# AVAILABILITY OF CAPITAL IN RURAL AMERICA: PROBLEMS AND OPTIONS

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## EXECUTIVE SUMMARY

### Rural Capital Availability: The Problems

The decade of the 1980s has been marked by important changes in our nation's financial markets primarily as the result of interest rate, product line, and geographic deregulation of depository institutions beginning in 1980 and continuing today. Deregulation was hailed as an important step toward "leveling the playing field" occupied by both regulated and unregulated financial institutions, but it has served, in addition, to alter the traditional playing field found in most rural financial markets. The impact of changing financial markets on rural capital availability is of concern since rural areas are perceived to have certain characteristics affecting capital flows: lack of economic diversification, higher risk lending opportunities, higher transactions costs associated with lending, and relatively small financial institutions with limited management capacity.

Capital availability, in the context of this paper, is defined as the availability of both debt and equity capital to business concerns in rural areas. The focus on business credit is based on the importance of commercial development to any overall strategy of rural economic development. In addition, it is assumed that the key capital market issue for rural areas, in general, and rural businesses, in particular, is gaining access to the type of capital needed to support job creation rather than the cost of capital.

A number of research hypotheses have been set forth regarding the impact of financial market changes on rural credit availability based on assumptions about the effect of bank size, institutional structure, management, and market structure on bank lending, particularly to small businesses. In general, these hypotheses paint an unclear picture of the potential impact of deregulation on rural credit availability, with some suggesting that size is the most important determinant of lending behavior, others that institutional structure predominates, and still others that management factors are key to understanding bank lending.

The empirical evidence to support these hypotheses is, in some cases, rather limited. On the supply side, research suggests that deregulation results in increased concentration of banking resources at the national level, but that local level impacts are unclear, hence limiting the applicability of this type of analysis to consideration of local capital markets. A more important area of research focuses on how a bank's institutional structure, i.e., affiliate vs. independent, affects lending. Evidence suggests that banks affiliated with holding companies are less risk averse, provide potentially greater relative lending support, may not create a greater outflow of local funds, and can offer a wider range of loan products and services to business customers, while independent banks provide greater support to agriculture and have greater flexibility in decision making at the local level. However, there has been limited research to explore other aspects of changing financial markets such as the impact of interstate banking on rural credit availability and the potentially important role played by management in determining a bank's lending behavior.

On the business demand side of rural capital markets, only limited research has attempted to identify the sources of capital available to businesses and the role of banks, as well as other institutions, in providing

that capital. As a result, there is little definitive evidence regarding what capital gaps might exist in rural markets. While it is clear that more work must be undertaken to evaluate both the supply and demand sides of rural capital markets, it is also evident that there is a public perception that certain rural areas or groups are underserved by more traditional financial institutions, that deregulation may have a negative impact on credit availability in some rural markets, and that public sector options are required.

While research results do not clearly delineate the problems of rural capital availability, the evidence does suggest that there are likely to be large variations in the impact of changing financial markets across rural communities, depending upon their initial banking structure, economic conditions, and whether they are growing or declining. As such, this paper describes a wide range of public, private, and public-private partnership options for dealing with perceived rural capital availability problems and attempts to offer some evaluation of the programs in terms of their ability to effectively improve rural capital availability, given that such problems exist in most rural areas.

## Rural Capital Availability: The Options

Given the variety of programs in place to provide, augment, or catalyze rural credit, options in three areas are considered: public initiatives, private initiatives, and public-private partnership initiatives.

### Public Initiatives

Public initiatives are defined as efforts by the public sector to (1) provide capital directly, (2) increase capital indirectly, (3) use regulatory authority to increase capital availability, and (4) provide technical assistance. These public programs must be evaluated based on their ability to provide funding for projects where private sector credit is unavailable and investment will lead to job creation in target areas and to increase capital availability, not simply subsidize capital cost.

Direct lending programs (Massachusetts Community Development Finance Corporation, Illinois Community Development Assistance Program, and Build Illinois), in general, meet these criteria with varying degrees of success. In addition, the funds available through these programs are small compared to the resources of most private financial institutions.

Indirect programs (Ohio Linked Deposit Program, California Loan Guarantee Program) have an advantage over direct lending programs in that a relatively small amount of money is used to encourage greater lending to target groups or higher risk businesses from financial institutions, suggesting that they are able to increase capital availability to currently underserved groups. Linked deposit programs, however, focus on reducing the cost of capital rather than increasing availability. It is possible, by using linked deposits as a reward for greater risk taking on the part of private institutions, to shift the focus to capital access rather than cost.

Use of regulatory authority (Vermont Community Reinvestment Legislation and Maine Net New Funds) is a relatively recent phenomenon and, as such, has a more limited history to evaluate. The advantage of regulation is that it works with existing financial institutions to encourage greater lending in

particular areas, allowing the state to benefit from the expertise embodied in those institutions, rather than potentially duplicating private bank efforts with state programs.

Technical assistance programs (Small Business Development Centers, Michigan's Northern Economic Initiatives Center, and Michigan Modernization Service) have typically taken a back seat to the other forms of intervening in rural capital markets. However, the importance of providing financial, management, marketing, and other business assistance in addition to capital is generally accepted and has been an important component of many private sector options.

**Private Initiatives**

The private sector options discussed are evaluated based on the same type of criteria as the public programs. In general, these options fall into the following categories: (1) rural community development corporations (Northern Communities Investment Corporation), (2) bank community development corporations (Southern Bancorporation, Self-Help Credit Union), (3) bankers' bank (Independent State Bank of Minnesota), (4) rural venture capital funds (Northeast Ventures Corporation), and (5) technical assistance programs (Coastal Enterprises, Women's Economic Development Corporation, and the Enterprise Network of Minnesota Bankers' Association).

In most instances, these private efforts are relatively small, but tend to be targeted more directly on rural regions. In addition, technical assistance is an important complement to capital availability in most programs, unlike the public options. However, there is some concern about the potential to replicate these types of programs across a number of rural areas, given the dependence of many of these programs on grants from the federal, state, or private sector to at least initially endow the programs.

**Public-Private Partnership Initiatives**

Three specific public-private partnership initiatives are highlighted: Michigan's Capital Access Program and Business and Industrial Development Corporation, Greater Minnesota Corporation and the Community Reinvestment Fund. These programs are characterized by the state getting out of the business of making direct loans to target individuals or companies. In the Michigan programs, state money is used either to work with existing institutions or create new ones to increase the capacity to accept greater risk in bank loan portfolios. The Minnesota program is focused on stimulating product development through the use of state funds to catalyze innovation, particularly in rural areas of the state.

## Policy Recommendations

The review of our knowledge base regarding rural capital availability and a range of public, private, and public-private partnership options for dealing with rural capital market problems sets the stage for a number of policy recommendations. Because of diversity in rural economies and financial markets, these recommendations are made at a relatively general level and may not be applicable to all state situations. In addition, these recommendations are most relevant when placed in an individual state context and evaluated relative to existing rural capital market needs.

Policy Recommendation #1: Determining the Status of Rural Capital Markets

To facilitate a better understanding of state capital markets, state universities and/or state agencies should be directed to conduct research periodically to evaluate the efficiency of rural capital markets and to define as precisely as possible any capital gaps that may exist in rural areas. State and federal regulatory authorities have a role to play in facilitating such research by providing necessary data and considering what data should be acquired in the future to permit ongoing analysis and monitoring of the status of rural capital markets in the state.

Policy Recommendation #2: Establishing an Appropriate Role for the State

The primary role of the state in addressing rural capital availability problems should be to use public monies to enhance the capacity of private sector lenders, e.g., banks, community development corporations, to increase their lending. Specific options include:

1. Linked deposit of state funds in banks and thrifts that agree to (a) increase their lending via state or federal guarantee programs to target groups identified by the state; (b) develop a set-aside high risk loan portfolio; or (c) engage in development lending through a CDC or other private agency.

2. Creation of a state fund to endow rural CDCs and private venture capital or product development funds that provide equity and near-equity financing along with technical assistance to rural target groups.

3. Creation of secondary market for small business or development loans to permit the recapitalization of private institutions such as CDCs.

4. Establishment of a loan reserve program to encourage greater risk taking on the part of participating banks and thrifts.

   Existing state financial assistance programs should be reviewed and, if necessary, revised to be used strategically to provide initial seed financing to get projects started or to encourage changes in private sector financial institutions, such as described above.

   State definitions of target groups, for use in the options outlined above, should be constructed to be broad enough to allow flexibility across diverse economic situations within the state and to allow programs to change along with economic circumstances. An institutionalized means for public-private dialogue to identify target populations, industries or regions of concern and to evaluate options for public, private, and public-private partnership initiatives should be established.

Policy Recommendation #3: Use of State Regulatory Authority

Use of state regulatory powers to increase rural capital availability should be carefully evaluated in relation to credit needs in rural areas. Any changes in regulations should provide for expanded bank involvement in

options identified by the state, e.g., higher risk lending, development lending through CDCs. And, review of these activities should be incorporated into legislation covering the application review procedure used for banks seeking to expand through branching or interstate acquisitions or into community reinvestment legislation. Regulatory authorities should consider ways in which bank and thrift institution involvement in providing equity capital might be expanded without jeopardizing the safety and soundness of financial institutions.

Regulatory reform, including expanded powers for financial institutions, should be coupled with requirements for providing information on geographical, size, and industry characteristics of the loan portfolio. Such information can then be used to assess the efficiency of state capital markets and the effectiveness of options directed to increase capital availability.

**Policy Recommendation #4: Providing Technical Assistance**

States should establish active technical assistance programs designed to bridge the gap between bankers and businesses so that the transactions costs and risks of financing these enterprises are effectively reduced. Assistance should be focused on smaller, growth and start up businesses and include technical, financial, management, and marketing services. Programs should be designed to include close collaboration with the private sector to identify and hire consultants to provide assistance. Outreach components should be included in any technical assistance program in order to bring services to rural entrepreneurs.

**Policy Recommendation #5: Promotion of capital market solutions**

The Governor's office should encourage private financial institution support for innovative approaches to filling capital gaps and should actively promote/publicize those strategies throughout the state. In addition, the private sector, i.e., foundations, investors, should be actively recruited to invest in new types of institutions, e.g., venture capital funds, bank CDCs, community development credit unions, developed to promote the economic development of the state. In short, the issue of capital availability, particularly in rural parts of the state, should be elevated in the public eye and innovative solutions actively encouraged through public-private cooperation.

States have a key role to play in providing leadership in designing programs to evaluate rural capital markets and, if warranted, to increase rural capital availability. Analysis of the track records of the options discussed in this paper is limited and, consequently, the transferability of these programs across states or between public and private sectors is limited. A thorough analysis of the strengths and weaknesses of a wide range of options would go a long way toward enhancing the ability of states to evaluate which options are most appropriate for addressing the particular capital needs of rural areas in their states. Rural economic development will be promoted only through innovative approaches to providing capital to support development activities. These approaches will require public and private sector cooperation to develop appropriate programs to increase capital adequacy in rural America. Such a partnership effort is the first step toward maintaining viable rural communities in the years ahead.

