

■ ■ ■ ■ Small and Micro Business Lending Program Report

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Commerce RI

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About the Report

The Small and Micro Business Lending Program Report provides a review of the current micro lending policies and outcomes in Rhode Island and provides recommendations for a program to improve access to capital for small and micro businesses. The Report focuses on businesses with capital needs under \$50,000. The analysis of current conditions and recommendations both emphasize the availability of capital and other resources for low- to moderate-income (LMI) businesses.

The Council of Development Finance Agencies (CDFA) produced the Small and Micro Business Lending Program Report through an intensive research- and stakeholder-driven process. The CDFA project team, which included an expert from an LMI-focused micro lender, conducted interviews with 17 stakeholder organizations. The majority of these interviews were coordinated by Commerce RI and took place during a site visit by the project team to Rhode Island. CDFA also conducted substantial research into the Rhode Island economy and national best practices for micro lending and LMI access to capital.

The Small and Micro Business Lending Program Report includes two sections.

Section A: Evaluation of Current Micro Business Resource Access – This section focuses on the availability and quality of the services, programs, and organizations available to support small and micro businesses in the state. The section addresses Commerce RI programs, micro lenders, and technical assistance services.

Section B: Micro Business Lending Program Recommendations – This section makes best practices-based recommendations for improving the micro finance market in the state. The two sets of recommendations cover convening micro business service providers and a new program that would add to the capital and technical assistance resources currently available.

Rhode Island micro business stakeholders should use the Small and Micro Business Lending Program Report as a starting point for an important discussion about the role of these businesses in the state. The current micro finance market includes significant challenges that may be keeping the economy from reaching its full potential. Fortunately, the recommendations in this report would significantly improve the outlook for all of Rhode Island’s small and micro businesses.



■ Small and Micro Business ■ Lending Program Report

Section A: Evaluation of Current Micro Business
Resource Access

Section B: Micro Business Lending Program
Recommendations

Commerce RI Lending Programs

Commerce RI is the state’s economic development finance authority. The entity operates several significant programs to support Rhode Island businesses, but none of these programs are capitalized with state funds. Commerce RI is therefore serving Rhode Island’s economic development solely with one-size-fits all development finance tools. This section provides an overview of each program and the program’s potential to provide micro financing.

Small Business Loan Fund

The Small Business Loan Fund (SBLF) is geared toward businesses in need of direct loans for existing manufacturing, processing, and selected services, as well as manufacturers in search of financing for the acquisition of land, buildings, and equipment. The fund provides fixed-rate financing for working capital of up to \$500,000 with terms of up to five years. Loans for hard assets can have terms of up to 10 years.

Despite being a “small business” program, SBLF is not suitable for the vast majority of micro enterprises. The definition of a small business for federally-funded programs is 500 employees, which is well beyond the scope of the five or fewer employees commonly found for micro businesses. More importantly, the fund is structured for manufacturers seeking financing for expansion projects.

Manufacturing expansion projects are typically addressed by asset-backed loans for projects 20-40 times larger than the typical micro loan, which is \$13,000. As such, the underwriting criteria for the SBLF are not well suited to micro enterprises. Commerce RI does allow these businesses to apply for financing, but sufficient capital and credit history—as well as business purpose—prevent the program from being an effective micro finance tool.

Taxable and Tax-Exempt Bonds

Manufacturers can obtain taxable and federally tax-exempt revenue bonds through the RI Industrial Facilities Corporation. The maximum amount for tax-exempt bonds is \$10 million, while a taxable bond’s dollar limit is established by the bond purchaser or credit enhancer. Funds can be used by eligible manufacturers to finance fixed assets for a specific project, new machinery & equipment, or various land and building needs.

Bond financing is, by definition, not suitable for micro enterprises. Transactions are rarely cost effective for capital needs of less than \$3 million—even the smallest “mini” or “express” bond programs will only finance down to \$250,000. The high capital costs for bonds stem from the necessity of paying for an underwriter, counsel, financial advisor, and trustees (at a minimum) to issue the bond.

