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Taking on More Risk: Examining the SBA's Changes to the 7(a) Lending Program Part II

Testimony before the U.S. House of Representatives
Committee on Small Business

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Submitted by:
Manuel Flores
President & Chief Executive Officer
SomerCor 504, Inc
Chicago, IL

Chairman Williams, Ranking Member Velázquez, and distinguished members of the Committee; good morning and thank you for having me today. My name is Manuel Flores and I am the President and CEO of SomerCor, a Certified Development Company (CDC) based in Chicago, Illinois. SomerCor is a long-time member of the National Association of Development Companies (NADCO) and I am honored to represent the CDC industry before you today to discuss rule changes affecting the lending programs at the Small Business Administration (SBA).

CDCs are non-profit organizations certified by the SBA whose mission is economic development in local communities. We meet this mission through delivery of the SBA's premier economic development program, the 504 Loan Program, as well as the 7(a) Community Advantage Pilot Program, and the Microloan Program. Many CDCs also deliver other federal programs through the U.S. Treasury, the U.S. Department of Commerce, and U.S. Department of Agriculture, and CDCs were designated Community Financial Institutions (CFIs) to do our part to provide critical capital to small businesses during the COVID-19 pandemic. Finally, CDCs deliver a variety of state and local programs and resources to meet the needs of the businesses we serve. In fact, CDCs are required to provide investments in economic development initiatives in their area of operations beyond their participation in the SBA 504 program.[1]

To use SomerCor as an example, we are one of the nation's larger CDCs by annual loan volume – we have originated more than $1.73 billion in 504 loans since our inception with a current loan portfolio of $498 million – and we also participate in the SBA's Community Advantage (CA) loan program. In addition, SomerCor administers the Small Business Improvement Fund (SBIF) and Neighborhood Opportunity Fund (NOF) grant programs on behalf of the City of Chicago. The SBIF and NOF programs provide place-based grants to assist

[1] Standard Operating Procedure 50 10 6 – Part 1, Section B, Ch 1, pg. 66 SOP 50 10 6 FINAL 8.7.20 LOCKED_0.docx (live.com)

small businesses making permanent building and property improvements to catalyze new neighborhood investment in lower income communities in Chicago. The NOF program specifically is part of a neighborhood investment initiative referred to as INVEST South/West, a private-public partnership between city departments, philanthropy, community leaders, and corporate partners to bring investment to commercial corridors on Chicago's South and West sides. In total, SomerCor has helped the City of Chicago disburse more than $133 million to 2,040 small businesses.

I provide this background as context for sharing the CDC perspective on the changes being made in the two final rules issued by the SBA on April 10, 2023, and April 12, 2023: the *Affiliation and Lending Criteria for the SBA Business Loan Programs*[2] and the *Small Business Lending Company (SBLC) Moratorium Rescission and Removal of the Requirement for a Loan Authorization.*[3] My comments will focus particularly on the affiliation and lending criteria rule as it relates to the 504 loan program, which has been in existence in different iterations since the inception of the SBA and for whom the affiliation rule will apply.

The 504 Loan Program is a prime example of a successful public private partnership with a typical structure that pairs a CDC – who provides 40 percent of the loan through a 100 percent SBA-backed debenture – with a banking partner who provides 50 percent of the loan, thus requiring only a 10 percent equity injection from the small business borrower. The program finances commercial real estate and equipment with terms of 10, 20, and 25 years, and especially important in today's economic environment, a fixed interest rate that allows small businesses to plan for the future.

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[2] Federal Register :: Affiliation and Lending Criteria for the SBA Business Loan Programs
[3] Federal Register :: Small Business Lending Company (SBLC) Moratorium Rescission and Removal of the Requirement for a Loan Authorization

The most important aspect of the 504 Loan Program is its purpose: the program's mission is economic development, and in order for a borrower to be eligible for a loan, they must create jobs or meet a public policy or community development goal. Public policy and community development goals include revitalizing a business district, assisting manufacturers, improving, diversifying, or stabilizing the economy of the locality, expanding exports and more.[4] The result is a zero-subsidy program that has served more than 175,000 small businesses, provided more than $100 billion in 504 financing, and leveraged private sector financing for an estimated total investment of more than $250 billion in local economic development across the nation.[5] The program's fees have covered the costs associated with the program for years, allowing this vital economic development initiative to provide integral capital to businesses at no cost to taxpayers. In fact, the 504 program – including the 504 debt refinance options within the program – have a collective performance of a 0.5 percent charge-off rate over the last decade.[6] SomerCor is in line with that standard as our current portfolio charge-off rate for the last 12 months is 0.45 percent.

