

Capitalizing Microenterprise Funds:  
The Virginia Enterprise Initiative

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Abstract

The Virginia Enterprise Initiative (VEI) is a state program established with the objective to help fund 15 microenterprise loan programs beginning in 1995. An important aspect of the VEI program is the use of leverage. A relatively small amount of state funds is used to attract a much larger amount of funds available from the Federal government, commercial banks and other sources. The program was successful in using leverage and attracted \$4.7 million in matching funds to support the programs that received state grants. The major sources of these funds were the Federal government (\$2.6 million) and commercial banks (\$1.4 million). This paper examines the sources of the matching funds and the degree of leverage achieved by this program in order to analyze the sources of funding available for start up microloan programs during this period.

Introduction

Since the mid 1980's a new financial institution, the microenterprise loan fund, has become a source of capital for small business start up in the United States. Microenterprise funds are designed to promote self-employment for economically disadvantaged individuals by providing credit and business training. Most of the businesses these programs service are very small, less than five employees, hence the term microenterprise. These funds usually target low income communities, women, and minority groups with their lending activity. The borrowers either do not qualify for bank business loans or have had a loan application rejected.

Microenterprise funds usually have both economic and social goals. The economic goals include self-employment, job creation, and local economic development. The social goals include personal and social development of clients with a view toward empowerment. Microenterprise funds are nonprofit organizations. They receive financing through government loans and grants, charitable foundation grants, and loans from local banks. This paper examines the process through which microenterprise funds are capitalized by analyzing the experience of the Virginia Enterprise Initiative (VEI). The VEI is a state program established in 1995 with the objective to help fund 15 microenterprise lending programs in the Commonwealth of Virginia. An important aspect of the VEI program is the use of leverage. The program uses a relatively small amount of state funds to attract a much larger amount of funds available from the Federal government, commercial banks, and other sources. The primary purpose of the paper is to describe the major sources of funding

for the VEI supported microenterprise loan programs. The cost of funds and the capital structure of the microloan programs is also examined.

The ongoing effort to increase the formation of microenterprise loan programs both in the United States and internationally makes this an important topic. For example, the Micorcredit Summit is a collaborative international effort to reach 100 million of the world's poorest families with credit for self-employment by 2005 (Results 1997). While this program is still in the planning stage, it also calls for extending microcredit to four million poor people in industrialized countries. An examination of the Virginia Enterprise Initiative can provide important information concerning potential sources of funds to support program growth in the United States. Before examining the VEI, background information is provided on microenterprise loan funds, and Federal programs and legislation in this area is reviewed.

## Background

### A Brief History of Microenterprise Loan Programs

Microenterprise lending originated in developing countries in the 1970's. A frequently cited example is the Grameen Bank of Bangladesh (Hassain, 1993). In 1976, Muhammad Yunus began an experiment in developmental lending that evolved and grew into a specialized financial institution called the Grameen Bank. The bank was capitalized in 1983 with a loan from the UN's International Fund for Agricultural Development and financial support from the Ford Foundation. The Grameen Bank developed a successful peer support system. Borrowers, the vast majority being women, must join lending circles that meet regularly. The lending circle provides monitoring, some training, and support to its members.[1]

Typically, microenterprise loan programs in developing countries such as Bangladesh can target a large portion of the population. This is due to a general lack of banking services and a large number of poor people who depend on self-employment for survival. Developmental banks are usually capitalized with grants and loans from international organizations and charitable foundations. Some have become self-sustaining. Low operating costs combined with economic growth opportunities can make developmental lending self-sustaining.[2]

The first microenterprise loan fund in the U.S., the Women's Economic Development Corporation (WEDCO), was founded in 1982.[3] WEDCO trained clients in business skills and business planning and provided business loans after the clients completed the training and planning process. This is the approach currently used by the majority of U.S. microenterprise loan programs. In 1988, two microloan funds started programs based on the Grameen Bank peer lending approach. These programs were the Good Faith Fund in Arkansas (Mondal and Tune, 1993) and the Full Circle Loan Program of the Women's Self-Employment Project in Chicago (Balkin, 1993). Theoretically, a microloan program using the peer lending model should have lower overhead compared to a program that uses a training model like WEDCO. This is because the peer group, instead of paid staff personnel, performs training, planning, loan approval and monitoring functions. The Self-

