**Conclusion**

CDFIs

The community development financial institution industry in Appalachia is less mature than the national industry. Appalachian CDFIs largely target rural markets for their lending. Appalachian CDFIs lend at levels on par with national counterparts of similar size, but have a much stronger emphasis on lending for small and mid-sized businesses development. Financing larger businesses with greater than five employees has allowed Appalachian CDFIs to impact substantially more jobs than national CDFIs. Appalachian community development loan funds and venture capital funds have a strong reliance on capital from government sources. Appalachian loan funds also have low levels of self-sufficiency, particularly when compared to national counterparts.

RLFs

Although revolving loan funds who received grant money from the Appalachian Regional Commission have smaller deal flow than some national indicators, they report being able to influence a substantial number of jobs in the region. The efficiency at which ARC RLFs influence jobs has increased over time, surpassing industry numbers in jobs created per loan and the dollars loaned per job influenced.

SBA Intermediaries

SBA microlending intermediaries are effective at lending in Appalachian distressed counties, but substantially lag in terms of lending to minority-owned businesses in distressed counties. SBA 504 lending in Appalachia substantially lags national averages. Of particular concern is the fact the zero 504 loans were made to minority- or women-owned firms in Appalachian distressed counties.

## Conclusion

The Appalachian Regional Commission (ARC) contracted with the National Community Reinvestment Coalition (NCRC) to conduct this study as part of ARC's effort to develop Appalachia through increasing access to credit and capital for small businesses. Heightened capital flows to small businesses would bolster the economic development of the region by creating jobs, diversifying the economy, and further developing an entrepreneurial class in Appalachia. This study found that banks have committed substantial amounts of community development financing to the region and are responding well to the credit needs of Appalachian small businesses in minority communities. The study recommends that stakeholders work together to close remaining credit gaps and needs in Appalachia.

Mid-size community banks were particularly responsive to the needs of small businesses in lower income and distressed rural communities in Appalachia. These lending institutions demonstrate that small business lending is profitable and rewarding for banks. The challenge for stakeholders is to encourage all lending institutions to expand upon profitable lending opportunities and to further finance an infrastructure for supporting small business and economic development.

This study is cautiously optimistic that stakeholders can work together to close remaining credit gaps. The reasons for optimism include a favorable comparison between Appalachia and the nation on some indicators of lending. In addition, Appalachia has a lending infrastructure that includes about 227 banks and savings and loans with more than $500 billion in assets, and a sector of alternative lending institutions featuring over 100 community development financial institutions (CDFIs) and 190 revolving loan funds (RLFs).

The Community Reinvestment Act (CRA) has had a substantial impact in leveraging increases in community development lending and investing in the Appalachian Region. This study finds that banks and thrifts headquartered in Appalachia issued about $5.4

billion in lending and investing for affordable housing, small business development, and economic revitalization each CRA exam cycle (about 2.5 years). In addition, small business lending exhibited a positively unique and puzzling trend in Appalachia. In contrast to most other regions in the country, small business lending was higher where the minority population was higher on a county level in Appalachia.

Despite signs of progress, differences in small business lending within Appalachia must be overcome by concerted and persistent efforts undertaken over a multi-year time period. Within Appalachia, small business lending is less accessible in non-metropolitan counties and counties experiencing economic distress. In addition, the smallest businesses with revenues under $1 million and businesses in low- and moderate-income communities experience the least access to credit. A series of policy initiatives are needed for overcoming the unequal access to credit including a program of branch building in underserved and non-metropolitan counties, the preservation of a community banking sector of mid-size banks, an intensified focus of Small Business Administration (SBA)-guaranteed lending in counties with high levels of minorities, and the vigorous application of the Community Reinvestment Act (CRA) to address the need for small business development in non-metropolitan and distressed counties.

The NCRC study updates the report commissioned by ARC in 1998 and conducted by Mt. Auburn Associations entitled *Capital and Credit Needs in the Appalachian Region*. The Mt. Auburn study motivated a follow-up study focusing on bank financing because one of the key findings of the Mt. Auburn study was that "Appalachian businesses are heavily dependent on the banking industry for financing." In addition, the Mt. Auburn study identified significant credit needs as "insufficient financing appears to have a serious impact on the investment decisions of about one in five established companies." Further, the Mt. Auburn study indicated that small firms with less than 10 employees had higher levels of unmet funding needs than their larger counterparts.