Energy Programs

Commerce RI offers two lending programs tailored for energy investment: the Renewable Energy Fund (REF) and the Energy Revolving Loan Fund (ELF). REF is a grant and loan program concentrated on financing renewable energy projects in the areas of small-scale solar, commercial development, and feasibility studies. The source of funding is through the System Benefit Charge on electric bills, as well as Alternative Compliance Payments. ELF is similar to REF but has broader eligibility for a variety of energy efficiency upgrades, as well as wind turbines.

Micro enterprises may be able to access the energy programs, but only for eligible, energy-related costs. Therefore, these programs are not suitable for the general capital needs addressed by this report.

Innovation Finance

Commerce RI supports innovation and entrepreneurs through two financing programs. One is an investment in the Slater Technology Fund, which leverages public funding with private capital to provide seed capital to high growth companies. Another is an investment in Betaspring, an accelerator that has helped graduates raise millions of dollars in funding.

Both of these innovation-focused programs are financed through the U.S. Department of Treasury's State Small Business Credit Initiative (SSBCI). Small and micro enterprises are eligible to pursue funding through either Slater Technology Fund or Betaspring, although most businesses would not exhibit the innovation and high-growth potential that is required. The state's funds are committed to the innovation finance programs through contracts. The SSBCI program continues through March 2017. Beyond restrictions placed on the funds through the contracts, the U.S. Department of Treasury must determine whether any changes to current programs are permissible.

Micro Business Lenders in Rhode Island

Commerce RI is not the only potential source of financing for small and micro businesses in the state. Micro lending-specific organizations, cities, commercial lenders and other organizations also provide commercial micro financing in Rhode Island.

Micro Lending Institutions

Several micro lending institutions service Rhode Island, including operators of the U.S. Small Business Administration (SBA) micro lending program and dedicated micro lenders.

South Eastern Economic Development Corporation

The South Eastern Economic Development Corporation (SEED) is a Community Development Financial Institution (CDFI) and SBA micro lender based out of Massachusetts. SEED was mentioned throughout the stakeholder interviews as the primary group handling micro loans in Rhode Island. Despite this reputation, the number of loans issued by SEED in Rhode Island appears to be far too small to meet the anticipated micro financing demand within the state. SEED issued only four micro loans in Fiscal Year 2014, down from just nine during 2013. The loans are also connected to a significant collateral hurdle, as SEED requires borrowers to place their house as collateral on loans above \$10,000.

Social Enterprise Greenhouse

Social Enterprise Greenhouse (SEG) is a network of business and community leaders focused on improving social enterprise. SEG provides services in an effort to help organizations achieve their mission. SEG provides loans of \$20,000–\$60,000 with 3.75 percent interest for social entrepreneurs and ventures. SEG relies on donations to capitalize its fund and has only six employees, four of which are AmeriCorps volunteers. Unfortunately, these capital and capacity concerns stymie the potential impact of SEG's micro finance operation.

ACCION

ACCION is one of the most active micro finance organizations in the country. A chapter of the company makes loans in Rhode Island—primarily through an online platform. ACCION's business model is based on providing many loans to a broad customer base at comparatively high rates. Micro loans through ACCION have interest rates of 9–15 percent and an additional closing fee of 3–5 percent. On average, loans are for \$7,000 with a two-year term.

ACCION is perhaps the most prevalent micro lender in the state. The organization's ability to finance small and micro businesses lacking the collateral and credit required by traditional lenders has led to a number of applications received. ACCION's interest rates and fees reflect the level of risk inherent in serving this clientele, which is to say that the loans are somewhat expensive for many micro businesses.

Community Investment Corporation

The Community Investment Corporation (CIC) is based in Connecticut and has recently begun serving businesses in Rhode Island. CIC, an SBA-approved micro lender, completed its first micro loan in Rhode Island in 2014 and has issued 73 micro loans in Connecticut this year. With only a few months and one loan of experience in Rhode Island to date, CIC does not yet have a reputation among the state's micro business stakeholders. If CIC is able to bring any of the scale it has achieved thus far in Connecticut, then the organization's involvement will be significant for Rhode Island.

Center for Women & Enterprise

The Center for Women & Enterprise (CWE) is a nonprofit dedicated to helping individuals start and grow their business. CWE provides services across the New England region. Although primarily known for its technical assistance, CWE has recently received a \$50,000 grant from the State of Rhode Island to start a pilot micro loan program. The program will offer loans of \$500–\$5,000. Approximately 10-15 loans are expected to close per year. CWE’s loan fund is not designed to be self-sustaining, as loans will have zero interest (as well as a two percent penalty that can be applied for problem borrowers).

