Financing Real Estate for Mid-Atlantic Businesses

Review of SBA's 504/CDC Loan Program

Testimony before the
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Committee on Small Business
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Chairwoman Chu, Ranking Member Spano, and other distinguished members of the Committee, good morning. Thank you for inviting me here today to provide my testimony regarding the SBA 504 Loan Program and the work that my colleagues and I do every day pursuing of our mission to provide entrepreneurs and small businesses with access to affordable, responsibly unwritten capital that in turn promotes local economic development through job creation.

My name is Wayne Williams, and I am here on behalf of Business Finance Group, a non-profit certified development company headquartered in Fairfax, Virginia with offices in Maryland, West Virginia, and Washington, DC. I have been involved in the SBA 504 Loan Program since 1989. I began my career in commercial banking in 1987 and was initially a bank partner in the 504 program. I joined Business Finance Group in 1997, transitioning to the CDC side of the 504 loan program. I currently serve as Senior Vice President and Senior Lending Officer. Throughout my 32-year career, I have been active in management, marketing, loan structuring, and credit underwriting. As you heard from my bio, I also currently serve on the board of directors of the National Association of Development Companies (NADCO), the 504 industry's national trade association, where I am on the Executive Committee and was the immediate past Vice Chair of Regulatory Affairs. I am also a national instructor for NADCO specializing in the statutes, regulations, and standard operating procedures that govern the SBA 504 Loan Program.

Background on Business Finance Group Inc.

Business Finance Group (BFG) was originally organized in 1982 as a joint effort of the Fairfax County Economic Development Authority and the Fairfax Chamber of Commerce with a mission to provide creative financing solutions to help small businesses succeed and strengthen local communities by promoting economic development through job creation. Since 1982, BFG has grown from our initial single county to become a multi-state CDC with a professional staff of 26 employees assisting small businesses in Virginia, Maryland, West Virginia, and Washington, DC. Likewise, our board of directors has grown to a large, diverse group that reflects our trade area.

While our headquarters remains in Fairfax, Virginia, we now have strategically located regional offices in the Richmond, Virginia metro area; Norfolk, Virginia; the Baltimore, Maryland metro area; Washington, DC; and Hedgesville, West

Virginia, all staffed with local employees. As a mission-based lender, it is important that we reflect our local communities to not only better serve our small business clients, lending partners, and referral networks but to also ensure local presence, outreach, and connection to all areas where we are authorized to make loans, especially rural and underserved markets.

BFG has also expanded our product offerings over the years to better serve our mission and our small business clients. While the 504 loan program continues to be our primary financing tool, BFG also participates in SBA's Intermediary Lending Pilot (ILP) Program (since 2011) and SBA's Community Advantage (CA) Pilot Loan Program (since 2013). Both programs principally provide small loans for working capital and equipment for businesses that are not readily available from traditional lending sources but are essential for small businesses to grow and create jobs. These complimentary loan programs provide affordable capital to our small business clients to help responsibly bridge their credit needs until they become bankable for the next level of growth. As an aside, I strongly urge the committee to support making the Community Advantage Loan Pilot a permanent program. These loans, earmarked for very small businesses, are crucial to helping the most underserved markets. By making this program permanent, these small and start-up businesses can continue to access critical, reasonably priced capital paired with critical technical assistance to better assure long term success.

Business Finance Group's Economic Development Success Record

I'd like to share a little of our CDC's success record in meeting our mission of promoting economic development. We believe that the best measure of success combines loan activity generated on behalf of our small business borrowers with the economic impact of that activity on the community.

Business Finance Group is the #1 CDC in the Mid-Atlantic and a top 20 CDC in the nation (out of over 200 CDCs). The company has consistently been the top producing CDC for SBA's Washington, Richmond, and Baltimore District Offices earning honors from SBA at the state and regional level.

In Fiscal Year Ending September 30, 2019, Business Finance Group authorized 102 SBA 504 loans for $83 million supporting total capital investment of $219 million and that in turn is estimated to result in total jobs created/retained of 1,418 in our local communities. Since 1982, BFG has assisted 3,116 small businesses with

$1.8 billion in SBA 504 Loans supporting total capital investment of $4.8 billion and total jobs created/retained of 41,170.

