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Microenterprise and the Small-Dollar Loan Market

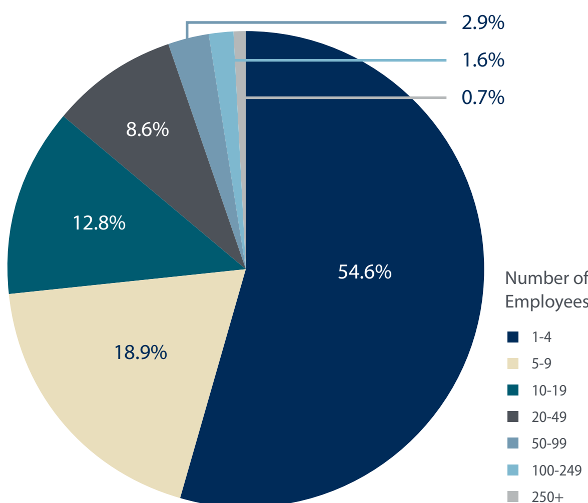
By Tammie Hoy, Jessie Romero, and Kimberly Zeuli

"Small business" is a designation that includes businesses of many different sizes with varying financial needs and access to credit. Microenterprises—businesses with fewer than five employees—are served primarily by the small-dollar loan market, which ranges from payday lending to microloans offered by nonprofit organizations and, to a lesser extent, loans from traditional financial institutions. This *Economic Brief* explores the need for and challenges facing the small-dollar loan market in the United States.

Small businesses are widely viewed as an engine of growth for the economy, and ensuring that they have adequate access to credit has been a major concern for policymakers during the recovery from the 2007–09 recession. But "small business" is not a uniform category. The U.S. Small Business Administration (SBA) generally defines a small business as one with fewer than 500 employees, which includes nearly all of the 7.4 million businesses with paid employees in the United States.[1]

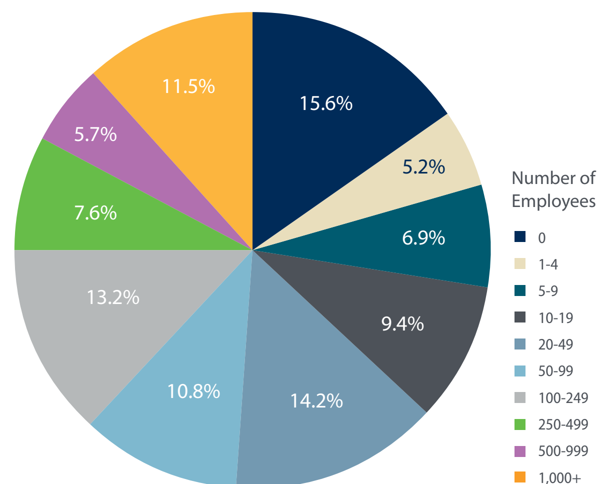
Of those businesses, 4.1 million, or 54.6 percent, employ between one and four people. An additional 21.1 million firms have no employees other than the owner, according to the U.S. Census Bureau. Nonemployer firms and companies with fewer than five employees account for 87.4

Figure 1: Share of Firms by Employment



Note: Chart includes only firms with paid employees.
Source: U.S. Census Bureau

Figure 2: Share of Employment by Firm Size



Note: Chart includes both firms with paid employees and nonemployer firms.
Source: U.S. Census Bureau

percent of all firms in the United States, and about 20 percent of total employment.

Many of these companies are deemed microenterprises, defined by the microenterprise development industry as companies with fewer than five employees that require less than $35,000 in start-up capital and are viewed as lacking access to traditional commercial bank financing. Many policymakers and community development professionals are interested in microenterprises as effective tools for supplementing household income or as paths to employment for workers with relatively poor job prospects.[2] According to some estimates, self-employment could be a viable livelihood for 8 percent to 20 percent of poor households in the United States. Other research suggests that poor individuals are more likely to prefer wage jobs because they entail less risk and offer higher pay than self-employment.[3] At present, however, it is possible that high unemployment, particularly long-term unemployment, has created a new pool of potential entrepreneurs.[4]

For many small business owners, there is little distinction between balance sheets for their households and their businesses. According to the most recent Federal Reserve Survey of Consumer Finances, in 2007, 17.8 percent of families with actively managed businesses used personal assets as corporate collateral, and 17.5 percent loaned the business money. Families headed by a self-employed person were much more likely to have a home equity line of credit and to borrow against it. About 45 percent of small employers use personal credit cards to pay business expenses, according to the National Federation of Independent Business. Small business owners also often borrow informally from family members and friends. Since the financial crisis and recession, many of these nonbank sources of credit have been more difficult to tap.[5]

Small-Dollar Loans

Small-dollar and near-small-dollar loans—defined as loans less than $1,000 and $2,500, respectively—are another financing option.