Capital Good Fund

Capital Good Fund is the only CDFI physically located in Rhode Island. However, Capital Good Fund is not oriented toward serving commercial enterprises. The organization’s mission is to fight poverty by providing underserved families with financial services, which include personal loans and financial coaching. The loans provided by Capital Good Fund are strictly for personal use, such as buying a computer or repairing a car, and are therefore not a contributing factor for micro businesses.

City Programs

At least two cities in Rhode Island operate a program providing loans to micro enterprises.

City of Providence

The City of Providence has two primary loan programs. Providence’s micro loan program can make loans of \$1,000–\$20,000. Rates are one percentage point above the U.S. Prime Interest Rate (prime). Businesses must have five or fewer employees, have been denied funding through conventional lenders, and have received training and mentoring assistance. Participation in the program has been extremely limited in recent years. Part of the limited activity may be attributable to multiple instances of a commercial lender deciding to underwrite a loan before Providence can close with a prospective client.

Providence also has a revolving loan program funded through the U.S. Department of Housing and Urban Development’s Community Development (HUD) Block Grant program. The maximum for the loan is \$125,000 with a 1:1 match of private capital. The loans can be used for rehabilitation, labor, materials, equipment, real property acquisition, and working capital. The applicant must meet one of HUD’s four national objectives for Community Development and create or retain one full-time employee for every \$35,000 loaned. This fund is suitable for small businesses but has underwriting targets that would be beyond the scope of most micro enterprises.

City of East Providence

The City of East Providence offers finance through two loan programs. The Commercial Loan Program is structured for commercial and industrial borrowers to finance the acquisition, construction, and improvement of land or buildings and for the purchase of capital equipment. The size of loans through this program range from \$10,000 to \$100,000 and have a variable rate with terms up to 15 years.

East Providence also has micro loans of \$1,000–\$10,000 available with rates one point above prime. Businesses must have five or fewer employees to qualify for loans through the program. The City's Economic Development Commission also requires proof of being denied from another traditional source of finance to qualify. Additionally, the business must submit a thorough business plan and participate in ongoing mentoring assistance after a loan is closed. East Providence has not underwritten a micro loan in the past three years.

Banks and Credit Unions

Rhode Island has a competitive banking landscape with multiple institutions eager to find ways to make loans to small businesses. As with much of the country, community banks and credit unions are more engaged in lending to small business than are the regional and national banks. Unlike many areas of the country, Rhode Island has multiple commercial banks that regularly underwrite loans of less than \$50,000. These lenders may have stringent financial requirements and lack the technical assistance services that greatly benefit many micro enterprises. However, the willingness of commercial banks to operate is a strong positive for Rhode Island. Publicly-supported micro lenders will not have to support promising micro enterprises as much to transition these businesses to traditional lenders, which is a key goal for every economic development finance program. Through research and stakeholder interviews, the following organizations were specifically mentioned as sources of micro finance for businesses.

Bank of America
Bank Rhode Island
Citizens Bank
Coastway Community Bank
Freedom Bank

Navigant Credit Union
Santander Bank
TD Bank
Washington Trust Company

Payday Lenders & Other Sources of Financing

The preceding sections do not cover all possible sources of micro financing. Many entrepreneurs looking are able to turn to family and friends for loans of a few thousand dollars. Multiple stakeholders in Rhode Island mentioned the prevalence of payday lenders—as well as less reputable loan providers—as regular sources of capital for micro businesses in the state. This is a concerning scenario. Payday loans typically have effective annual interest rates of 400–500 percent. While there is no commercial lender or publicly-funded program that should support a bad business, the state does have an economic interest in ensuring that good businesses are not heading down a ruinous path in their pursuit of micro capital.

Note about Collateral

One aspect of the micro lending market in Rhode Island stands out as unique. The stakeholders interviewed for this project consistently reported that lenders in the state expect—and often require—a house pledged as collateral against a loan as small as \$10,000. Multiple micro lenders reported this as a requirement of underwriting, as did many technical assistance providers and other micro business stakeholders. In most micro finance markets around the country, personal guarantees, co-signors, and equipment and commercial real estate pledges are more commonly taken as collateral.