The Mt. Auburn study broke important ground through its use of surveys of Appalachian small businesses. The study did not benefit, however, from publicly available data on CRA small business lending. The CRA data for the year 1996 first became available in summer

of 1997 when the Mt. Auburn study was well underway. In addition, researchers became much more familiar with the strengths and weaknesses of the database over the next several years. Thus, this study provides an important update to the Mt. Auburn report by utilizing the small business lending data and probing to what extent the unmet credit needs overall and for very small businesses still exist in Appalachia.

Since the Mt. Auburn study, new trends and challenges confront Appalachia. The heightened pace of globalization, consolidation in the banking industry, the high cost of energy, and rising interest rates pose significant challenges as well as new opportunities for business development. Changes in the Community Reinvestment Act (CRA) and federal economic development programs likewise present a series of challenges and opportunities. For example, the federal New Markets Tax Credit program promises to provide a significant amount of resources for development in Appalachia. The program authorizes the Department of Treasury to provide tax credits of 39% on up to $15 billion of private investments in low-income areas for business development activities and small business lending. Nonprofit and private sector entities in Appalachia are just beginning to take advantage of this new program.

NCRC's study was able to consider the impact on small business lending of a number of these large economic changes such as consolidation in the banking industry and the growing use of credit scoring in small business lending. However, future studies will be needed to further evaluate the impact on access to credit of changes in federal programs and banking regulations as well as globalization and other economic structural adjustments.

**Methodology and Findings**

This report employed a number of datasets and created datasets for the quantitative analysis. For the analysis of small business lending trends, NCRC used the publicly available data on CRA small business lending. This data was combined with U.S. Census data on population demographics and Dun and Bradstreet data on business demographics and credit scores. In addition, data was obtained from the Small Business Administration (SBA) on SBA lending programs. Branch and deposit data was obtained from the web

page of the Federal Deposit Insurance Corporation (FDIC). The section of the report analyzing community development lending and investing created a database consisting of data pulled from CRA exams of banks and thrifts located in Appalachia. Finally, the chapter on alternative financial institutions used data collected by public agencies, ARC, and trade associations of Community Development Financial Institutions (CDFIs).

The CRA small business lending data analysis used the year 2003. A longitudinal data analysis was not employed because changes in the definitions of loans in the CRA small business data had a significant impact on annual loan volumes. In addition, the number of lenders required to report the data has changed. It is recommended that ARC commission a future study, using the CRA small business data as one of the resources. Such a study should carefully assess the influence of changes in the database on similarities and differences in lending patterns found in this current study and the future one. A similar caveat applies to the CRA exam analysis. The most recent CRA exam was used for each lender in this study. A future study can assess if levels of community development financing by banks increased or decreased by using the subsequent exams for each lender headquartered in Appalachia.

The major findings in this report include:

*Appalachia Compared to the Nation*

Small business demographics in the nation and in Appalachia were remarkably similar. The two largest small business sectors in the nation and in Appalachia were services and retail. Similarly, almost 60 percent of the small businesses in Appalachia and the nation were very small, consisting of 1 to 4 employees.

Appalachia compares favorably against the nation on some lending indicators. Appalachia compares favorably against the nation when considering small business loan-to-deposit ratios and small business lending in minority counties. The small business loan-to-deposit ratio for Appalachia was 7% in contrast to 5.2% for the nation, or 35% higher in

Appalachia than the nation. In addition, banks made loans to 39.4% of the businesses in counties in which less than 20% of the population is minority in Appalachia, which was similar to national loan penetration rates of 41% for these counties. However, in counties in which more than 20% of the population is minority, banks made loans to 51.4% of the businesses in Appalachia, compared to national loan penetration rates of 42%. The lending levels within high minority population counties were 22% higher in Appalachia than the nation.

Nationally, banks provided significantly more small loans per branch than did banks in Appalachia, but Appalachian banks provided more loans per branch in non-metropolitan counties. In 2003, banks across the country originated 85.6 loans per branch, which was 35% higher then the 63.6 loans per branch for banks in Appalachia. But for non-metropolitan counties, banks loaned at higher levels in Appalachia. Banks in Appalachian non-metropolitan counties provided 57.5 loans per branch, which was 8% higher then the 53.2 loans per branch for similar counties in the nation.

