National Association of Development Companies

STATEMENT

by

The National Association of Development Companies

on

The Small Business Administration

504 Loan Guaranty Program

Improving Access to Capital

Submitted to the

SUBCOMMITTEE ON FINANCE & TAX

COMMITTEE ON SMALL BUSINESS

UNITED STATES

HOUSE OF REPRESENTATIVES

by

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The National Association of Development Companies (NADCO) is pleased to provide a statement to the House of Representatives Subcommittee on Finance & Tax concerning how 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 2007, 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 Bean, Ranking Member Heller , Chairwoman Velazquez, Ranking Member Chabot, and the entire Committee, for continued support of 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 question of maintaining access to long term capital by small businesses during an increasingly volatile period in our economy. We will also comment on issues within SBA that will impact that capital access in the coming years.

504 FY 2009 Authorization:

We expect to end FY 2008 with about $6.5 billion in authorized 504 loans. The Administration proposes an authorization ceiling of $7.5 billion for FY 2009, the same as the current FY 2008 ceiling. While 504 program demand by small businesses has grown at an annual historical rate of almost 15%, demand has flattened during 2008. This appears to be due to the credit environment and to many small business owners holding back on planned expansions until they gauge the impact of a looming recession on their businesses.

Through three recessions, 504 has been a counter-cyclical capital access program. Even at the depths of a major economic shift, such as we face today, 504 has continued to meet the financing needs of small firms that are the ones who bring us out of recessions by continuing to create new jobs. With America facing perhaps its greatest credit crisis in history, we are treading on unknown ground today. We cannot risk shortchanging businesses that need capital by allowing 504 to come even close to running out of loan authority for the next two years. NADCO believes that a ceiling of $7.5 billion would increase that risk of running out of authorization during FY 2009.

Fortunately, the 504 program has been at "zero subsidy" since 1997. This means that there is absolutely no cost to the taxpayer for the program's authorization level. It is fully paid for by user and lender fees. Given that there is no cost whatsoever for 504 loans, we urge the Committee to increase the loan authority for FY 2009 to ensure that small businesses are not turned away by SBA. We request a minimum of $8.5 billion in loan authority, which is $1 billion more than the Administration's proposal.

Commercial banks are the primary source of long term capital for businesses in today's economy. History demonstrates that as banks become more wary of possible loan defaults in tough times, they react in two ways. First, they "shrink the credit box", and demand higher down payments, shorter terms, and apply higher interest rates to compensate for likely loan losses. Second, they turn to "credit enhancement" vehicles to decrease their risk of loss in the event of a loan default. This is where 504 comes in. Historically, during recessionary periods or periods of very slow economic growth, banks will bring more of their small business loan requests to CDCs and the 504 program as a means of decreasing their "loan to value" ratio by sharing the project debt risk with the SBA-guaranteed second mortgage.

This response in tough economic times is exactly why the program exists: to provide long term financing with reasonable terms to small businesses that continue to thrive and create jobs. Those jobs are what pulls our economy out of recessions, and 504 is a primary financing provider when other lenders have pulled back from the small business market.

NADCO believes that the 504 program may be needed over the next several years even more than in recent years as our economy slows. We urge the Committee to meet this potential need by increasing the authorization ceiling to $8.5 billion for 504 for FY 2009.

504 FY 2009 Subsidy & Fees:

As small businesses fall on hard times and income shrinks, SBA has taken an interesting approach to its calculation of the "subsidy" of 504 for FY 2009. With an outstanding loss rate of less than 3% historically, SBA has again slightly decreased the fees a borrower must pay for his 504 loan guaranty. NADCO appreciates SBA's conclusion that the program will likely maintain this track record.

However, SBA also decided to NOT decrease the program fees enough to simply fund its cost. Instead, the President's budget proposes to establish a "negative subsidy"; that is, knowingly charge borrowers MORE than is needed to fund 504 loan losses. Thus, the administration is proposing to impose a new tax on small business. While they expect this to be only about $1.4 million in excess fees, NADCO is appalled that SBA would seek more money than needed. We believe this action by SBA may even violate federal law.

SBA stated that they could not decrease the other existing fees due to statutory restrictions but in fact the agency could have done so by proposing a very small change in either the current fixed CDC fee or the first mortgage fee that the lenders pay. SBA refused to do so. We ask this Committee to seek passage of legislation to require a reduction of those fees in order to return this excessive cost to our borrowers. Such legislation would require the Administration to recalculate the 504 program subsidy and eliminate the negative subsidy prior to the beginning of FY 2009. The result would be lower costs for our borrowers.

504 Lender Oversight:

SBA recently issued a proposed regulation to define how it would implement and new lender risk management system and use it to enforce its policies on banks, SBLCs, and CDCs. Last week, NADCO submitted comments to SBA questioning the accuracy and applicability of this database and its procedures.

No one wants close oversight of the 504 loan process and CDCs more than the CDC industry itself. Operating at zero subsidy for many years, the cost of 504 to the government is zero, and the cost to our borrowers is incredibly low. We must all work continuously to keep these costs low through proper loan structuring, underwriting, servicing, and even liquidations of defaulted loans. All these processes must be overseen by qualified auditors who understand lending and credit from A to Z. We believe SBA has made substantial progress in creating an audit and review process that may one day rival the quality of oversight by FDIC.

However, this process of creating a completely new oversight unit has one potentially fatal flaw: its reliance on an unproven database that attempts to identify potential defaulting borrowers years before they actually default. This is tantamount to predicting the weather in Washington two years out!

