Congress of the United States
U.S. House of Representatives
Committee on Small Business
2361 Rayburn House Office Building
Washington, DC 20515–6315

MEMORANDUM

To:	Members, Subcommittee on Economic Growth, Tax, and Capital Access
From:	Andy Kim, Chairman
Date:	March 6, 2019
Re:	Subcommittee hearing: "Small but Mighty: A Review of the SBA Microloan Program"

The Committee on Small Business Subcommittee on Economic Growth, Tax, and Capital Access will meet for a hearing titled, "Small but Mighty: A Review of the SBA Microloan Program." The hearing is scheduled to begin at **10:00 A.M. on Thursday, March 7, 2019 in Room 2360 of the Rayburn House Office Building.** The hearing will allow Members to learn about the program and its functions, explore opportunities to continue strengthening the program, and listen to some of its success stories. The witnesses will be:

- Ms. Ceyl Prinster, President and CEO, Colorado Enterprise Fund, Denver, CO
- Ms. Carolina Martinez, CEO, California Association for Micro Enterprise Opportunity, San Francisco, CA
- Ms. Mariama Jallow, Owner, Mariama's Beauty Supply, Portland, ME
- Ms. Michelle Richards, Executive Director, Great Lakes Women's Business Council, Livonia, MI, Testifying on behalf of Women Impacting Public Policy

<u>Background</u>

Congress created the Microloan Program in the Small Business Act (section 7(m)) in 1991,[1] which makes funds available to nonprofit, community-based lenders who in turn make very small loans to eligible borrowers—mainly higher-risk, fledgling entrepreneurs, whose businesses generally serve their local communities. These borrowers may be unable to get a traditional loan due to poor credit, no credit history, or a lack of business experience. This program reaches various demographic groups that would otherwise not be served by the private sector or even the SBA's 7(a) program. For example, microloans have been a source of capital for women business owners (who in FY 2018 received about 47 percent of Microloans issued[2]) and minority borrowers (who in FY 2018 received over 48 percent of Microloans issued[3]).

---

[1] P.L. 102-140, approved October 28, 1991 as a Demonstration Program. The designation "demonstration" was removed by P.L. 105-135 approved Dec. 2, 1997.
[2] Congressional Research Service, *Small Business Administration Microloan Program*, R41057 (Dec. 19, 2018) [hereinafter "CRS Microloan"].
[3] *Id*.

There are currently 144 active intermediaries servicing 49 states, the District of Columbia, and Puerto Rico.[4] SBA loans made to the intermediaries have averaged a 2 percent charge-off rate[5] over the life of the program.[6] The average microloan is approximately $13,000.[7] Since the program's inception in 1992, intermediaries have made more than $845 million in loans to small businesses that created or retained some 246,000 jobs. In FY 2018, SBA approved 58 loans to intermediaries for a total of $37.3 million, or an average intermediary loan of $643,724.[8] In turn, microloan intermediaries made 5,459 loans to small businesses totaling $76.8 million, for an average microloan amount of $14,071.[9]

Furthermore, program data shows the program is effective at meeting its objective of targeting women- and minority-owned businesses. An analysis conducted by the Urban Institute found that about 9.9 percent of conventional small business loans are issued to minority-owned small businesses and about 16 percent of conventional small business loans are issued to women-owned businesses.[10] Comparatively, in FY 2018, of those reporting their race, minority-owned or controlled firms received 47.4 percent of the number of Microloans issued and 33.8 percent of the amount issued.[11] Women-owned or -controlled firms received 48.7 percent of the number of Microloans issued and 38.9 percent of the amount issued.[12]

Microloan Program Overview

Authorized in 1991 as a five-year demonstration project, the SBA's Microloan program became operational in 1992, and was made permanent subject to reauthorization in 1997.[13] It is important to note the program is not a loan guarantee program like the SBA's 7(a) and 504/CDC programs, but instead provides direct loans to intermediaries who then make loans to the small business borrower. The Microloan program is open to all small business entrepreneurs, but targets new and early-stage businesses in underserved markets, including borrowers with little to no credit history, low-income borrowers, and women and minority entrepreneurs in both rural and urban areas who generally do not qualify for conventional loans, or other, larger SBA guaranteed loans.[14] It provides them small-scale loans for working capital or the acquisition of materials, supplies, or equipment.[15]

The program provides direct loans to qualified nonprofit intermediary lenders who, in turn, provide "microloans" of up to $50,000 to small businesses, entrepreneurs, and nonprofit childcare

---

[4] Active intermediaries are defined as those having made at least four microloans in fiscal year 2016. Congressional Research Service, *Small Business Administration: A Primer on Programs and Funding*, RL33243 (Feb. 9, 2016); *see also* CRS Microloan *supra* note 2.

[5] Charge off rate is the amount uncollected by the company and therefore written off the books.

[6] Small Business Administrator Office of Inspector General, *Audit of SBA's Microloan Program*, Report Number 17-19 [hereinafter "SBA OIG Report"].

[7] *Id*.

[8] CRS Microloan *supra* note 2.

[9] *Id*.