*Trends within Appalachia*

Within Appalachia, businesses in low- and moderate-income census tracts and businesses with revenues under $1 million experienced particular difficulties accessing credit. In 2003, 14% fewer businesses in low- and moderate-income census tracts received loans as compared to businesses throughout the region (35.4% compared to 41% for the region). In addition, only 23.6% of the small businesses with less than $1 million in revenues located in low- and moderate-income tracts received loans, which was 43% below lending levels for the Region as a whole.

Banks have more difficulty serving non-metropolitan and distressed counties than metropolitan and non-distressed counties. In the Appalachian portion of nine states, the ratio of loans per small business was lower in non-metropolitan counties than metropolitan counties. For example, in Alabama, 58.6% of the businesses received loans in metropolitan counties while 48.6% of the businesses received loans in non-metropolitan

areas during 2003. In addition, just 32.1% of the small businesses in distressed counties obtained small business loans in contrast to 41.9% of the businesses in non-distressed counties (Distressed counties have higher unemployment, higher poverty rates, and lower income levels).

Banking industry structure impacts access to credit for small businesses in Appalachia. It is more likely that small businesses will receive loans in counties in which banks compete vigorously for customers by building and maintaining branches than in counties dominated by fewer banks that are less concerned with their branch presence. The study finds that small business lending was higher in counties with higher levels of bank branches. In counties with above median number of branches, the median number of loans by all banks was 1,287. In counties with below median number of branches, the median number of loans was 235. In contrast, overall lending was lower in counties with higher levels of bank concentration or consolidation. In Appalachian counties with below median levels of concentration (as measured by the Herfindahl-Hirschman index), the median number of small business loans was 1,120. In counties with above median levels of concentration, the median number of small business loans was 287 during 2003.

The econometric analysis in the report reaffirmed the finding that lending in Appalachian counties was higher in counties with higher numbers of minorities. The federal government reports that minority-owned firms are expanding at a rapid clip across the country. Perhaps the rapid growth contributes to more lending in counties with high minority populations in Appalachia. Perhaps counties with greater diversity have more robust economies. This dynamic needs further exploration since it appears to be unique to Appalachia, and is a strength that can be built upon by stakeholders in Appalachia.

*Role of Small and Mid-Size Banks*

Another asset in Appalachia is its significant sector of small and mid-size banks. The literature suggests that small and mid-size banks are particularly oriented to the needs of

small businesses in underserved communities. This study tends to confirm the distinct lending focus of smaller banks in Appalachia. The findings from the study include:

Banks with assets between $250 million to $1 billion (mid-sized banks) had a higher percentage of total loans in non-metropolitan counties (12.3% of all loans) than metropolitan counties (6.5% of all loans) during 2003. Mid-size banks also had a higher market share of loans in distressed counties (14.7% of all loans) than non-distressed counties (8.4% of all loans) during 2003.

In contrast to their loan penetration in non-metropolitan and distressed counties, mid-size banks were not as uniformly successful in counties with significant numbers of minorities. Mid-size banks made almost 30% of the loans in counties with more than 50% minorities but had their lowest market share of 6.7% of the loans in counties with 20% to 50% minorities. Mid-size banks therefore had mixed success reaching minority counties in Appalachia during 2003.

As predicted in the literature, mid-size banks did not base their lending in Appalachia on the distribution of small business credit scores on a county level whereas all banks had higher levels of lending in counties with the greatest portions of low risk businesses. In addition, mid-size bank lending levels were not dependent on the size of small businesses whereas all banks had higher levels of lending in counties with a greater portion of businesses with 10 to 19 employees. This suggests that mid-size banks may be more oriented to the smaller businesses that may not have established credit histories. The mid-size banking sector in Applalachia is therefore an important sector to start-ups and smaller businesses seeking to grow and expand.

*Trends in Small Business Administration (SBA) Lending*

The major lending program of the Small Business Administration (SBA) was more successful in reaching non-metropolitan counties than minority small businesses during 2003. In Appalachia, African-Americans were 8.3% of the population but were issued just

2.1% of the SBA 7(a) loans. SBA-guaranteed lending fared better in serving non-metropolitan counties as the SBA 7(a) market share of loans was higher in non-metropolitan counties than metropolitan counties during 2003.

In contrast to overall lending, SBA 7(a)-guaranteed lending was not higher in counties with greater portions of minorities. It is possible that the relatively low levels of SBA-guaranteed loans to minority-owned businesses or businesses in minority counties were due to relatively high levels of conventional lending to these businesses. In contrast to the findings for minorities, SBA-guaranteed lending exhibited more of a focus on non-metropolitan counties.

