SBA Publishes New Interim Final Rule for 504 (DCPC) Debt Refinancing Program

- Authorized under Section 328 of Economic Aid Act enacted on December 27, 2020
- Interim final rule effective immediately on July 29, 2021 and is a permanent change
- Notably, allows for the refinance of existing government guaranteed debt, including 7(a) and 504 loans
- Qualified debt must only be 6 months old to be eligible for refinance, previously 2 years
- Refinance of government guaranteed debt must provide “substantial benefit”, 10% savings on payment
- Investors in 7(a) backed pools “SBA Floating Rate” and 504 “Fixed-Rate DCPC” debentures should take note

On July 29th, 2021 an interim final rule was published by the Small Business Administration (SBA) implementing section 328 of the Economic Aid to Hard-Hit Small Businesses, Nonprofits, and Venues Act (Economic Aid Act). Section 328, titled *Low-Interest Refinancing,* revises the requirements for refinancing debt with a SBA 504 Loan. The net effect of these revisions points towards greater ease and availability for certain borrowers, who were previously disallowed, to refinance using an SBA 504 loan.

SBA 504 Loan Program Refresher

The SBA 504 loan program provides long-term, fixed-rate financing for purchase or construction of major fixed assets such as new facilities, existing buildings or land, and long-term machinery and equipment. A loan may not be used for working capital, inventory, or speculation or investment in rental real estate. Prior to this rule change, a 504 loan could not be used for “consolidating, repaying or refinancing debt” according to the SBA. The terms of available loans are 10-, 20-, and 25-years. Loan rates are commonly touted as below-market. For example, the current 25-year borrower rate is approximately 2.86%. The SBA 504 loan program is unique in that it effectively requires two loans. The first loan is made by a third-party lender, a Bank or Credit Union, and is typically 50% of the total cost. The second loan is provided by a CDC, Certified Development Company, and is typically 40% of the total cost. The borrower is required to contribute 10% equity.

What borrowers, previously disallowed, are now eligible to refinance using a 504 loan?

The biggest change SBA investors should be aware of is the ability for borrowers with current debt “subject to a guarantee by a Federal agency or department” to refinance using a 504 loan. Previously, a 7(a) or 504 borrower could not, or only under very limited circumstances, refinance their loan with another SBA loan.

Other revisions may lead to greater ease and availability to use a 504 loan to refinance

- Removed the requirement for the program to be available only when the 504 program is at a zero subsidy (losses in the program are entirely covered by borrower and CDC fees, no cost to taxpayers)
- In Section 327 of the Economic Aid Act, the CDC processing and third-party lender participation fee were waived through 9-30-2021
- Removed a cap on CDCs from processing new refinance loans in excess of 50% of prior year dollar amount
- Qualified debt must be at least 6 months old, previously set at 2 years
- Removed the necessity for a borrower to be current on all payments for at least one year before the SBA application date

Borrowers must still meet certain stipulations to use a 504 loan to refinance

- The applicant must have been in business for at least two-years prior to the application date, for context, 50% of 7(a) borrowers approved this year through July had a business age of "existing or more than 2 years old"
- Debt being refinanced must be for Eligible Fixed Assets
- For an existing 504 loan, the third-party and 504 loan must both be refinanced or the third-party loan must be paid off
- For an existing 7(a) loan, the CDC must verify in writing that the current lender is unable or unwilling to modify the current payment schedule
- In the case of "same institution debt", where the third-party lender or the CDC is the 7(a) lender, it will only be eligible for a 504 refinance if a secondary market investor will not agree to modified terms
- The refinancing of any federally guaranteed loan will provide a "substantial benefit" to the borrower, a minimum of 10% savings on the new payment

Loans most likely to be affected

Looking at program size alone, there are more 7(a) than 504 loans by a wide margin, so we will start there. Knowing what we do, not all 7(a) loans would be eligible simply because they do not finance an Eligible Fixed Assets. In general, these types of loans would be included in shorter WAM "Equipment Loan" pools. Longer WAM "Real-Estate Loan" pools on the other hand, would likely contain more eligible candidates for a 504 refinance as the collateral is more in line with a typical 504 loan. Loans with higher balances and higher rates would be the most likely to prepay. According to the rules, 504 loans could also be candidates. They're already part of the 504 program so perhaps there are some efficiencies there. The rate incentive for them to refinance is likely harder to hit than a 7(a) borrower, but not impossible.

Looking at the changes holistically

It is most important to view these changes from a marginal perspective. What I mean is, holding everything constant, prepayments prior to this change can be looked at as a sort of baseline. Prior to these changes, the single biggest impediment to a 7(a) or 504 borrower refinancing *outside* of conventional financing, was their inability to refinance with another SBA loan. In general, this would have held down voluntary prepayments, at least until conventional financing became a viable option. Since that is no longer the case, it seems reasonable to expect some higher level of prepayment activity due to this new ability for some SBA borrowers to refinance back into another SBA loan.