These results reflect the vision set by our Board of Directors, the leadership of our management team, the dedication and hard work of all our professional staff, and the tenacious optimism and strength of our small business borrowers who open their doors daily in local communities stretching from the rural farmlands of Virginia and West Virginia to the urban centers of Baltimore and Washington, DC. I have seen up close how 504 lending can bring jobs to rural communities and be a catalyst for transforming once neglected urban cores.

The ability and obligation to measure economic impact differentiates SBA 504 lending from other SBA loan programs and from conventional loan programs. It's what makes 504 work – the 504 Loan Program promotes small business, stimulates economic development, creates and saves jobs…. **all while operating at zero subsidy**. As an industry, CDCs are extremely proud of that fact, but we are fully aware of our resulting obligation to assure that the 504 Loan Program remains on firm footing with prudent underwriting and responsible portfolio management.

To further differentiate us from other SBA Loan Programs and conventional lenders, CDCs are non-profit, mission-based lenders connected to their communities both physically and financially. We use our excess capital to support economic development in every state in which we are authorized to conduct business. Beyond SBA 504, many of my CDC industry colleagues run a variety of other programs to assist small businesses, including – lending programs like SBA ILP, Community Advantage, Microloans, USDA IRP loans, state and local loan programs, small direct loan programs; business incubators and accelerators; grant writing services and grant funding; and counseling services in partnership with Small Business Development Centers and SCORE chapters.

Background Information on SBA 504 Loan Program

I'd like to take a few moments to provide just a little background on the 504 Loan Program. SBA developed the 504 Loan Program (also referred to as the CDC/504 Loan Program) to promote economic development in local communities by encouraging healthy businesses to expand and create jobs.

The program provides long-term, fixed-rate financing for the purchase of fixed assets – typically land, buildings, machinery and equipment. Refinancing existing debt is now allowed and can also include a limited amount of cash out for certain eligible business operating expenses. To be eligible a business must meet all regular SBA business eligibility requirements and size standards, and the project must meet an economic development goal specific to the 504 Loan Program – typically the project must create or retain one job for every $75,000 in SBA financing; projects for manufacturers are adjusted to one job for every $120,000 in SBA financing. If the project will not qualify based on jobs impact, there are 14 public policy and community development goals that can be used to qualify the project under certain conditions. These are outlined at 13CFR§120.862 and include items such as assisting businesses owned and controlled by women, veteran, or minorities or assisting businesses in rural areas or in enterprise zones, opportunity zones, labor surplus areas.

The costs in a 504 project are typically split with a Third Party Lender (a participating bank, non-bank, or credit union) funding 50% and receiving a 1st lien on the project assets, the CDC/SBA 504 Loan funding up to 40% of the costs and receiving a 2nd lien, while the borrower/applicant injects an equity contribution of as little as 10%. The 504 Loan is funded from a 100% SBA-guaranteed debenture sold on Wall Street. The 504 Loan is not financed using funds from the government. The CDC works with the applicant small business borrower to get the SBA 504 Loan approved, closed, and funded, and then the CDC provides loan servicing to the small business for the life of the 504 Loan. Let me share with you how some stories of how our small business borrowers have successfully used the SBA 504 Loan Program.

Success Story – Greater Unity Adult Services, LLC – Richmond, Virginia
Business Finance Group has had the pleasure of working with Eugene Thomas, Jr. and Greater Unity Adult Services in Richmond, Virginia on multiple occasions. Greater Unity provides training, treatment, and support for adults with disabilities. The company provides skills training in the environments where the individuals will live and work. Individuals with intellectual disabilities, mental illness, or physical challenges utilize the company's Day Support Program facility to develop soft skills and become more independent in a structured classroom setting. The company provides long-term and temporary care for individuals with intellectual disabilities in a variety of assisted living residential care homes. And

the company is now offering employment services (recruitment and job screening and job training) ultimately placing individuals with disabilities in competitive employment integrated with non-disabled individuals.

Greater Unity is the quintessential SBA 504 story – a growing small business needing to preserve capital to grow and expand. Greater Unity has used the SBA 504 Loan Program to finance six of its facilities, and it has used the SBA ILP Loan Program three times for short term working capital needs. When Business Finance Group first started working with Eugene in 2012, he had two locations and 10 employees. Today, the company has 8 locations and 60 employees.