## INTRODUCTION

The decade of the 1980s has been marked by important changes in our nation's financial markets, primarily as the result of significant deregulation of depository institutions beginning in 1980 and continuing today. Deregulation has changed the character of financial markets at both the national and local levels. Hailed as an important step toward "leveling the playing field" occupied by both regulated and unregulated financial institutions, deregulation has altered the traditional playing field found in most rural financial markets. Rural markets had long been dominated by relatively small independent banks serving primarily their local commercial and consumer depositors. Deregulation opened the way for expansion of banks across geographic barriers. With this opening came changes in rural financial markets, with more banks affiliated with multibank holding companies operating in a larger geographic area, typically a state or region.

Capital availability in rural areas is a concern because of certain characteristics of rural markets that are perceived to affect capital flows. Many rural areas suffer from limited economic diversity, i.e., reliance on a single industry like agriculture or mining. And, there is concern that rural lenders are overly conservative because of this constraint. There is also the perception that rural lending opportunities are higher risk, because industries in rural areas tend to be cyclical (e.g., mining, energy exploration and development) and frequently subject to considerable competition (e.g., textiles, agriculture). Further, loans in these areas have higher transactions costs, associated with the relatively small size of loan typically made and more limited information about viable lending opportunities. Other limitations on rural capital availability relate to the relatively small size and, consequently, limited management capacity in many of these financial institutions.

Rural areas of this country face important challenges. The much-heralded rural-urban turnaround of jobs and population in the late 1970s slowed or even reversed in many rural areas in the early 1980s. The stability of some traditional bases of rural economic activity (agriculture, textiles, apparel, and other labor intensive manufacturing industries) is threatened by increased international competition. The economic base of most rural areas continues to be dependent upon slower growth industries, e.g., manufacturing and resource based activities, rather than the high growth business and personal service industries and high technology enterprises. Finally, state and local governments are called upon increasingly to shoulder a larger share of the responsibility for providing services previously in the federal domain.

Rural capital market issues will differ from one rural economy to another, depending upon local economic and banking structures. Consequently, to deal with rural capital availability requires an understanding of specific rural capital markets and not simply a national or even regional perspective. This paper is an attempt to evaluate the state of our knowledge about rural capital availability problems and to review public, private, and public-private partnership options for dealing with them.

## RURAL CAPITAL AVAILABILITY: THE PROBLEMS

It is important to begin by defining capital availability, specifically what types of capital, available to whom, and for what purpose. It is important to consider availability of both debt and equity capital. Particularly in rural areas, access to the former has been primarily through formal market channels, such as banks and thrift institutions. In terms of equity capital, however, more informal channels tend to predominate, e.g., family, friends, personal savings. Access to equity capital may present a formidable barrier to small business development, an important source of job creation in many rural areas.

If concern is with access to capital as a means for promoting rural economic development, then specific attention must be focused on the availability of capital for rural commercial and industrial concerns. Capital availability represents an important ingredient in any strategy to create jobs, increase income, and diversify the local economy in response to changing economic conditions. Given changing economic conditions for many rural areas in the 1980s, capital availability to support economic development in rural areas should be an important concern. In this paper, primary attention is focused on problems concerning availability of debt and equity capital to rural businesses as an important component of any overall rural economic development strategy.

The cost of capital for rural businesses is typically of less concern than availability. Interest expenses for most businesses represent a relatively small proportion of operating costs. Also, studies of rural business financing experience have found that it was not the cost of capital but raising sufficient quantities of capital, particularly in the start up phase of the business, which was the most significant problem for businesses. Consequently, the key capital market issue for rural areas and rural businesses appears to be gaining access to the type of capital needed to support job creation and other economic development activities.

### Research Findings on the Supply Side of Rural Capital Markets

A significant part of capital market research has been devoted to evaluating changes in market competition and concentration at both the national and local levels. The consensus is that deregulation increases concentration of financial market resources at the national level, although the level of concentration still remains relatively low. However, evidence on local market impacts is mixed at best, with some markets experiencing reduced concentration and increased competition while others experience opposite effects. Clearly the impact of banking deregulation is not uniform beyond the national level. Rural areas are likely to face different post-deregulation situations depending upon the structure of the local market prior to deregulation, the size and character of banks in the local market, and the level of nonbank competition faced by new entrants.

A number of studies have identified differences in the lending behavior of independent banks and branch or affiliate banks. In general, the results of these studies suggest that:

1. Banks affiliated with bank holding companies are less risk averse, i.e., they place less of their assets in government securities; potentially can offer a wider range of services and lending expertise; maintain higher overall loan to deposit ratios; and have primary decision making authority outside the local market.

2. Independent banks provide greater relative support for the agricultural sector; have greater flexibility in decision making; are more conservative in their investment, i.e., place a higher percentage of their assets in government securities; and have primary decision making authority at the local level.

Given that banking deregulation has resulted in increased merger and acquisition activity, these results suggest the potential impact of banking deregulation on rural capital availability. To the extent that formerly isolated rural banking institutions find themselves increasingly open to competition from outside the local area and to acquisition by urban-based bank holding companies, rural markets are likely to be characterized by institutions willing to accept greater levels of risk in loans, able to provide access to a greater range of services and to greater amounts of capital, and disposed to make decisions outside the local market.

Additional evidence suggests that a shift from independent banks to branches of institutions outside the local area results in a shifting of funds between rural areas, rather than from rural to urban areas. Deregulation will not have a uniformly negative impact on rural areas. Rapidly growing rural areas, presumably with excess demand for capital, will benefit from a transfer of funds from more slowly growing rural areas. The presence of large banks (typically holding companies) does not result in a greater outflow of local funds, since small banks already contribute heavily to this outflow via their high investments in government securities, a nonlocal investment.

Finally, the role of regulation in proscribing bank behavior must be recognized. The extent to which banks provide certain types of financing, e.g., equity capital, or make specific loans, e.g., those perceived to bear higher risk, is constrained by the regulatory framework within which they operate. Regulation provides important protection for the safety and soundness of our nation's banking system, while at the same time determining the activities undertaken by commercial banks and thrift institutions. Thus, regulatory authorities have a large role in determining the ultimate structure of rural capital markets.

## Research Findings on the Business Demand Side of Rural Capital Markets

Comprehensive evaluations of business credit needs and experience in rural markets across the country are limited. However, a number of efforts have been undertaken to identify sources of financing for business and, specifically, the role of banks in providing business capital. In general, these results suggest that while commercial banks are a common source of loans for most businesses, banks are less important in supplying initial start up capital. A more recent study in Iowa, however, found that rural banks were important sources of start up capital for many businesses. These studies suggest that bank support of business start ups is not necessarily uniform and, consequently, merits further study to evaluate what factors may influence rural bank provision of start up capital. In addition, whether banks could

play a larger role in financing rural businesses can not be addressed without further consideration of capital demands among rural businesses as well as the regulatory restrictions placed on the risk exposure of commercial banks.

Work in progress at the University of Michigan suggests that higher birth and growth rates for new businesses are associated with small banks operating in concentrated local markets. While this result is counter to that suggested by economic theory, the authors suggest that small banks in concentrated markets are able to obtain deposits at lower rates, can lend to businesses at lower rates, have greater information about new business opportunities in their local markets, and have a greater stake in encouraging economic growth in the local market than would the branches of large bank holding companies less dependent on conditions in the local market. State regulatory policy that removes limits on bank expansion within or outside the state and on the merger activities of holding companies must be evaluated not only in terms of the positive impacts on consumers, i.e., market determined deposit interest rates, but also with an eye toward the potential impact on small or new business credit availability.

**Perceptions of Rural Capital Availability Problems: Anecdotal Evidence**

While a number of important observations have been made about rural capital availability based on research into both the supply and demand sides of rural capital markets, there are also some very important perceptions of what is happening in rural capital markets as a result of regulatory change and what impacts those changes have on credit availability. These perceptions are based typically on anecdotal information derived from experience working with firms in rural areas, as well as working on capital market issues in general. More importantly, however, these perceptions have an important influence on the design of public policy to address rural capital availability problems. Some of these perceptions are outlined below.

The report of a 1987 conference on "Commercial Credit Availability and Economic Development" reflects a range of observations on rural credit availability from individuals involved in evaluating capital markets in relation to economic development. Several general perceptions can be cited:

1. Since 1980, there has been increased consolidation of banking resources, at the state level, as a result of increased acquisitions.

2. More recently in some regions, locally controlled subsidiaries of holding companies have been converted into branches of large, regional banks, reducing local decision making authority.

3. Consolidation results in more creative, flexible, and aggressive lending in rural markets through the presence of larger, more sophisticated banks.

4. Consolidation results in greater reliance on financial analysis rather than character analysis in lending decisions, to the disadvantage of some rural businesses.

5. Large lenders have more limited understanding of local markets and, consequently, local credit needs.

6. Interstate banking is likely to drain capital from slow growth rural communities, but may help to inject capital into more rapidly growing rural areas.

7. Small rural bankers are generally more conservative than large bankers, earning higher profits and accepting lower risk, while making less money available to the community via loans.

8. Bankers can and should do more to encourage economic growth by making more capital available in rural areas.

Some of these perceptions seem to be supported by research evidence. But, at the same time, they reflect our lack of understanding of what is happening in rural capital markets and our need to undertake a more systematic analysis of rural credit needs and supplies in order to become less reliant on anecdotal information in making policy decisions.

**Research Issues Still At Large**

It continues to be difficult to evaluate the issue of rural capital availability in any systematic way based on these results. Part of the failing results from lack of high quality data with which to conduct analyses. In other cases, however, it comes from lack of consideration of the potentially different impacts of national level changes, such as deregulation or interstate banking, when viewed from the perspective of a rural capital market. As a result, concluding that the supply of rural capital is adequate or inadequate or is affected positively or negatively by structural and regulatory changes is not yet possible. Several specific limitations are discussed below.

First, it is clear that little is known about the impacts of financial market changes such as deregulation and interstate banking specifically on rural capital markets. The respective roles of large money center banks, superregional banks, and local banks in providing capital to rural areas, particularly to small business concerns in those areas, remain unclear. Research which focuses on national market changes and then extrapolates those results down to the local market level has serious limitations in terms of accurately describing impacts on rural markets. In order to evaluate rural capital availability, much more information is required which is specific to rural markets. In addition, of primary importance is a process for monitoring the changes that occur in rural markets over the next five to ten years as a means of evaluating both short term and long term impacts. There is a need to track the behavior of banks, thrifts, and other providers of capital over time so that an accurate picture of the availability of capital in rural areas can be obtained.

Second, in order to evaluate capital market changes at the local level, better quality data must be gathered. Specific data needs are for geographically specific information on bank lending, information related to commercial loan products and services provided by the bank, and information related to decision making regarding loans and bank policy, in general. While the type of information required will vary depending on the analysis undertaken, to identify the impact of changes in the institutional and market structure of rural capital markets it is necessary to gather more specific information from banks as to their lending policies and practices. Some more

recent studies in Wisconsin, West Virginia, and New England are designed to provide such information through various survey instruments. Alternatively, data requirements of bank regulators could be increased to provide a more comprehensive data base on bank lending. However, the benefits and costs of acquiring additional data from financial institutions must be carefully evaluated in order to determine what types of information can be effectively obtained without placing undue administrative burden on institutions and regulators.