The prevalence of an excessive collateral requirement is a serious problem for Rhode Island micro businesses. Borrowers should not need to pledge a house on a loan under \$35,000. While this is true of all potential borrowers, the requirement is more of a burden for low- to moderate-income businesses who may not have the same degree of financial reserves as wealthier business owners. Therefore, the same requirement, applied uniformly, may have a disproportionate impact on the market.

Small Business Technical Assistance in Rhode Island

Providing businesses with access to financing is only sustainable when the businesses also have access to the technical support they need. The following section establishes the sources of technical assistance available in Rhode Island. Two organizations were particularly noted for the services they provide.

Small Business Development Center

Small Business Development Centers (SBDCs), such as the one in Rhode Island, provide technical assistance and support to small businesses through free individual business counseling and a variety of training programs. The contract for an SBDC is awarded by the U.S. Small Business Administration (SBA) and goes through the Rhode Island district of the SBA. SBDC assistance can be topic- or industry-specific, and these organizations are frequently one of the go-to resources for small business assistance.

The SBDC was run through Johnson & Wales University from 2007 until 2014. In 2014, the contract for the SBDC was moved to the University of Rhode Island and the SBDC program was restructured. SBDC has opened three locations throughout the state, including one office co-located with Commerce RI.

The new SBDC management has already made several important strides. The SBDC has replaced many previously-contracted services with direct staff, who have made favorable impressions on the stakeholders. SBDC has also hired a bilingual business counselor to accommodate the state's significant Latino population. The new structure has not had enough time to permit a thorough review of the entity's effectiveness going forward, but there is plenty of justification for an optimistic outlook.

Center for Women & Enterprise

CWE's primary reputation is for the technical assistance it provides to entrepreneurs across the New England region. CWE does not solely engage women: 22 percent of their clients are male. The clientele represents a variety of racial, ethnic, and socio-economic backgrounds. CWE offers scholarships to disadvantaged entrepreneurs and develops influential networks for successful business women. CWE services cover education, training, technical assistance, and women's business enterprise certification.

A variety of micro business topics are covered through CWE's online classes and webinars, which are sometimes also offered in Spanish. The courses are typically 24 hours of class time over a six week period and cost \$100. One-on-one services are offered to provide expert counseling on all aspects of business. CWE will attempt to meet a client's need to the best of their ability, through such means as meeting a client at before or after work to fit the client's schedule. Occasionally, training is offered on the weekends to accommodate those unable to attend during the work week. CWE offers workshops provided by experts volunteering.

The reputation of CWE among regional stakeholders was extremely positive. The Center's website reports an internal survey finding that 94 percent of clients believed their experience led to increased understanding of business and entrepreneurship. Stakeholders repeatedly referenced CWE's program that targets recently unemployed individuals for entrepreneurial training. This program provides information and training for launching a new business, and the majority of graduates have been able to start their own enterprises. This innovative and apparently successful format has garnered significant attention throughout the state.

South Eastern Economic Development Corporation

SEED's technical assistance was not regularly identified by Rhode Island micro enterprise stakeholders. This is likely due to the fact that SEED's programs are operated through its headquarters in Massachusetts. However, as the state's most-recognized micro lender—as well as an entity obliged by the SBA to assist micro enterprises, SEED's technical assistance services should be considered.

SEED focuses assistance to start-up businesses and those in the first phase of development. The organization offers free workshops and provides resources, including publications, computer software, and internet access. SEED provides workshops throughout the year and partners with banks, credit unions, Massachusetts-based SBDC and SCORE, and local chambers of commerce. The partnership aspect is particularly important to achieving meaningful community outreach.

Other Providers

Several additional organizations were noted for providing technical assistance to small and micro businesses in one form or another. These organizations provide services that include one-on-one counseling, education related to accounting and other topics, posting information on micro business resources, and hosting forums for small business owners.

- ACCION
- Northern Rhode Island Chamber of Commerce
- Rhode Island Black Business Association
- SCORE Association
- Social Enterprise Greenhouse
- Urban Ventures



■ Small and Micro Business ■ Lending Program Report

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Recommendation Objectives & Overview

The analysis of micro business support in Rhode Island reveals three primary concerns.