There is no place in this critical oversight process for a system that attempts to “forecast” loan defaults if it is still unproven to the public. As any bank and borrower knows, this database has almost no real financial data in it; it consists mostly of vendor payment and tax data, and is used by almost no private lenders to assess business credit quality. Even SBA’s own contractors, Dunn & Bradstreet and Fair Issacs, have admitted in public meetings and the press that their databases are not accurate when dealing with large loans or with pools of loans. Yet, because SBA has already spent untold millions for this system, it is seeking a new contract even as Congress, our industry and the banking industry question its viability.

NADCO urges Congress to step in and stop this contracting process. You should demand that SBA obtain unbiased outside verification by firms with both credit underwriting and financial modeling expertise of this risk management system. SBA must provide complete and transparent information to the public on its processes and accuracy. Two entire lending industries – CDCs and banks – should not be risk rated and regulated by a system that none of us believe to be accurate or transparent.

<u>504 Loan Liquidation & Recovery Efforts:</u>

As with any loan program, there are defaults by borrowers, and 504 is no exception. 504 will make over 10,500 loans this year. Even with good underwriting and close loan servicing, we would expect to see defaults by about 400 borrowers for our $30 billion portfolio. This would be a very good default rate of only 4%, and after liquidation of collateral, we would see a net loss of only about 2% for these loans.

However, as in previous recessions, we expect to see increasing defaults. Information from SBA indicates that defaults are up over the past three months, and are expected to rise further as delinquencies increase in the 504 portfolio.

Four years ago, SBA sought to begin cutting its operating budget, and laid off virtually all of its field staff responsible for recovery of 504 defaulted loans. Since that time, there has been no dedicated SBA staff working defaulted loans. Until SBA recently moved fewer than ten staff into liquidation jobs at the two servicing centers, it was truly “catch as catch can” for 504 defaults.

SBA continues to focus virtually all of its liquidation efforts on the 7(a) program, with an average loan of under $175,000, while ignoring 504, with an average loan size of almost $600,000. Further, almost all of the 504 loans are secured by “hard assets”, ie, land and buildings, so the likelihood of a significant recovery for a 504 default would be high if a default is addressed quickly. Instead, SBA has paid lip service to the 504 default situation. Even when the Administrator approved additional positions for the liquidation centers, these jobs for the most part were never filled.

Amazingly, SBA appears to have turned an already difficult situation into a potential disaster for 504. The Congress passed, and SBA was supposed to implement, a program whereby CDCs could staff up or retain outside contractors to handle all 504 liquidation work in place of all those laid off SBA staffers. CDCs were to be compensated through the almost certain increase in net recoveries, as was demonstrated during a five-year liquidation pilot wherein the recovery rate increased by as much as 10% over the current rate for 504.

Unfortunately, it appears that someone forgot to tell SBA’s budget planners that they needed to adjust the subsidy formula to account for the costs of reimbursing CDCs and contractors, as required by Congress and their own regulations! Working hard on existing recoveries, CDCs have completed a number of cases and returned to SBA collected funds for a number of defaults. As required by SBA regulation, these CDCs have submitted invoices for costs of contractors and internal staff work. To date, none of these invoices have been paid by SBA. When questioned, it was indicated there is a “policy problem” with these reimbursements. It appears the real problem is that SBA simply forgot to figure these cost reimbursements into BOTH their 2008 and 2009 budgets.

What's the result of this situation? CDCs will simply not be able to afford to continue working on loan defaults in the future—work will cease, the program's subsidy rate will increase, and future borrowers will pay for SBA's failure to account for needed fees. Nobody will track down defaulting borrowers and recover assets for the government on either existing loans (approximately 500) or on future defaults (approximately 35 per month).

So SBA appears to have ignored both Congress and its own new liquidation regulations. The end result will be plummeting recoveries and increasing future fees on 504 loans. With little or no recovery work by SBA, the expected net recovery rate of about 43% will fall rapidly, and government losses may well skyrocket both this year and for FY 2009.

NADCO asks this Committee to intervene in this situation immediately. There are only two options. First, SBA could be directed to either immediately hire, or to re-deploy trained staff to handle liquidations around the country. This would be tantamount to re-staffing some of those portfolio management positions they cut four years ago from the field offices. Alternatively, the Administration, Congress, and the CDC industry can work together to pass legislation to enable SBA to recalculate its subsidy model to include an allocation of some of the proceeds of loan recoveries to pay for the CDC and contractor labor needed to do this work.

No one, not the Congress, the Administration, or the CDC industry, wants to see fees increase due to increasing loan losses for 504. We believe SBA management wants to deal with this situation, but is hamstrung by the Federal budget process. The only way to break through this impasse is to pass legislation requiring SBA to recalculate its subsidy cost and fees. NADCO urges Congress to act now to deal with this situation. The almost certain alternative will be decreasing recoveries from defaults and rapidly increasing 504 program losses.

Conclusion:

Through 504, SBA provides the largest and most successful community and economic development program the Federal government has today. A study recently completed by California State University has concluded that, for every $1 of 504's program costs, it returns $94 in increased business revenues, and federal, state, and local taxes. Through the jobs our borrowers create and the business growth it fosters, 504 benefits employees, business owners, communities, and government at all levels. This takes place with no cost for the loan program to the U. S. taxpayer.

However, with a recession becoming more likely, it is imperative that Congress enable the CDC industry to meet the increasing needs for long term financing with low down payments for America's small businesses. To do this, we must work to keep our fees low. We must address the potential cost increases due to ineffective program oversight and lack of sufficient effort on recovery of defaulted loans. NADCO urges the Committee to address these problems through legislative direction to SBA immediately.

Again, we thank the Committee for its support of 504 and we look forward to another successful year of creating more jobs for our country.