Third, another important weakness of most past banking research has been the lack of importance attributed to management factors in explaining lending behavior. Preliminary evidence from work in West Virginia suggests that the more qualitative aspects of a bank's management, e.g., attitude toward small business lending, perceived role of the bank in the community and in the economic development process, attitude toward risk, may be important in determining how the bank behaves with respect to commercial and other types of lending. The importance of management as a factor in bank lending is an area requiring further research attention focused on effectively measuring management variables and incorporating them into more quantitative analyses of bank lending practice.

Finally, the question of capital gaps in rural areas deserves more research attention. Most of the studies reviewed above have focused on the private sector suppliers of capital and, more specifically, commercial banks. Attention must be given to defining rural capital market suppliers more broadly to include thrift institutions as well as other private and nonprofit institutions providing debt or equity capital. More research along the lines of that conducted at the University of Wisconsin needs to be undertaken to identify where rural businesses get their capital, what types of capital they have been able to obtain and which types are still needed, and how these capital needs relate to the ability and willingness of private sector firms to supply the capital. And, the demand side of the rural capital market must be evaluated, particularly in relation to the demand for credit on the part of businesses, whether they are small, start up, growing, stable, or declining. Only with better information on both the supply and demand sides of rural capital markets can the need for and effectiveness of public and/or private sector interventions be evaluated.

More work must be undertaken to evaluate rural capital markets. However, there is a public perception that certain rural areas or groups are underserved by more traditional financial institutions, that deregulation may have a negative impact on credit availability in some rural markets or for some types of firms, and that public sector options are required. The following section describes a range of public, private, and public-private options for dealing with perceived rural capital availability problems. It offers some evaluation of the programs in terms of their ability to effectively improve rural capital availability.

## RURAL CAPITAL AVAILABILITY: THE OPTIONS

Arguments for public sector intervention in rural capital markets can be made on two counts. First, rural capital markets may operate under some barriers because of incomplete information about lending opportunities, particularly related to loans for new or expanding young businesses. Transactions costs associated with making loans in rural areas would be high and would restrict the flow of funds into rural areas.

Second, our nation has a history of public programs to achieve equity goals or to improve the economic prospects of depressed regions. Efforts to increase the flow of capital to rural economies may help ensure that people can lead productive lives, that social and economic support systems for farmers are maintained, that population remains dispersed across the nation rather than concentrated in large urban centers and their surrounding suburbs, etc.

Public programs should be evaluated in terms of their benefits and costs, both locally and nationally, and both short-run and long-run impacts should be considered. A large number and wide range of programs to increase capital availability currently are being used across the country, but there has been only limited evaluation of the economic impacts.

Given the variety of programs in place to provide, augment, or catalyze rural credit, it is useful to categorize the range of options available and to review examples of each type. The next sections provide a brief evaluation of each program to highlight its major components and its strengths and/or weaknesses. Three distinct types of programs are discussed: public initiatives; private initiatives; and public-private partnership initiatives.

## Public Initiatives

The public initiatives discussed in this section are defined as efforts by the public sector to either (1) provide capital directly to eligible borrowers, e.g., rural small businesses, (2) increase capital availability indirectly by packaging or targeting capital available from other institutions, or (3) affect capital availability through regulatory authority. The public sector role in providing technical assistance as one means of increasing access to capital from private sector lenders is also considered. Each type of initiative is discussed separately below. However, any state may pursue a blend of options. In some cases, the success of one program may be dependent upon another, e.g., targeting private sector capital combined with technical assistance to businesses.

### Direct Lending Programs

A number of programs lend public monies directly to eligible borrowers. These programs typically are concerned with creating equality of economic opportunity for certain groups and with overcoming the failure of private capital markets to provide credit to these groups. Direct lending programs should be evaluated, at a minimum, on their ability to accomplish three goals. First, program funds should be used only when private financing is unavailable and not as a replacement for private funds. Capital gaps may exist for rural businesses that are higher risk, just starting up, or in need of only small amounts of capital. These gaps, when they exist, may be appropriate targets for public sector funds. However, if public funds substitute for private funds, an inefficient allocation of resources occurs and capital availability to rural businesses will not be increased.

Second, funds should be channeled to enterprises that will expand economic activity in particular target areas or that will permit retention of jobs that would otherwise be lost so that local economic development is an outcome of

public investment. Since states have assumed the primary role in stimulating economic development, public funds should be used to produce some positive economic impact. Public funds must be expended for a broader public purpose and not simply to enhance private profit potential.

Third, programs should increase the availability of capital, particularly start up or equity capital, in rural areas, rather than simply reduce its cost. For most businesses, interest expense is a very small portion of operating costs. If public programs only reduce the cost of capital, they provide a subsidy to businesses that currently receive credit. Such programs do not help to close capital gaps for businesses that are unable to get credit, at any cost. It is these businesses that should be the target of public programs to correct any inefficiencies in rural financial markets. Several state programs are described below and evaluated in terms of these three goals.

Massachusetts has one of the oldest state agencies involved in direct lending programs, the Community Development Finance Corporation (CDFC). Capitalized by a state appropriation of $10 million, CDFC is a state-owned venture capital corporation "which provides flexible financing for viable businesses and real estate development projects when there is a clear public benefit." The program works with the existing network of community development corporations (CDCs) operating in the state. Through the Venture Capital Investment Program, the state provides both debt and equity financing to small businesses that will provide employment opportunities and for which no private sector sources of funds are available. These business opportunities must be located in a CDC target area and have the support of the local CDC. While direct investments range from $75,000 to $300,000, the CDFC typically works with local financial institutions to provide additional funds. Any equity position taken by CDFC is in conjunction with the local CDC. The CDFC also funds real estate development through local CDCs under the Community Development Investment Program to promote development and revitalization of low and moderate income housing. Under this program, CDFC can provide 20 percent or $250,000 in financing or equity along with the CDC.

In 1986, CDFC invested over $3 million in CDC-sponsored companies and real estate developments, resulting in the creation of 374 jobs and 438 housing units. While the focus of CDFC is not strictly on rural areas, funding for rural projects has been an important component of its activities. Currently, about 14 percent of CDFC's total commitments are in rural areas, while about 16 percent of the state's population is classified as rural.

The CDFC's current record does not reflect the difficulty the organization had initially in making sound investments. CDFC lost $4 million of the first $6 million it invested. Loss rates for its first four years were 84, 42, 40, and 85 percent, respectively. One problem faced by CDFC, as well as the local CDCs, was the lack of capability on the part of management to make and monitor sound investments. Without oversight of investments like that found in a private venture capital firm, CDFC had less control over its investments and, therefore, a relatively poor track record in creating viable enterprises and jobs. Performance in the past few years has improved primarily due to more experienced management of the CDFC, and loss rates are now at a more acceptable level of 6 percent. The experience of CDFC suggests the importance of designing any state venture capital company so that it closely parallels the private sector institutions that have been relatively successful to date. This structure requires active involvement by the state agency in managing its investments and working with small businesses and/or CDCs receiving investment funds.

The size of investment typically made by CDFC may also limit its accessibility to firms with smaller financing needs. Five rural CDCs have formed the Western Massachusetts Enterprise Fund. The fund will be capitalized with private dollars from local corporations, banks, and national foundations. The goal is to capitalize a central fund with $1,250,000. Since the CDCs have different objectives, e.g., self-employment, small business development, each CDC would establish its own program with capital from the central fund. Loan size is expected to vary across CDCs, with the maximum size loan set at $20,000. To date, the fund has a grant commitment from local banks of $90,000 to support operating costs for three years. Proposals are pending before several foundations and it is anticipated that the fund can begin operation in January 1990.

The state of Illinois has two programs that provide direct state funding for private initiatives. In both programs, lending is linked to job creation and requests for funding must show capability for creating or retaining jobs. First, the Community Development Assistance Program (CDAP) is designed to use federal Community Development Block Grant monies administered by the state to provide "gap financing," i.e., money to borrowers for whom no other funds are available. The program provides grants to local communities to establish revolving loan funds. These community funds, in turn, extend below market rate loans to businesses that will provide jobs to the community. The program is targeted specifically to communities with less than 50,000 people. A number of states have developed programs similar to CDAP with favorable results. Based on an analysis of investments made under 24 state programs in 1984 and 1985, funds were used to assist 893 firms and create 50,499 jobs at an average cost of $2,815 per job.

Second, in recognition of imperfections in Illinois capital markets, the Build Illinois program was established in 1985. One component of this program provides funds directly to small businesses (those with fewer than 500 employees). The state will provide up to 25% of total project funding, working with a private financial institution. These loans would act like a second mortgage and provide funds in addition to those obtained from a private lender. To satisfy the requirement that public funds be expended only for a public purpose, loans are made to companies to encourage their location or retention in the state. As with the CDAP program, a job creation/retention criterion is used to ensure that the monies encourage economic development. In 1986, the first year of the program, 30 companies received loans under the program for a total investment of $7.5 million. In total, 848 jobs were created for an average investment of $7,500 per job. Although not specifically targeted, almost 50 percent of the funds expended in 1986 went to rural areas, twice the percentage of the state's rural population.

The direct lending programs described above are not unique, in most cases, to these states. However, there are several important differences in the way each program works.

First, most of the programs function as lenders of last resort, requiring that a business exhaust private options for financing before program funds are approved. In this way, public funds augment rather than substitute for private capital. However, the key factor considered in investment decisions made under some of these programs is job creation or retention, not a business's limited access to private capital. Thus it might be possible for public funds to be used when private financing is already available. As such, net rural capital availability may not be increased, unless strict eligibility criteria are applied.

Second, all of the programs tie public funding to encouragement of rural economic development through requirements for job creation/retention by each enterprise funded. However, the programs vary in terms of the targeting achieved, either for rural areas or specific groups, e.g., small businesses. While several programs are targeted to rural areas, others seem to be allocating funds in rough proportion to the representation of rural areas in the state's population. However, if a program objective is to increase relative capital availability in rural areas, then targeted programs are likely to achieve this end. Targeting a lending program to rural areas can help to overcome capacity limitations that might be found in rural communities.

Third, with the exception of the Illinois CDAP, the focus of these programs is on increasing the availability of capital to fill perceived gaps as opposed to providing funds at lower cost than those obtained through private institutions. In addition, most of the programs provide debt financing, with a mix of loan and grant programs. Only the Massachusetts CDFC provides an example of state equity capital financing, a type of capital that may be particularly limited in rural areas. At the same time, however, this program is not restricted to rural areas, a feature that may be important in its ability to provide equity capital by spreading funds across a range of different local economies in the state.

**Indirect Lending Programs**

Two examples of programs in which the state is only indirectly involved in increasing capital availability to target groups are characterized by (1) use of state funds to create a pool of low interest money for lending by private financial institutions, e.g., linked deposit programs, or (2) state loan guarantee programs. In the first case, no additional state funds are appropriated for these programs beyond state monies currently invested in private financial institution instruments, e.g., certificates of deposit. Guarantee programs require some additional state appropriations.

In 1983, Ohio developed a linked deposit program to support small businesses. The program authorizes the use of 12 percent of the state's regular investment portfolio for linked deposits, to be made available to private financial institutions at rates 3 percent below current market rates. In return for these low cost funds, the private lender agrees to lend money to qualified small business borrowers at rates 3 percent below market, fixed for two years, in amounts up to $500,000. To qualify for such a loan, the business must have fewer than 150 employees, must be approved for a market rate loan by the institution, and must show the potential to create jobs. The state provides no guarantee for the loan, so the private lender assumes the risk of default.