Employment Learning Project of The Aspen Institute (Edgecomb, Klein, & Clark, 1996) found that due to cultural differences, the pure peer lending approach has to be modified to work in the United States. The modifications made to adapt peer lending to the U.S. environment have resulted in increased operating costs compared to the pure model.[4]

In the U.S., microenterprise funds include a very diverse group of organizations. Some are formed by insured deposit institutions such as banks or credit unions. Most are non-profit community development organizations. Many programs administer their loan funds while others use banks or other credit sources for this function. The business loans made are usually very small, averaging less than \$5,000 per loan in most programs. Most microenterprise lending programs need continuous outside support for operating funds due to the high transaction costs and the large overhead needed to support training and mentoring activities. Programs that target welfare recipients typically make smaller than average loans and have higher than average operating costs. Programs that do not have client income restrictions make larger loans and tend to have lower operating costs. These factors, combined with the costs and restrictions associated with funding sources affect the ability of a program to be self-sustaining.

Federal agencies, most state governments, and many local government agencies are committed to support and fund microenterprise formation efforts. Foundations, churches, and other non-profit organizations were instrumental in starting the microenterprise fund movement in the United States and are still important sources of support. As we will show below, the commercial banking system is playing an increasingly important role in capitalizing the loan pools of microenterprise funds.

#### Why Developmental Lending in the US?

There are several sources of capital that entrepreneurs draw upon when starting a business. The most important source is the entrepreneur's personal savings. Another significant source is loans from friends and relatives. Data from the 1993 National Survey of Small Business Finances (Cole and Wolken, 1995) show that banks and other financial institutions are the most important source of credit for small businesses. Seventy-four percent of the firms that obtained credit lines, loans, and leases used financial institutions. However, banks do not make business start up loans unless the entrepreneur has significant personal wealth. The minimum bank business loan is usually \$25,000. A low-income individual, trying to finance a business start up, would not normally qualify for a bank loan.

Venture capital funds can also be an important source of capital for new businesses. However, venture capital funds tend to gravitate to high tech areas such as communications and computer hardware and software. Further, venture capital funds typically deal only in relatively large investments, with minimums of one-half or one million dollars.

The poor have restricted access to traditional funding sources for business endeavors. By definition, the poor do not have much in the way of personal savings. They are also less likely to have

friends or relatives with enough wealth to finance a business start up. Furthermore, the poor characteristically have little financial sophistication and often bad credit records, which make them unlikely candidates for bank financing.

Access to credit is not the only barrier that challenges the poor who wish to start their own business. Training in basic business skills is an important factor in increasing the probability for success of any business start up. The poor usually have little or no business training and often have little or no experience in using a checking account or keeping business records.

#### Federal Programs

The major Federal initiatives that support microenterprise loan programs are reviewed in this section. These Federal programs facilitate the growth of microenterprise loan funds and provide funding for the continued operation of many programs. The Federal government also provides incentives for commercial banks to support these programs.

#### Small Business Administration

The Small Business Administration (SBA) has traditionally played an important role in the availability of funds for small businesses by guaranteeing bank loans. In 1992, the SBA implemented a new program, the Microloan Demonstration Program. This program lends money to microenterprise loan funds and provides technical assistance grants. The organizations selected to participate in the program function as intermediaries, borrowing money from the SBA and in turn make loans to their clients. The purpose of the program is "to assist women, low-income, and minority entrepreneurs, business owners, and other individuals possessing the capability to operate successful business concerns; . . ."[5]

The SBA Microloan Demonstration Program has become an important source of funds for microenterprise loan programs. Programs that have become intermediaries have been able to significantly increase their loan portfolios. The SBA technical assistance grants also provide a needed source of funds to cover administrative and training costs. The SBA Microloan Program has also allowed microenterprise funds to broaden their target population since there are no income restrictions on the borrowers. The SBA loans carry an interest rate based on the size of the loan extended to the client and the current T-Bill rate. The microenterprise loan program is required to relend the money at a spread of 8.5% over cost for loans under \$7,500 and 7.75% over cost for loans over \$7,500. For example, if a microenterprise program made a \$10,000 loan to a client using SBA funds and the cost of funds to the program was 5%, the cost to the client would be 12.75%. The program must make payments even if their clients default. To help insure repayment, the SBA requires the microenterprise fund to maintain a loan loss reserve of 15%.

