

Are Revolving Loan Funds A Better Way To Finance Rural Development?

Revolving loan funds (RLF's) operate, in principle, by issuing new loans as old loans are repaid. Although best suited to increasing credit access for viable firms that lack alternative funding sources, many RLF's are assisting local businesses in need of capital but financially non-viable. Two major problems arise when RLF's are used to transfer this kind of public subsidy to failing businesses: (1) RLF's require periodic refunding to avoid continued erosion of their capital base and (2) in lending money to high-risk borrowers, RLF's experience high loss rates.

RLF's are one tool the Federal Government uses to provide businesses with improved access to capital. RLF's were first used in the early 1970's to offset reductions in direct Federal financing. Largely reliant on a Federal grant or long-term/low-interest loan for their initial funding, RLF's are funded through several Federal programs (see box, p. 2).

Major objectives for Federal credit programs, including RLF's, are to: (1) correct market imperfections, (2) promote activities with a greater social than market value, and (3) stabilize economic activity. Proponents argue that RLF's can promote these goals without recurring injections of public funding.

Recent legislative proposals would significantly promote State-level RLF's by "block granting" funds from current Federal development programs. The consequences of a major RLF expansion are unclear since their share of Federal business credit assistance has always been small and their ability to meet various development goals is poorly understood (fig. 1).

Rural Credit Markets Are Effective, But Some Rural Businesses Have Financing Problems

Rural economies are characterized by: (1) a preponderance of small businesses, (2) fewer and smaller local sources of financial capital, (3) less diversification, and (4) fewer ties to nonlocal economic activity. These rural attributes may exacerbate businesses' funding difficulties.

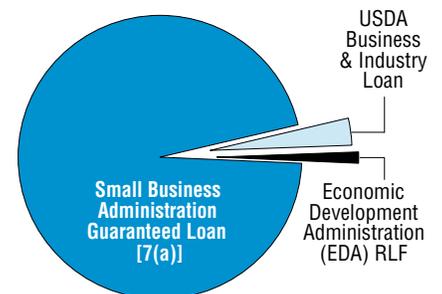
Nonetheless, studies have consistently concluded that rural financial markets generally work well for most firms and that credit problems are not endemic to rural areas. Limited access to credit is usually a problem for specific business types or economic conditions. Rural firms most likely to have financing difficulties are start-ups, those with limited or unusual collateral, and those that are adjusting to new technologies, that are unlike other local businesses, and that are seeking equity capital.

RLF's Are Appealing

Federal programs are often criticized for their excessive paperwork and restrictive regulations. RLF's, however, are largely unregulated, particularly once their initial Federal funding has been disbursed. With the exception of guidelines that specify interest rate and applicant-eligibility requirements, RLF operators are generally

Figure 1

RLF's constitute a small part of lending to rural businesses relative to other Federal business assistance programs



Source: Fiscal Year 1997, appendix to the budget of the United States Government.

Note: EDA/RLF figure is calculated by assuming a leverage ratio of \$3.00/RLF dollar.

free to determine which businesses have need of financial assistance.

RLF's are attractive because, in principle, they are self-renewing, make credit more available, are a low-cost way to provide credit assistance, lend to high-risk borrowers, effectively use their limited funds, and provide benefits to local communities that exceed the cost of the assistance.

While it may be tempting to view RLF's as the "Swiss army knife" of development policy, they are best directed at specific credit-market problems. Increased credit will not promote sustained economic activity if: (1) more fundamental problems, such as competitiveness, are ignored; (2) it is used only because more appropriate development tools are not available; or (3) it is used in desperation to forestall failure.

Subsidy, Leveraging, and Permanence Jeopardize Sustainability

RLF's are subsidized via low-cost government funding and by tax advantages conferred by their nonprofit status. Subsidies confer economic benefits to recipients at the expense of others. RLF borrowers receive a subsidy conveyed through credit enhancements, such as low-cost loans. Since RLF's appear to make loans at a single interest rate, riskier loans receive a larger implicit subsidy. Also, private lenders who join RLF-sponsored financing packages are often subsidized.

RLF's attempt to increase the total lending associated with each RLF dollar by assuming the junior lien position in all such loan packages. By assuming the financial risk in a loan, the RLF improves development by increasing the level of private lender participation. This is called leveraging. While higher leverage is used as a positive measure of RLF performance, it comes at a cost. The expected value of additional losses taken by the RLF becomes a form of subsidy to the private lender. The

What Is A Revolving Loan Fund?