*Role of the Community Reinvestment Act*

In addition to measuring how many home and small business loans banks and thrifts make to low- and moderate-income borrowers, the Community Reinvestment Act (CRA) exams scrutinize banks' level of financing for affordable housing, and small business and community development. NCRC's study found substantial levels of community development financing in Appalachia due to CRA.

Banks and thrifts in Appalachia made about $3.52 billion and $1.69 billion in community development lending and investing during a time period of approximately once every 2.5 years (which is the average time period evaluated by CRA exams in the study). In other words, lenders made about $5.4 billion in community development lending and investing every 2.5 years. This figure of more than $5 billion represents a significant financial resource for economic development in Appalachia.

Banks with higher ratings on CRA exams were found to have substantially higher levels of community development lending, investing and branches in low- and moderate-income communities. Through the rating system, CRA exams are providing motivation and public recognition for banks to increase their level of community development financing in Appalachia.

Despite the overall benefits of CRA, disparities remain in community development financing. Non-metropolitan and distressed counties had considerably smaller shares of bank assets. Banks located in the metropolitan counties had combined assets of $420.6 billion (117 banks) versus $73.3 billion for assets of banks located in non-metropolitan counties (103 banks). Only 11 banks with combined assets of $4.3 billion were headquartered in distressed counties in Appalachia. The substantial differences in bank assets translated into non-metropolitan and distressed counties receiving less community development financing than metropolitan counties.

Despite the large total dollar amount for community development financing, relatively fewer dollars were devoted to small business development. In total, all banks and thrifts in Appalachia made $297 million in community development loans that financed affordable housing versus $117 million in community development loans for small businesses in Appalachia. Similarly, banks and thrifts issued $807 million in investments for affordable housing as opposed to $174 million in investments for small businesses in Appalachia.

*Role of Alternative Financial Institutions in Appalachia*

This report also examined the characteristics and abilities of alternative financial institutions in financing small businesses in Appalachia. Alternative financial institutions consist of Community Development Financial Institutions (CDFIs), community development credit unions, loan funds and others that specialize in serving hard-to-reach populations and small businesses. The report documents that alternative financial institutions were effective in serving Appalachian small businesses and in creating and preserving jobs. At the same time, they did not serve the smallest of the small businesses to the same extent as their national peers. This study also documents that mainstream banks had difficulties serving the smallest businesses with revenues under $1 million; thus alternative financial institutions have a gap to fill that perhaps they are not filling as much as they could. Also, alternative financial institutions in Appalachia were not financed by banks to the same extent as their national peers. This suggests that CRA has a role to play

in encouraging mainstream banks to increase their levels of debt and equity financing for small businesses directly and through the alternative financial institutions.

The community development financial institution (CDFI) industry is made up of a diverse set of institutions that specialize in providing a mix of financial products and services to distressed communities. There were over 100 CDFIs in the Appalachian region. Seventy-one of these were community development loan funds. Appalachian loan funds had a strong emphasis on business lending with over 70 percent offering a microfinance product for very small enterprises (typically five or fewer employees) and 35 percent offering loan products for larger businesses (typically greater than five employees). In the region, Pennsylvania had the largest number of loan funds with 21. Kentucky and Tennessee also had high concentrations of loan funds. Finally, in Appalachia there were 10 institutions set up specifically for community development venture capital investment.

Appalachian CDFIs predominantly focused on rural markets and had been established more recently than counterparts in the national industry. Appalachian CDFIs loaned at levels on par with national counterparts of similar size. Appalachian CDFIs had lower loan levels by number of loans, but loaned more in terms of dollars and had larger outstanding loan pools.

Appalachian CDFIs were successful in reaching small businesses but were not as successful in serving the smallest of the small businesses with less then five employees. In FY 2003, over 32 percent of Appalachian CDFI loan dollars outstanding were dedicated to small or mid-sized business development compared to only 18 percent for national CDFIs, a difference of nearly 14 percentage points. Additionally, in FY 2003, over 61 percent of the businesses financed by Appalachian CDFIs were enterprises[56] with more than five employees compared to 23 percent for national CDFIs who focused more heavily on financing micro businesses (with under five employees).

[56] The CDFI Data Project defines a larger business as one that has greater than five employees or one that received financing greater than $35,000 for the purpose of expansion, working capital, equipment purchase/rental, or commercial real estate development or improvement. A microbusiness would be a firm with five or fewer employees or one receiving a loan for $35,000 or less.