From 1992 to 1996, the program grew to 126 intermediaries. The organizations who serve as intermediaries receive a specified level of lending authority and a Technical Assistance Grant of up to 30% of the lending authority. The SBA selected three Virginia

microenterprise programs to participate in the Microloan program: the Ethiopian Community Center in Arlington, the Lynchburg Regional Small Business Partnership, and People Incorporate in Abingdon. Congress has continued funding this program for FY 1997.

#### Department of Housing and Urban Development

The Department of Housing and Urban Development (HUD) administers the Community Development Block Grant (CDBG) program and the Economic Development Initiative (EDI). Block grants are made to city and state Development Agencies and support a variety of programs, one of which is microenterprise development. EDI funds are used in conjunction with the loan guarantee provision of the CDBG program. Local community development organizations that receive funds to operate microenterprise loan programs must use the HUD low/moderate income guidelines to determine eligible clients.

#### U.S. Department of Agriculture

The U.S. Department of Agriculture (USDA) has an ongoing Intermediary Relending Program that targets business facilities and community development in rural areas. Through this program, the USDA provides up to \$2 million to non-profit corporations or public agencies with business lending experience to act as an intermediary developmental lender. Many of these intermediaries operate microenterprise loan programs. Federal Legislation and the Banking Industry In the last twenty years there have been several pieces of Federal legislation that have sought to create fair-lending standards in the banking industry. The Community Reinvestment Act (CRA) is a 1977 Federal law that requires banks to lend in their communities. When the law was first enacted, many banks were seen as discriminating and practicing unfair-lending practices by avoiding doing business in distressed urban areas. Particularly important was the absence of credit for home loans and business start ups in these areas. The CRA sought to remedy this situation by having the bank and thrift regulators create and enforce performance based standards to guide banks in providing service to all people in their service area. The banks have criticized the regulators for the paperwork that is associated with the CRA. Community action groups have complained that the regulators are not tough enough on banks with poor lending records.

The Equal Credit Opportunity Act and the Fair Housing Act are further efforts to eliminate discrimination in lending practices. These two laws are enforced by the Justice Department which has taken an aggressive approach to alleged discrimination in lending. The Justice Department's 1994 settlement with Chevy Chase Federal Savings Bank, the Washington DC area's largest thrift institution, highlights the dissimilar approaches taken by the Justice Department and the bank regulators. Chevy Chase had been found to be in compliance by the Office of Thrift Supervision. The Justice Department however filed a discrimination suit that accused Chevy Chase of failing to open offices in black neighborhoods in the District of Columbia.

These Acts and other administrative and regulatory actions have created a situation where a bank can satisfy the demand for

affirmative fair lending activity in their business lending area by supporting local microenterprise loan programs. Local banks, regional banks, and even moneycenter banks are actively participating in the development of microenterprise programs and in providing loan pool funds for these programs.

#### Community Development Financial Institutions

On September 23, 1994, President Clinton signed into law the Riegle Community Development and Regulatory Improvement Act (Public Law 103-325). The law established a new government corporation, the Community Development Financial Institutions (CDFI) Fund. The CDFI Fund's purpose is to help promote the growth of community development financial institutions through financial support and technical assistance. The purpose of the Fund is to ease the credit crunch on small businesses and homeowners in low- and moderate-income areas. Originally, the Clinton administration envisioned starting new institutions to provide lending and related services in poor communities, but the final version of the bill prioritizes funding of existing CDFI institutions. To receive money from the fund, CDFIs would have to match Federal subsidies with capital or funds from other sources. The amount of funds that go to any one CDFI would be restricted to provide some funding for a broad range of programs. In 1996, the Fund conducted its first round of funding, committing \$35.5 million to 32 CDFI's.

On January 30, 1997, President Clinton announced plans to increase funding for the CDFI Fund by \$1 billion over the next five years. This announcement was made at a White House ceremony where the president presented awards for outstanding work in microenterprise development. While microenterprise lending will benefit from the CDFI, there is no target set in this area.

Along with administering the above award program, the CDFI Fund will coordinate a new Federal Microenterprise Initiative. This coordination function is supposed to "promote coherence among the many microenterprise development programs housed in several Federal agencies" (Moy, 1996). The purpose of the initiative is to help ensure that Federal funding effectively supports the growth and development of the microenterprise development field.