Retail payday lenders dominate the short-term, small-dollar loan market. Payday lending has grown rapidly in recent years from about 2,000 outlets in 1996 to more than 23,000 today. The annual value of these loans is between $40 billion and $50 billion, according to industry estimates. Payday lenders usually offer a two-week term and charge a flat fee of about $15 per $100 borrowed. Because payday borrowers tend to roll the loan over rather than pay it off, the effective annual interest rate on such loans can reach more than 400 percent. Payday lenders require borrowers to have a checking account and a steady source of income, but poor credit histories or a desire for convenience and immediacy might keep these borrowers from seeking lower-cost sources of credit.[6] As demand for small-dollar loans has grown, many credit unions and a few banks have entered the market in search of new customers and revenue streams. Credit union and bank loan terms are typically longer than those of retail payday lenders.

About 30 banks ranging in size from $28 million to $10 billion in assets participated in the Federal Deposit Insurance Corporation's (FDIC) Small-Dollar Loan Pilot Program, which was designed as an alternative to payday lending and other high-cost forms of credit. During 2008 and 2009, participants offered loans of $2,500 or less to borrowers who otherwise would not have had access to bank financing. The banks loaned a total of $40.2 million during the pilot program. They created a streamlined underwriting process and required a minimum credit score in the low 500s. Loan terms were at least 90 days, and annual interest rates could not exceed 36 percent, including origination fees. Charge-off rates were comparable to other forms of unsecured consumer credit, and nearly all the banks indicated that they would continue to offer small-dollar loans at the conclusion of the pilot program. Banks offering such loans remain in the minority, however.

Microenterprise Development

While small-dollar loans are open to any qualified borrower, microloans, defined as loans less than $35,000, are specifically targeted toward current and aspiring microenterprise owners.[7] In 2008, the total amount of microloans was $101 million in the United

States, with an average loan size of $11,000, according to the Aspen Institute Microenterprise Fund for Innovation, Effectiveness, Learning and Dissemination (FIELD). Many loans are much smaller, sometimes as little as $500. Interest rates usually range from 5 percent to 18 percent, often higher than traditional bank loans but lower than payday loans and many credit card rates.

Microcredit often is associated with the developing world, but microenterprise development organizations (MDOs) emerged in the United States in the mid-1980s. MDOs provide business development services to entrepreneurs. There are about 700 MDOs in the United States, according to FIELD, and 362 of them offer microloans and other credit products. The remainder only provide services such as technical assistance or mentoring. The Association for Enterprise Opportunity (AEO), an MDO membership organization, puts the total number of MDOs somewhat higher, at 1,163. There are 113 MDOs in the Fifth District, according to the AEO, including both lenders and nonlenders.

The MDO lending market is somewhat concentrated: only 10 MDOs in the United States disbursed more than 100 loans in 2008, and they accounted for 49 percent of all the dollars disbursed, according to FIELD. Most MDOs are very small, with five or fewer full-time employees and a median operating budget of $250,000, and they tend to serve small geographic areas. The largest microlender in the United States is the ACCION U.S. Network, which has affiliates covering 11 states and a nationwide online application program.[8] ACCION is an international microfinance organization founded in Venezuela in 1961. It launched the U.S. Network in 1991.

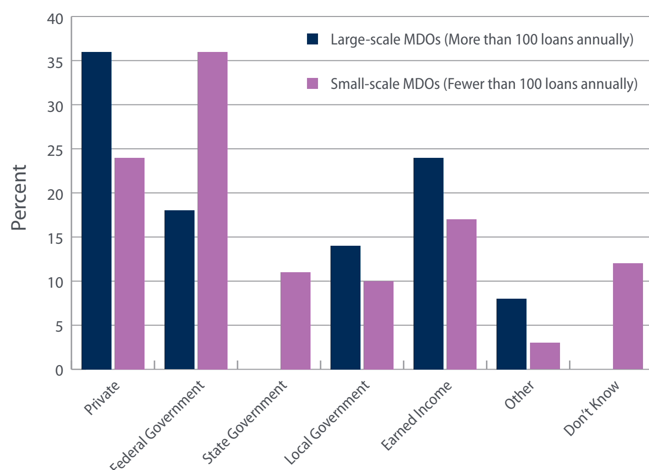
Another large MDO, Grameen America, is relatively new to the U.S. market and to the Fifth District. The original Grameen Bank was founded in Bangladesh in 1976 by economist Muhammad Yunus, who won the Nobel Peace Prize in 2006. Grameen America opened its first branch in 2008 in Queens, N.Y. Since then it has opened five additional branches, with new branches scheduled to open in Charlotte, N.C., San Francisco, the Bronx, and Queens in 2012. Grameen America caps loans at $1,500 and interest rates at 15 percent. It has disbursed more than $20 million to 7,000 borrowers so far, with a repayment rate of 99 percent, according to the organization. Unique among U.S. microlenders, Grameen uses a "peer-lending" model, which requires each prospective borrower to find four friends or family members who also want to take out loans to start their own businesses.[9] This group then goes through a week of mandatory financial education followed by weekly meetings with other borrower groups.