[10] Urban Institute, *Competitive and Special Competitive Opportunity Gap Analysis of the 7(A) and 504 Programs*, (2008).

[11] *See supra* note 2.

[12] *Id*.

[13] CRS Microloan *supra* note 2.

[14] *Id*.

[15] *Id*.

centers.[16] It also provides marketing, management, and technical assistance (TA) to microloan borrowers and potential borrowers.[17] Intermediaries are eligible to receive a Microloan TA grant of not more than 25 percent of the total outstanding balance of loans made to it.[18] Grant funds may be used only to provide marketing, management, and technical assistance to Microloan borrowers, except that no more than 50 percent of the funds may be used to provide such assistance to prospective Microloan borrowers, nor on third-party contracts for the provision of such assistance.[19] This requirement was recently eased by increasing the amount to 50 percent, as stated, from 25 percent to further the technical assistance provided through more flexible standards.[20]

Grant funds may also be used to attend training required SBA.[21] Intermediaries must also contribute, solely from non-federal sources, an amount equal to 25 percent of the grant amount.[22] Intermediaries that have a portfolio of loans made under the program that averages not more than $10,000 during the period of the intermediary's participation in the program are eligible to receive an additional training grant equal to 5 percent of the total outstanding balance of loans made to the intermediary.[23]

Borrower Eligibility Requirements

Each intermediary lender has its own lending and credit requirements.[24] Generally, intermediaries require some type of collateral as well as a personal guarantee of the business owner.[25]

Use of Proceeds

Microloans may be used for working capital and acquisition of materials, supplies, furniture, fixtures, and equipment.[26] Loans cannot be made to pay existing debt or to acquire real estate.[27]

Repayment Terms, Interest Rates, and Fees

Loan repayment terms vary according to factors including: (1) loan amount; (2) planned use of funds; (3) requirements determined by the intermediary lender; and (4) the needs of the small business borrower.[28] The maximum repayment term is six years.[29] Interest rates also vary, depending on the intermediary lender and costs to the intermediary from the U.S. Treasury, with rates generally ranging from 6.5 percent to 9 percent.[30]

---

[16] CRS Microloan *supra* note 2.
[17] *Id*.
[18] *Id*.
[19] *Id*.
[20] The Consolidated Appropriations Act, P.L. 115-141 included the language of H.R. 2056, the Microloan Modernization Act of 2017 to increase the amount intermediaries could spend from 25 percent to 50 percent of their technical assistance grant funds on prospective borrowers and for contracts with third parties to provide such technical assistance.
[21] CRS Microloan *supra* note 2.
[22] *Id*.
[23] *Id*.
[24] *Id*.
[25] *Id.*
[26] *Id*.
[27] Small Business Administration webpage, available at https://www.sba.gov/loans-grants/see-what-sba-offers/sba-loan-programs/microloan-program.
[28] *Id*.
[29] *Id*.
[30] CRS Microloan *supra* note 2.

Intermediary Lender Requirements
Intermediaries are not required to make any interest payments on the microloan during the first year, but interest accrues from the date that SBA disburses the loan proceeds to the intermediary.[31] After that, SBA determines the schedule for periodic payments.[32] Loans must be repaid within 10 years.[33] Intermediaries are required to contribute not less than 15 percent of the loan amount in cash from nonfederal sources and, as security for repayment of the loan, must provide SBA the first lien position on all notes receivable from any microloans issued under the program.[34] For FY 2019, SBA received $31 million for grants to Microloan intermediaries and qualified "non-lending technical assistance providers" to provide Microloan borrowers and prospective borrowers marketing, management, and technical training assistance.[35]

Current Issues
Many of the current issues involving the Microloan program are outgrowths of the program's origin as a pilot program. Some of the rules currently governing the program were designed for a pilot program with a limited financial and geographic footprint. Though those rules may have worked well for the Microloan program during its pilot phase, the program has grown considerably in the ensuing 21 years. Participants in the Microloan program have identified some of these rules as limiting their ability to meet demand for microbusiness financing and technical assistance. Accordingly, the program would benefit from a review of its current rules with an eye towards optimizing and updating those designed for a nascent program.

The 1/55 Rule
Under the Microloan program, SBA approves and lends funds, subject to the availability of appropriations, to intermediaries based on the order in which applications are received. The amount provided is subject a statutory limitation that has been in effect since the program's early stages:

- During the first six months of each fiscal year, subject to the availability of appropriations, at least $800,000 or 1/55 of available loan funds (whichever is less) is required to be made available for loans to intermediaries in each state (including the District of Columbia, the Commonwealth of Puerto Rico, the United States Virgin Islands, Guam and American Samoa).[36]

The 1/55 rule has been in the statute governing the program since its nascent stages. The purpose of the 1/55 rule was to ensure the Microloan program was generally available to intermediaries and borrowers in all states and territories, and not concentrated to only a few with active participants. Today, however, the Microloan program is widely available, with 144 active intermediaries serving 49 states, the District of Columbia, and the Commonwealth of Puerto

[31] *Id*.
[32] *Id*.
[33] *Id*.
[34] *Id*.
[35] *Id*.
[36] 15 U.S.C. § 636(m)(7)(B)(i); *see also* P.L. 106-22.