A provision to the CDFI Act provides a financing mechanism for the Bank Enterprise Act (PL 102-242). The Bank Enterprise Act (BEA) gives commercial banks and thrifts a rebate on their Federal deposit insurance premiums in exchange for community developmental lending efforts. The rebates would be given primarily to institutions that provide financial aid to CDFIs. Commercial banks and thrifts now have a financial incentive along with regulatory and Justice Department pressure to increase efforts in community development lending.

#### The Virginia Enterprise Initiative

The Virginia Enterprise Initiative is outlined in a report written by the Department of Housing and Community Development (DHCD) in response to a Virginia General Assembly request to develop a plan to implement a microenterprise loan program for the state. The purpose of the Initiative is to "make it possible for more Virginians, including low-income citizens, women and

minorities, to realize their dream of small business ownership" (VEI, 1994). The benefits of the Initiative included stimulating revitalization of economically distressed communities, and reduction of transfer payments and the demand for government social services such as Aid to Families with Dependent Children (AFDC), food stamps and housing assistance.

An important concept in the Virginia Initiative is leverage. Commercial banks, private foundations and Federal agencies all have resources available for microenterprise fund programs. The Virginia program acts as a catalyst for these resources and envisions that a \$3 million investment by the Commonwealth will draw an additional \$3 million into community microenterprise programs. This investment is expected to provide capital to help establish loan pools and provide operating funds to run these fifteen programs for at least two years.

The Virginia Enterprise Initiative emphasizes flexibility in selecting fifteen rural and urban community-based programs to be supported under the plan. The selection criteria included organizational capacity, program design, partnerships, program impact, and sustainability. Program design was the most important criterion. The Request for Grant Proposal (1995) states that the "overall portfolio of microenterprise programs will also be reviewed to assure some degree of geographic balance, diversity of delivery approaches, and a blend of urban and rural program models." Since there is no existing program that the planners saw as the ideal microenterprise model, the VEI report indicates that flexibility will ensure a that variety of programs will be sponsored, and each of the selected programs will be able to reflect the needs and resources of the community that it serves. The plan's flexibility was a necessary element because in 1994 Virginia had a low level of microenterprise lending activity with only four programs showing any lending volume.

#### Request for Proposals

Various Community Development Corporations (CDCs) and community action groups around the state submitted 24 proposals for funding by the VEI. In August 1995, the commonwealth made first year awards of up to \$70,000 (the maximum) to 15 of these organizations. The successful and unsuccessful proposals are examined to analyze the use leverage and sources of matching funds.

The typical proposal requested a grant of \$70,000; with \$25,000 to be used in the loan pool for loan loss reserves and \$45,000 to be allocated for program operating costs. Various partners provided matching funds that were committed to the loan pool or to support operations. Table 1 lists each proposal along with the amount requested, the amount awarded, and the amount of matching funds committed to the proposal. The unsuccessful proposals are listed at the bottom of the Table. All but three proposals requested \$70,000, the maximum amount of first year funding available. In making the awards, the state awarded the requested amount with only two exceptions. Proposals 6 and 16 received \$50,000, which was \$20,000 less than requested.

The matching funds column in Table 1 shows the total amount of loan pool funds and operating funds committed to each proposal.

For the purpose of this study, matching funds that are not designated for the loan pool are categorized as operating funds. This covers funds for administration, training, technical assistance, and follow-up assistance. The proposals included letters of commitment that documented some of the various sources of matching funds. The proposals were not audited and showed substantial variation in listing and documenting matching funds. Because of these inconsistencies, the matching funds amount does not represent the financial strength of the proposal in each case. The average matching funds for successful proposals is \$314,297 and for unsuccessful proposals \$222,324.

The last column of Table 1 gives the leverage factor for each proposal. This figure is computed by dividing the matching funds amount by the award amount for successful proposals and by the requested amount for unsuccessful proposals. The leverage factor indicates how powerful the state grant was in attracting other funds to each proposal. The average leverage factor was 4.81 for the successful proposals and 3.23 for the unsuccessful ones. Since leverage was not the only consideration for selection, some of the proposals that were rejected had greater leverage than some of the ones that were selected.

#### Operating Funds

Table 2 shows data concerning the operating funds committed to each proposal. The amount each proposal requested (or was awarded) for operations and the amount of matching funds committed to the proposal is listed. The leverage ratio is computed by dividing the matching amount by the VEI grant in this area. Some of the matching funds' sources are shown in the last three columns. The SBA Microloan program technical assistant grants were a significant source of cash matching funds. Three of the successful proposals had already been awarded SBA funds contingent upon receiving non-Federal money to support their programs.

