NAFCU

Testimony of

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On behalf of

The National Association of Federally-Insured Credit Unions

"A Review of SBA's 504/CDC Loan Program"

Before the

House Small Business Subcommittee on Economic Growth, Tax, and Capital Access

June 29, 2017

Introduction

Good morning, Chairman Brat, Ranking Member Evans and members of the Subcommittee. My name is Natasha Merz, and I am testifying today on behalf of the National Association of Federally-Insured Credit Unions (NAFCU). Thank you for holding this important hearing today. I appreciate the opportunity to share with you my experience with the Small Business Administration's (SBA's) 504 Loan Program.

I currently serve as Vice President of Commercial Lending at Langley Federal Credit Union located in Newport News, VA. I joined Langley in June 2011, with over 16 years of experience in commercial and SBA lending with various lenders in New Jersey and Virginia. When I arrived at Langley, I helped create the infrastructure necessary to accommodate in-house commercial loan origination, underwriting, servicing and collection functions. Since then, Langley's member business loans (MBLs) have grown from $7 million to nearly $110 million. I actively pursue SBA Lending at Langley including SBA 7(a), Express and 504 loans. I was awarded a Financial Services Credit Union Champion of the Year award in 2014 and Langley was named a Top Credit Union in SBA Lending in 2014 and 2016 by the SBA Richmond District Office. I believe that the SBA's mission to promote small businesses closely resonates with any credit union's goal to support business members in their communities.

As you may know, NAFCU is the only national organization that exclusively represents the interests of the nation's federally-insured credit unions at the federal level. NAFCU is celebrating its 50th anniversary this year. NAFCU member credit unions collectively account for approximately 70 percent of federally-insured credit union assets. NAFCU and the entire credit union community appreciate the opportunity to participate in this discussion regarding the 504/CDC loan program under the Small Business Administration.

Background on Credit Unions

Historically, credit unions have served a unique function in the delivery of necessary financial services to Americans. Established by an act of Congress in 1934, the federal credit union system was created, and has been recognized, as a way to promote thrift and to make financial services available to all Americans, many of whom would otherwise have limited access to such services. Congress established credit unions as an alternative to banks and to meet a precise public need—a niche credit unions continue to fill today for nearly 108 million Americans. Every credit union is a cooperative institution organized "for the purpose of promoting thrift among its members and creating a source of credit for provident or productive purposes." (12 § USC 1752(1)). While over 80 years have passed since the *Federal Credit Union Act* (FCUA) was signed into law, two fundamental principles regarding the operation of credit unions remain every bit as important today as in 1934:

- credit unions remain totally committed to providing their members with efficient, low-cost, personal financial service; and,
- credit unions continue to emphasize traditional cooperative values such as democracy and volunteerism. Credit unions are not banks.

The nation’s nearly 6,000 federally-insured credit unions serve a different purpose and have a fundamentally different structure than banks. Credit unions exist solely for the purpose of providing financial services to their members, while banks aim to make a profit for a limited number of shareholders. As owners of cooperative financial institutions united by a common bond, all credit union members have an equal say in the operation of their credit union—“one member, one vote”—regardless of the dollar amount they have on account. These singular rights extend all the way from making basic operating decisions to electing the board of directors—something unheard of among for-profit, stock-owned banks. Unlike their counterparts at banks and thrifts, federal credit union directors generally serve without remuneration—a fact epitomizing the true “volunteer spirit” permeating the credit union community.

Credit unions continue to play a very important role in the lives of millions of Americans from all walks of life. As consolidation of the commercial banking sector has progressed, with the resulting depersonalization in the delivery of financial services by banks, the emphasis in consumers’ minds has begun to shift not only to services provided, but also—more importantly—to quality and cost of those services. Credit unions are second-to-none in providing their members with quality personal financial services at the lowest possible cost.

Credit unions also play an important role in the on-going recovery from the financial crisis. As widely recognized by elected officials in Washington, credit unions did not cause the financial crisis. Because they did not engage in the same risky practices as big banks, credit unions fared well during the crisis and, as a result, had the capital available to lend. Surveys of NAFCU-member credit unions have shown that many credit unions saw increased demand for mortgage loans and auto loans as other lenders were leaving the market. A number of small businesses who lost important lines of credit from other lenders turned to credit unions for the capital that they needed.