Other Success Stories

There are many 504 success stories. Local names that you might recognize – Schneider's Liquors of Capitol Hill, Bourbon, Dolcezza, Nellie's Sports Bar, Old Town Trolley Tours, Pizzeria Paradiso, Pacers, Ambar Capitol Hill, Bus Boys and Poets, Black Cat, and Silver Diner. Others are national successes such as Chobani Yogurt, Fat Boy Ice Cream, and the local Sunrise Senior Living and Port City Brewing Company that at one time could not find financing outside SBA 504, but because of the program, they are all now household names.

Recommended Changes to the Program

I applaud the Committee's efforts to modernize SBA and keep it relevant to America's entrepreneurs and small businesses. While the SBA 504 Loan Program is a valuable tool for economic development and job creation, small businesses who want to use the program face unnecessary challenges, and there is room for improvement with a goal to increase speed, transparency, and certainty for all stakeholders involved – the small business applicants, the CDCs processing the 504 Loans, and the Third Party Lenders partnering in the SBA 504 projects. The challenges and suggestions outlined below are focused on reducing overly burdensome and cumbersome regulation and modernizing the loan delivery system. All will improve program reputation, integrity, and usefulness to America's small businesses while appropriately managing risk exposure to SBA and the American taxpayer.

1. **Reduction in Owner Occupancy Requirement –** Occupancy standards are a problem that prevent or limit the ability of small businesses to use the SBA 504 Loan Program particularly in more densely populated suburban

communities and urban cores with multi-story buildings and limited real estate inventory. Current statute requires a 504 borrower who purchases an existing building to occupy 51% of that building (not 50.9%, it must be 51% or more). In many suburban and urban areas, it is common to have 2-story buildings where the first floor may have commercial zoning, but the second floor is residential zoning. If the floors are of equal size, the commercial occupancy is 50%, and the project is not eligible for SBA 504. Even if the property is a live-work unit and the owner lives in the residential space, the project is still not eligible for SBA 504, as SBA only allows residential space to count toward the 51% owner occupancy requirement if the residential space is "essential" to the business – the business by its nature or my local jurisdiction code requires someone to be on sight at all times (i.e. a horse-boarding facility requires someone on premises at all times to care for the horses; many jurisdictions require resident managers for a bed and breakfast operation). And if the building is multi-story where the business only needs the first floor, the project is further removed from SBA 504 eligibility, as occupancy can drop to 20-30% This becomes an increasingly larger concern for our urban core small businesses in areas such as Washington, DC; Baltimore, MD; Richmond, VA; and inner suburbs like Alexandria and Arlington in Virginia; and Bethesda in Maryland – particularly areas where the commercial space is restricted to the ground floor and upper levels are typically residential rental units. These buildings are ineligible for SBA financing, and their mixed use nature prevents them from qualifying for more traditional credit programs, making it very difficult for business owners to get financing of any kind when seeking to acquire their space and control their occupancy and overhead costs.

Our CDC has not historically tracked the number of small businesses that we could have helped purchase properties in these situations, as these projects have never been eligible for SBA 504 financing. Anecdotally, we know that there is a large pool of potential buyers who could benefit from the SBA 504 Loan Program if the occupancy requirement was relaxed. Our urban core markets like Washington, DC and Baltimore, MD and their inner suburbs are home to thousands of successful small businesses. Relaxing the occupancy requirement to 20% or 30% will better reflect the reality of real estate in urban core and inner suburban communities and the nature of how business is conducted in these areas, and it will expand CDCs ability to support the credit needs of small businesses seeking long term capital to purchase these properties for their business use. We regularly see transactions that are 50%/50% evenly split 2-story buildings.

A relaxed occupancy requirement will create a couple of associated challenges that will need to be considered, as many of the issues here are intertwined. By their very nature, these properties will have more third party tenant rental space which will exacerbate the EPC-OC lease restriction concern (detailed below) which will need to be relaxed. Also, the SBA's credit standards require that the Small Business must support the debt service on the entire project without any contribution from third party rents. This will need to possibly be reevaluated considering a higher portion of the property will be dedicated to third party tenant space.

2. **Changes to Restrictions on EPC-OC –** Another policy unnecessarily harming small businesses is SBA's restrictions on the relationship between Eligible Passive Companies and Operating Companies, or EPCs and OCs. This business structure is common and provides benefits recommended by accountants and lawyers. However, EPC/OC relationships within the 504 program have their rent structures dictated by SBA, their lease structures dictated by SBA, and restrictions placed on other business activities outside of the 504 loan project. All of these are outside the norm of conventional commercial business practices and come at the detriment of the legal and tax advice these small businesses receive. A small business who structures their business this way should not be penalized by the SBA.