Financing businesses with greater than five employees allowed Appalachian CDFIs to impact more jobs. By focusing on financing businesses with greater than five employees, Appalachian CDFIs reported being able to create or retain over 3,300 jobs in the region in FY 2003. Appalachian CDFIs reported assisting over 11 jobs per business financed. By comparison, national CDFIs, assisted 2.8 jobs per business financed.

Appalachian CDFIs, particularly loan funds, had a heavy dependence on government funding and received less bank financing. Forty four percent of Appalachian loan fund debt capital came from federal, state, or local government sources while nearly 47 percent of venture capital fund capitalization was from government sources. Nationally, loan funds received less than 14 percent of debt capital from government sources while venture funds received just over 23 percent. Therefore, Appalachian loan funds received over three times as much of their debt capital from government sources as their national counterparts while Appalachian venture capital funds received twice as much funding from government sources as national venture funds. At the same time, Appalachian loan funds received 37 percent of their debt capital from banks while national loan funds obtained 47 percent of their debt capital from banks.

Appalachian community development credit unions and venture capital funds were more self-sufficient than their national peers while Appalachian community development loan funds had lower self-sufficiency rates than the national averages. In FY 2003, Appalachian community development credit unions had a self sufficiency ratio of .88 and Appalachian community development venture capital funds had a self sufficiency ratio of .68. Both of these numbers were well above national averages in their respective industries. In contrast, Appalachian community development loan funds had a very low self-sufficiency ratio of .35 indicating that only 35 percent of total expenses could be covered by earned revenue. This number was well below that of national loan funds which had self-sufficiency rates of .65.

Within the sector of alternative financial institutions, ARC supported revolving loan funds were performing admirably. ARC funded revolving loan funds had declining deal flow,

but had taken a more active position in the projects in which they participate. The average number of loans originated by ARC-funded RLFs had declined since 2000 when an average of over four loans were originated per fund. This number declined to low of 2.6 loans per fund in 2005, but grew somewhat in 2006 where the average increased to 3.4 loans per fund.

Despite this decline in deal flow, ARC RLFs had increased their average level of participation in deals particularly relative to other government-funded RLFs. Between 2000 and 2006, the percent of outside project financing tied to ARC RLF lending increased from 14.4 percent to over 22 percent. This growing level of project participation by ARC RLFs was in contrast to declining levels of participation by RLFs funded by other government agencies. Loans through RLFs funded by other government agencies contributed nearly 38 percent of total outside project financing in 2000, but this number declined to less than 13.5 percent by 2006.

ARC funded RLFs had been effective at influencing job creation and retention in the region. Between 2002 and the first quarter of 2006, loans from ARC capitalized revolving loan funds helped create over 3,600 jobs and retain over 8,300 jobs in the region. In 2002, ARC RLFs influenced 26.1 jobs per loan and loaned $3,254 per job influenced. In 2005, ARC RLFs influenced 48.4 jobs per loan and loaned $1,797 per job influenced. This means that ARC RLFs were influencing more jobs per loan, but spending less per job influenced.

The Appalachian Regional Commission has worked to improve access to equity capital in the region. In response to lack of available equity capital in Appalachia, ARC began an entrepreneurship initiative that focused on promoting the growth of community development venture capital funds in the region. To this end, ARC initiated a partnership building effort through a series of conferences focused on access to equity capital in rural markets that brought together foundations, financial institutions, and economic development organizations. ARC also worked with the Community Development Venture Capital Alliance to enhance the capacities of area CDVC management teams.

Additionally, as of October 2004, ARC had granted $4.4 million to 13 CDVCs (11 active funds) in seven states in the region. These funds had a total capitalization of $96 million and have invested $13.6 million in 59 regional businesses creating over 1,000 jobs in the region.

SBA programs using alternative financial institutions recorded mixed success. SBA funded microlenders were effective at lending to distressed markets, but SBA microlending and 504 lenders provided only limited support to minority businesses in distressed counties. In Appalachia, distressed counties received 10.1 SBA microloans per 10,000 microbusinesses compared to 6.0 per 10,000 microbusinesses in non-distressed counties. However, minority owned businesses in distressed counties received far fewer microloans than did other businesses throughout the region. Additionally, no SBA 504 loans were originated to minority- or women-owned businesses in Appalachian distressed counties, while over 20 percent of SBA 504 loans were originated to minority or women-owned businesses through the rest of the region.

