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

**Memorandum**

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| To: | Members, Committee on Small Business |
| From: | Rob Yavor, Professional Staff, Joe Hartz, Policy Director, Committee Staff |
| Date: | October 18, 2017 |
| Re: | Hearing: "Small Business Capital Access: Supporting Community and Economic Development." |

On Friday, October 20, 2017 at 2:30 p.m., the Committee on Small Business will meet in Studio C at The Enterprise Center at 4548 Market Street in Philadelphia, Pennsylvania, for the purpose of examining the role access to capital has on the economic development of communities and neighborhoods across the United States of America.

## I. Introduction

While large companies regularly raise capital through debt and equity markets, small businesses often finance their endeavors with personal assets or commercial bank borrowing. Unfortunately, the lending environment around the country for small businesses continues to be stagnant. According to research, the total value of loans by small domestic banks has remained flat since the recession and depressed as compared to levels before the recession.[1] Moreover, in the Federal Reserve's most recent Small Business Credit Survey, more than 60 percent of small businesses surveyed reported facing financial hardships within the last year.[2] With capital options limited, small businesses turn to the SBA to finance their projects. The SBA, which was created in 1953 by the Small Business Act, administers several programs designed to assist small businesses, including capital access programs that aim to bridge the debt and equity gaps that exist in the marketplace.

## II. The 7(a) Loan Program

In order to increase access to capital, the SBA offers small firms guarantees through private lenders that participate in the 7(a) Loan Program, whereby loan proceeds can be used for general business purposes. Named after § 7(a) of the Small Business Act,[3] the program is SBA's flagship lending option for creditworthy small firms that cannot obtain sufficient capital from conventional lending.[4] The program does not provide direct loans to participating small businesses; rather, SBA guarantees the repayment of loans made by lenders. The maximum loan

[1] https://fred.stlouisfed.org/series/EVAXSSNQ.
[2] https://www.newyorkfed.org/smallbusiness/small-business-credit-survey-employer-firms-2016.
[3] 15 U.S.C. §§ 632-57s.
[4] SBA SOP 50 10 5(I), Subpart A., Ch. 1(I).

a small business can acquire is $5 million[5] and the guarantee percentage ranges from 75 to 85 percent based on the loan amount.[6] The interest rate charged to small businesses has an inverse relationship with the size of the loan whereby the smallest loans have the highest rate.

Authorized in the 1974 Small Business Amendments,[7] the SBA charges lenders an upfront fee to run the loan program and cover any losses to protect the American taxpayer in accordance to the 1990 Federal Credit Reform Act (FCRA).[8] In previous years, the program has relied on a subsidy from Congress to operate the program. However, because the fees have been sufficient, the program has been running on a zero subsidy cost to the American taxpayer for the last five fiscal years, including FY 2018.[9]

## III. The 504/CDC Loan Program

As a way to bridge the gap for small businesses that cannot use traditional markets, the SBA also offers the 504/CDC Loan Program, which provides long-term and fixed-rate financing. Originally created in the Small Business Investment Act of 1958,[10] the 504/CDC Loan Program assists small businesses with the acquisition of major fixed assets, such as real estate or machinery or for equipment purchases that expand or update their small businesses.

Unique to the loan program is the role of the certified development company, or CDC, which must be a non-profit corporation and certified and regulated by SBA to participate in the program.[11] Along with the small businesses and the financial institutions that are involved in the credit transaction, CDCs also play a major role in the cost structure of the loan program. A standard loan is organized where the small business or borrower is responsible for 10 percent of the project. The financial institution is in the senior lien position and is responsible for 50 percent of the value of the project, and the remaining balance of 40 percent belongs to the CDC, which is in the second lien position, through a federal government guaranteed debenture. As with SBA's 7(a) Loan Program, funds are not lent by SBA; rather, SBA guarantees the loans made by the CDC.

A hallmark of the 504/CDC Loan Program, and a differentiating characteristic among SBA's many loan products, is the focus on economic development. Eligibility in the loan program and debenture size of the loan is determined based on the borrower either meeting a job creation or job retention requirement. Job creation is defined by creating or retaining at least one