- a) **Sufficient capital access for micro businesses:** While a variety of institutions that are at least potentially interested in providing micro financing exist in the state, stakeholders shared the opinion that many businesses struggle to acquire loans. Hard numbers on exact capital needs do not exist, so the sufficiency of current capital access cannot be quantified. However, what is clear is that even the state's most-named lenders (e.g., SEED and ACCION) are not lending in Rhode Island to a level that would suggest that the market is approaching saturation.
- b) **Accessibility of effective technical assistance for micro businesses:** Rhode Island contains several well-known technical assistance providers, but only one (CWE) has a clear reputation for effectiveness. The restructured SBDC may prove successful in the near future, and other providers appear to serve narrow market segments or are generally unknown to—or at least not readily thought about by—micro business stakeholders.
- c) **Impact of over-collateralization requirements on micro businesses:** From a national perspective, commercial micro lenders in Rhode Island have a nearly unique fixation on requiring a primary residence as collateral on loans above \$10,000. Other options, such as vehicles and co-signers, are commonly used in other markets across the country. This market condition likely has a dampening effect on micro businesses in the state.

Each of the concerns listed above stems from a micro lending market that is under-developed in Rhode Island. The state should therefore focus on opportunities to bolster this market. Preferably, these efforts will further serve to demonstrate to existing commercial lenders the sufficiency of less-stringent collateral requirements for micro loans.

Many improvements could be made by having an organization serve as a convener of both micro lenders and technical assistance providers. The primary goals of coalescing the lenders would be to focus on education and discussions about (a) marketing loan products to micro businesses and (b) non-housing sources of micro loan collateral. The goals of the technical assistance cohort would be to (a) share best practices and (b) encourage more thorough coverage of the state.

A more aggressive response to the concerns could be achieved if the State of Rhode Island could create a program to cultivate additional micro lenders in the state. The state would capitalize micro lenders, which would agree to develop technical assistance services and not require a house as collateral on homes for loans under \$35,000. This program would stimulate additional capital access and technical assistance options for state micro businesses, as well as providing a market demonstration of lesser collateral requirements to commercial lenders. The long-term impact of such a program on the state would be a healthier micro finance market and better options for micro businesses.

Convening Micro Business Supporters

The capital and technical assistance shortfalls that exist in Rhode Island are not entirely attributable to a lack of resources. The inefficient deployment (or availability) of resources is also a substantial problem. Organized, regular meetings of providers discussing best practices and resource availability could therefore significantly improve micro business support in the state.

Micro Lenders

The state's micro lenders should be convened for regular meetings. These organizations should discuss the micro business capital market in the state and best practices in providing loans to the market. Meetings of this group could achieve two primary outcomes. First, some of the group's activities should focus on education regarding micro loan collateral options—specifically, alternatives to primary residences as collateral. Second, the group should stimulate discussion of loan and business types not served by commercial lenders—providing mutually beneficial partnership and market opportunity information to nonprofit lending organizations. This convening would help the state's micro businesses, as well as the micro lenders themselves.

A wide array of lenders should be encouraged to participate in these meetings. Community banks, credit unions, community development financial institutions (CDFIs), local governments, and other lenders providing loans under \$50,000 should participate. The group should not be limited to providers based in Rhode Island, but should include any lender active in the state. Broad participation is preferable for generating better distribution of the meetings' information.

In order for these meetings to begin, occur regularly, and involve a number of important lenders, an organization will need to take the lead on convening the micro lenders. The organization that assumes (or is assigned) the responsibility of leading the meetings should likely plan on monthly or bimonthly meetings for a year. Topics, in addition to collateral, could include common problems with potential borrowers, new regulation concerning micro finance, reviewing profiles of successful and unsuccessful businesses, and economic opportunities in the state. If the meetings are well-run and interesting, then one or more organizations may be willing to take on the task of organizing future meetings themselves.

Technical Assistance Providers

A separate convening of small business technical assistance providers is important for Rhode Island. These meetings should focus on best practices, partnership opportunities, and service availability. The goal would be to bolster the overall level of technical assistance services in the state and expand to availability of those services. While the quality of different services and providers in the state were directly measured in this report, there are clear reputational differences across the providers. Furthermore, many businesses do not feel that they have ready access to quality technical assistance. Regular discussions geared toward improving quality and identifying market blind spots could go a long way toward helping both the state's micro businesses and the service providers.