A key element in this program is the interest subsidy. Since the small business borrower is already approved for funding at market interest rates, concern is not with access to but with the cost of capital. Through the program, the state is able to increase benefits to small businesses by reducing interest costs, as well as increase benefits to the state through job creation or retention. Expected revenues from increased employment are to compensate for the revenue lost from receiving below market interest rates on a portion of the investment portfolio.

However, there is concern that the costs of such programs outweigh the benefits. Particularly if availability rather than cost of capital is the main problem for small businesses, the program represents an interest subsidy to specific groups rather than a stimulus to general economic growth. On the other hand, more innovative linked deposit programs can also be used to reward financial institutions which make higher risk loans or which focus some component of their lending activities on underserved groups, e.g., first time entrepreneurs. If the public's goal is to stimulate rural economies by increasing capital availability, such linked deposit programs should be designed to address capital access problems rather than subsidizing capital cost.

The California Loan Guarantee Program provides $35 million to guarantee up to 90 percent of the value of loans made by private lenders to small businesses, to a maximum guarantee of $350,000. An interesting feature of the California program is that the state has authorized seven regional nonprofit corporations to issue the guarantees. Thus the program is decentralized and the regional corporations have a large role in evaluating and determining which loans are eligible for guarantees. Under the program, funds are committed by a bank to a small business (less than 500 employees) and the regional corporation is then contacted to arrange a guarantee. While the program is not limited to rural areas, three of the seven regional corporations are in relatively rural parts of the state.

Loan guarantees facilitate the provision of capital to projects that may be perceived by private lenders to have greater risk. In this case, the lender shares the risk of a particular project, with the state government assuming a large part of that risk. This arrangement is in sharp contrast to the linked deposit program, where the lender bears all risk. If such a program is to succeed in the long run, however, the state must be in a position to evaluate accurately the potential success of the ventures it guarantees so that money is available on a continuing basis to support the program. From this perspective, the California approach of authorizing guarantees through regional corporations appears well founded. These groups may have access to better information about lending prospects in their local areas and may be in a better position to evaluate the risk-return tradeoffs inherent in each loan guarantee decision.

A common thread in these two programs is the use of state funds to steer capital from private institutions to small businesses. In both programs, the overall commitment of state resources is less than in direct lending programs described earlier. The state works through private sector lenders and relies, in most cases, on the management of those institutions to evaluate lending opportunities. However, in a linked deposit program like Ohio's, no more capital is made available to target groups than would occur otherwise. The major result is cheaper capital, not more capital. Loan guarantee programs, on the other hand, may increase the availability of capital to higher risk projects, where these loans would not have been made without the state guarantee. Programs that only reduce the cost of capital may serve to subsidize borrowers willing and able to pay market rates of interest. In designing linked deposit programs, such costs and benefits need to be considered to ensure that public funds are indeed spent in pursuit of some public purpose.

**Use of Regulatory Authority**

Another option for increasing rural capital availability is use of the state's authority to regulate financial institutions and markets. States have the power to regulate the activities of institutions doing business in the state as well as to create new institutions.

Twenty-four states have established some type of state community reinvestment provision, along the lines of the national community reinvestment act (CRA) passed in the 1970s. The state of Vermont recently passed the most extensive piece of community reinvestment legislation in conjunction with approval of regional interstate banking. Several features of the legislation are unique. First, the law creates a Citizen Advisory Board with representatives from community development and housing groups. These representatives will make recommendations to the commissioner on interstate banking acquisitions. Second, the law requires evidence that an interstate acquisition will bring net new funds to the state and that community credit needs will be met. Net new funds are defined as the change in a state's funds or deposits in relation to the change in a state's assets or loans held by the out-of-state institution. In this regard, a bank's track record in other states and particularly in areas where the bank operated branches, is considered relevant to the acquisition decision in Vermont.

Maine was one of the first states to implement the "net new funds" provision in association with its national interstate banking legislation in 1984 and currently five other states have such provisions. Maine has developed an extensive set of requirements for evaluating the creation of net new funds by bank holding companies operating in the state. In its initial application, each institution is required to show plans for meeting community credit needs as well as to provide detailed information about its lending activities. This information will be used to evaluate "net new funds" flowing into the state from these holding companies. In essence, the law provides a monitoring device for evaluating how interstate banking affects capital availability.

An important aspect of state community reinvestment legislation relates to rural capital availability. The national CRA has been much less useful in rural areas than in urban areas in generating data required to evaluate capital availability. However, state legislation may prove to be a useful tool for identifying capital conditions and needs in rural areas. In addition, CRA does not provide an enforcement mechanism to be used against banks that do not serve community credit needs. The act provides a means for community groups to challenge the track record of banks and, depending upon the power of these local groups, to negotiate a new reinvestment strategy with the bank.

Another state use of regulatory power relates to the legal structure within which banks operate. Reducing restrictions on branching or bank holding company expansion, either in- or out-of-state, may help to increase competition in rural markets and bring new banking services to these areas. However, the long run impact of geographical deregulation is not yet known. Deregulation must be pursued in conjunction with policies to permit monitoring of changes in banking structure and its impact on rural credit availability.

Another possible use of state regulatory power to expand bank lending capacity would require increasing the bank's capacity to bear risk. If rural lending opportunities are inherently riskier, then mechanisms to enhance bank

risk taking should enhance rural capital availability. For example, banks could be allowed to develop small, high risk portfolios that would be evaluated separately from their regular portfolios; or banks could be encouraged to make higher risk loans through establishment of bank-borrower-state loan reserves, such as that of the Michigan program discussed later. Finally, selective changes in federal regulations could permit greater bank involvement in equity financing.

Regulatory change requires a relatively small public commitment of capital relative to the direct and indirect lending programs discussed above. Regulatory change is likely to be more efficient since it works through private financial institutions that have the expertise and capacity to evaluate the risk-return tradeoffs involved in any lending decision and to monitor investments once they are made.

**State Technical Assistance**

While the programs described above involve the state in actively promoting capital availability to target populations, technical assistance programs require state support of a different type. The most frequently used state technical assistance program has been the Small Business Development Centers (SBDCs), sponsored by the U. S. Small Business Administration (SBA). By linking public, private and university resources, these centers provide business management assistance to small business owners who cannot otherwise afford it. Currently, these centers operate in 48 states, with each state matching the federal contribution. Centers are typically housed in private or public colleges, but there may also be involvement by state chambers of commerce or private organizations.

While the SBDCs do not provide direct funding for small businesses, they are involved in providing a wide range of business services, e.g., accounting, marketing, financial planning. Services are available free of charge to anyone who cannot afford them, typically to businesses with fewer than 150 employees. The SBDCs work to improve the business's planning and management, making bank financing more likely. In addition, the SBDC may help to identify less traditional sources of financing for firms, e.g., venture capital or quasi-public sources of funding, once viable business plans are developed.

While technical assistance programs do not increase the total amount of capital available to rural or small businesses, they do serve to improve a small business's ability to compete for funds available through public and private institutions. However, access to this technical assistance may be limited somewhat by the location of SBDCs. In many cases, these centers are located at major universities where resources for providing technical assistance are extensive. However, these locations may be relatively distant from the rural areas and small businesses most in need of assistance. Each state's SBDCs are required to provide state coverage, but the capacity for doing so differs from state to state. Typically, a network of regional offices is used to extend the reach of SBDCs. In addition, access to SBDCs requires knowledge of their programs. These centers will not be effective if little information regarding their services reaches potential clients. SBDCs, in most cases, do not provide outreach, but rather deal with clients as they come in to each center. These constraints may limit the assistance available to rural concerns so that alternative service providers or methods of delivery may be required.

Another university program provides a broader range of business development and technical assistance. The Northern Economic Initiatives Center (NEIC), created by Northern Michigan University in 1985, serves entrepreneurs and small businesses in Michigan's Upper Peninsula. NEIC's programs include technical assistance through its SBDC, technology audits and loans, and product promotion and distribution. Several of the programs are targeted to small- or micro-enterprises. The center receives state funding and supplements with private funds raised for particular programs.

Several programs merit further discussion. The Micro-Industry Promotion Program assists home-based businesses and small, limited production manufacturers, including artists and craftspersons, by providing assistance with marketing, promotion, and distribution. NEIC's activities help to encourage the expansion of these businesses by identifying markets for Upper Peninsula products.

Microenterprise Technology Deployment Services targets small manufacturers in the region that might increase sales by adopting new production technology. Staff review a firm's manufacturing capability and needs, then provide in-depth counseling to address technology problem areas on a fee for service basis. In conjunction with this program, a micro-industry revolving loan fund is available to provide low interest loans to assist businesses.

Finally, NEIC operates the Upper Peninsula Venture Capital Network, a matching system for entrepreneurs and informal venture capital investors. The network is confidential, matching investors to the capital needs of regional entrepreneurs. The network is unique because most entrepreneurs would not be aware of the individuals willing to provide venture capital, since they do not typically operate as formal financiers.

NEIC's programs are unique because they go beyond traditional technical assistance to include product and market development, technology transfer, and potential sources of venture capital. Most services are provided by using the resources available at Northern Michigan University. However, most of NEIC's staff have previously owned small enterprises and bring this experience to their assistance efforts.

The final example of public technical assistance is not directly involved in small business finance. The Michigan Modernization Service (MMS) provides comprehensive assistance for small to medium sized manufacturing firms (20-500 employees) in technological improvement, workforce training, and market information. Funded by the state Department of Commerce and the Michigan Strategic Fund, MMS has an annual budget of $4 million and has worked with 500 firms to date. MMS sends a team to conduct a modernization assessment, prepare a written report and review the suggestions with the firm. While the program does not provide or help the firm obtain financing, the firm's chances for continued profitability and growth are enhanced through these modernization efforts. Stronger, more competitive small businesses are likely to have greater access to capital from traditional financial institutions.

**Summary**

The preceding discussion has highlighted a number of public sector initiatives directed at increasing the availability of capital. While these

programs may not reflect all available public sector options, they do represent a range of alternatives with some unique features. The next section evaluates some private sector options being undertaken to improve capital flows in rural areas. These programs can be evaluated in conjunction with public sector initiatives in order to establish an effective mix of public and private strategies for increasing rural capital availability.

## Private Initiatives

The options described in this section are those undertaken by the private sector, including nonprofit institutions, to address concerns about rural capital availability. Again, the options described below are not necessarily unique, but they do represent a range of private sector programs designed to enhance capital availability in rural communities or for specific groups of rural residents.

### Rural Community Development Corporations

A large number of rural community development corporations (CDCs) have been established since the 1970s. These nonprofit organizations promote economic development in certain target areas by providing a range of assistance. A key feature of some CDCs is their provision of gap financing in their service area to organizations that are unable to obtain private or public sector funds, most typically through the establishment of a revolving loan fund. However, there are other models where CDCs engage in higher risk lending for start up firms.

One example of a rural CDC is Northern Communities Investment Corporation (NCIC) which serves the economic development needs of communities in the rural northern tier of Vermont and New Hampshire. Established initially with federal funds to support administrative costs, the fund has been self-sufficient since 1982 and relies on investment income to meet operating expenses. The goal of NCIC is to promote employment and economic development in its service area through investment and technical assistance programs.

