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A Jump Start for Stalled Small Business Lenders

A program to revive the secondary market for Small Business Administration 504 loans could unlock credit for companies trying to expand

By John Tozzi
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In recent months President Obama has pressured banks to increase lending to small businesses in order to spur job growth. Now, a long-awaited program approved in the stimulus package last February is set to begin that could help make that happen by reassuring wary bankers with a new approach.

For the first time, the Small Business Administration will guarantee up to $3 billion in pools of banks' 504 loans sold into the secondary market. That way, if borrowers fail to pay, investors who bought the loans would be made whole by the government. The SBA expects the program to start soon but doesn't have a firm date, according to spokeswoman Hayley Matz. 504 loans give small businesses favorable financing to invest in fixed assets like property or machinery.

Commercial lenders have not been able to sell their portions of 504 loans since investors lost their appetite for asset-backed securities in the financial crisis, prompting many lenders to drop out of the 504 loan program. "In essence that market has not returned," says Kurt Chilcott, CEO of San Diego-based CDC Small Business Finance, a nonprofit that partners with commercial lenders to make 504 loans. "We've gone from at least half a dozen active players who were willing to purchase those loans to maybe half a player," he says. Because banks can't resell their loans, Chilcott estimates that 40% of the banks his firm used to work with have stopped making 504 loans.

Collateral Limits

Nationwide, 257 lenders that made 504 loans in the 12 months before Sept. 30, 2008, dropped out of the program the following year, a decline of 13%, according to the SBA. Loan volume dropped 28%, from $5.4 billion to $3.9 billion, in the same period. "If the bank wants to make these loans, they have to hold them on the books," says Bob Coleman, publisher of the *Coleman Report* newsletter on SBA lending.

That's a problem because regulators want banks to limit their exposure to the troubled commercial property market. "Most of your small business loans will be secured by some sort of commercial real estate. The regulators are asking us to reduce our concentrations in that," says Cynthia Blankenship, vice-chairman of Bank of the West, a community bank in Grapevine, Tex.

While the Small Business Administration guaranteed loans are a small piece of total credit to small businesses, they are growing more important as fewer companies hammered by the economy qualify for conventional loans. The SBA's 504 loans in particular fund expansion projects that are directly tied to jobs: Companies must demonstrate that one job will be created or retained for each $65,000 the SBA guarantees.

Borrowers in the 504 program pay 10% of a project's cost. The rest of the financing is split between two lenders: 40% from a nonprofit known as a Certified Development Company and 50% from a commercial lender. The government guarantees the CDC's portion, but private lenders have no such guarantee. Their loans are secured by the first claim on the property if a borrower fails to pay. The new program means SBA will guarantee 80% of commercial lenders' stake in 504 loans, which would let them pool the loans into securities and sell them to investors.

Risk on Principal

Even that 80% guarantee may not be enough to lure lenders back. The SBA will require banks to keep 15% of the loans on their books and pool assemblers—the companies that buy loans and package them into securities—to assume 5% of the risk. "They're not used to taking principal risk," warns Chris Crawford, president of the McLean (Va.)-based National Association of Development Companies, the trade association for CDCs that partner with banks in 504 lending.

If lenders and pool assemblers aren't willing to hold on to those unguaranteed pieces of loans, the program "could fall flat on its nose," he says.

Last year's stimulus package bolstered the SBA's other main loan guarantee program, known as 7(a), by eliminating fees and raising government guarantees from 75% to 90% of the loan's value. Small banks often sell the guaranteed portions of their 7(a) loans so they can use the proceeds to make new loans. The market for those guarantees froze last year but has largely thawed, thanks in part to the Federal Reserve program known as the Term Asset-Backed Securities Loan Facility, or TALF, which provides investors attractive financing to buy securities backed by assets like credit-card debt, student loans, and small business loans.

TALF has supported purchases of $1.5 billion in SBA-guaranteed loans—both 7(a) and 504—since May, according to the Federal Reserve Bank of New York. The program is scheduled to expire in March. "Nobody really knows what will happen to the market once the TALF program disappears," says Bob Judge, a principal at Government Loan Solutions in Cleveland, which helps lenders and investors price SBA loan securities.

Less Incentive for Banks

No one is predicting the kind of paralysis that halted the market a year ago, when Judge says dealers selling pools of SBA loans might have been lucky to get one or two bids, compared with 10 today. But TALF's expiration could slacken demand and reduce the premium lenders get for their SBA loans, which in turn means less incentive for banks to make the loans to businesses. "You'll probably see a softening in the market at least temporarily," says Chris LaPorte, the head of government loan operations at Coastal Securities in Houston, one of a handful of firms that pools SBA loans into securities.

In addition, the increased guarantees and fee waivers that have helped revive 7(a) lending are set to expire at the end of February. The measures, supported by $375 million in stimulus funding, have already been extended once with an additional $125 million Congress approved after the initial funds ran out in November. Pending legislation would extend those enhancements to the end of 2010 and increase the maximum size of SBA loans from $2 million to $5 million for 7(a) loans, and from $4 million to $5.5 million for 504 loans. The bill would also let businesses use 504 loans to refinance existing commercial mortgages on more favorable terms.

For now, lenders are waiting to see whether the SBA's effort to unfreeze the market for 504 loans will allow more small business owners to invest in new property and equipment—and create jobs. "That lending has really been stymied and that's where they could really help," says LaPorte.

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