Table 1  
VEI Proposals: Overall Funding

#### Successful Proposals

Proposal	Amount Requested	Amount Awarded	Total Matching	Leverage Factor
1	\$ 70,000	\$ 70,000	\$153,250	2.2
2	57,583	57,583	65,000	1.1
4	66,856	66,856	209,214	3.1
6	70,000	50,000	110,000	2.2
7	70,000	70,000	569,050	8.1
9	70,000	70,000	110,390	1.6
10	70,000	70,000	126,903	1.8
12	70,000	70,000	101,890	1.5
14	70,000	70,000	977,723	14.0
16	70,000	50,000	658,968	13.2
17	70,000	70,000	114,600	1.6
18	70,000	70,000	66,300	0.9
21	70,000	70,000	456,000	6.5
22	70,000	70,000	591,974	8.5
23	70,000	70,000	403,197	5.8

Total	\$1,034,439	\$994,439	\$4,714,459	NA
Average	68,963	66,296	314,297	4.81
Std Deviation	3,251	7,359	279,410	4.37

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Unsuccessful Proposals

Proposal	Amount Requested	Amount Awarded	Total Matching	Leverage Factor
3	\$ 70,000	\$ 0	\$ 87,456	1.2
5	70,000	0	336,660	4.8
8	70,000	0	57,150	0.8
11	70,000	0	45,000	0.6
13	70,000	0	68,019	1.0
15	59,200	0	182,550	3.1
19	70,000	0	155,000	2.2
20	70,000	0	237,500	3.4
24	70,000	0	831,584	11.9
Total	\$619,200	\$ 0	\$2,000,919	NA
Average	68,800	0	222,324	3.23
Std Deviation	3,600	0	247,826	3.53

Table 2  
VEI Proposals: Operating Funds

Successful Proposals

Proposal	VEI Amount	Matching Amount	Leverage Factor	Matching Sources		
				SBA	CDBG	In Kind
1	\$ 50,000	\$ 33,250	0.7			\$ 33,000
2	45,000	27,250	0.6			26,310
4	36,856	59,214	1.6	\$ 50,000		4,870
6	20,000	10,000	0.5			10,000
7	30,000	137,050	4.6		\$95,000	25,000
9	45,000	35,390	0.8			35,390
10	45,000	51,903	1.2			51,903
12	51,250	26,890	0.5			28,000
14	34,500	232,948	6.8	187,500	YES	12,000
16	50,000	19,632	0.4			19,632
17	47,000	29,600	0.6		YES	12,960
18	55,000	13,750	0.3			14,825
21	30,000	56,000	1.9			???
22	50,000	251,974	5.0	93,750	YES	520
23	70,000	33,197	0.5			33,197
Total	\$659,606	\$1,018,048	NA	331,250	\$95,000	+\$307,607
Average	43,974	67,870	1.72			21,972

Std				
Deviation	12,186	77,116	2.03	13,926

Unsuccessful Proposals

Proposal	VEI Amount	Matching Amount	Leverage Factor	Matching Sources		
				SBA	CDBG	In Kind
3	\$ 55,000	\$ 42,456	0.8			
5	20,000	36,660	1.8			\$ 33,660
8	65,000	42,150	0.6		YES	
11	60,000	18,020	0.3			16,000
13	60,000	15,000	0.3			
15	11,200	42,550	3.8			4,800
19	20,000	27,750	0.3			27,750
20	24,450	27,500	1.1			19,000
24	20,000	31,500	1.6			27,000
Total	\$335,650	\$252,086	NA	\$0	\$0+	\$128,210
Average	37,294	31,511	1.26			21,368
Std						
Deviation	21,953	11,124	1.16			10,320

Several of the organizations that applied for the VEI grant had access to Community Development Block Grant funds. The amount of CDBG matching funds could be quantified for only one proposal. The organizations with access to CDBG funds are indicated either by the amount or by a 'YES' in the CDBG column. Federal matching funds, SBA technical grants, and CDBG funds account for 42% of the matching funds committed to support the operating costs of the successful proposals. Another important category of operating support for the proposals was in-kind support. In-kind support includes the value of goods and services committed to the program. An example is office space and equipment provided by a supporting organization. Another typical form of in-kind support was volunteer efforts. A bank might offer to provide a loan officer to evaluate loan applications or a local CPA or lawyer might volunteer to provide support on a pro bono basis. The estimated value of the in-kind goods and services was included as matching funds in the operations area. Approximately 30% of the matching operating funds for the successful proposals was in-kind as compared to over 50% for the unsuccessful proposals.