NCIC offers a program guaranteeing up to 50 percent of a loan obtained through a private financial institution. Through the guarantee program, NCIC is able to increase the likelihood that a small business can receive conventional bank financing and to help that business establish an ongoing relationship with a financial institution that can serve future business credit needs. This link with private lenders is an important component of the program and helps NCIC leverage money from private lenders in support of economic development objectives in the region.

Second, NCIC's direct loan program loans up to $200,000 to established firms. The program can be expanded to include start up ventures and larger loans as well. In addition to more standard considerations of the business's profit potential, perceived risk, collateral, and management, NCIC evaluates these loan applications based on the potential social and economic benefits to the region. To expand its direct lending capability, NCIC is approved to offer SBA-guaranteed fixed asset financing. These financing packages include a 10 percent equity or subordinated debt position by NCIC, along with 40 percent second mortgage financing from SBA, and 50 percent first mortgage financing from a private lender. In this arrangement, the private lender is

the primary lender, assuming the least amount of risk, since it has first claim on the collateral in the event of default. In addition, its role is traditional in that a commercial mortgage instrument is used rather than some more unique commercial loan product. While NCIC makes the smallest monetary commitment of the three parties, it assumes the highest risk since it provides equity not debt capital and takes a position behind both the public and private lenders. However, NCIC is the catalyst behind the deal, bringing all parties and its own capital to the table. And, this type of program allows NCIC to expand its link to include federal sources of capital in addition to those available from private lenders.

Third, NCIC is able to make equity and "near equity" investments in new or existing businesses in the region. This program was developed in response to the perceived lack of venture or equity capital from existing financial institutions. While NCIC's actual investment may take a variety of forms, typically $50,000 to $200,000 is invested in the enterprise. NCIC views these equity investments as a means of generating investment income that can be returned to the pool of funds available for future lending. Again, NCIC investments are made in conjunction with other financial participants and go to firms that offer substantial social and economic benefits to the region.

Between 1976 and 1988, NCIC invested $17.5 million in 231 ventures in the region. With this initial investment, NCIC leveraged $76.8 million in private and public sector resources, resulting in $4.38 leveraged per every dollar NCIC invested. From these investments, 2,357 jobs have been created or retained, primarily in the manufacturing sector. Overall investment per job created amounts to $7,458 from NCIC. This investment compares favorably with the upper end of the investment range established for some public lending programs.

NCIC represents a relatively successful rural CDC which presently does not rely on annual infusions of public capital. The initial federal investment in NCIC served as an endowment that now permits the organization to survive without additional federal funds. In addition, one important feature of NCIC, and many other rural CDCs, is the mechanism for local input into investment decisions through a board of directors representing the local service area. The make up of the board ensures that local economic development concerns will be reflected in the CDC's investment decisions while also promoting the local capacity for doing economic development work.

However, the CDC model should be viewed cautiously in terms of its ability to generate enough investment income to be self-sustaining. The federal sources of funds used to endow CDCs in the late 1970s are no longer available. Expansion of the CDC model would require funding from some other sources, since the federal role in such programs is unlikely to increase in the near future.

**Bank Community Development Corporations**

The Comptroller of the Currency, through regulatory authority, has provided an opportunity for commercial banks to either establish a CDC or participate in CDC activities. The regulations are intended to stimulate private sector investment by permitting banks to make debt or equity investments in CDCs provided that the funds are used to fulfill a public purpose. While a relatively small number of banks have taken advantage of the

opportunities provided by these regulations, the Illinois Neighborhood Development Corporation (INDC), a bank holding company in Chicago established according to these guidelines, is dedicated to the process of economic development in its urban community. More interesting from the perspective of rural capital markets, however, is INDC's ongoing work with Southern Development Bancorporation (SDB), a similar type of bank holding company operating in Arkansas.

Southern Development Bancorporation grew out of concern for capital availability in rural parts of Arkansas. While INDC's focus had been on working with South Shore Bank (its bank subsidiary) to promote housing rehabilitation and ownership, the perceived capital need in rural Arkansas was for enterprise development. In accordance with these concerns, a holding company was structured to permit such investments, initially in a multicounty region of Arkansas. Currently, about $13 million in equity capital has been raised to capitalize the holding company and its subsidiaries. Several foundations have committed capital to the venture in the form of long term debt.

The structure of the holding company is important in enabling SDB to achieve its development objectives. Under the holding company, three subsidiaries are organized. First, a $60 million local Arkansas bank, Elk Horn Bank and Trust, was acquired in May 1988 and provides SDB with an immediate tie to the local capital markets. The bank is an important component of the overall design of SDB since it provides the steady source of income required to finance the development activities of other subsidiaries. However, because of the highly regulated nature of commercial banks, its lending is limited to more traditional financial packages. Other subsidiaries focus on stimulating development activities for which the bank structure is less well suited.

Second, a nonprofit subsidiary, Arkansas Enterprise Group, engages in higher risk lending and other development activities. Within this nonprofit subsidiary, a venture capital small business investment corporation, Southern Ventures, undertakes higher risk and equity type investments. To date, the fund has experienced strong, high quality demand for its investments. Initially, the fund was provided with $1,250,000 of private capital. All of that capital has already been committed.

A second component, the Good Faith Fund, makes small loans to individuals who desire to become self-employed. This fund, modeled on the Grameen Bank experience in Bangladesh, makes very small, short term loans to local residents. Generally, loans do not exceed $5,000. Repayment is encouraged through peer pressure to preserve the integrity of the fund for future users. Currently, the fund has nine active borrowing groups with a total of 50 members. A total of $93,000 has been disbursed through 32 loans, averaging $2,500. Another 100 individuals are on a list to become part of a group once it can be organized. The market acceptance and demand for both the venture fund and the Good Faith fund has been higher than anticipated.

A third component, the Seed Capital Fund, will make loans to entrepreneurs for product, management, and marketing development. It will be operated as a nonbank revolving loan fund.

Finally, the fourth arm of the nonprofit corporation provides management assistance to increase the capacity of small rural businesses to operate their enterprises successfully and compete for funds from other more traditional financial institutions.

SDB also has a for-profit real estate development corporation, Opportunity Lands Corporation which undertakes a wide variety of commercial and residential real estate investment activities, e.g., acquiring, developing, leasing, or managing real estate for the benefit of low and moderate income people. The role of this corporation is to initiate development activities that can increase employment opportunities, provide low cost housing, or encourage entrepreneurial development.

A community development bank holding company, like INDC or SDB, differs from a more traditional banking operation in a number of ways. The objective underlying the holding company is the encouragement of economic development activities, not the generation of a particular rate of return on investments. While the bank subsidiary must be run according to basic standards of safety and soundness, the nonprofit subsidiary is less constrained. In this way, a mechanism has been created for increasing the availability of capital in rural areas through more traditional banking channels when that best matches investment needs; through access to venture capital in the early stages of a business's life; and through small loans to help people gain self-employment or develop innovative ideas.

Investors in such an enterprise must be patient and willing to consider the long term prospects for return on their investment. Many of the activities undertaken by a development bank have prospects for earning reasonable rates of return, in the long run. Through the holding company, the steady stream of profits generated from the bank's more traditional portfolio can be used to augment returns from the development lending activities in the short run.

The holding company examples described above will also expand the available pool of management talent and assistance. This institution is capable of taking an active role in stimulating economic development through its subsidiaries and drawing together public and private resources to support its economic development initiatives.

Another important example of a development bank is the Self-Help Credit Union (SHCU) in North Carolina. Credit unions are not traditionally viewed as an important source of commercial or development loans, but SHCU created the first statewide development bank in the country with its establishment in 1983. The development objectives of SHCU parallel those of Southern Bancorporation. The organization has three components. The SHCU, an $8 million state chartered credit union, provides traditional banking services as well as making loans for low income housing, employee owned businesses, and other economic development activities. The Self-Help Ventures Fund (SHVF), a $2.3 million nonprofit corporation, provides both debt and equity financing to employee owned and cooperative businesses in the state. SHVF makes investments of up to $85,000 and is capable of putting together financing packages of up to $300,000 through its affiliates. Finally, the Center for Community Self-Help is a statewide CDC providing management and technical assistance to employee owned businesses, which complements the lending function of the other two components. In 1987, about $4 million in loans was made through this organization, much of which was targeted to rural North Carolina. With plans to add $5 million in additional capital and increasingly recognized as a "development bankers' bank" by other alternative institutions in the state, the role of SHCU should expand in the state in the next few years.

One important aspect of the SHCU's role as a development bank relates to the expanded powers given to thrift institutions, particularly savings banks, in the past few years. With these expanded powers also come increased opportunities to assume a more important role in providing capital for commercial lending and economic development programs, more generally. The SHCU experience suggests that the supply of development capital in rural areas is not limited to commercial banking organizations and that strategies for increasing that capital should not be narrowly focused on those institutions.

**Bankers' Bank**

Another approach that may be taken by private financial institutions is the development of a bankers' bank to help community banks gain access to services, e.g., check clearing, as well as other resources to enable them to better serve their communities, e.g., capital, managerial, and technical assistance, that were previously provided only through correspondent relationships with larger institutions. The consolidation of institutions occurring due to interstate banking and other aspects of deregulation have made it increasingly difficult or costly for small community banks, particularly those in rural areas, to obtain services from larger institutions. Yet these services are essential if the community bank is to effectively meet credit needs.

The first institution established to address this problem was the Independent State Bank of Minnesota. The bank is currently owned by 265 banks in the state (more than half of the community banks) and approximately 70 percent of those banks are in rural areas. No one bank can own more than $100,000 in shares so that ownership is spread widely across institutions. Approximately 60 percent of the community banks in Minnesota, generally those with less than $50 million in assets, do business with the Bank.

The bank provides a number of services to its clients. First, in response to the difficulty many banks or individuals face in getting capital to purchase a rural bank, the Independent State Bank makes loans for the purchase of community bank stock. In addition, the bank does overline lending with community banks, i.e., Independent State Bank will lend money to a community bank to originate a loan above its legal lending limit. This enables community banks to make larger loans to businesses in their community by helping them overcome the limitation placed on lending activities by their relatively small size.

Second, the bank's investment and liability management services help community banks structure and manage their investment portfolios. Given interest rate fluctuations in recent years, a community bank's ability to lend money is dependent upon its capacity to manage investments in such a way as to control interest rate risk. The Independent State Bank helps community banks develop better management capacity and, therefore, better serve their community.

Third, the bank provides smaller banks with technical assistance in strategic planning, management, and advice about new products and services, assistance which a community bank would not be able to obtain through a more traditional correspondent relationship. And the bank provides all these services at a competitive rate.

In addition, the Independent State Bank allows community banks to participate actively in an organization dedicated to preserving the community bank as an institution and to making it a strong competitor in today's financial markets.

These benefits to community bankers translate indirectly into increased capital availability in rural communities. A community bank with expanded management capacity is a stronger bank, one that is capable of surviving market changes. In addition, technical assistance along with overline lending should result in more capital being available to some rural enterprises, particularly those that have financing needs that are greater or require more sophistication than the local community bank can handle. However, unlike the bank CDC example described above, the bankers' bank strengthens the traditional aspects of community banking without necessarily expanding the range of financial options used by the bank. It is possible that capital availability is increased through a bankers' bank, but it is also likely that capital gaps will remain for those rural enterprises requiring capital outside the realm of commercial bank finance.

