertake their company expansion and create jobs. With inflated guarantee fees for both FY 2010 and 2011, almost 20,000 small businesses will pay millions in extra fees to SBA over the entire twenty years of their 504 loans.

We ask the Committee to consider the impact of these increased guarantee fees on the very small businesses that are the job creators that will lead America out of this recession. NADCO believes that the only way to restore the fairness of this subsidy process is for Congress to step in and appropriate sufficient federal funds to offset these fees. We request this be taken up as soon as possible in order to negate the impact of this subsidy fee on our borrowers for FY 2010.

### **Reach Out to More Small Businesses With New Capital:**

The Congress and the Obama administration have worked hard to put more fixed asset and working capital 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.

However, our industry believes that more should be done quickly to have even more impact. Even as SBA worked to implement new programs and fee reductions created through the stimulus bill, the loan eligibility and underwriting policies set forth by SBA that are so critical to maximize the effectiveness of these programs were drifting towards more conservative interpretations on numerous issues.

For example, even with a history of successful lending and no data demonstrating unusual loan losses, SBA has moved to restrict 504 borrowers from accessing their personal home equity in order to inject these funds into their new 504 expansion projects. NADCO and the banking industry have prevailed upon SBA to reconsider this policy and collect data to mitigate its negative impact on business borrowing. We are hopeful that SBA will reverse the planned implementation of this potentially highly restrictive policy.

SBA has also moved to interpret the energy-saving project financing changes passed by Congress in ways that are unusual and inconsistent, to say the least. NADCO is working with SBA to try to maximize the impact of these program enhancements and provide financing that will incentivize businesses to become much more energy efficient as they expand their plants.

Our discussions with member CDCs and banks lead us to believe that there are many small businesses eager to expand that either need access to larger guaranteed loan amounts, or have already used up their allocated maximum for 504 under current law. Sometimes these are larger businesses that can create many more new jobs with a new plant; other times they may be successful entrepreneurs that have one or two stores today and want to add more sites based on their current (and profitable) business models. NADCO believes that these restrictions can be addressed in three ways: first, increase the maximum 504 debenture beyond its current limit of \$1.5 million, second, allow a borrower to maximize use of both 504 and the 7(a) loan limits for a single project, third, eliminate the regulation that restricts business owners with higher net worth from participating in 504 projects. These are the very business owners that can create the most jobs as their businesses expand, and do so with the least risk of future loan default.

Our industry is concerned about the potentially catastrophic damage to the nation's entrepreneurial sector as a result of the current capital markets and banking sector crisis. The commercial mortgage backed securities industry remains frozen and banks are failing, or failing to lend, in spite of historic efforts by this Congress and Administration to get these markets moving. One area where this is having very adverse effects is in situations where companies own their own buildings, but have financed these buildings with conventional financing which often has 5 year call provisions. As the banks for these companies fail or substantially tighten their lending standards, performing loans to good companies are being called, causing historically good small businesses with performing loans to be put into foreclosure and causing jobs to be lost. Because of the CDC industry expertise in providing optimally structured fixed asset financing to small business, we believe 504 should be made available to refinance this badly structured conventional debt and save these good companies and the jobs they have created.

NADCO is also concerned that many small businesses that urgently need working capital to fund salaries, raw materials, inventories, and everyday expenses are being hamstrung by their inability to gain access to needed working capital from their substantial commercial real estate equity. This equity is locked up in the current capital markets and banking crisis, with many banks simply unwilling to renew even good loans as federal and state regulators force major adjustments in bank balance sheets and loan portfolios. We believe that SBA and our 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 the taxpayer. We urge Congress and SBA to work with NADCO to develop and 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.

### **Reduce Loan Losses by Focusing More Effort on Liquidation:**

Clearly, loan defaults and charge offs within the 504 portfolio are increasing. However, NADCO believes that the net losses for the program do not have to increase at the same rate. At Congress' direction several years ago, SBA created a new regulation that enabled it to take advantage of the recovery expertise within the CDC industry to increase the labor effort focused on liquidating collateral from defaulted loans, and going after guarantors of those loans at the local level. All agreed that this was especially difficult for SBA, as it has only two small and extremely overworked liquidation staffs, located in Little Rock and Fresno, with no local recovery specialists able to do this work in every city and town. They are simply too far away from the projects and too small of a staff to maximize recoveries on the growing number of loan defaults.

This work is highly specialized and invariably requires staff work in local courts, as well as local contractors to maintain collateral property and negotiate settlements with local guarantors. Many, if not most, CDCs already perform such tasks for other loan and grant programs they administer. They have simply not been given the ability and freedom by SBA to do this on a broad scale for 504. Nor have they, as set up in the SBA's own regulations, been given the expense reimbursements for the costly work of their staff efforts to maximize recoveries.