Our nation's small businesses represent 99.7 percent of all employer firms, employ nearly half of all private sector employees, pay more than 40 percent of total U.S. private-sector payroll, and have generated over 60 percent of net new jobs annually over the last decade. It is inarguable that the strength of the economy directly correlates to the health and well-being of America's small businesses. Many small business owners are members of credit unions around the country and rely on their services to help make their small businesses successful. Our nation's credit unions stand ready to help and, unlike some other institutions, have the assets to do so. Unfortunately, an antiquated and arbitrary member business lending cap prevents credit unions from doing more for America's small business community.

Artificial Member Business Lending Cap at Credit Unions Hurts Small Business

When Congress passed the *Credit Union Membership Access Act* (CUMAA) (P.L.105-219) in 1998, it put in place restrictions on the ability of credit unions to offer member business loans. Credit unions had existed for nearly 90 years without these restrictions. Congress codified the definition of a member business loan and limited a credit union's member business lending to the lesser of either 1.75 times the net worth of a well-capitalized credit union or 12.25 percent of total assets.

CUMAA also established, by definition, that business loans above $50,000 count toward the cap. This number was not indexed and has not been adjusted for inflation in the more than 18 years since enactment, eroding the *de minimis* level. Where many vehicle loans or small lines of credit may have been initially exempt from the cap in 1998, many of those that meet the needs of small businesses today are now included in the cap due to this erosion. To put this in perspective relative to inflation, what cost $50,000 in 1998 costs $74,500 today, using the most recent consumer price index data. That is close to a 50% rate of inflation change that is completely ignored by current law and greatly hamstrings a credit union's ability to meet its members' needs.

It should be noted that the government-guaranteed portions of SBA loans do not count toward the member business lending cap, but the non-guaranteed portions do. This could ultimately lead to a situation where a credit union may be an excellent, or even preferred, SBA lender and ultimately has to scale back participation in SBA programs as it approaches the arbitrary cap. This arbitrary cap can have its biggest impact on SBA 504 loans since the first mortgage issued by the credit union in a 504 loan is a regular commercial loan that counts toward the cap. Congress could aid credit union SBA 504 lending by enacting legislation to exempt SBA 504 loans from counting toward the credit union member business lending cap. Given the nature of the program, 504 loans should be treated differently than regular commercial loans when it comes to the credit union member business lending cap.

A 2011 study commissioned by the SBA's Office of Advocacy affirmed the important role of credit unions to small businesses. (James A. Wilcox, *The Increasing Importance of Credit Unions in Small Business Lending*, Small Business Research Summary, SBA Office of Advocacy, No. 387 (Sept. 2011)). The SBA study indicates that credit union business lending has increased in terms of the percentage of their assets both before and during the 2007-2010 financial crisis, while banks' lending decreased. This demonstrates not only the need for lifting the MBL cap in order to meet credit union members' demand, but also that credit unions continued to meet the capital needs of their business members even during the most difficult of times. One of the findings of the study was that bank business lending was largely unaffected by changes in credit unions' business lending. Additional analysis in the study also found that credit unions' business lending can actually help offset declines in bank business lending during a recession.

We would urge the Subcommittee to support legislation to remove or raise the arbitrary cap on credit union member business lending.

Small Business Administration's 504/CDC Loan Program

The Small Business Administration developed the Certified Development Company (CDC)/504 Loan Program to promote economic development and create and retain jobs. The program helps lenders provide small businesses with long-term financing to acquire and improve major fixed assets, such as owner-occupied commercial real estate and heavy machinery. The program helps businesses by giving them access to financing backed with as little as 10 percent owner equity.

Under the program, a financial institution partners with a CDC, a specialized SBA-certified nonprofit corporation, to finance small businesses looking to expand. Each partner makes a loan to a qualifying small business. Typically the lender's loan is secured by a first lien covering 50 percent of a project's cost. The CDC's loan is secured by a second lien for up to 40 percent of the project's cost. The CDC loan is also backed by a 100 percent SBA-guaranteed debenture.

The program helps financial institutions attract and serve small business borrowers that need financing for plant and major-equipment acquisition that may not meet conventional underwriting criteria. Participating with a CDC can help reduce risk for the lender.