**Rural Venture Capital Funds**

While venture capital in the nation as a whole has rapidly become more available in the 1980s, it remains relatively concentrated in a few states (e.g., California, Texas, Massachusetts) and within those states most of the capital flows to enterprises operating in urban rather than rural areas. While traditional sources of capital, i.e., commercial banks, have been important providers of debt capital, their role in providing equity capital is severely limited by regulatory constraints. As a consequence, formal sources of equity capital may be relatively limited in rural areas. While there have been some public efforts to provide equity capital in rural areas, e.g., Small Business Investment Corporations under SBA and Massachusetts CDFC, private sector examples are more limited. A new venture in northeast Minnesota provides an interesting example of a private venture capital corporation that combines a more traditional approach to equity financing with economic development objectives.

Northeast Ventures Corporation is established as a holding company with two subsidiaries, the for-profit Northeast Venture Development Fund and the nonprofit Northeast Entrepreneur Fund. Initially, the corporation will be capitalized at a level of about $10 million, with $7.5 million going into the Venture Development fund and $750,000 in the Entrepreneur Fund. The two subsidiaries will undertake separate, but related, investment strategies aimed at stimulating economic development in northeast Minnesota through prudent investments in new or existing businesses. While the Venture Development Fund is projected to be self-sustaining, because of the high risk and transactions costs associated with the Entrepreneur Fund, it will rely on raising funds via grants and limited fees for the services it renders.

The Venture Development Fund will operate like a traditional venture capital pool, with $50,000 to $500,000 being invested in each venture. In addition to more typical concerns about expected rate of return on investment, the fund will consider the potential contribution to rural economic growth from each investment as well as the export potential of the product developed. In addition, the fund will emphasize the "development" nature of

the fund in the sense that investments will not be expected to earn rates of return experienced by traditional venture capital firms, i.e., rates of 30-50 percent. The fund will provide the same monitoring, control and management assistance found in other venture capital firms and will provide businesses with a wide range of business assistance as a means of insuring their investment in each enterprise. In this way, the Venture Development Fund differs significantly from publicly funded efforts such as the Massachusetts CDFC that had difficulty providing this required level of personal attention to their business investments. In all cases, the fund will invest in such a way that very explicit means for exiting these investments, primarily through the use of management buyouts, will be specified at the start. In this way, a constant replenishment of the fund for other investments may be possible.

The nonprofit Entrepreneur Fund will be used to invest in individuals, primarily low income and long term unemployed, who are attempting to achieve economic self-sufficiency through starting their own business. Funds will be made available through loans, loan guarantees, or other strategies. The fund will also provide management assistance initially and throughout the period of the loan to ensure that individuals have access to the type of assistance required to achieve success in their operations. One important aspect of this fund is its reliance on very traditional lending methods, i.e., preparation of a business plan, loan applications, financial projections, etc. These methods are used to develop the applicant's capacity for dealing with financial institutions. After their experience with the Entrepreneur Fund, it is hoped that these individuals will have the skills required to obtain credit from traditional financial institutions.

Northeast Ventures Corporation has succeeded in raising $4.5 million required for its initial capitalization. They are committed to begin operation with initial capital of $5 million. Although no funds are being disbursed at present, businesses are being assisted and business plans considered for funding in the near future. While it remains untested, the corporation is structured with the major components required for success: capital, skilled personnel to provide constant monitoring of investments and assistance to entrepreneurs, and a commitment to make investments that will serve broader economic development goals. In this way, Northeast Ventures may be able to overcome some of the constraints faced by public venture capital programs.

**Private Technical Assistance**

The CDC model has been used frequently to provide small business financing and technical assistance. A CDC with a strong and innovative commitment to small business technical assistance is Coastal Enterprises Inc. (CEI) operating in Maine's midcoast region. CEI is a nonprofit CDC that provides financing and technical assistance to small businesses in an attempt to create income, employment and ownership opportunities. Most of the technical assistance is provided in conjunction with requests for a loan from the Enterprise Development Fund. This fund has capital of $900,000 and makes loans up to $50,000. A business plan is required to apply for a loan and the business can work with a CEI counselor, at no cost, to develop that plan. Other counselors provide technical assistance to nontraditional entrepreneurs, i.e., women, welfare recipients, and dislocated workers. CEI is also involved in training income eligibility workers with the Department of Human Services so that these workers are familiar with business resources, such as CEI, available to their clients.

Several features of CEI's technical assistance programs are relatively unique. In its capacity as an SBDC subcenter, CEI is able to commit additional resources to providing technical assistance. In return, the SBDC has an effective outreach mechanism in CEI, because its staff are familiar with the business development needs in their region of Maine. CEI has taken an active approach to technical assistance, relying on a variety of mechanisms for identifying potential clients. Recommendations from other clients are very important in bringing people into CEI. Workshops are conducted that attract entrepreneurs. And, businesses are referred by banks, particularly when CEI is aggressive in contacting banks and explaining the role it can play in assisting and financing small businesses.

Another example of private sector technical assistance is the Women's Economic Development Corporation (WEDCo), a Minnesota organization designed to serve as an intermediary between small businesses, typically in the start up phase, and lenders. By working as a bridge between borrowers and lenders, WEDCo uses its expertise to help the business enhance its ability to receive funds and to reduce the costs for bankers considering small business loan opportunities. The group's well-trained staff can respond to a variety of business concerns and has developed important connections with local financial institutions. In addition, WEDCo has an incentive to work hard to identify funding for each client, since fees are based on the successful financing of each venture. While this group has focused on women-owned businesses in urban areas, it has recently created the Enterprise Development Partnership to extend its expertise to more rural areas of Minnesota by linking up with rural development practioners to share data and expertise in the area of business financing.

A program developed by the Minnesota Bankers' Association (MBA) has a direct bearing on the willingness of rural bankers to assume a greater role in economic development activities in their communities. The Enterprise Network is designed to heighten rural bankers' awareness about economic development problems and, more importantly, to provide bankers with examples of ways in which other bankers have worked to stimulate economic development. The MBA commits $120,000 for annual operating expenses for this program.

The program was begun by establishing three pilot programs in rural counties around the state. The premise behind the MBA program is that bankers are looked to in the community for leadership and that in many cases the bankers need help to do a better job of stimulating economic development. In this sense, bankers are encouraged to explore a wider range of options for their involvement, including but not limited to providing funds for economic development projects. Options may include playing a leadership role on an economic development planning committee and using banking expertise to evaluate expected returns from different strategies. Other options may relate more directly to the bank's operation, such as the creation of a bank CDC or contributions to a local CDC.

In 1989, the Enterprise Network conducted meetings for rural bankers and technical assistance providers to increase the bankers' awareness of such options for their small business clients. As a result of the meetings some small businesses have been referred to technical assistance programs by the bankers. This program attempts to indirectly increase capital availability in rural Minnesota by educating bankers about options for assisting or financing

small business owners. By combining information and access to technical assistance programs with heightened awareness of the banker's role in economic development, the Enterprise Network may improve capital availability. However it is not likely to address the needs of entrepreneurs seeking equity capital or those involved in higher risk ventures. Other options must be pursued for these enterprises.

**Summary**

The private sector alternatives described above cover a wide range of possible options for improving rural capital availability. Some features parallel public programs while others do not. Public activities in conjunction with private initiatives may be required to address rural capital problems adequately. The next section describes some public-private partnership initiatives that provide useful examples of these joint efforts.

## Public-Private Partnership Initiatives

Public-private partnership initiatives are characterized by public action that serves to catalyze an expanded private sector role in providing capital. The state's role is to reduce the obstacles faced by private financial institutions as they attempt to increase the capital available to certain groups. The state can also catalyze new types of institutions capable of filling specific capital gaps.

The Michigan Strategic Fund created the Capital Access Program (CAP) to expand small business financing. CAP is unique in that the state has moved away from using its resources to provide direct loans to a relatively limited number of small businesses and is creating, instead, a tool that banks can use to expand their capacity to make small business loans that are more risky than conventional loans. As a result, the state's resources could be used to help more businesses than could a direct lending program.

The CAP emphasizes the role of private sector lending, investment, and decision making and is designed to use a small public investment to generate a large amount of bank financing. The program is structured so that banks are able to maintain portfolios of loans with expected loss rates of up to 14 percent, compared with the more typical loss rate of 1 percent on a bank's business loan portfolio.

The program is based on a risk pooling concept. Each bank making loans under CAP has a reserve established in its name and is able to draw on that reserve only in the event of losses on loans it maintains under CAP. At the time a loan is made under the program, the borrower pays a one time charge into the reserve (1.5 - 3.5 percent of the loan amount). In addition, the bank matches the borrower's contribution and the state matches the combined bank-borrower contribution to the reserve. The bank would have between 6 and 14 percent of the loan amount placed in the reserve. This reserve would enable the bank to absorb loan losses on this portfolio significantly higher than on conventional loans.

The bank retains complete control over the lending process, deciding which loans to make and place under the program and negotiating with the borrower the amount of the initial contribution to the reserve. The state supplements funds available through the reserve to the extent that banks participate.

It was initially projected that the first $5 million in state funds committed to CAP would result eventually in an estimated $100 million in bank lending. By 1987, 51 banks were participating in CAP and loans totaling $6 million had been made under the program. Approximately $17 in private bank financing was leveraged for every $1 the state committed to the reserve fund. Of those banks participating in the program, 15-20 percent were rural.

Another example of a public-private partnership program to increase capital availability is Michigan's Business and Industrial Development Corporation (BIDCO). Under the program, BIDCOs are chartered as private financial institutions. Their primary activity is to provide financing and management assistance to business firms. Each BIDCO is capitalized with both state and private investor funds. Typically, one-third of the capital is provided through a state appropriation while two-thirds is raised privately. The capitalization and regulatory structure allow the BIDCOs to assume greater risk than banks and they are authorized to use a broader range of financing instruments, e.g., loans with equity investment features such as cash flow participations or warrants to purchase stock.

In 1987, one BIDCO was operational in Michigan and several others were pending. Included in those BIDCOs pending are several that would be authorized under a minority BIDCO program designed to encourage the formation of BIDCOs where more than half the private equity investment is obtained from minorities and where BIDCO investments are targeted to creating jobs and economic opportunity in minority companies and companies in depressed areas of the state. While none of the BIDCOs pending or in operation are located in rural areas, the model lends itself to such development.

The major limitation of applying the BIDCO concept in rural areas is creating a significant pool of equity capital from rural investors. If the minority BIDCO program were applied to rural areas, at least $500,000 in equity would have to be raised. In some depressed rural areas, the difficulty of achieving such an equity capital investment may limit the ability to take advantage of the opportunity embodied in the BIDCO concept.