3. **Change to Small Business Ownership / Management Control percentage threshold to qualify for public policy goals for SBA 504 Loan Program from 51% to 50%** – This change will expand access to capital by allowing more small businesses to qualify for the 504 Loan Program under certain public policy goals when their project does not meet 504's job creation/retention goals, provided the CDC's loan portfolio meets its job opportunity average. Expanding access to capital to more economically and socially disadvantaged small businesses increases economic vitality, community development, and job creation throughout the country. Like Congress and SBA, Business Finance Group has a commitment to offering financing programs that promote the vitality and expansion of economically and

socially disadvantaged entrepreneur businesses, including women, minorities, and veterans. However, SBA's current minimum 51% ownership and management control benchmark may not always accurately capture the changing complexity of America's small businesses.

For example – a small business is owned 50% equally by two partners who are both active in all daily management; one is a Black female, while the other is a White/Caucasian male who happens to also be a veteran of the US Navy. The small business is 50% woman-owned, 50% minority-owned, and 50% veteran-owned, yet it does not meet any existing public policy goals for an SBA 504 Loan. Assuming the business does not meet the job creation requirement or any other policy goals, this business is not eligible for an SBA 504 loan. Surely this is a business we want to encourage lending for, not shut out based on a 1% difference in ownership.

4. **Streamline Closing Process –** My colleagues on the panel will be providing more detailed information on this recommendation, so I will keep my comments brief. In order to improve program delivery, speed loan closing and funding, and improve service quality to our small business borrowers, we recommend several improvements in the closing process –
    a. Delegate authority to ALP CDCs (high performing CDCs who pass certain established competency and performance requirements and benchmarks) to approve specific minor changes to the SBA approval, eliminating the need for SBA personnel to review non-substantive changes, creating greater efficiency and cost savings for SBA, and avoiding delays in the debenture funding process that could be costly to small business borrowers
    b. Streamline and Simplify the Legal Review Process by standardizing documentation as much as possible nationwide and removing all superfluous documents added by local SBA district counsel

5. **504 Debt Refinance –** Minor changes to the 504 debt refinance programs (with and without expansion) could increase the usefulness of the programs and allow more small businesses to benefit from the programs' below market, long-term fixed interest rate and unlocked trapped equity tied up in real estate to finance growth and expansion.

a. **504 Debt Refinance with Expansion –** this program was our original debt refinance program authorized in 2009 where Congress allowed small businesses to refinance a limited amount of pre-existing debt not to exceed 50% of the cost of any new expansion project. This has always been a restrictive limitation that was difficult for small businesses and lending partners to understand and reduced utilization of the program. While there is a cap of the amount of debt that can be refinanced into a new 504 project, the program still allows any excess debt refinance above the cap to be refinanced by the bank partner and simply added to their final loan amount in senior lien position. So, the artificial cap is confusing to explain and implement, it restricts SBA's participation in a project, and it diminishes SBA collateral position relative to the senior lender. I would recommend a minor tweak in the program to allow the existing debt to be refinanced provided it does not exceed 100% of the costs of the new expansion project. This will significantly improve the usefulness of the program to small business applicants.

b. **504 Debt Refinance without Expansion –** Our CDC gets multiple calls every week from referral sources and potential borrowers who would like to use this program, but current restrictions prevent the program from helping as many small businesses as it could. To unlock the program's potential and assist small businesses get access to long-term, below market, fixed rate financing –

    i. Allow SBA 504 to refinance any government guaranteed debt

    ii. Reinstate the alternative job retention goal to assist more small businesses qualify and for and reap the benefits of the program

    iii. Remove all restrictions on the number of refi loans that a CDC can provide; CDCs ultimately exist to serve small businesses, and providing appropriate lending options helps to fulfill that mission

6. **SOP Reform –** Many policies and procedures that govern the 504 Loan Program are part of SBA's Standard Operating Procedures (SOP). This document, over 400 pages, is updated and re-released almost every year. It contains almost every detail necessary to get a 504 loan to a small business. However, it does not go through the regulatory notice and comment

process, which means small businesses and CDCs like those at this table do not have a chance to share their perspective on these policies and the problems that changes can unintentionally cause, despite being the ones who are affected by them. This leads to unnecessary confusion for small businesses, and a switch in the "rules of the road" sometimes without an explanation from the Agency. I think there could be a more collaborative way to issue these policies while ensuring small business voices are heard. Below are a few ideas to start that discussion –