NADCO believes that the charge off losses for the 504 program can be reduced over time if CDCs are given the freedom to perform recoveries and seek settlements from loan guarantors of 504 projects. This will require cooperation with, rather than dictation from, SBA liquidation staff, who sometimes have far less experience than CDCs at this work. It will also require greatly improved and accurate collections of payments and loan accounting systems. NADCO continues to make proposals to SBA regarding use of its centralized loan servicing contractor to improve this process and speed up collections and payments for defaulted notes that are renegotiated with borrowers or guarantors, with access to this information provided to the CDC industry to assist them in their recovery efforts.

### **The Need to Make SBA Programs More Relevant and Productive:**

Loan volume for both the 504 and 7(a) guarantee programs has improved slightly since passage of the Stimulus act, but many of those benefits are just now being implemented by the SBA. However, in spite of the Stimulus bill, both programs are still down over 50% from their highest levels two years ago.

A substantial part of this volume loss is clearly due to this historic recession with small businesses pulling back on demand for long term capital. But part may also be due to SBA, and even our own lending industries, failing to fully respond in innovative new ways to the ever-changing needs of small business financing. As we have seen with our inability to convert equity

to working capital, and the ever more conservative policies on loan programs, it is possible that SBA's programs are becoming less relevant as small businesses are pushed to find other, and often more expensive, means of funding their growth and job creation.

Each of these guarantee programs is over twenty years old, and an environment of restrictive and over-bearing regulations has evolved within the Federal bureaucracy. With this new administration, and the fresh thinking from senior policymakers it is attracting, NADCO sees an opportunity to break out of the old program's structure and bureaucracy. We see the chance to work with this new leadership team, and with the new Congress to expand the reach of the many benefits of both 504 and 7(a) to more borrowers with different capital needs in new and leading edge industries that will be the job creators for the next fifty years.

Working together, we must become more creative and flexible in serving the needs of these new industries. We can't finance just hotels and C-stores and create the kinds of jobs that Americans will move into in record numbers to create new wealth. Working together, we must tear down the walls of arcane, irrelevant and restrictive regulations or policies that create unnecessary barriers to reaching the industries of the 21<sup>st</sup> century's economy.

Further, neither SBA nor our CDC industry should shy away from working with other lending industries or other federal credit agencies such as EDA, HUD, USDA or Treasury to create new financing tools that will maximize job growth and economic development for our nation. Instead, we should embrace the concept of change for our program in order to respond to new small business needs.

In the end, SBA should recognize the expertise and the broad financing knowledge of its lending partner industries. CDCs are not just loan packagers; they are versatile and skilled economic developers that have the well-being of their communities as their number one goal. SBA can leverage this industry's skills and contacts to expand its own programs and re-make itself into a more relevant agency whose impact can be so much more substantial and be felt by thousands of additional small businesses.

## **Conclusion:**

In its fifty-six years of existence, SBA has become the most efficient and certainly the most successful small business economic development agency in the Federal government. By leveraging its guarantee authority and lender industries, SBA has directly assisted in the creation of over five million jobs through more than \$200 billion in 504 first mortgages, 504 second mortgages and 7(a) bank loans. Many hundreds of thousands of small businesses have been assisted. Every State has seen the job growth and business success achieved by the capital brought to them by SBA programs. SBA has touched the lives of millions of business owners and employees in its short existence. Few agencies can claim this record of accomplishment and impact on our economy.

But like any maturing organization, SBA has to re-evaluate its product lines, and strive to serve the changing needs of America's small businesses. With fresh leadership bringing extensive market and financing knowledge to the agency, and with the twin pains of plummeting loan

volume and increasing loan defaults, we have the “fiery cauldron” of opportunity from which new and revolutionary programs can evolve tomorrow.

Failure to respond to the new needs of 21<sup>st</sup> century small businesses will make both the SBA and its programs less and less relevant in the next 56 years, and even in the next decade. Success in changing its programs and throwing off the burden of its increasing regulatory bureaucracy will keep it in the forefront of small business assistance. This will certainly lead to the creation of another five million new jobs at a time when solid, well-paying American jobs will be precious indeed for our economy.

NADCO urges the Congress, through the two Small Business Committees, to collaborate with the new SBA management and with far-sighted, market driven lenders to tear down those unneeded and overly restrictive regulatory walls and create the financing and economic development programs so vital to America’s future in a competitive new world.

“By working together we can help get America working.”

Thank you.