Once again, all organizations involved in technical assistance services should be convened for these meetings. These providers include SBA providers, CDFIs, chambers of commerce, and other organizations. Broad representation is important to addressing the existing issues.

The structure for these meetings should be very similar to the structure described for the micro lenders. An organization will need to take the lead to convene the stakeholders and get the meetings scheduled and launched. Specific topics should include services needed in the state, methods of services delivery, and discussions about how to reach low-income and other hard-to-reach groups with technical assistance marketing and services. If the meetings are effective, then the long-term goal should be for a committee of providers to share the duties of hosting meetings beyond the first year.

Micro Loan Fund Capitalization Program

If Rhode Island is interested in taking a more aggressive approach to addressing the challenges confronting micro businesses in the state, then a new program provides the greatest promise for a solution to the issues discussed above. The program should focus on providing a source of capital, demonstrating the sufficiency of alternative collateral requirements, and cultivating additional technical assistance options. The program described in this section, which could be named the Small & Micro Business Opportunity Program, can achieve these objectives.

Overview

The Small & Micro Business Opportunity Program, as presented here, is designed to bolster the Rhode Island micro finance market. The purpose of the program is to capitalize three new or existing funds, which would not be tied to the house-based collateral requirements currently seen in the market, and also to expand technical assistance outreach.

The program would serve as a bridge to achieving two longer term objectives. First, the program is structured so that awarded lenders will be in a position to transition into becoming SBA micro lenders. Second, loans enrolled through the program would provide a market demonstration of collateral sufficiency and micro loan portfolio performance, encouraging commercial lenders to be better engaged in the future.

The Small & Micro Business Opportunity Program could be effective with a variety of price points. The detailed structuring information below is based on a \$1 million program that would capitalize and provide operational funding to three micro loan funds. The primary intention of this program is to serve as a one-time investment by the state. This funding level would have the potential to support dozens of micro loans in the state and have a significant impact on the Rhode Island micro finance market.

Eligible Applicants

The program should award funds to three organizations on a competitive basis. Minimum eligibility for organizations is willingness and capacity to operate a micro loan fund and provide technical assistance services in Rhode Island. The capacity should either currently exist within the organization, or else the applicant should prove an ability to build the capacity once funds are provided. Out-of-state applicants should be required to demonstrate how they will use the operational funds to ensure that services and capital are deployed within Rhode Island in order to be eligible.

Beyond these minimum requirements, Rhode Island should encourage—or provide bonus points on application scoring for—organizations that exhibit certain qualities. Experience with lending programs demonstrates experience, if not capacity. Similarly, experience with providing or partnering to deliver technical assistance services to micro enterprises is desirable. Organizations operating larger finance programs (or another, primary source of revenue) should be given particular preference as the micro loan business will not provide enough revenue to cover overhead beyond the end of the grant. Organizations stating an interest in using funds to pursue the SBA micro lender status are also preferable, as this will reduce the likelihood that future state investments are necessary. Additional preference should also be given to organizations providing matching funds.

Lending Expectations

The Small & Micro Business Opportunity Program should dictate some aspects of the loan structure to the participating lenders. Best practices in economic development loan fund management dictate that organizations should assess rates, fees and terms in a manner that allows the funds to at least recycle, if not also provide for administrative overhead. This later goal is more difficult for micro loans, which have slimmer margins due to their smaller nature. Nonetheless, any fund should at least set rates and terms that will allow funds to recycle above losses.

CDFA recommends that the program follow the SBA guidelines for micro loan rates and terms. Loans enrolled through the program should have a maximum of \$50,000, and participating lenders should be targeting capital needs from \$5,000-\$20,000. Loans over \$10,000 would be assessed a maximum interest rate of 7.75 percent, while smaller loans would be at 8.5 percent, above any costs of capital.* Loan terms should be a maximum of six years, but lenders should target shorter terms (three years) in practice to facilitate broader lending.