*Data Limitations*

The CRA small business data has limitations that must be kept in mind when conducting research. Firstly, the definition of a loan origination changed over the years. The regulatory agencies allowed banks to count one loan renewal for a small business borrower as an origination in a given year. This means that if a sizable number of borrowers of a particular bank refinanced in one year as opposed to another year, the annual loan volume of a particular bank can fluctuate dramatically. When NCRC was starting this report, the yearly loan volume of all banks and thrifts in a couple of test cases (New York and West Virginia) fluctuated substantially. Because the definition of a loan origination caused a significant amount of this fluctuation, NCRC and ARC decided against a time series analysis. Nevertheless, it is acknowledged that a one-year snapshot limits the descriptive and statistical data analysis.

A second data limitation is that the CRA small business data does not include the race and gender of the small business owner unlike the SBA data. It is therefore not possible to compare SBA and CRA small business lending patterns to women- and minority-owned small businesses. A third data limitation, as discussed above, was the elimination of the requirement for mid-size banks to collect and publicly report their CRA small business data.

A fourth issue that may be related to a data limitation was the lack of a relationship in the regression equations between lending levels and sector of small businesses. Small businesses in different sectors such as retail as opposed to heavy machinery have needs for different types of loans. This report tried various versions of a small business sector variable but did not generate any statistically significant results for that variable. If we had more data on the type or purpose of the loans (such as loans for establishing stable cash flow as opposed to purchasing new equipment), the sector variable may have become significant. A future study should attempt to procure more detail on the purpose of the loan and/or perhaps experiment with specifying various dollar amounts of loans.

A fifth issue related to data limitations and time constraints is a full investigation of the use of credit scoring by in-market versus out-of-market banks and financial institutions. The report investigated the use of credit scoring by mid-size banks with branches located in Appalachia but did not expand this inquiry to scrutinize the use of credit scoring by all banks with branches within Appalachia versus lenders lacking a branch presence in Appalachia. This is an area worthy of additional investigation to determine if the use of credit scoring corresponds to branch presence as well as the asset size of a bank.

Another constraint regarding time series analysis involves the CRA exam analysis. NCRC conducted an analysis using the most recent CRA exam for each bank and thrift in the sample. If resources had permitted, the study could have considered bank lending and investing over two CRA exams (the most recent exam and the previous exam). That would have permitted the study to assess trends over time in different categories of counties. For example, the study found that the levels of community development lending and investing

in non-metropolitan areas were lower than the levels of community development financing in metropolitan areas. Nevertheless, the study cannot comment upon whether levels of community development financing in non-metropolitan areas had been increasing over time since the study did not use the most recent and previous CRA exams for the banks and thrifts headquartered in Appalachia. It is possible that levels of community development lending and financing have been increasing in non-metropolitan areas due to the increased attention CRA received in the late 1990s and into the 21st century. Future studies will be able to pick up this important analysis commenced by the NCRC study.

**Policy Options**

Based upon the report's findings, the following policy options are offered to increase access to credit and capital in non-metropolitan areas, distressed counties, and among small businesses with revenues under $1 million. A number of these recommendations can be implemented by ARC working together with stakeholders in the Appalachian region. These stakeholders include state agencies, elected officials, lending institutions, Federal Home Loan Banks, federal regulatory agencies, the U.S. Department of Treasury, financial intermediaries, public finance markets, development organizations, and the Federal Reserve Banks:

*Increase Branch Presence, particularly in non-metropolitan areas and distressed counties* – The report found that lending is higher in counties with higher number of branches. Building bank branches, particularly in non-metropolitan and distressed counties, should be regarded as an important part of an economic development program. Public and private sector stakeholders should work together on a branch building program. Banks have been expanding their branch networks in the last 3 or 4 years; the challenge is to build branches in minority and low- and moderate-income communities. ARC, state agencies, and lending institutions should investigate New York State's Banking Development District (BDD) Program. Begun in 1998, the BDD program offers partial property tax exemptions for branches opening in geographical areas in need of banking services. Local governments can also agree to earn below market rates of return on Certificates of Deposits in these

branches. The New York State Banking Department reports significant increases in banking services including 256 loans per BDD branch and financial education services delivered out of these branches.[57]