- In the brainstorming/drafting phase of a new SOP, SBA discusses key concepts and issues under review for change (ideally with trade associations who speak for those using the loan programs)
- SBA releases the SOP with a 30 day comment period
- At the end of the 30 day comment period, SBA has 30 days to make revisions and publish the final SOP
- The SOP implementation date is no less than 30 days from final publication
- Implement a requirement on how frequently SBA must update SOP so the opportunity for small business feedback and modernization of program policies occurs regularly

7. **Personal Resources/Credit Elsewhere –** SBA has recently reinstituted a policy that means borrowers can be forced to take funds from personal liquidity held for children's educational or family health savings and invest in a 504 project. Currently, SBA personnel are inconsistent and unpredictable in implementing this issue which can lead to loan screen outs and declines. This impacts the consistent delivery of the 504 Loan Program and the injures program's reputation contributing to uncertainty with small business borrowers and third party lending partners. While there has been some improvement from time to time with SBA, there is no predictability to SBA's concern over the issue.

   From April 2014 to December 2017, SBA had a great policy on this issued through a "Final Rule" that eliminated the Personal Resources Test and made clear that in respect to funds otherwise available to support the project, only non-federal financing would be examined, not personal resources. It meant there were healthy borrowers who also of course contributed to the 504 Loan. SBA had no problems with any loans as far as we know. We would like to return to that policy. However, SBA is now suggesting in a proposed rule (the “Express Rule”), that it wishes to reinstate a personal resources test to be applied to the 504 Loan Program that the agency specifically eliminated in 2014 and promised not to reinstate.

Reinstituting this requirement would harm small business owners. The proposed regulation does not adjust for personal circumstances that require liquidity, such as cost of living (which varies significantly throughout the country), childcare, health care, and education needs (such as college tuition for children). The regulation also does not adjust for the variety of business needs, such as business development and training, other business opportunities that may arise, market changes, or increased competition, all of which require liquidity. As a result, the small business that must abide by this will lack the necessary capital required for growth, job creation, and continued economic development within its community and beyond. Finally, the proposed regulation disincentivizes prudent business practices and penalizes small business owners who are economically prudent and are reserving funds for future market changes, expansion, and growth.

Reinstituting a requirement that SBA eliminated just 5 years ago promising in writing to never bring back, demonstrates SBA’s inconsistency in delivering its loan programs and damages the 504 Loan Program’s reputation with small businesses and third party lending partners. Also, in reinstating a personal resources test to 504 loan program, SBA appears to be extending to 504 a policy that specifically applies to one of its other loan programs and is not applicable to 504, a habit of theirs and one we have never supported. The 504 Loan Program is all about economic development and job creation.

Having the committee explicitly remind SBA through statutory language if needed, that in respect to funds otherwise available to support the project, only non-federal financing would be examined, not personal resources.

8. **504 Express Loan Program –** Modernization also means looking at ways to speed up low dollar, low risk loans to small business owners, to help keep them from predatory online lenders. These lenders charge exorbitant

amounts, but small businesses sometimes are trapped into accepting their help because no timely alternative exists.

9. **Community Advantage –** Although not a part of SBA 504, I wanted to add a few suggestions here for improvements to the SBA Community Advantage Loan Program to make the program more useful to small business applicants –
    a. Make CA permanent loan program to improve consistency and reliability for small businesses and bank lenders
    b. Add women and minorities to "underserved" communities to expand small businesses that can be served

Beyond statutory changes, SBA controls the 504 Loan Program and its usefulness to small business through its regulations, policies, and procedures. We all strive to be prudent, responsible lenders in assisting our small business clients. All lending involves risk. Our job is to properly assess, manage, and mitigate risk. We cannot eliminate or avoid risk and remain in the lending business. In our opinion, SBA through its recent actions with policies and procedures, has been pursuing more risk avoidance than risk management. The result is a decrease in the usefulness and effectiveness of the agency's lending programs to small business and lending partners.

As we all strive to make SBA and its loan programs relevant to a dynamic, changing marketplace and business environment, I remain hopeful that we all share the same goal to better serve America's small businesses with responsive, relevant, and innovative lending solutions. Reducing burdensome regulation and streamlining and modernizing program delivery will help improve the SBA 504 Loan Program.

Thank you for the opportunity to submit testimony, and I am available to answer any questions or provide additional information.