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[5] *Id.* at Subpart B., Ch. 3(I).
[6] *Id.* at (II).
[7] Pub. L. No. 93-386 (1974).
[8] For any government loan program, FCRA requires an agency to collect an appropriation or fee to cover the cost of the program. For the 7(a) Loan Program, SBA charges lenders guarantee fees depending upon the loan amount. 2 U.S.C. § 661.
[9] For FY 2014, SBA requested zero subsidy. SBA, FY 2014 CONGRESSIONAL BUDGET JUSTIFICATION AND FY 2012 ANNUAL PERFORMANCE REPORT 36. For FY 2015, SBA requested zero subsidy. SBA, FY 2015 CONGRESSIONAL BUDGET JUSTIFICATION AND FY 2013 ANNUAL PERFORMANCE REPORT 35. For FY 2016, SBA requested zero subsidy. SBA, FY 2016 CONGRESSIONAL BUDGET JUSTIFICATION AND FY 2014 ANNUAL PERFORMANCE REPORT 39. For FY 2017, SBA requested zero subsidy. SBA, FY 2017 CONGRESSIONAL BUDGET JUSTIFICATION AND FY 2015 ANNUAL PERFORMANCE REPORT 37. For FY 2018, SBA requested zero subsidy. SBA, FY 2018 CONGRESSIONAL BUDGET JUSTIFICATION AND FY 2016 ANNUAL PERFORMANCE REPORT 28.
[10] 15 U.S.C. § 695.
[11] SBA SOP 50 10 5(I). Subpart A., Ch. 3(I)(B).

job for every $65,000 spent on the project. For small manufacturers, the requirement is one job for every $100,000.[12] If meeting the job creation or retention requirement cannot be achieved, a borrower can still qualify if they meet either one community development goal or a number of public policy goals.[13]

## IV. The Microloan Program

In order to meet the needs of low dollar borrowers, the SBA offers the Microloan Program, which began as pilot program in 1991 and was made permanent in 1997. As with all SBA financial assistance programs, the SBA does not make a microloan directly to a small business. Rather, it makes a direct loan to a non-profit called a microloan intermediary.[14] The intermediary, in turn, makes loans of up to $50,000 to borrowers.[15] Borrowers then repay the intermediary, which in turn repays the SBA.

Unlike the banks operating in the 7(a) Loan Program, the SBA requires that the intermediaries provide education and training to its borrowers. The intermediaries can provide such training or contract other enterprises to provide training and counseling. Funds for training and counseling are provided, in part, by appropriated funds made available to the intermediaries.

## V. The Small Business Investment Company Program

As a way to increase the amount of private equity flowing to small businesses, SBA offers the Small Business Investment Company (SBIC) program. SBICs are for-profit enterprises organized under state law as either a corporation or partnership. SBICs receive a license to operate from the SBA pursuant to authority in the Small Business Investment Act of 1958.[16]

Once licensed, the SBIC is able to "borrow" money from the federal government to invest in small businesses. These borrowed funds are denominated "leverage" (as in leveraging private dollars with federal funds) in tiers. For every dollar of private investment, an SBIC is entitled to draw up to three dollars in government funding (but is not required to draw that maximum amount). Rather than simply borrowing directly from the federal government, SBICs sell securities to private investors and the federal government guarantees that the lenders to the SBIC are repaid with interest. The SBICs must repay the federal government for the leverage.

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[12] *Id.* at Ch. 2(III)(H)(1)(a)(i).

[13] The community development goals are: improving, diversifying, or stabilizing the local economy; stimulating business development; generating new income; helping manufacturing firms; or assisting the labor supply. The public policy goals are: revitalizing a business district with a redevelopment plan; increase of exports; increase of women owned small businesses, veteran owned small businesses, or minority owned businesses; assisting with rural development; increasing productivity or competitiveness; modernizing facilities to meet health, safety and environmental requirements; helping businesses in areas impacted by Federal budget reductions or base closings; or reducing the unemployment rate. 13 § CFR 120.862.

[14] SBA, Partner Identification & Management System (2016), *available at* https://www.sba.gov/sites/default/files/articles/microlenderrpt_160927.pdf. Although 210 microloan intermediaries exist, only 140 are making at least 4 microloans each year, which is considered the threshold for success by SBA.

[15] Maximum loan size in the program was $35,000 before it was raised in the Small Business Jobs Act of 2010 to $50,000.

[16] 13 C.F.R. §107.

## VI. Conclusion

With over 29 million small businesses in the United States and roughly half of all private sector employees working for a small business, small firms are the strength of the American economy.[17] When small businesses succeed, so does the economy. However, access to capital continues to remain a top concern for small businesses. The Committee is dedicated to ensuring the programs run by SBA address the credit gap for creditworthy small businesses that cannot obtain capital through conventional means, while also working on behalf of the American taxpayer to ensure that SBA is a responsible steward of taxpayer funds.

[17] SBA OFFICE OF ADVOCACY, SMALL BUSINESS PROFILE (2017), *available at* https://www.sba.gov/sites/default/files/advocacy/United_States_1.pdf.