*Growth of a Community Banking Secto*r – Since mid-size banks with assets between $250 million to $1 billion played important roles in small business financing, stakeholders therefore should ensure that the mid-size and smaller bank sector remain viable and vibrant. Incentives could be developed to support existing mid-sized banks, or encourage the formation of new banking institutions in underserved areas. For example, the Federal Home Loan Bank System should consider additional advances and other incentives to support the small business lending of mid-size banks. Currently, the Federal Home Loan Bank of Pittsburgh operates a Banking on Business (BOB) program that provides financing for bank loans that would not otherwise be made due to insufficient cash flow from the small business. Since its inception, BOB has provided $20.5 million in funding, creating and retaining 3,500 jobs.[58] Likewise, the Federal Home Loan Bank of Atlanta runs the Economic Development Program that helps provide financing to small businesses.[59] ARC could also work to stimulate the formation of development banks in the Region. In addition, the New York State program for expanding branches mentioned above could serve as a model and be especially adapted for mid-size banks headquartered in Appalachia. Finally, private sector incentives and investments for mid-size banks can play an important role in the preservation and expansion of the community banking sector.

*Increase levels of community development financing for small business development* – The report found banks located in Appalachia devoted significantly higher levels of community development lending and investing for affordable housing than small business development. This finding does not mean that community development financing levels for affordable housing should go down so that levels for small businesses can go up.

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[57] See http://www.banking.state.ny.us/pr980226.htm and http://www.banking.state.ny.us/pr050810.htm. Last accessed July 3, 2006.
[58] See http://www.fhlb-pgh.com/housing-and-community/real-life-stories/banking-on-business.html, last accessed December 21, 2006.
[59] http://www.fhlbatl.com/fhlb_content.cfm?lev1=5cis&lev2=bcedp&lev3=2edp, last accessed December 21, 2006.

Instead, it suggests that banks should be encouraged to increase their overall levels of community development financing and then could devote substantial portions of the increases towards small business development. Stakeholders including ARC, state agencies, and lending institutions should work together to expand community development financing for small business development and support.

*Diversify sources of debt and investment capital for community development loan funds and venture capital funds.* Appalachian CDFIs need to diversify their funding base. Community development loan funds and venture capital funds are heavily reliant on government sources for debt and investment capital. These same institutions, however, lag national counterparts in accessing capital from depository financial institutions, non-depository financial institutions, and foundations in the case of loan funds and depository financial institutions and foundations in the case of development venture capital funds. ARC can develop relationships with potential investors and regulatory agencies to encourage increased investment within Appalachia, including partnerships with financial intermediaries such as the Community Reinvestment Fund, participation in public secondary markets, and continue efforts to utilize tax credit financings such as the New Markets Tax Credit program. Additionally, ARC should review other potential barriers to diversifying CDFI capitalization such as product offerings and loan pricing and structuring. Finally, CRA should be used to encourage banks to provide more financing to alternative financial institutions.

*Appalachian loan funds must increase operational self sufficiency*. Appalachian loan funds, both Revolving Loan Funds and microenterprise funds, must increase levels of self sufficiency by reducing operating costs or increasing revenues. Costs can be reduced through consolidation of back office operations, a growing trend among national CDFIs. Costs could also be reduced by undertaking joint marketing efforts among independent loan funds. Operating revenues could be increased by increasing loan volume. This would likely require increased levels of capitalization or access to new financing through intermediaries.

*Continue to grow capacity of Appalachian development venture capital funds.* Available literature shows that there remains a significant gap in access to equity financing in non-metropolitan markets. ARC's efforts to develop regional equity investment funds are important in bridging this gap and increasing regional entrepreneurship levels. ARC should continue to seed these investment funds, but also continue to build the capacity of regional fund managers and develop networks and relationships with key investment partners outside the region to reduce the reliance of Appalachian venture capital funds on government investment. ARC should also closely monitor the performance of these funds as they mature.

*Maintain Integrity of CRA exams* – Maintaining CRA exam integrity is important since substantially different levels of community development financing were recorded by banks with different CRA ratings. Most banks headquarted in Appalachia are banks with $250 million to $1 billion in assets. The federal regulatory agencies have implemented new CRA exams for these mid-size banks. Stakeholders must ensure that the new CRA exams require these mid-size banks to maintain and increase their levels of community development financing in Appalachia. In addition, the regulatory agencies recently amended the CRA regulations to provide CRA points for community development financing in rural middle-income census tracts located in distressed and underserved counties. Stakeholders should monitor CRA exams to ensure that rural low- and moderate-income areas as well as middle-income areas receive community development financing. In addition, stakeholders should ensure that metropolitan-based banks are also serving rural areas. Finally, more detailed data on the purposes of community development financing is needed on CRA exams to assess if the financing is responding to community needs. NCRC found that much more detail was available on the purposes (whether for housing or small business development) of community development investments than lending. Congressional oversight and hearings regarding CRA exam quality would also bolster the integrity of CRA exams.

