

RD AN No. 4669 (4279-B)
June 30, 2012

TO: State Directors, Rural Development
ATTN: Business Programs Directors
SUBJECT: Business and Industry Guaranteed Loan Program
Loan Processing Issues

PURPOSE/INTENDED OUTCOME:

The purpose of this Administrative Notice (AN) is to provide guidance in processing loans under the Business and Industry (B&I) Guaranteed Loan Program.

COMPARISON WITH PREVIOUS AN:

This AN updates and replaces RD AN No. 4582 (4279-B) dated June 13, 2011, which expired on June 30, 2012.

IMPLEMENTATION RESPONSIBILITIES:

The purpose of this AN is to clarify the Agency policy concerning several loan processing issues. Please be reminded that RD Instruction 4279-B, section 4279.101(b), states in part: "... It is not intended that the guarantee authority will be used for marginal or substandard loans or for relief of lenders having such loans." Loan underwriting standards are not being relaxed.

• **Percentage of guarantee**

RD Instruction 4279-B, section 4279.119(b), establishes the maximum percentage of guarantee permitted. While the cited paragraph provides for flexibility in establishing the percent of guarantee, the Agency policy is to grant the maximum percentage of guarantee permitted by the regulations on all B&I loans, whenever possible. Risk mitigation measures may be considered as appropriate, including but not limited to requiring additional equity through a capital injection, additional collateral including secured personal guarantees, longer repayment terms, or subordinated debt and gap financing.

EXPIRATION DATE:
July 31, 2013

FILING INSTRUCTIONS:
Preceding RD Instruction 4279-B

State Directors are encouraged to use their authority to grant exceptions for 90 percent guarantees on loans of \$2 million or less, as provided in section 4279.119(b)(3). However, all 90 percent guarantees must be submitted to the National Office for tracking purposes to ensure we do not exceed the annual limit. Once the limit has been reached, the guaranteed percentage for the remainder of the fiscal year will not exceed 80 percent.

• Planning and Performing Development and Issuing the Guarantee Prior to Substantial Completion of Construction

The intent of this AN is to facilitate the issuance of the guarantee prior to substantial completion of construction, when warranted. As a reminder, the tangible balance sheet equity requirement must be met at loan closing, and the balance sheet as of loan closing must reflect the assets and liabilities associated with the guaranteed loan to show the balance sheet's post-closing status. RD Instruction 4279-B, section 4279.181(p), states that for projects other than turnkey operations where the Loan Note Guarantee will be issued at the time of loan closing, there are added risks to the Agency. During the review, the Agency should consider the added risk associated with issuing the Loan Note Guarantee prior to the substantial completion of the project. When negotiating the percentage of guarantee with the lender, these risks should be considered in conjunction with the credit risks and the lender's experience in financing the type of project. There may be increased risk to the Agency in that the project may not be satisfactorily completed with available funds. This could result in the need for additional loans or equity to complete the project or the possible failure of the business and loss to the Agency. We believe the mitigation measures described in this AN will protect the interests of the Government while considering the interests of rural lenders and businesses in the current economic climate.

Among other things, RD Instruction 4279-B, section 4279.156(a), requires the lender to ensure that the project (1) is designed utilizing accepted architectural and engineering practices and conforms with all applicable Federal, State, and local codes and requirements and (2) will produce products in the quality and quantity proposed in the completed application approved by the Agency. RD Instruction 4279-B, section 4279.156(b), clearly states the lender is responsible for monitoring the progress of construction and undertaking the reviews and inspections necessary to ensure that construction conforms with applicable code requirements; proceeds are used in accordance with the approved plans, specifications, and contract documents; and that funds are used for eligible project costs. The administrative language in the cited instruction indicates that the lender would normally be expected to have inspections made by a qualified individual prior to any progress payment. There is no absolute requirement that the goal be achieved by the use of an independent professional applying these methods. After careful review, if it appears that the use of an independent professional is the only method that ensures that the regulation's requirements are achieved, one may be required. If other less expensive or rigorous methods will achieve the same result, they may be utilized. The decision should be made on a case-by-case basis and be reasonable, given the specific circumstances of the case.

The lender should normally ensure the use of any borrower funds in the project first; have a complete set of plans and specifications at the lending institution; have a firm construction contract(s) and provisions for change order approval, retainage percentage, and disbursement schedule; and obtain lien waivers from all contractors prior to disbursements.

The administrative language also states that the lender should normally ensure that the borrower has a 100 percent performance and payment bond on the contractor. There may be cases where a 100 percent performance and payment bond is prohibitively expensive or unavailable. In those cases, in lieu of a performance and payment bond, the lender may provide the Agency with a construction monitoring plan. This plan may include contracting with a reliable and experienced firm. The Agency's experience with the lender and the complexity of the project should be considered in determining whether the construction monitoring plan is acceptable.

Other means to mitigate the Agency's risk when issuing the guarantee prior to substantial completion of the project may include:

- Requiring the use of American Institute of Architects (AIA) contracts and documents;
- Requiring firm fixed-price construction contracts;
- Requiring construction contracts through an independent general contractor and not allowing the owner or an affiliate to act as the general contractor;
- Requiring all construction contracts and equipment quotes be firm or fixed price contracts and all be received for the entire project before loan closing and issuance of the guarantee;
- Requiring an additional 5 percent tangible balance sheet equity; and
- Requiring adequate contingency funds.

• **Interim/construction financing**

RD Instruction 4279-B, section 4279.113(s), states that the takeout of interim financing is eligible provided the lender submits a complete preapplication or application that proposes such interim financing prior to completing the interim loan. This means that the preapplication or application must be submitted prior to closing the interim loan and that no advances may have been made from the interim loan. If the interim financing does not meet these requirements, it is considered debt refinancing and must meet the requirements for debt refinancing in accordance with section 4279.113(r) to be eligible. This will enable the Agency to conduct an adequate environmental assessment and preclude circumvention of the debt refinancing 50 percent rule.

Interim financing is used to pay construction and other costs associated with a planned project and is usually no longer than 2 years. Therefore, the takeout of interim financing is only eligible when a temporary or short-term loan is being taken out by a permanent loan on which a guarantee will be placed and when the lender submits a complete pre-application or application that proposes the interim financing prior to closing the interim loan.

When a preapplication or application is filed that involves the takeout of interim financing, the Agency should immediately notify the applicant that during the period of application review and processing, the applicant must not take any actions (i.e., initiate construction) that would have an adverse impact on the environment or limit the range of alternatives to be considered by the Agency during the environmental review process. It is very important that the lender be notified that the Agency cannot approve the loan and issue the Conditional Commitment until the environmental process is complete and that the Agency assumes no responsibility or obligation for interim loans advanced prior to the Conditional Commitment being issued.

If you have any questions, please contact the Business and Industry Division, Processing Branch, at (202) 690-4103.

(Signed by John C. Padalino)

John C. Padalino
Acting Administrator
Rural Business-Cooperative Service