Research suggests that the peer-lending model can reduce monitoring and screening costs for lenders, and the model has been successful in some developing countries.[10] But it's uncertain how well the approach translates to the U.S. market, where low-income individuals are more geographically mobile and more geographically distant from one another. They might not have the same strong community ties that enforce a sense of joint liability.[11] This was the case in Arkansas with the Good Faith Fund, an organization founded in 1988 that was an early attempt to replicate the Grameen model in the United States. Between 1989 and 1994, the fund served only about 20 borrowers per year and suffered from high default rates and fraud. It gradually phased out peer lending in favor of credit checks and collateral requirements, and today it focuses primarily on career training.[12]

MDO Funding Sources

MDOs depend on a mix of private donors and government agencies for both operating expenses and lending capital. At the largest microlenders, income from lending covers only 24 percent of their operating budgets on average; at smaller organizations, the average is 13 percent The primary source of lending capital is the federal government. One major federal funder is the SBA, whose PRIME program offers grants to MDOs for technical assistance and capacity building. The SBA Microloan program also provides lending capital to selected MDOs, who serve as intermediaries between the SBA and borrowers. SBA Microloans are capped at $50,000, and the average loan is about $13,000.

Figure 3: MDO Funding Sources for Operating Expenses



Source: William Girardo and Elaine L. Edgcomb, "Key Data on the Scale of Microlending in the U.S." FIELD, February 2011.

Another source of funding is the U.S. Treasury Department's Community Development Financial Institution (CDFI) Fund. CDFIs are specialized financial institutions, certified by the Treasury Department, that operate in urban and rural low-income communities. The CDFI Fund provides equity capital and grants and allocates tax credits to these organizations. There are currently 963 CDFIs operating nationally, including loan funds that serve microenterprise, business, housing, or community service organizations. The Fifth District has 89 CDFIs, including 55 loan funds.[13]

Traditional banks contribute to MDOs in a variety of ways that earn favorable consideration under Community Reinvestment Act regulations.[14] One method is program-related investments, or PRIs. These are low-interest, typically unsecured loans used to finance charitable activities. Another common mechanism is "equity equivalent" or EQ2 investments. An EQ2 investment is similar to a permanent capital investment in that it allows the recipient to strengthen its capital structure and leverage additional debt capital. Unlike permanent capital, however, EQ2 investments must eventually be repaid with interest, albeit it at below-market rates. In 2010, Wells Fargo made a $1 million EQ2 investment in Grameen America with $500,000 directed to the Charlotte, N.C., branch.

Challenges for Small-Dollar Lenders

Despite the emergence of several large-scale microlenders, the industry as a whole is small. U.S. MDOs served approximately 274,000 individuals in 2008, including those who received loans and those who received only training services. The potential target market is about 10 million people, according to FIELD, but the industry faces a number of challenges in scaling up to serve this potential.

One challenge is assessing the demand for microenterprise services. Although FIELD estimates a potential market of 10 million entrepreneurs, it is not certain that all of these individuals need microcredit. Unlike developing countries, the United States has a large and mature financial sector, which offers a broad range of credit options to potential borrowers, even if some of those options are relatively high cost. For example, some borrowers might prefer the convenience and immediacy of credit cards or payday loans to microloans, which often require training or financial education or have other transaction costs. In addition, not all microentrepreneurs have the same goals. Some are "income patchers," who want only to supplement a wage income, while others are focused on growing their businesses. These owners require different levels of assistance and financing.

On the supply side, it is difficult to price small-dollar loans. Microlenders and traditional banks entering the market express a desire to provide safe, affordable loans, but they also must charge an interest rate that allows them to recover the high costs of offering the loans. Banks in the FDIC pilot program reported that given the small size of the loans, the interest and fees generated were not enough to make the loans profitable in the short term, even with annual interest rates of up to 36 percent. Most MDOs recover only a portion of their costs; those that focus primarily on credit products recover 47 percent of their annual lending costs, on average, while MDOs that offer both credit products and training recover only 16 percent, according to FIELD.

The underwriting process contributes to high lending costs. Microlenders traditionally have relied on "relationship-based" underwriting with a high

degree of client interaction in decision making. As larger microlenders have found, however, scaling up requires more "transaction-based" underwriting, using credit scorecards and other quantitative factors. Despite the potential savings, just under half of MDOs use credit scoring, according to FIELD; many are reluctant to switch from a high-touch approach they view as integral to their mission.