The program should set firm requirements regarding collateral, which will help ensure that the program achieves the market demonstration goal. Participating lenders should be prohibited from taking a house as collateral on loans of less than \$35,000. For loans from \$35,000-50,000, a house should not be required collateral. However, for loans of this size, lenders should be given the option to have a policy extending a lower interest rate to borrowers who do pledge a house. Acceptable forms of collateral used by other micro loans throughout the country are personal guarantees of the borrower and/or a co-signor, non-housing assets, commercial real estate, and equipment.

Participating lenders should be required to maintain a loan loss reserve fund as part of the program. Because the state is providing the capital without an expectation of return to the state treasury, the reserve is not truly necessary. However, in recognition of best practices and requirements that will come with any future SBA (or other) awards, a reserve fund will help the lenders build their experience and capacity appropriately. The SBA requires a 15 percent reserve to be maintained for micro loan funds. Although reasonable for the SBA's purposes, that rate is inefficient for the Small & Micro Business Opportunity Program. Therefore, the state should set a more modest requirement of no less than 10 percent of loan funds to be held in reserve.

Technical Assistance Expectations

Participating lenders should be required to provide technical assistance services to borrowers both before and after closing on a loan. While assistance before closing is more valuable to both the borrower and the lender, the SBA program requires substantial post-closing services. CDFA does not recommend that the Rhode Island program force providers to emphasize post-closing assistance, and instead recommends that services be provided on an ongoing basis.

There are many examples of best practices in technical assistance services. The primary pre-closing issue for micro enterprises is loan readiness. Therefore, providers should be encouraged to offer classes,

* The SBA guidelines cap interest rates at 7.75 percent and 8.5 percent above the lender's cost of capital. Under this program design, there is no cost of capital for the state funds. Organizations that provide matching capital that carries a cost should be allowed to charge a higher interest rate that is the organization's cost of capital plus the percentages given above.

resources and counseling addressing how to build credit, maintain proper accounting records, and complete necessary tax records. Additional topics that prove effective assist businesses with software, internet access and skills, marketing plans, and personnel issues.

Prospective lenders should provide a clear technical assistance plan outlining the services to be provided, along with when and where these services will occur. Applicants should be encouraged to explicitly consider how they will provide services to LMI business owners, who expressed a lack of equitable access to existing technical assistance services in the state. These technical assistance outlines should also include plans for partnering with existing technical assistance providers. No one organization can cover all desirable technical assistance services, and the state must ensure that the providers it supports are part of Rhode Island's broader small business technical assistance network.

Administrative Requirements

Operating any development finance program requires strict administration to ensure appropriate use of public funds. The Small & Micro Business Opportunity Program should be specifically assigned to a state entity with the capacity and experience required to manage a program of this nature. This entity will be responsible for letting the initial RFP, selecting awardees, managing the transfer of funds, reviewing reports, measuring outcomes, addressing shortcomings or failures, and publicizing the results of the program to the government and citizens of Rhode Island.

The structure of the funds to the participating lenders should be divided into two grants. The first is the grant to capitalize each micro loan fund. Of the \$1 million, 75 percent should be used toward this purpose (providing each lender with a \$250,000 fund). The second grant would go toward service costs, including both the technical assistance and the operation of the loan fund. If the state wishes to keep the entire costs of the program within the \$1 million, then the operating grants should be set to \$75,000 apiece, bringing the total amount of operating funding to \$225,000. The remaining \$25,000 can then be allocated to the administering state agency to offset increased personnel and hard costs associated with program management.

In order to further ensure the appropriate and effective use of the state's funds, the monies for both the fund and operational grants should be advanced to participating lenders in two tranches. The first tranche would be due upon the execution of an operational agreement between the administering entity and the participating lender. This tranche should be \$100,000 (40 percent) of fund capital and \$50,000 (67 percent) of operating funds. The second tranche should not be advanced to the lender until 80 percent of the first tranche's loan funds have been committed to businesses and the program has been reviewed for compliance by the administering entity. This model is based on the U.S. Department of Treasury's SSBCI, which utilizes three funds with Treasury staff or Inspector General audits between the allocation of new tranches. While this degree of inspection would be excessively expensive for this program, a similar design will help secure the public monies used for the loan funds.