In awarding VEI grants, the Commonwealth of Virginia achieved a significant amount of leverage in the area of operating funds. Successful proposals had commitments for \$1,018,048 in matching operating funds and received \$659,606 in VEI grants for overall leverage of 1.54. Unsuccessful proposals had matching operating fund commitments of \$252,086 and requested VEI operating funds totaling \$335,650, a leverage factor of 0.75.

#### Loan Pool Funding

Table 3 reflects the loan pool data for the successful and unsuccessful proposals. The second column lists the amount of the

VEI grant that was requested, or awarded, for loan pool use. The third column, shows the amount of matching funds committed to the microenterprise loan pool. On average, successful proposals attracted over twice the level of commitment for matching funds as unsuccessful proposals. The next column shows the leverage factor for each proposal and the average leverage factor for the two groups. The average leverage factor was 7.27 for the successful proposals and 5.17 for the unsuccessful proposals.

Since Proposals 16 and 23 did not request VEI funds for its loan pool, the average leverage figure in Column 4 understates the total loan pool leverage achieved by the VEI funds. Successful proposals had total matching loan pool commitments of \$3,686,525 and received VEI loan pool grants of \$334,833, for an overall leverage factor of 11.01. Unsuccessful proposals had loan pool commitments totaling \$1,740,000 and requested VEI loan pool funding of \$283,550, a leverage factor of 6.14. As a group, successful proposals had a loan pool leverage factor that was almost double the leverage of the unsuccessful proposals. This demonstrates the effectiveness of the VEI grant in leveraging funds for loan pool purposes.

Table 3 also shows the matching loan pool funds broken down into commitments that were dependent on the awards and funds that were available or committed independent of the VEI award. The proposals with funding sources that were not dependent on the VEI award were usually from well-established community development organizations, some of which were already operating microenterprise funds. Proposal 16 has the largest source of independent funding, \$587,000 in grant money from a USDA Rural Business Enterprise Grant and CORD, a state rural development program. Unsuccessful proposals indicate little funding independent of the VEI award. The small amount of independent funding available to the unsuccessful proposals is probably due to lack of experience in community economic development.

Table 3  
VEI Proposals: Loan Pool Funds

Successful Proposals

Proposal	VEI Amount	Matching Amount	Leverage Factor	Dependent On Award	Independent of Award
1	\$ 20,000	\$120,000	6.0		\$120,000
2	12,583	37,750	3.0	\$ 37,750	
4	30,000	200,000	6.7	200,000	
6	30,000	100,000	3.3	100,000	20,000
7	40,000	432,000	10.8	400,000	
9	25,000	75,000	3.0	75,000	
10	25,000	75,000	3.0	75,000	
12	18,750	75,000	4.0	75,000	
14	35,500	744,775	21.0	744,775	
16	-	587,000			587,000
17	23,000	85,000	3.7	60,000	15,000
18	15,000	45,000	3.0		45,000
21	40,000	400,000	10.0	400,000	
22	20,000	340,000	17.0	340,000	
23	-	370,000		220,000	150,000

Total	\$334,833	\$3,686,525	NA	\$2,727,525	\$937,000
Average	22,322	245,768	7.27	227,294	156,167
Std Deviation	12,247	221,085	5.89	211,196	218,078

Unsuccessful Proposals

Proposal VEI					
Proposal	VEI Amount	Matching Amount	Leverage Factor	Dependent On Award	Independent of Award
3	\$ 15,000	\$ 45,000	3.0		\$ 10,000
5	50,000	300,000	6.0	\$300,000	
8	5,000	15,000	3.0		
11	10,000	30,000	3.0	30,000	
13	10,000	50,000	5.0	50,000	
15	48,000	140,000	2.9	140,000	
19	50,000	150,000	3.0	150,000	
20	45,550	210,000	4.6		
24	50,000	800,000	16.0	800,000	
Total	\$283,550	\$1,740,000	NA	\$1,470,000	\$ 10,000
Average	31,506	193,333	5.17	245,000	10,000
Std Deviation	20,602	246,336	4.22	288,219	

One of the objectives of the study was to determine the sources of funding for microenterprise fund loan pools. The VEI first year award was approximately \$1 million and that sum resulted in matching fund commitments of \$4.7 million. Approximately 80% of the matching funds were committed to the loan pool. As noted above, the loan pool is separated into funds that are committed for loan loss reserve and funds that are available for lending. The purpose of the loan loss reserve is to absorb risk associated with the lending program. The loan loss reserve makes it much easier to attract capital for the loan pool. There was no minimum amount designated by VEI for loan loss reserve. Most proposals had a loan loss reserve that ranged between 10% and 25% of the total loan pool.