Investors purchase interests in the debenture pools and receive certificates representing ownership of all or part of the pool. The SBA and CDCs use various agents to facilitate the sale and service of the certificates and the orderly flow of funds among the parties. After a 504/CDC loan is approved and disbursed, accounting for the loan is set up at the Central Servicing Agent, not the SBA. The SBA guarantees the timely payment of the debenture. If the small business is behind in its loan payments, the SBA pays the difference to the investor on every semiannual due date. In FY2016, the SBA approved 5,938 504/CDC loans amounting to roughly $4.74 billion.

504/CDC Lending at Langley Federal Credit Union

Langley currently has a total Commercial Loan Portfolio of nearly $110 million, of which $3.5 million is in various SBA programs: 504, 7(a) and Express. This represents a total of 114 commercial loans, of which 30 are SBA loans (over 26% of total loans). Without the SBA programs we would not have been able to service these members. When a small business comes to us at Langley, we work with them to place them in the right type of loan, whether a conventional loan or SBA product.

The SBA 504 program has helped us meet some specific needs for our small business members at Langley FCU. Some examples include:

- A member with a small information technology and telecommunications business was leasing an office space to use for their primary business operations. The initial lease term expired and the landlord was looking to raise the rent, which would have been a strain on the borrower’s cash flow. The 504 program helped this borrower, who did not qualify on conventional terms, to purchase a building to move their operations into and reduce leasing expenses.

- The landlord of a member with a granite and tile contracting business was looking to sell the property the member's business was operating out of and offered it to the borrower. The borrower did not have the required 20% cash down in order to qualify for conventional financing. However, he was the perfect fit for the SBA 504 program. Furthermore, owning the building and taking advantage of the 20-year fixed rate on the SBA portion has resulted in other income opportunities and improved cash flow for our member.

- A successful hotel manager and operator who needed to purchase an office space for his operations was declined by a conventional lender who was not lending to hotels or hotel operators. The borrower came to Langley asking for financing options. With the help of the 504 program, the borrower was able to purchase an office building and lock in a great rate for 20 years on the SBA portion.

There are many more stories like these of small business owners looking for that loan to enable them to start or grow their business. The demand is out there. Unfortunately, in this current environment, many banks have scaled back their smaller dollar business lending that credit unions are readily able and willing to fill. At Langley, we are pleased that we have been able to help step up to meet this demand.

Benefits of the 504/CDC Program

Benefits of the SBA's 504/CDC program include:

1. Low fixed interest rates for 20 years on commercial real estate and 10 years on equipment for the SBA portion;
2. Down payments as low as 10%, thereby making 504 loans more affordable to borrowers;
3. New businesses are eligible for the program, even when they may not be eligible for conventional financing;
4. There is a simultaneous closing with the CDC which makes the process easy for all parties; and,
5. The right CDC partner can make the application and approval process seamless for the borrower as they can bring their expertise to assist with the loan.

The SBA 504 program also has features that can make it attractive for lenders. These include:

1. Determining SBA eligibility is the responsibility of the CDC. This makes it easier on the lender and a great program for those lenders that are looking to get into SBA lending and may not have in-house SBA expertise;
2. Since a lender does not need to have staff with specialized SBA expertise, they can save on the cost of hiring an SBA expert;

3. There is no need for monthly Colson reporting and SBA approved loan accounting processes – the lender treats the first mortgage (their portion of the 504) as a regular commercial loan;
4. There is a low loan-to-value (LTV) on the lender's loan after debenture funding;
5. Lenders can participate out the first mortgage (their portion of the 504) thus increasing their interest rate yield;
6. The new 504 refinancing option allows for existing debt refinance, financing of fixed assets and working capital;
7. The 504 loan can be assumed by the buyer if the borrower decides to sell; and,
8. In the event of liquidation – lender has the benefit of the low LTV and can follow their own processes and has no risk of SBA guaranty denial/repair.

Challenges and Recommendations

While there are a number of benefits of the 504/CDC program for lenders and borrowers, the program does present some challenges and have areas where we think it can be improved.