What I have outlined is a governmental anomaly – a program that meets critical gaps in private sector lending that creates jobs, builds healthy communities, and does so without taxpayer dollars. Unfortunately, despite program success, the 504 program is weighed down by a complex approval process that can have an adverse effect on borrowers. NADCO and the CDC lending industry have advocated for years for regulatory changes to create efficiencies in the approval process to get capital into the hands of small business owners faster while maintaining the integrity of the program. These conversations have been ongoing for more than a decade and covered many of the adjustments to affiliation and underwriting the SBA made in its recent final

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[4] Dilger, Robert Jay. (Updated June 16, 2022) Small Business Administration 504/CDC Loan Guaranty Program. Congressional Research Service, 7-8. [R41184.pdf (fas.org)]

[5] [7(a) & 504 FOIA - Dataset - U.S. Small Business Administration (SBA) | Open Data]

[6] Appendix: 10-Year 504 Charge-Off Chart

rule. As a result, NADCO and the CDC lending industry have largely supported the intent of the changes included in the affiliation rule – to create bright line parameters for underwriting and affiliation determination that will allow CDCs the flexibility to be reasonable, while continuing to use prudent underwriting practices and maintain requirements to focus on ensuring repayment ability.

The previous affiliation reporting requirements for the 504 program have had a direct impact on SomerCor's small business borrowers. For example, a specialty food brand partnered with us to finance a commercial real estate purchase with renovations. Ten years after the first successful project, the company returned seeking financing for an additional property. This family business had grown during that decade and the owner now participated in new endeavors, separate from the food brand. The burden of providing documentation on forty different affiliates, many with no direct ties to the business seeking financing, was too arduous to close the loan.

Affiliation is just one part of the recent rule making changes to the SBA's lending programs. The rule also addresses lending criteria and the underwriting process for SBA program loans, including the 504 loan. The structure of the 504 loan means the loan is underwritten by a CDC (complying with all SBA requirements), which includes an independent review and approval by the CDC's Loan Committee and Board before the loan is submitted to the SBA. CDC board members and Loan Committee members are approved by the SBA, and must include at least two members with commercial lending experience. The third-party lender (typically a bank) that is providing the 50 percent financing in a 504 loan project will also conduct its own underwriting process in compliance with its internal credit policies and applicable bank safety and soundness lending practices. Moreover, SBA staff conducts its own review for eligibility and credit before approving the loan package. This process is unique to the 504 program and provides multiple layers of underwriting and examination to ensure solvency of the borrower to the greatest extent possible.

In addition to the multi-step underwriting and approval process, the 504 program is offered solely through CDCs, for whom SBA is the primary regulator. To provide context around the depth of oversight the CDC lending industry currently experiences, I am including an excerpt from NADCO's comment letter on the *Affiliation and Lending Criteria for the SBA Business Loan Programs* rule dated December 12, 2022:

> "*The Agency is the primary regulator and conducts rigorous oversight of CDCs, including – but not limited to – a biennial review of each CDCs risk rating, historical performance measures (e.g. default rate, purchase rate and loss rate), and portfolio compliance; quarterly Loan and Lender Monitoring System (L/LMS) analysis of the outstanding balance of each CDCs portfolio; specific reviews and biennial reapproval for CDCs who have Accredited Lenders Program (ALP) or Premier Certified Lenders Program (PCLP) status; an extensive Annual Report to SBA covering every aspect of CDC activity from operations of the CDC to loan portfolio metrics; and more.*"

Combine the extensive oversight of CDCs with the underwriting and approval process of the 504 program and it becomes clear why the 504 program and its debt refinancing offerings perform so well.

As I conclude my testimony, I want to acknowledge the difficult job Congress has in processing and balancing feedback from all parties who have a stake in these rule changes. I appreciate your thoughtful approach to hearing from all industry participants before determining next steps. As you consider congressional action, I offer the following recommendations:

- First, there are several lending programs at SBA impacted by these rules who operate differently and perhaps a one-size-fits-all approach is not the best way to address serving more borrowers who are struggling to access capital. The SBA's lending programs have different parameters, including eligibility requirements, terms, use of proceeds, and more. At a time when Congress has repeatedly discussed modernizing the SBA to best meet the needs of not only today's entrepreneurs, but tomorrow's, it is important to continue differentiating the programs and approaching their rules, and administrative and legislative governing, through this lens.
- Second, while Congress continues to weigh the rules and their impact, the CDC lending industry and our banking partners need time and open communication with the SBA to understand the changes as they are currently being implemented. The SBA released Standard Operating Procedure (SOP) 50 10 7[7] on May 10, 2023, which is intended to provide the guidance lenders need to operate in compliance with the new rules. The SOP is effective beginning on August 1, 2023, and it is my strong opinion that trainings, open dialogue, and a collaborative approach is integral to the ability of industry participants to understand, learn, and adapt to the rule changes. Our goal is to keep our focus on providing capital opportunities to as many small businesses as possible. In order to do that we need the training, tools, and time to digest and incorporate the new rules and SOP without fear of being penalized during that process.
- Finally, the discussion today is based on rules that seek to serve more small businesses through SBA's lending programs and industry response to these efforts. In addition to the two most recent final rules, SBA is considering a final rule pertaining to changes to the

[7] SOP_50_10_7_effective_08.01.docx (live.com)

504 debt refinance without expansion program made in the *Economic Aid to Hard-Hit Small Businesses, Nonprofits, and Venues Act* (P.L. 116-260) passed in December of 2020. In this law, Congress revised the requirements for refinancing debt in the 504 loan program to expand small business access to, and use of, this critical capital resource. To illustrate congressional intent of the law, the Senate Small Business and Entrepreneurship Committee released a section-by-section guide to the Economic Aid Act, which states the statute, "(e)nhances the 504 refinancing rules in order to create reciprocity for refinancing between 504 and 7(a) programs."[8]

It is clear the legislative intent of the statute was to create parity in the ability to refinance existing debt under either the 504 or 7(a) loan programs – both should be equally accessible and guided by what is in the best interest of the small business borrower, while protecting program integrity. As SBA considers comments submitted in September 2021, it is critical they remove administrative barriers not included in the law that restrict the ability of borrowers to access the program and release a final rule as soon as possible.

The changes made in the Economic Aid Act are particularly important in the current interest rate environment where the much lower fixed rate of the 504 program can provide enormous cost savings to small businesses.

The CDC lending industry cares deeply about maintaining our role as a trusted partner for small business success and take seriously the integrity of the programs we serve so they remain options for small businesses for years to come. We will continue to focus on collaboration and communication with SBA and Congress to meet our collective goal of making lending programs, like the 504, easier, faster, and more secure in support of a strong small business ecosystem

[8] Attachment: *Economic Aid to Hard-Hit Small Businesses, Nonprofits, and Venues*, Section-by-Section

nationwide. I sincerely appreciate the opportunity to testify this morning, and I look forward to answering any questions.

Appendix: 10-Year 504 Charge-off Chart

10 Year 504 Charge Off Data for 504 Refi, Refinance, 504 Regular, ALP and PCL Loans

	Funded Loans				Charged Off Loans				
Delivery Type	# of Loans	% of #'s of Loans	$ of Loans	% of $ of Loans	# of Loans	% of #'s of Loans	$ of Loans	% of $ of Loans	Loss Rate
504	16,724	28.03%	$12,750,918,540	28.24%	161	41.18%	$108,900,877	46.27%	0.9%
504 Refinance	1,966	3.29%	$2,046,805,000	4.53%	3	0.77%	$2,333,397	0.99%	0.1%
504REFI	1,160	1.94%	$1,123,331,000	2.49%	24	6.14%	$15,655,807	6.65%	1.4%
ALP	39,473	66.15%	$28,938,737,290	64.08%	203	51.92%	$108,476,669	46.09%	0.4%
PCLP	350	0.59%	$300,093,000	0.66%		0.00%	$0	0.00%	0.0%
Grand Total	**59,673**	**100.00%**	**$45,159,884,830**	**100.00%**	**391**	**100.00%**	**$235,366,750**	**100.00%**	**0.5%**

Explanation:
The loans funded and charged off by type of 504 loan (504 Refi and Refinance) and delivery method (504 Regular, ALP, PCLP) over the ten year period from 10/1/12 to 9/30/22.
Example: Line 1, 504 (Regular) shows 16,724 loans funded (28.03% of all loans funded) for $12.8 billion (28.24% of loan dollars funded). 161 loans were charged off (41.18% of loans charged off) totalling $1.09 million in losses (46.27% of all losses). The loss rate was 0.9% (dollars lost divided by dollars lent).

NOTE:	504REFI	Original Refinance Program (2010-2012)
	504 Refinance	Current Refinance Program (2016-Present)

PLEASE NOTE: DATA IS DERIVED FROM INFORMATION SUPPLIED BY THE SBA. THE DATA TABLES EXCEED 160,000 LINES AND MAY INCLUDE ERRORS, OMMISSIONS OR "UNKNOWN" DATA.