The program should require participating lenders to submit reports, at least annually, to the administering state entity. These reports should—at a minimum—list the businesses receiving the loans, the size of the loans, collateral held, payment status, any jobs created, and technical assistance services received. Additionally, the amount of funds remaining in both the loan fund and operating grant, size of reserve fund, and any write-offs should be provided. The state may reasonably decide that quarterly reporting and additional metrics, such as business location and MBE or WBE qualifications are also required. In making reporting decisions, the state should bear in mind that additional reporting

requirements add to the administrative cost of the program for both the participating lenders and the administering state agency. Additional requirements may also add to the length of time required for the business to access the funds, as well as the overall willingness of businesses to utilize the program.

Continuing Funding

The Small & Micro Business Opportunity Program is primarily designed to be a one-time infusion of capital into the Rhode Island micro finance market. Effectively-managed micro loan funds with at least \$250,000 should be able to sustain themselves, and a nearly 25 percent operational contribution is more generous than most lending programs provide to their participants. Furthermore, a key long term goal of the program is to transition the participating lenders to SBA (or other) sources of micro finance capital, reducing the necessity of a future round of state funding.

Of course, legislators should expect that their participants will be interested in future funding for the program. The design should ensure a successful operation, and future rounds will be desirable. Whether additional funding is appropriate is a decision that will have to be made down the road.

Any additional infusion of loan fund capital may even more tightly follow the SBA's example by charging the participating lender one-two percent for program funds, rather than making an additional grant. However, the program is designed so that the funds should be self-sustaining. With \$750,000 capital out the door (from the state) and 10 percent held in reserve, a fund achieving the SBA's average performance of \$13,000 average loan size, 40-month terms, and 12 percent losses will return \$750,930 at a 7.75 percent interest rate. This is just enough to recycle the funds. A fund based on smaller loans (and charging higher interest) can return more than \$759,000 under similar conditions, as would a fund experience a lower loss rate or longer terms. Losses of 15 percent or more, or loan terms shorter than three years, would decrease the funds at a rate of \$10,000-\$25,000 per year (across the board), which is a slow enough rate for the funds to remain viable for years.

Whether the state should provide further operational grants is a more difficult judgment. Providing quality services is not cheap. Therefore, to the degree that the state selects participants who do not already have an existing business model incorporating loan fund management and technical assistance services, an additional round of operational grants may prove a necessary and worthwhile investment.

Performance Metrics

The Small & Micro Business Opportunity Program is designed to achieve a more robust micro finance market for the state of Rhode Island. There are micro and macro performance objectives that the state should track to measure the performance of the program.

On the micro scale, the state should look at the use of the loan funds. Considering the difficulties with launching new programs, Rhode Island can reasonably expect that the funds will not achieve significant penetration until late in the first year at the earliest. With an average micro loan term of 40 months, this means that the funds should recycle through the program within five years. Over this time period, the funds would provide approximately 52 loans (at an average of \$13,000 per loan) for Rhode Island micro enterprises. To put this in perspective, SEED and CIC combined have made five micro loans in the state in fiscal year 2014—a pace of 25 over five years. The program would therefore provide a significant boost to the market.

On a macro scale, which is the key for the program, the state should look for changes in the micro finance market. The program will really be successful if commercial lenders who provide loans under \$50,000 stop requiring a house as collateral for these loans. Considering the reported competition for these loans in Rhode Island, it is reasonable to expect that this change will occur once the state's participating lenders provide a track record of success. The second macro-level metric for success is whether the participating lenders are able to achieve SBA micro lender status and/or find alternative sources of additional loan fund capital.

The program's success relies on two primary factors. First, whether reasonably effective operators are selected as participating lenders. The numbers for the fund work, so as long as (a) the program is marketed and borrowers participate, (b) the funds are not mismanaged, and (c) the lenders do not make a glut of poor lending decisions. The second is more outside of anyone's control—whether the market demand for micro finance truly exists. Unfortunately, no data effectively captures a true need for micro lending in Rhode Island. The best evidence of a need lies in the absence of substantial existing services and in the statements of a wide variety of stakeholders. If micro businesses in the state do not need the financing, then no program will achieve substantial results.

Assuming the more likely scenario in which Rhode Island micro businesses do face barriers in accessing capital, the Small & Micro Business Opportunity Program is designed to effectively address these barriers in the near and long term.

Small and Micro Business Lending Program Report

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