A Revolving Loan Fund (RLF) is a pool of public- and private-sector funds that recycles money as loans are repaid. Funding sources are the Economic Development Administration (EDA), Department of Housing and Urban Development (HUD), U.S. Department of Agriculture (USDA), Appalachian Regional Commission (ARC), State and local governments, and nonprofit philanthropic foundations. Funding by either a grant or long-term/low-cost loan is used to start, replenish, and expand RLF's. Funding recipients are State or local government agencies and nonprofit entities structured to make loans. They must demonstrate economic need and have a plan that both meets program requirements and spurs growth.

Frequently stated objectives of RLF's are to: (1) provide a dependable fi-

nance source for long-term economic development, (2) fill a credit gap for business start-ups, expansions, and re-tentions, (3) spur economic growth by making loans as affordable as possible, (4) customize loans to the financial needs of each individual business, and (5) enhance commercial lenders' return on shared loans.

Most loans are made to high-risk borrowers at concessionary terms. RLF funds take a subordinated lien position to leverage their capital through joint lending with private lenders. Borrowers receive education in business operations and market development. RLF loans most often go to manufacturing firms and are used to purchase fixed capital. Many RLF's lend in rural areas.

larger the expected value, or subsidy, the higher the return to the private lender for participating. On the other hand, if increased leverage lowers the RLF's share of the loan package, the RLF's maximum possible loss is also less. Leveraging may explain the large losses experienced by RLF's on their failed loans. Average RLF losses are about 80 percent of remaining loan principal.

Although RLF's are designed to be permanent, local development needs are probably transitory. Thus, government funds soon become allocated by an outdated measure of need. In 1993, over 95 percent of 260-plus active RLF's funded by the Economic Development Agency (EDA) had a substate geographic focus, often a single community or county. This microlevel focus makes it difficult to shift resources as needs change. Thus, central decisionmaking imposed at larger geographic levels creates a mechanism to shift resources as needs change, but only by diminishing local control.

Low-Cost Loans Have Unintended Consequences

Federal financial-assistance-program regulations require that RLF operators lend at a rate well below prevailing market interest rates. This policy is intended to enhance the financial situation of borrowers. While this clearly gives borrowers a cost advantage, there are additional consequences.

RLF's are neither growing nor sustainable. The advantages RLF's derive from cheap loanable funds is seldom transformed into a sustained or growing capital base. In fact, most RLF's can avoid shrinking only through periodic injections of new public funds. Typically the low-interest-rate requirement forces operating income to a level below operating costs.

Inflation quickens the decline of an RLF's capital base. Consider an RLF with its total equity lent at an average rate of 4 percent, while inflation is 3 percent. A mere 1-percent margin (return on equity) remains to cover all operating costs, while commercial lenders' typical return on equity is

14 percent. Only 13 percent of EDA-funded RLF's that make both rural and urban loans report a capital base growth that exceeds the rate of inflation (fig. 2). This percentage would be lower if RLF's accounted for all their costs. Some "profitable" RLF's are operated by government agencies that charge the RLF few administrative expenses. Additionally, loan losses are understated since RLF's do not use generally accepted accounting principles to recognize anticipated losses on outstanding loans. In comparison, commercial banks set aside reserves to cover such costs as they become apparent.

Resource allocations are distorted.

Firms with access to less costly credit tend to borrow more than they would at market rates. They may then alter operating methods, expand production, and increase profits. While cheap credit is an advantage to firms that receive those loans, it may also distort markets because: (1) other businesses may find their inputs more costly, (2) competitors may lose business to the RLF borrower, and (3) plant and equipment acquired with low-cost credit may lock in a production process that will be inefficient in the future, when only market-rate financing is available.

Interest subsidies are inflexible. The RLF borrower's direct subsidy is the amount that out-of-pocket expenses are lowered. The total subsidy and the timing of its disbursal are entirely determined by the loan term and amount, since RLF's are single-rate lenders. Bigger or longer term loans carry a greater subsidy. When borrowers entice larger and longer term loans from RLF operators, fewer loans can be made and funds revolve more slowly. For development purposes, the optimum level and timing of a subsidy may be quite different from that conveyed by an RLF loan.

Borrowers are sheltered from market incentives. An RLF borrower may become dependent on subsidies as the cost advantages they provide protect them from competition and

Figure 2

Few RLF's making both rural and urban loans posted positive inflation-adjusted returns



Source: Semi-annual RLF reports to the Economic Development Administration, Mar. 1993.

insulate them from the consequences of poor management practices. The longer a firm receives subsidies, the more dependent it may become. Additionally, while successfully repaying the RLF loan will help RLF borrowers obtain a commercial loan, the advantage is less when the prior loan was subsidized.

All borrowers like low interest rates.