The final example of a public-private partnership is the Greater Minnesota Corporation (GMC), a publicly chartered corporation established to create jobs and economic growth in rural areas by promoting technology transfer and product development. The enabling legislation for GMC was passed as part of the 1987 Rural Development Act, with an initial state appropriation of about $15 million. In addition, GMC will receive part of the proceeds of a newly established state lottery, estimated to be about $60 million annually, for 5 years. Eventually, these monies will be administered as an endowment or trust, with only the earnings from the fund used to finance activities. GMC's long term objective is to have revenue streams from new product development returned to the fund to increase the endowment over time.

GMC's primary activity to date has been the establishment of business innovation centers around the state. Currently, 5 centers have been approved and 2 more are likely to receive approval in December 1989. To establish a center, a regional group consisting typically of the Chamber(s) of Commerce, a local college or university, and government officials would prepare a proposal, with guidance from GMC. If GMC feels the center is viable, they provide an initial appropriation of $500,000-800,000, with the regional group providing matching funds and/or services. Each center elects its own Board of

Directors from the region, but all projects are approved by GMC. Most of the centers have been established in relatively large towns, such as Duluth, rather than in small, rural communities.

These business innovation centers provide technical and business assistance to entrepreneurs in technology-related manufacturing enterprises and, therefore, are focused on the needs of a segment of the rural business community rather than the needs of typical rural businesses, such as service sector enterprises. In most cases, the centers are built in conjunction with advanced manufacturing centers that house the latest manufacturing equipment, to serve entrepreneurs who have technical assistance and equipment needs. Currently, GMC does not provide any financing for these entrepreneurs, although it may move into the financing area in the future.

The centers have been established only recently and are in the process of hiring staff. Therefore, it is not possible to evaluate how well they will serve their clients and just who those clients will be. However, several observations can be made. First, the state has made a significant investment in GMC, an innovative approach to providing technology transfer, as part of a strategy for promoting rural economic development. Critics of GMC argue that the impact on small rural towns will be negligible, since those towns are not likely to have a large pool of eligible entrepreneurs who can take advantage of the services of a business innovation center. Second, it remains to be seen whether the relatively large public investment in GMC yields a comparable public benefit. Possible public benefits include creating jobs and income in rural parts of the state.

GMC provides an interesting example of a public-private partnership designed to promote business development. From the perspective of rural economic development, it is not clear yet whether GMC's programs will generate high returns. However, for small business development in general, the model must be viewed cautiously since its focus is exclusively on technology-related enterprises that may be atypical of small communities. Such an approach must be evaluated in relation to other examples of public and private technical assistance programs that focus on entrepreneurs and small businesses more broadly defined.

In addition to creating new institutions, the state can play a greater role in supporting the activities of nonprofit organizations, such as rural community development corporations. These CDCs may provide financing for ventures that cannot receive funding through traditional institutions. However, their funding base may be small and, at times, may be tied up completely in current investments. While most banks minimize this problem by selling loans in established secondary markets, CDCs do not have that option. There is currently no well developed secondary market for economic development loans made by these small agencies. Consequently, their effectiveness is limited by their capital base. To address this issue, the Community Reinvestment Fund (CRF) began operation in Minnesota in March 1989. CRF is designed to recapitalize development agencies by setting up a secondary market for their loans. The fund purchases loans from community development organizations and then sells bonds through private placement to investors.

Recently, CRF completed its first issue, purchasing 158 loans from 7 organizations in the state--3 nonprofit community development organizations and 4 municipal development agencies or municipalities. The value of the issue was $1.5 million, with $1.1 million returned to the sellers. Investors

included some banks, an insurance company, and a church pension fund. About 40 percent of the loan dollars came from rural organizations and the purpose of the loans was varied, e.g., economic development, industrial development, commercial rehabilitation, and low income housing rehabilitation.

Through this secondary market, CRF hopes to encourage more private investment to augment existing public investment in areas experiencing economic decline. To do so, CRF must raise capital for its credit reserve, a pool of funds used as additional collateral for the loans it purchases. Although part of the loan purchase price is contributed to the reserve, CRF must raise additional money to continue offering bond issues. CRF hopes to raise this money from both public and private sources.

Although originally intended to operate within Minnesota, CRF has decided to open itself to any community across the country. The first issue will be an initial test of the concept underlying CRF, but it appears to provide a means for existing agencies to continue to provide financial assistance to small businesses and communities through recapitalization.

At the national level, a bill is before the House Small Business Committee to create the Venture Enhancement and Loan Development Administration for Smaller Undercapitalized Enterprises ("Velda Sue"). If enacted, this government-sponsored enterprise would create a national secondary market for small business loans. Passage of the bill is not assured and there are also questions about how the market would operate, what institutions would take advantage of it, and how rural areas in particular might benefit from such an innovation.

## PROGRAM DESIGN ISSUES

In evaluating the public, private, and public-private partnership initiatives described above, a number of key issues must be addressed. While not all may be relevant in a particular state, they represent some of the more important considerations for designing the appropriate mix of public and private programs to deal with rural capital problems.

### Level of Financial Support

In evaluating options for increasing rural capital availability, an important consideration is the level of financial commitment possible in any program design. Most of the state direct lending programs described above are capitalized at levels far below those of many private financial institutions and, as a result, the impact of these funds is necessarily limited. One criticism levied at the Massachusetts CDFC is that too few funds were spread over too large an area. Private initiatives have also had relatively low levels of capitalization, but in most cases relied on those funds to leverage other monies. Both the rural CDC example and the Michigan CAP program have shown success in using a relatively small pool of money to leverage additional private and public sector funds.

Also related to funding levels is the question of the source of funds. State programs which rely on annual appropriations of general funds are subject to a great deal of uncertainty and may be affected by the state's general economic condition. If state economies experience depressed

conditions, program funding may be reduced at the very time when rural economies need additional sources of capital. Short term sources of funds to increase capital availability in rural areas have serious limitations. Long term, more stable options should be considered. Creating endowments by tapping public and private sources of funds is one option to be explored.

### Targeting Program Funds

An issue related to funding levels is whether capital programs should be targeted specifically to rural areas. In most cases, the private sector options discussed were focused on rural economies. The organization initiating the financing program was located in a particular rural area and had a well defined and usually narrow area within which the program and funds were targeted. In contrast, state programs were mixed, with some specifically targeted to rural areas and others more generic in nature. A targeted state program may be required to ensure that available funds have an impact on improving rural capital availability.

Another means of targeting that should be considered is designing programs to provide capital based on individual need for capital. The state or private program may choose to support new business ventures based on their need for capital and expected return, rather than strictly on some criterion such as size or location. In all cases, the monies should flow to firms that are unable to obtain credit through traditional avenues and for which the capital represents an important opportunity to develop or maintain a viable enterprise.

### Program Objective: Cost vs. Availability of Capital

The design of any capital program must reflect the program's objectives. It is generally accepted that the key issue in rural markets is access to sufficient quantities of capital for small businesses, new firms, and entrepreneurs. Given this need, programs designed to reduce the cost of capital would be less effective in solving rural capital problems than programs designed to provide more capital to target groups at market rates of interest. Programs such as direct lending, loan guarantees, equity financing, regulatory reform and technical/business assistance may increase the availability of capital rather than merely reducing the cost of capital to groups that already have access to capital through traditional sources.

### Equity vs. Debt Capital

Rural areas may have important deficiencies of capital to support start up ventures, entrepreneurs, or expansion of existing businesses into new product lines. Programs designed to provide equity financing are important to rural capital availability since such sources of capital may not be available through traditional lending institutions. In addition, programs designed to provide "gap financing," e.g., small loans or debt that assumes a secondary position to a bank loan, also can meet important rural credit needs. The key feature of any such program, whether public or private, should be to work with more traditional local lending institutions to expand capital availability but not to duplicate the services or products provided by those institutions.

Another consideration in developing state financing programs is to realistically evaluate the state's ability to administer a venture capital

fund. The early experience of the Massachusetts CDFC attests to the critical need to manage such funds in ways that are not typical of most state agencies. Constant monitoring and assistance to clients are required. Such expertise may not be readily available in state agencies. Without this expertise, other options may prove to be better alternatives in the long run.

### Technical Assistance

While a number of private and public sector options for providing technical assistance were discussed above, it is clear that such programs take a back seat to direct or indirect lending programs, particularly in the public sector options. However, in some cases, technical assistance may be the most crucial component of any program attempting to fill capital gaps. Successful technical assistance programs serve two important functions. First, a business is more likely to acquire initial financing with a carefully developed business plan. For many entrepreneurs, development of such a plan is possible only with technical help. Second, once a business is established, the owner can use the skills developed through the assistance program to establish a long term relationship with a financial institution, increasing access to capital in the future.

If capital availability problems result from the inability of borrowers to develop effective financial plans and identify appropriate sources of capital, then technical assistance programs such as CEI and WEDCo may be the most appropriate strategy for bringing borrowers and lenders together. These programs are particularly important for small and nontraditional entrepreneurs whose access to assistance from other for-profit sources, e.g., accountants and financial planners, may be limited. Programs like those of CEI attest to the importance of tying technical assistance to financing packages to encourage successful small business development. Clearly, the importance of technical assistance will depend upon the capital gaps which exist in any given rural market and further research effort should be devoted to the role of technical assistance in filling gaps that may exist.

## POLICY RECOMMENDATIONS

The preceding review of our knowledge base regarding rural capital availability and a range of public, private, and public-private partnership options for dealing with rural capital market problems sets the stage for a number of policy recommendations. Because of diversity in rural economies and financial markets, these recommendations are made at a relatively general level and may not be applicable to all state situations. In addition, these recommendations are most relevant when placed in an individual state context and evaluated relative to existing rural capital market needs.

### Policy Recommendation #1: Determining the Status of Rural Capital Markets

Before any alternative programs can be considered, whether public or private, a more thorough understanding of the status of rural capital markets in each state is required. There is a need for more detailed information about how the structure of rural capital markets has changed in the past five years and, consequently, how lending behavior is affected. Such an analysis requires a more thorough understanding of bank lending behavior, available only by collecting more detailed information from banks.

Two specific areas of research merit attention. First, more information needs to be obtained about changes in the structure of rural banking markets. While changes in state level consolidation are relatively easily tracked, there is a need to evaluate rural markets in the state to determine how the local financial market is changing. And, this evaluation needs to be done periodically to permit evaluation of both short term and long term market changes. Second, information should be obtained to permit evaluation of individual bank behavior over time, particularly in relation to lending. It is necessary to evaluate bank lending behavior in terms of the geographical and size distribution of loans and the type and size of business receiving loans. Information about decision making across bank types would provide some insight into the extent to which local control over decision making is related to lending and in what ways. Management practices and policies, and how these differ across bank types, would be important to understand since bank management will influence lending policy.

Although much of the data needed to conduct this type of analysis is available from bankers, they are not currently required to report such detailed information on lending. Changing regulatory data requirements would help to facilitate future analysis. In some cases, data must be obtained through direct interviews with bankers and will require additional research and, consequently, funding.

In addition, the capital gaps in rural areas need to be identified so that programs can be targeted to fill those gaps. While the issue of capital availability for small businesses was a focus of this paper, other sectors of the state economy should be evaluated as well. In particular, gaps in the availability of financing for declining rural areas and industries should be one focus of analysis, e.g., capital for low income housing, infrastructure, upgrading plants and retraining labor. In addition, the availability of capital to fuel the growth industries springing up in rural areas should be evaluated, e.g., capital for tourism, recreation, high technology enterprises, business service sectors. While some research has been conducted to determine sources of capital for small businesses in several states, there has been no research to date to attempt to identify businesses that were unable to start up due to limited capital. The failure of these businesses may provide an important example of a rural capital gap and research attention should be focused on better understanding and investigating this issue.