*Restoration of Small Business Lending Data for Mid-Size Banks* –The study finds positive and important findings of the lending patterns of mid-size banks. In 2005, federal

regulators deleted the small business loan data reporting requirements for banks and thrifts with assets between $250 million and $1 billion in assets. It is counterproductive to eliminate this data because studies in future years will not be able to carefully examine the lending patterns of mid-size banks and fully and accurately assess their role in Appalachia. Federal regulators should consider ways to continue to collect this important economic data. In addition, federal regulators and Congress should consider requiring banks and thrifts to report upon the race and gender of the small business borrower. Lending to minority- and women-owned businesses would likely increase just as lending to minority and women homebuyers increased because the Home Mortgage Disclosure Act (HMDA) was amended in 1988 to require the reporting of race and gender of the borrower. Finally, the regulatory agencies need to establish stability in the definitions of loan originations and other aspects of the small business data so that time series analysis can become possible. It would also be preferable to require separate reporting of loan originations and renewals/refinances as is done with HMDA data.

While data collection imposes costs, the benefits can exceed those costs. The data can document positive trends and highlight new opportunities as revealed by this study. Moreover, data reporting motivates banks to maintain and increase their lending levels to small businesses.

*Encourage Small Business Administration (SBA-guaranteed lending to Minority-Owned Businesses* – The SBA should investigate ways to increase SBA-guaranteed lending to minority-owned businesses and in minority counties. It is possible that the relatively low levels of SBA-guaranteed loans to minority-owned businesses or businesses in minority counties were due to relatively high levels of conventional lending to these businesses. Also, there may be fewer lenders in minority counties that use SBA products. Alternatively, it is possible that there are still certain types of credit needs that are not being satisfied by the conventional lending, opening up new opportunities for the SBA-guaranteed lending. In Appalachia, the counties with high levels of minorities are in Mississippi, Alabama, Georgia, South Carolina, and North Carolina. SBA regional offices in those states should work with ARC, state officials, lending institutions, nonprofit

counseling organizations, and other stakeholders to investigate credit needs and see if it is possible to increase SBA-guaranteed lending in minority counties and to minority-owned businesses.

*Increase SBA microloans to minority-owned businesses and SBA 504 lending in distressed counties, particularly to minority- and women-owned businesses*. No SBA 504 loans were originated to women or minority-owned businesses in distressed counties, and, overall, distressed counties saw very low levels of 504 lending. In contrast, SBA microloans reached distressed counties but were not as successful in reaching minority-owned businesses in distressed counties. ARC should investigate possible barriers to 504 lending in distressed counties and access for minority-owned businesses to microloans in distressed counties. It is possible that lenders in distressed counties are unfamiliar with the 504 product or are discouraged due to concerns about the length of underwriting or program fees. Also, if smaller banks in distressed counties are unable to make 504 loan deals, it may be necessary to recruit larger institutions to participate in these loans if demand exists.

*Financial Counseling and Technical Assistance for Small Businesses* – Lending was higher in counties with higher portions of small businesses with the lowest risk credit scores. This suggests that lending will increase to small businesses overall if small businesses improved their credit scores. High quality financial counseling efforts are therefore important in Appalachia as a means to improve the credit scores of small businesses. In addition, technical assistance should be provided to improve the knowledge and skill level of the small business entrepreneurs regarding cash flow, understanding financials, business planning and taxation issues. ARC, state officials, lending institutions, and community organizations should work together to intensify financial counseling directed towards small businesses in Appalachia.

*Better Understanding of Lending in Minority Counties in Appalachia* – The report's finding about higher levels of lending in counties with higher levels of minorities was a surprising and positive finding. Future research should be conducted to more fully understand why lending is unusually successful in reaching firms in counties with high

levels of minorities in Appalachia. Lessons from this research should be applied to other regions of the country since the literature overall suggests serious barriers in access to small business lending for minority-owned firms.