The low interest rates charged by RLF's are attractive to businesses that qualify for conventional credit. Because these low rates are so attractive, RLF's need to reserve program funds for those lacking alternative sources of credit due to market failures. Since fund operators may be tempted to offset anticipated losses on high-risk loans with profitable loans to "blue chip" borrowers, RLF's need a nonprice way to screen out commercially viable borrowers; however, businesses denied RLF financing may refuse to participate in the local development activity. Even with careful screening, RLF loans may seem to finance activities consistent with the development plan when in fact they substitute RLF funding for available private funding.

Private lenders may capture subsidies meant for RLF borrowers.

The subsidy from an RLF loan is meant to enhance the borrower's chance of financial success by lowering debt service costs. However, some or all of that subsidy may actually be cap-

tured by lenders that agree to participate in the RLF loan package. RLF funds are essentially insuring these lenders against the possibility of financial loss. Through subsidy enhancements, the costs associated with loan defaults are shifted to the RLF. The subsidy arises because RLF's lower the borrower's loan costs by reducing the risk to cooperating lenders. The difference between the market rate and the artificially lower rate charged by the RLF is the rate of subsidy. The lender captures that share of the subsidy not accruing to the borrower. However, if there are no restrictions on interest rates on the non-RLF portion of the loan, it is possible that borrowers will receive no subsidy and will face even greater total credit costs than they would have paid in the RLF's absence. While pricing limits on private loans can increase the borrower's share of the subsidy, experiences of other Federal loan guarantee programs suggest that imposing too strict a limit has the unintended effect of greatly reducing lender participation.

RLF's Can Be Improved

Many recent credit programs in developing nations have changed from low-interest to market-rate lending with very positive results. Not only are program costs dramatically lower, but borrowers have been able to pay market rates and graduate more easily and quickly to private financing. Also, charging market interest rates has increased the supply of investment capital for developing sectors. While subsidies are still needed, they usually are used to provide education and business training to enhance the financial management skills of the borrower. Similarly, a National Federation of Independent Businesses survey found that U.S. small businesses care more about credit availability than credit price.

Advantages from RLF programs' use of market-rate lending include: higher operating income; replacing losses with loanable funds; loans sought only by borrowers who lack other sources;

and loan histories that better assist graduation to private funding.

RLF resources must adjust to fit changing needs. One way to achieve this capital reallocation would be to require that RLF's operate in larger geographic areas. This would, however, create trade-offs between local control and balancing the investment needs of the larger economic area. Funds could be reallocated in many ways, and the specifics of any change should be considered carefully. For example, after an initial grace period, RLF funds would repay annually a fixed percent of their original capital grants to a regional development recapitalization fund. Existing and new RLF funds could then compete for these funds through investment proposals.

Tighten RLF accounting practices.

To improve the measurement of financial status and performance, RLF operators could estimate expected loan losses and administrative costs according to generally accepted accounting principles. These changes would likely increase outside investors' interest in development opportunities by providing them with useful information that could be used in evaluating potential risks and returns.

Improve measures of RLF effectiveness. Current measures of effectiveness (jobs created/saved and private dollars leveraged) do not adequately assess what would have happened in the absence of an RLF and are difficult to interpret. RLF sustainability and customer success are more direct indicators of positive performance results and are a better reflection of when borrowers lack alternative financing because of market failures.

Expand the financial activities of successful RLF's. RLF operators would

have greater incentive and opportunity to be a positive force in development finance if their fund use were less constrained. For example, successful RLF operators might be allowed to use their increased capital bases to finance development activities that are not currently authorized. RLF operators could also be allowed to use funds to secure loans or sell notes to leverage existing capital. While not currently feasible because of the low interest rates charged on loans and the magnitude of RLF losses, loans might be securitized if RLF's operated at a profit. Currently, RLF loans can be securitized only at a loss because money markets require a higher rate of return than is currently charged on these loans.

The Bottom Line on RLF's and Rural Development

RLF's are not an all-purpose tool for delivering funds to promote community development. The community development role best suited to RLF's is to provide financing when credit access (availability of credit at a price that properly considers risk and the market cost of funds) is a problem. RLF's may be more appropriate for rural than urban applications, because such factors as small scale, less diverse economies, and remoteness make rural communities vulnerable to credit access problems.

Low-interest-rate lending reduces the effectiveness RLF's can have on economic development. Market-rate lending is the most critical potential improvement. RLF's could also benefit from: (1) periodic reallocation of outstanding monies, (2) tighter accounting practices, (3) more market-based performance measures, and (4) rewards for successful RLF's, including an expansion of permitted activities.

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Further Readings

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