Challenges for lenders and borrowers include:

1. Partnering with the right CDC is critical for the lender. A poor lender-CDC relationship can make the process slow and inefficient for the borrower and the lender – not all CDCs are consistent in their processes;
2. The 10-year prepayment penalty for the borrower is not attractive and harder to sell for a lender – a 5- or 7-year prepayment penalty would be a better option;
3. Construction loans in the 504 program will not close with the SBA until construction is completed and the borrower has moved in to the new facility. Construction monitoring

is the lender's responsibility. This means that the lender needs to have a sophisticated and rigorous construction monitoring ability in order to have the project completed per the SBA authorization. Lack of expertise and resources, especially with lenders new to commercial lending, may compromise the project or halt the process. We have heard stories of lenders who have been hampered by this – they approved a loan for a new auto body shop, but the existing shop had to close during construction and revenues plummeted, leading to a deteriorated financial situation, which led the CDC to decide on its own to back out citing a "material adverse change" to the project. It would be helpful for the CDCs to assist with the construction monitoring process;

4. Some borrowers prefer not to have to make two payments on one property. This could be amended if lenders would be allowed to collect payments and remit to the CDC on a monthly basis;
5. Other borrowers hesitate about additional legal expenses and closing costs that arise out of the need to have two closings; and
6. Some lenders may not know how to market an SBA loan to the borrower – better SBA or CDC outreach and support or networking opportunities for loan officers would be helpful in marketing SBA loans to borrowers.

With a 504 loan, the lender does not have a guarantee in place from closing – the CDC holds the guarantee. If a lender uses the 7(a) program, they hold the guarantee immediately on day one of the loan. On a 504 loan, the SBA issues an Authorization for Debenture which lists the financial institution to be paid off once the debenture funds. The SBA guaranty is issued to the CDC. The financial institution gets the promise that their lien will be paid off as long as there has not been a material adverse change to the borrower's finances. With a 7(a) loan, the lenders are issued the SBA guaranty directly. If a problem arises, the lender has the control to manage its own credit and still maintain the SBA guaranty.

The 504 program has restrictions that do not allow lenders to use their underwriting standards. Some 504 loans will benefit the member if the financial institution has stricter underwriting standards, while some will not if a lender is comfortable with the credit criteria of the borrower but the 504 program or CDC is not. Giving financial institutions some greater flexibility in this area is something that should be considered.

With a 504 loan, the borrower pays a penalty if they pay it off within 10 years. A 7(a) loan secured with commercial real estate has an imposed 3-year pre-payment penalty, while a 504 loan for commercial real estate has a 10-year pre-payment penalty on the CDC's second lien. The CDC's pre-payment penalty descends 1% every year. As noted above, dropping this window to 5- or 7-years could help the borrower.

There should also be some greater flexibility for use of 504 funding for certain types of businesses. For example, if a lender issues a 504 loan for a hotel, the proceeds can be used for bedding, equipment, etc. However, if the loan is made to a borrower with a restaurant, they cannot use the funds for smaller furniture, fixtures and equipment such as chairs, small equipment, working capital, etc. Greater flexibility for use of funds in this situation would be helpful.

The SBA is an Important Partner for Credit Unions

I am pleased that NAFCU signed a memorandum of understanding (MOU) with SBA in February 2015. The MOU formalized a joint-partnership that aims to increase the availability of small dollar loans by providing more outlets for entrepreneurs to access SBA products in their neighborhoods. The partnership also helps small business owners get capital for investments into their new or existing business they may have otherwise put on a high-interest credit card or a personal credit line. And finally, it makes the small dollar loans more accessible to underserved communities, including women and minorities.

Conclusion

Small businesses are the driving force of our economy and the key to its success. The ability for them to borrow and have improved access to capital is vital for the job creation that will lift our nation out of the economic malaise in which we find ourselves today. While the Small Business Administration's 504/CDC program provides much needed opportunities to established and fledgling businesses, there are several relatively simple steps that could propel the program to its full potential. We are confident this Subcommittee will do what is necessary to ensure that these programs are successful, while ensuring eligibility requirements and other qualifying criteria are not overly burdensome on the financial institutions that participate in them. We would urge Congress to ensure credit unions can meet the needs of their small business members.

We thank you for your time and the opportunity to testify before you here today on this important issue to credit unions and our nation's economy. I would welcome any questions that you may have.