One factor in the underpricing of microloans is funding sources. The SBA, for example, limits fees and requires lenders to charge no more than 8 percent above their cost of funds. Private sources also may make such limits a condition of their donations. While MDOs depend on government subsidies and private donations to serve their clients, this reliance could be a hindrance to growth because MDOs must devote resources to attracting and complying with diverse funders.

Technology could help microlenders increase their efficiency, although many have not adopted new tools. For example, ACCION Texas offers an automated credit scoring system and a web-based loan application process to microlenders across the country. Currently, only 15 other lenders use the tool. Kiva, an online person-to-person lender, is a new funding option for microlenders. A prospective borrower applies for and receives a loan through an MDO. The borrower's story is then posted on Kiva's website. As individuals read the story and choose to donate to the borrower, Kiva reimburses the MDO for the cost of the loan. Two large U.S. lenders—ACCION USA and Opportunity Fund, in California—participate in Kiva. Although tools such as online lending and social media could help smaller lenders achieve greater scale, not all have the capacity to take advantage of them.

Finally, the small-dollar loan market and the microenterprise industry are constrained by a lack of data. For example, many MDOs don't have robust cost-accounting systems or adequate information to make pricing decisions, and more research is needed into the effects on borrowers and the economy as a whole. Without reliable information about the costs, benefits, and impact of microlending programs, potential donors and policymakers might be reluctant to support new programs.

Meeting the financial needs of microenterprise owners presents a number of challenges to both MDOs and traditional financial institutions, including determining appropriate pricing, underwriting, and risk management strategies. Whether or not microenterprise development organizations can scale up and achieve sustainability in the United States—and what affect that would have on small-dollar lending—are questions that remain. ▪

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Endnotes

[1] This definition varies according to industry. For example, a manufacturing firm can have up to 1,500 employees and still be considered a small business.

[2] For example, see "Microenterprise: Creating Wealth for Individuals and Communities," Federal Reserve Bank of Cleveland Community Reinvestment Report, Summer 2006; and the proceedings of "Small Business and Entrepreneurship during an Economic Recovery," a conference held at the Federal Reserve Board of Governors in Washington, D.C., November 9–10, 2011.

[3] See Mark Schreiner and Jonathan Morduch, "Replicating Microfinance in the United States: Opportunities and Challenges," in *Replicating Microfinance in the United States*, James H. Carr and Zhong Yi Tong, eds., Woodrow Wilson Center Press, Washington, D.C.: 2002.

[4] Research suggests that an increasing unemployment rate is a key driver of nonemployer start-up rates. See Zoltan J. Acs, Brian Headd, and Hezekiah Agwara, "Nonemployer Start-Up Puzzle," SBA Office of Advocacy Working Paper, December 2009.

[5] See Betty Joyce Nash and Kimberly Zeuli, "Small Business Lending During the Recession," Federal Reserve Bank of Richmond *Economic Brief* No. 11-02, February 2011.

[6] Gregory Elliehausen and Edward C. Lawrence, "Payday Advance Credit in America: An Analysis of Customer Demand," Monograph No. 35, Georgetown University Credit Research Center, April 2001.

[7] This definition is based on the previous SBA Microloan program limit of $35,000. The Small Business Jobs Act raised the limit to $50,000 in September 2010, but the $35,000 benchmark remains widely used.

[8] The ACCION U.S. Network includes ACCION Chicago; ACCION New Mexico, Arizona, and Colorado; ACCION San Diego; ACCION Texas-Louisiana; and ACCION USA, which has offices in Florida, Georgia, Massachusetts, and New York.

[9] Several MDOs have tried to replicate the peer-lending model in the United States with limited results. See Schreiner and Morduch (2002).

[10] See Edward S. Prescott, "Group Lending and Financial Intermediation: An Example," Federal Reserve Bank of Richmond *Economic Quarterly*, Fall 1977, vol. 83, no. 4, pp. 23–48.

[11] Schreiner and Morduch (2002).

[12] See Rajdeep Sengupta and Craig P. Aubuchon, "The Microfinance Revolution: An Overview," Federal Reserve Bank of St. Louis *Review*, January/February 2008, vol. 90, no. 1, pp. 9–30; and Richard P. Taub, "Lost in Translation: A Grameen Bank Clone in Southern Arkansas," Presentation to the American Sociological Association in Toronto, August 1997.

[13] The Richmond Fed's Community Development Department maintains a directory of CDFIs at http://www.richmondfed.org/community_development/resource_centers/cdfi/.

[14] For descriptions, see "Community Development Financial Institutions: A Unique Partnership for Banks," Federal Reserve Bank of Richmond Community Development, 2011.

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