Table 4 shows the sources of loan pool funds. In the second and third columns, information on the source and amount of the loan loss reserve is listed. The typical proposal intended to use about two-thirds of the VEI grant for operations and one-third for the loan pool reserve. Two proposals from established programs, 16 and 23, requested no funds for the loan pool since they had sufficient funds committed in that area. These two proposals only needed the VEI award to augment their operating funds. For most proposals, a VEI grant for loan loss reserve was the critical factor in attracting matching funds for the loan pool.

The remainder of Table 4 shows the major sources of the lendable funds. Matching funds provided by banks were the most important loan pool funding source, accounting for 39% of the matching loan pool funds for the successful proposals. Almost all the bank commitments were dependent on the organization receiving the VEI grant. The second most important source of funds was the SBA Microloan Demonstration Program. This pilot program provides loan pool funds and Technical Assistant Grants to three Virginia organizations that were also successful in receiving VEI grants. These three organizations received a total of \$1.15 million in SBA Microloan lending authority. This amount is 31% of the matching loan pool funds for successful proposals.

The remaining sources of loan pool commitments are grouped under 'Other' and totaled almost \$1 million, accounting for 26% of the matching loan pool funds for the successful proposals. Over half of the funds in this category were the result of the USDA-RBEG grant mentioned above. Other sources in this category are HUD's CDBG and HUD's Economic Development Initiative (EDI) grants. Two non-bank, non-governmental sources of funds in the other column are a low interest loan from the Calvert Social Investment Fund and a grant from the Levi Strauss Foundation. In general, established community development and microenterprise loan programs have multiple sources of funds and were not totally dependent on the VEI grant to fund their loan pools. New microloan programs usually were dependent on the VEI grant for their start up and their only source of matching loan pool funds was commitments from banks.

Table 4

## VEI Proposals: Loan Pool Sources

Proposal	Successful Proposals					Source of Other
	Loan Loss Reserve Source	Amount	Loan Pool Funding Source Banks	SBA	Other	
1	VEI	\$ 20,000				\$120,000 ParentCDC
2	VEI	12,583	\$ 15,000			
4	VEI	30,000		\$200,000		
6	VEI	30,000	100,000			
7	VEI	40,000	400,000			
9	VEI	25,000	75,000			
10	VEI	25,000	75,000			
12	VEI	18,750	75,000			
14	VEI/Other	101,775		750,000		
16	USDA/Other	58,700			528,300	USDA
17	VEI	23,000	60,000		25,000	CDBG
18	VEI	7,500			43,500	NGO Grants
21	VEI	40,000	400,000			
22	VEI/Other	60,000	200,000		140,000	NGO, CDBG
23	HUD-EDI	37,000	220,000		113,000	HUD-EDI
Total		\$529,308	\$1,420,000	\$1,150,000	\$969,800	
Average		35,287	157,778	383,333	161,633	

Standard Deviation	23,665	147,925	317,543	185,276
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#### Unsuccessful Proposals

Proposal	Loan Loss Reserve Source	Loan Loss Amount	Loan Pool Banks	Funding Source		Source of Other
				SBA	Other	
3	VEI	\$ 15,000			\$10,000	USDA Grant
5	VEI	50,000	\$300,000			
8	VEI	5,000			15,000	CDBG
11	VEI	10,000				
13	VEI	10,000	50,000			
15	VEI	45,000	140,000			
19	VEI	50,000	150,000			
20	VEI	25,000	210,000			
24	VEI	50,000	800,000			
Total		\$260,000	\$1,650,000	\$0	\$ 25,000	
Average Standard Deviation		28,889	275,000		12,500	
		19,650	270,167		3,536	