Here is another way to think about it. If you invest in Agency MBS, you are likely aware of the amount of refinance (prepayment) activity we have seen recently. Imagine how much less refinancing would have occurred if borrowers couldn't refinance into another Agency-backed loan. To be fair, it certainly isn't an apples-to-apples analogy given the many differences between residential and commercial borrowing though.

It will be two to three months before we can start to gauge the changes, if any, in prepayments. The latter part of a year is usually a period of lower prepayment activity so it will be particularly interesting to see if that changes this year. It is also worth noting that in the midst of these changes ,7(a) prepayments are also in a period of normalization after virtually disappearing for part of 2020 due to the pandemic. Included on the next page is recent historical prepayment activity in pooled 7(a) loans. I invite you to follow along in our *SBA Prepay Commentary*.

As always, if you have any questions, comments, or would like to discuss further, please reach out to your account representative or directly to me.

Kevin A. Smith, CFA

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Equipment Loan Pools by Vintage	Prepayment Speeds (One-Month CPR)																		
	Jan 2020	*Feb 2020*	*Mar 2020*	*Apr 2020*	*May 2020*	*June 2020*	*July 2020*	*August 2020*	*Sept 2020*	*Oct 2020*	*Nov 2020*	*Dec 2020*	*Jan 2021*	*Feb 2021*	*March 2021*	*April 2021*	*May 2021*	*June 2021*	*July 2021*
All Equipment Loan Pools[1]	18	18	17	12	12	5	6	7	6	9	13	12	14	11	9	9	11	12	14
2021	-	-	-	-	-	-	-	-	-	-	-	-	-	-	2	2	4	4	4
2020	-	-	5	2	1	0	1	1	1	6	4	4	7	8	5	5	8	5	8
2019	9	7	8	7	6	3	3	5	3	5	7	10	10	8	8	7	8	9	12
2018	14	17	16	10	14	4	5	5	5	7	11	12	13	9	7	8	13	15	17
2017	24	19	19	16	19	5	7	5	10	7	16	14	17	10	11	9	13	13	16
2016	20	25	24	16	13	6	5	9	6	11	21	17	20	12	10	13	10	22	20
2015	13	21	22	14	14	14	10	10	8	10	17	13	19	13	10	15	16	15	24
2014	29	24	26	16	18	6	16	12	7	19	25	12	25	13	9	16	22	23	23
2013	26	30	19	18	11	4	11	19	8	31	30	21	27	21	26	14	23	26	30
2012	53	34	30	11	22	8	6	9	17	29	24	23	36	22	20	12	40	36	31

Real-Estate Loan Pools by Vintage	Prepayment Speeds (One-Month CPR)																		
	Jan 2020	*Feb 2020*	*Mar 2020*	*Apr 2020*	*May 2020*	*June 2020*	*July 2020*	*August 2020*	*Sept 2020*	*Oct 2020*	*Nov 2020*	*Dec 2020*	*Jan 2021*	*Feb 2021*	*March 2021*	*April 2021*	*May 2021*	*June 2021*	*July 2021*
All Real-Estate Pools[2]	23	19	18	13	13	6	6	6	6	7	12	11	12	11	7	9	11	12	12
2021	-	-	-	-	-	-	-	-	-	-	-	-	-	-	2	0	1	4	1
2020	-	-	0	2	0	0	0	2	0	0	0	4	3	3	3	3	4	3	10
2019	7	3	9	4	5	4	3	2	1	3	4	4	9	5	4	7	5	6	11
2018	17	16	15	9	8	3	6	4	5	4	11	10	17	10	6	10	11	16	16
2017	29	22	20	16	16	7	7	8	9	9	14	18	15	16	12	11	21	20	12
2016	34	29	26	22	18	6	6	7	5	7	15	8	12	11	4	8	11	17	17
2015	33	24	23	23	24	2	9	5	9	11	19	16	10	14	7	10	11	19	15
2014	31	28	33	17	26	11	9	6	7	12	13	17	15	13	18	19	11	10	15
2013	40	31	22	19	17	13	9	11	8	8	20	12	22	11	11	10	11	12	7
2012	25	21	10	15	11	12	10	20	6	2	14	13	20	20	22	11	15	13	11
2011	12	23	23	15	5	7	3	4	16	27	19	22	12	15	5	11	12	12	5
2010	31	12	30	24	20	3	11	18	3	9	16	16	14	11	7	24	14	15	5
2009	22	13	15	11	20	8	2	2	7	5	14	12	12	14	11	18	19	13	14
2008	18	23	21	5	12	7	0	13	7	9	11	12	9	7	6	27	20	2	23

[1] *Equipment loan pools have original WAMs between 8 and 13 years*
[2] *Real-estate loan pools have original WAMs greater than 18 years*
Source: Vining Sparks, Colson Services