Rico.[37] These organizations report that, in most cases, they are unable to borrow additional loan funds for the third and fourth quarter of each fiscal year, which limits their ability to meet existing demand and continue financing microenterprises.

Caps on Technical Assistance Expenditures

Another rule governing microloan intermediaries is the 50-50 rule on TA expenditures. Currently, intermediaries may not spend more than 50 percent of their TA grant on either technical assistance for prospective borrowers, or contracts for third parties to provide technical assistance. These new levels were enacted in the 115th Congress, prior to which they were set at 25 percent. Many intermediaries have expressed support and gratitude for these new levels, calling them a step in the right direction. However, some have gone a step even further, questioning whether restricting the way an intermediary, spends its TA grant is still necessary given the age of the program and the maturity and experience of some of the intermediaries who participate in the program – some of whom have participated in the program since its inception.

Aggregate Loan Limit

Current rules also limit the amount of overall debt an intermediary may have outstanding after its first year of participation in the program to $6 million. Recognizing the strong performance of the program and the significant impact the program has on entrepreneurship and small business growth generally, Congress has incrementally increased this aggregate loan limit over the years. The new $6 million level was enacted in the 115th Congress,[38] prior to which the aggregate loan limit was $5 million. The $5 million limit was set by the Small Business Jobs Act of 2010, up from the previous level of $3.5 million.[39] Some active intermediaries, particularly those in states with relatively few microlenders, report being restricted by the $6 million cap, and seek conventional banking financing once they reach the cap in order to meet demand. This needlessly raises costs for active intermediaries.

SBA OIG Report: Audit of SBA's Microloan Program

In September 2017, the SBA Office of Inspector General (OIG) issued a report on its audit of the Microloan program that looked at whether SBA effectively implemented actions to improve oversight of the program and the extent that SBA oversight is sufficient to measure program performance and ensure program integrity.[40] The OIG found that a number of improvements were needed in SBA's oversight of the Microloan program to measure performance and ensure integrity.[41] First, SBA did not implement all of the prior audit recommendations from the OIG's 2009 audit.[42] In addition, despite recommendations to better measure the program's success, in the current audit, the OIG identified some intermediaries were not reporting whether small businesses were still in operation and reported that improvements to Microloan Program Electronic Reporting System (MPERS) to capture technical assistance were not implemented.[43]

[37] CRS Microloan *supra* note 2.
[38] P.L. 115-232.
[39] P.L. 111-240.
[40] SBA OIG Report *supra* note 6.
[41] *Id*.
[42] *Id*.
[43] *Id*.

The OIG also reviewed a sample of 52 microloans approved for approximately $1 million by 14 intermediaries to validate input in MPERS and assessed whether intermediaries originated and closed the loans in accordance with SBA's requirements.[44] In the review of the files, the OIG found that data in MPERS for 27 of the loans reviewed did not match information included in the intermediaries' loan files and that intermediaries did not have sufficient documentation to support that it originated 44 of the 52 loans in accordance with SBA requirements.[45] Among the deficiencies found, the OIG identified inadequate support for use of proceeds, unsupported credit elsewhere, interest rate charges above SBA guidelines, and fees exceeding SBA guidelines.[46] The OIG also identified issues with SBA's ability to monitor the program using MPERS. In addition, both limited capabilities of MPERS (such missing selection options for allowable uses of proceeds) and measuring program performance using output indicators in lieu of outcome measures, prevented SBA from providing adequate oversight of the program.[47]

Industry Response to OIG Audit

Concerns have been raised about the results of this audit. For instance, Friends of the Microloan Program, an informal network of intermediaries, claimed that the review failed to provide an equitable assessment of the performance of the intermediaries. The network objected to the use of such a small sample size—10 percent of the intermediaries and 0.4 percent of the loans—and disputed the extrapolation of this sample to some 9,000 loans for $137 million. They also objected to the finding on lack of adequate support to document the credit elsewhere test, noting that the Standard Operating Procedure for the Microloan Program does not provide details on the requirements for documenting the lack of credit elsewhere. Last Congress, the Committee heard from the SBA OIG and the SBA concerning the report and this hearing will give Members the chance to hear from industry stakeholders about their views on the audit report.

Conclusion

SBA's Microloan program has successfully funded thousands of small businesses and created many more jobs in its almost 30-year existence. In spite of that, many participating intermediaries report being restricted in their lending activity as a result of numerous rules governing the program that were designed for a pilot program, and that many participants believe the program has now outgrown. In order to continue this strong performance, Congress should review those rules and update and optimize them for a fully mature Microloan program. The program was originally authorized to address specific needs to encourage entrepreneurs to "home-grow" a small business with the help of the local community. Measured by criteria such as job creation, default rate, community development and long-term success, the program has built a strong case for being broadened. Members will hear from witnesses about how the program has a long track record of success and has been helpful in teaching and assisting those who are interested to grow their business.

[44] *Id.*
[45] *Id.*
[46] *Id.*
[47] *Id.*