#### Capital Structure and the Cost of Funds

The most important sources of VEI loan pool funds are loans from the SBA Microloan Demonstration Program and commercial banks. Both of these sources have significant costs and loan loss reserve requirements associated with use of their funds. As noted above, the interest rate on the SBA Microloan funds is based on the T-Bill rate and the loan loss reserve requirement is 15%. Banks that are providing loan pool funds to VEI microenterprise programs are charging the prime rate and requiring a 25% loan loss reserve.[6] The difference between the cost of funds and what the microenterprise programs are charging their borrowers, the spread, is mandated in the SBA program at an average of 8%. The spread used by one VEI supported program that uses bank provided loan pool funds ranges from 2% to 3%. Each program will have a unique spread that will be a function of the program's average cost of money and the average loan rate charged the program's clients.

For a commercial financial institution, the spread must cover loan losses, operating costs, and provide an adequate return for investors in the institution. Experience has shown that microenterprise funds in the United States have not been able to cover loan losses and operating costs from their spread. If a microenterprise fund could cover loan losses with their spread, then the loan pool would self-sustaining and only operating funds would have to be provided by outside sources. Loan pool funding from sources with low or no costs obviously helps sustain the loan pool. A program with a large spread and a low default rate could even cover some of their operating costs with income earned from lending activities. The study of six mature microenterprise programs that Edgecomb (1996) performed indicates that loan

default rates of 10% are not unusual. A microenterprise loan program with a spread on only 2% or 3% will probably have difficulty sustaining loan pool without continued grants for loan loss reserves.

Capital structure refers to the mixture of debt and equity funds used to finance a business. This concept has application to microenterprise programs if grants are treated as equity and any funding that has to be repaid is classified as debt. Loan loss reserves, by definition, have to be equity. A microenterprise program that borrows bank funds for its loan pool will have to have a greater percentage of equity in its capital structure than a program using SBA Microloan funds for their loan pool. Debt funding from sources that have low or no loan loss reserve requirements is advantageous since the microenterprise program can operate with a lower percentage of equity. This will allow more of its grant funding to be used for operating purposes.

An alternative partnership arrangement with local banks is for the bank to extend credit directly to the client. One VEI supported microenterprise fund uses this arrangement with its bank partners. The microenterprise program conducts training and assists clients in business plan preparation. Clients then submit loan applications to one of three local banks participating in program. The banks can make the loan with or without a guarantee from the microenterprise program. This arrangement allows the program to avoid the costs associated with loan application and collection. The amount of credit the program will create will be a function of the number of loans requiring a guarantee and the size of the loan loss reserve.

#### Summary And Conclusion

In 1995, the Virginia Enterprise Initiative effort to expand microenterprise lending programs completed its start up phase and fifteen programs were selected and funded for first year grants. The program was successful in using leverage and attracted \$4.7 million in matching funds to support the programs that received state grants. The major sources of these funds were commercial banks and the Federal government. Banks made commitments to lend the microenterprise programs \$1.4 million for loan pool purposes. Bank participation is the result of Federal legislation to encourage fair lending practices and reward banks for CRA type loans. This study shows that Federal CRA efforts have resulted in banks helping to finance microenterprise loan programs.

The Federal government provided over \$2.6 million in matching funds to the fifteen successful programs. Some of the Federal funds are loans and some are grants. Since these microenterprise programs will probably not be self-sustaining, the continued availability of Federal and state grants will be critical for long term operation.

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#### Footnotes

[1] David Bornstein (1996) and Alex Counts (1996) both provide an in-depth look at the Grameen Bank.

[2] See Rahman and Islam (1993) for performance data on the Grameen Bank.

- [3] The Women's Economic Development Corporation later merged with CHART, a women's career and employment services agency, to form Women Venture. Shorebank (1992) is an excellent source of information on the state of microenterprise loan fund practice in the early 1990's.
- [4] The Practice of Microenterprise in the U.S. (Edgecomb, Klein, & Clark, 1996) is a useful source of information on goals, program strategies, and the cost effectiveness of U.S. microenterprise programs. This report is based on the study of seven programs over a three year period. Also see Raheim and Foster (1995) for an evaluation of programs specifically designed to facilitate self-employment as a route to economic self-sufficiency for welfare recipients.
- [5] Microloan Demonstration Program Fact Sheet, Revised 12/95, U.S. Small Business Administration, Washington, DC.
- [6] Information on bank funding of VEI microenterprise programs was acquired through interviews with program directors at the two funds with the largest bank commitments.