**To facilitate a better understanding of state capital markets, state universities and/or state agencies should be directed to conduct research periodically to evaluate the efficiency of rural capital markets and to define as precisely as possible any capital gaps that may exist in rural areas. State and federal regulatory authorities have a role to play in facilitating such research by providing necessary data and considering what data should be acquired in the future to permit ongoing analysis and monitoring of the status of rural capital markets in the state.**

**Policy Recommendation #2: Establishing an Appropriate Role for the State**

By looking at public and private initiatives and the lessons learned from their experiences, it is possible to suggest an appropriate role for the state in dealing with rural capital availability problems. Until better information is available with which to evaluate rural capital needs, one can argue that

the state should proceed cautiously in the development of new programs or in the commitment of state funds. In considering a possible state role in rural capital markets, a key question is whether the state should use its limited resources to provide capital directly or even indirectly to target areas or firms or whether the more appropriate role for the state is to enhance the capacity of private sector financial institutions to increase rural capital availability.

It seems clear from the program options described above that the most effective application of limited state resources is their use to encourage more private sector lending in rural areas and to riskier businesses. By designing state programs that facilitate increased private sector investment, state resources can be used to address a broader range of capital problems than if direct lending methods are used. Consequently, direct lending programs should be instituted only when there are specific capital needs in rural areas that are unlikely to be met by private financial institutions, even with state encouragement. These programs should be designed to channel funds based on an evaluation of an individual firm's capital need and chances of success and should have some mechanism for ensuring that public funds are used to promote rural economic development.

**The primary role of the state in addressing rural capital availability problems should be to use public monies to enhance the capacity of private sector lenders, e.g., banks, community development corporations, to increase their lending. Specific options include:**

1. **Linked deposit of state funds in banks and thrifts that agree to (a) increase their lending via state or federal guarantee programs to target groups identified by the state; (b) develop a set-aside high risk loan portfolio; or (c) engage in development lending through a CDC or other private agency.**

2. **Creation of a state fund to endow rural CDCs and private venture capital or product development funds that provide equity and near-equity financing along with technical assistance to rural target groups.**

3. **Creation of secondary market for small business or development loans to permit the recapitalization of private institutions such as CDCs.**

4. **Establishment of a loan reserve program to encourage greater risk taking on the part of participating banks and thrifts.**

**Existing state financial assistance programs should be reviewed and, if necessary, revised to be used strategically to provide initial seed financing to get projects started or to encourage changes in private sector financial institutions, such as described above.**

**State definitions of target groups, for use in the options outlined above, should be constructed to be broad enough to allow flexibility across diverse economic situations within the state and to allow programs to change along with economic circumstances. An institutionalized means for public-private dialogue to identify target populations, industries or regions of concern and to evaluate options for public, private, and public-private partnership initiatives should be established.**

**Policy Recommendation #3: Use of State Regulatory Authority**

The extent to which state regulatory authority can be used as a means of increasing rural capital availability is an important question for future consideration. The increased use of state community reinvestment requirements in conjunction with expanded interstate banking powers represents one example of the use of regulatory authority. However, there are a number of other options that states might consider, as outlined earlier in this paper. A thorough analysis of state regulations in relation to rural capital markets is necessary to consider how branching and holding company laws, interstate banking regulations, and restrictions on banking activities, such as equity investment restrictions, may be affecting rural capital availability. While such an evaluation can be done at the state level, it is also necessary to evaluate the system of federal regulations that may be influencing bank support for rural investments.

At the same time, however, regulatory change should proceed cautiously so that the impact on rural markets of any legislated changes can be carefully evaluated. Such evaluations must be considered as part of packages to alter regulations and mechanisms should be established to review and revise regulations as rural capital market conditions change.

**Use of state regulatory powers to increase rural capital availability should be carefully evaluated in relation to credit needs in rural areas. Any changes in regulations should provide for expanded bank involvement in options identified by the state, e.g., higher risk lending, development lending through CDCs. And, review of these activities should be incorporated into legislation covering the application review procedure used for banks seeking to expand through branching or interstate acquisitions or into community reinvestment legislation. Regulatory authorities should consider ways in which bank and thrift institution involvement in providing equity capital might be expanded without jeopardizing the safety and soundness of financial institutions.**

**Regulatory reform, including expanded powers for financial institutions, should be coupled with requirements for providing information on geographical, size, and industry characteristics of the loan portfolio. Such information can then be used to assess the efficiency of state capital markets and the effectiveness of options directed to increase capital availability.**

**Policy Recommendation #4: Providing Technical Assistance**

The importance of providing technical assistance, either to bankers or businesses, is clear from the programs cited above. As such, technical assistance should be given as high a priority as the provision of funds in any state program. Businesses need assistance in developing the skills required to successfully compete for private sector funds and to identify alternative sources of capital when their needs cannot be addressed by traditional financial institutions. On the other hand, it is clear that many bankers, particularly in rural areas, lack the skills and, in some cases, the understanding of rural economic development problems to effectively intervene to improve rural capital availability. Programs similar to the WEDCo model that attempt to bridge the gap between borrower and lender should be encouraged and supported by the state.

**States should establish active technical assistance programs designed to bridge the gap between bankers and businesses so that the transactions costs and risks of financing these enterprises are effectively reduced. Assistance should be focused on smaller, growth and start up businesses and include technical, financial, management, and marketing services. Programs should be designed to include close collaboration with the private sector to identify and hire consultants to provide assistance. Outreach components should be included in any technical assistance program in order to bring services to rural entrepreneurs.**

**Policy Recommendation #5: Promotion of capital market solutions**

**The Governor's office should encourage private financial institution support for innovative approaches to filling capital gaps and should actively promote/publicize those strategies throughout the state. In addition, the private sector, i.e., foundations, investors, should be actively recruited to invest in new types of institutions, e.g., venture capital funds, bank CDCs, developed to promote the economic development of the state. In short, the issue of capital availability, particularly in rural parts of the state, should be elevated in the public eye and innovative solutions actively encouraged through public-private cooperation.**

## CONCLUSIONS

States have a key role to play in providing leadership in designing programs to evaluate rural capital markets and, if warranted, to increase rural capital availability. The federal role, either in terms of monitoring and directing future regulatory changes or in providing capital directly, is continuing to decline and prospects for renewed federal efforts are not bright given that budget limitations are expected to continue. However, state governments cannot hope to fill rural capital gaps through their efforts alone. This paper has attempted to evaluate a number of existing examples of public, private, and public-private partnership programs created to increase rural capital availability either directly or indirectly. Yet, analysis of the track records of such endeavors is limited and, consequently, the transferability of these programs across states or between public and private sectors is limited. A thorough analysis of the strengths and weaknesses of a wide range of options would go a long way toward enhancing the ability of states to evaluate which options are most appropriate for addressing the particular capital needs of rural areas in their states.

Programs to increase capital availability in rural areas should not be viewed as an end in themselves, but rather as a means of achieving greater levels of economic development in rural America. In most of the programs described above, increased capital availability was the means to encourage entrepreneurial activity, improve infrastructure, and create or retain jobs, all of which contribute to improved economic conditions in rural areas. As a result, an important component of any private or public program should be creation of the local capacity to initiate, nurture, and support economic development activities. This local capacity is essential to fostering the innovation required to deal with changes in the rural economy and in the financial markets serving rural communities. Rural economic development will be promoted only through innovative approaches to providing capital to support development activities. These approaches will require public and private sector cooperation to develop appropriate programs to increase capital adequacy in rural America. Such a partnership effort is the first step toward maintaining viable rural communities in the years ahead.

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9. John E. Jackson and Ann R. Thomas, "Financial Industry Structure and Industrial Change," Unpublished manuscript, Center for Political Studies, Institute for Social Research, University of Michigan, Ann Arbor, MI, December 1985.

10. Aspen Institute, Commercial Credit Availability and Economic Development: Issues and Analysis, Draft report of symposium sponsored by the Rural Economic Policy Program, a collaborative project of the Aspen Institute, the Ford Foundation, and the Wye Institute, Shakertown, Kentucky, October 1987.

11. Superregional banks are those that are located within one of the banking regions defined by regional reciprocity agreements among states to permit the expansion of bank holding companies across state lines, e.g., New England, Southeast, but that operate in and outside the region. Robert Guenther, "Some Regional Banks Grow Rapidly, Reach Major-League Status," Wall Street Journal, October 1, 1987, 1,22.

12. Bruce S. Boggs, David J. Sorenson, and Andrew M. Isserman, Commercial Bank Lending Patterns and Economic Development in West Virginia, Mountain Association for Community Economic Development, Berea, Kentucky, January 1988.

13. Equity goals involve changing the distribution of resources in the nation in favor of disadvantaged groups or regions. For example, welfare programs transfer resources from higher to lower income individuals while revenue sharing programs, in the past, shifted tax revenues from wealthy to depressed areas.

14. Community Development Finance Corporation, 1986 Annual Report, Boston, MA.

15. David Osborne, Economic Competitiveness: The States Take the Lead, Washington, D.C.: Economic Policy Institute, 9-14.

16. Cost-per-job figures such as those cited for the CDAP program should be viewed cautiously. There is a great deal of potential variation in jobs created in terms of their permanence, whether they would have been created without the program, and quality considerations such as wage level, benefits, etc. Low- and moderate-income individuals were the recipients of 65 percent of these new jobs. Council of State Community Affairs Agencies, State CDBG Loan Assistance to Startup Firms: A Summary and Analysis, Washington, D.C., February 1988.

17. Under a linked deposit program, the state sacrifices interest revenue on its deposits by accepting below market interest rates from participating banks. To compensate for these "foregone revenues," the state expects increased tax revenues from businesses that expand as a result of obtaining lower cost funds. However, there is some concern that increased tax revenues do not compensate for lost interest revenues. See Mark G. Popovich, State Emergency Farm Finance Volume II, Washington, D.C.: Council of State Policy and Planning Agencies, April 1987.

18. The regional corporations are Small Business Development Corporations established following passage of state legislation in 1968 to create organizations that would provide technical and financial assistance to small businesses in the state. Initially, these corporations relied primarily on funding from the state general fund to finance their activities. However, all of them currently rely on other sources of funds, such as funds raised from private sector donations, grants, and fees charged for services provided.

19. National Center for Policy Alternatives, Legislative Sourcebook on Financial Deregulation, Edited by Farley Peters, Robert Stumberg, and Roxanne Ward, Washington, D.C., 1988.

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21. Roger Vaughan, Robert Pollard, and Barbara Dyer, The Wealth of States: Policies for a Dynamic Economy, Washington, D.C.: Council of State Policy and Planning Agencies, 1984.

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24. For example, if Northeast Ventures were to enter into a limited partnership with outside investors, the target rates of return would be 20 percent for the limited partners and only 5 percent for the Venture Development Fund.

25. The unanticipated strong demand for SDB's venture capital in rural Arkansas provides some evidence that equity capital was limited previously. However, research is needed to develop additional information about the supply of and demand for venture capital in rural areas.

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