Alternative Financial Institutions in Appalachia

Previous chapters have discussed trends in the financial services industry that affect access to capital for small business development in Appalachia, particularly in distressed and underserved markets. As the financial services industry modernizes and becomes increasingly consolidated, there are concerns that access to capital may be threatened in lower-income markets where small business borrowers often have marginal credit or limited business histories. Improvements in technology allow for much more streamlined, cost-effective underwriting, and consolidation leads to increasingly centralized decision-making. As decision making becomes more standardized and less relationship oriented, businesses owners without strong credit or capital, particularly those in disinvested or underserved markets, may have difficulty accessing necessary capital for starting or growing their businesses. In recent decades, a diverse network of non-bank financial institutions has grown and attempted to fill such gaps in access to credit.

This chapter examines the presence of regional development finance institutions and other intermediary business development lenders in Appalachia. Such intermediaries are often loan funds which are typically operated by a mix of public, private, non-profit, or for-profit organizations and receive capital from sources such as mainstream financial institutions; federal, state, and local government agencies; and foundations. This section uses a variety of data sources to analyze the presence of different types of such institutions in the region, focusing on community development financial institutions (CDFIs), government-backed revolving loan funds (RLFs), development venture capital funds, and SBA lending intermediaries.[27]

[27] In the following chapter we make a distinction between community development financial institutions (CDFIs) and revolving loan funds (RLFs). In broad terms, we consider a CDFI an institution whose primary mission is providing community development finance and technical assistance to underserved and distressed markets. RLFs also provide loans and technical assistance to businesses in underserved markets, but, frequently, RLFs are a small part of a larger quasi-government organization whose mission is to promote regional economic development. As such their primary mission is not providing community development finance. The analysis in this chapter uses data from the CDFI industry and from ARC on their RLF lending pool. While there is a modest degree of overlap between institutions in the two data sets, we feel that differences in organizational mission and available data warrant two distinct sections.

Community Development Financial Institutions (CDFIs)

The current Community Development Financial Institution (CDFI) industry emerged over decades as public and private sector players responded to the difficulties that many distressed markets, such as minority, lower-income, and rural communities, experienced in accessing mainstream financial services. CDFIs are niche financial institutions whose mission is to provide targeted financial services such as retail bank accounts, affordable housing finance, and small business capital to disinvested areas. In addition to such products, CDFIs also place a strong emphasis on building the capacity of the markets they serve through providing high levels of hands on financial literacy training, housing counseling, and entrepreneurial technical assistance.

The CDFI industry is made up of a diverse set of institutions that to varying degrees provide a mix of financial products and services and capacity building to distressed communities. The four basic types of CDFIs are community development banks, credit unions, loan funds, and development venture capital funds.

Community development banks and credit unions are regulated financial institutions with the ability to take deposits and offer loan products. Community development banks are for-profit entities whose focus is to provide targeted lending and investment geared towards the redevelopment of distressed communities. The main source of capital for community development banks is deposits received from individuals and institutions and government grants and investments. Community development credit unions (CDCUs) are non-profit cooperatives that provide affordable financial services to individuals without traditional bank accounts and help these individuals develop assets. CDCUs specialize in providing low-cost deposit accounts in communities not served by mainstream financial institutions and often extend credit at more flexible terms. CDCUs are primarily capitalized by member deposits, but also receive capital investments from other sources such as mainstream financial institutions. CDCUs offer consumer loans, vehicle loans, mortgages, and small business loans to distressed markets and often lead the way in product innovation. CDCUs were the among the first institutions to offer low-cost, short term consumer loan products to compete with high cost payday lending operations.

Community development loan funds are not depository institutions, but are non-profit organizations that leverage investments by outside sources such as banks, foundations, corporations, and government agencies to provide lending for small business development, housing, microenterprise, or community facilities in distressed markets. Community development venture capital funds are for-profit entities who also leverage investments from outside sources to provide equity investments or equity-like loans for business development in distressed communities.

In its early years, the growing CDFI industry was primarily capitalized with government or foundation resources, but changes in government policy and the financial services industry have led to shifts in the sources of financial support for CDFIs. Mainstream financial institution participation was limited and typically involved investing in loan pools for affordable housing development and mortgage lending. The Community Reinvestment Act (CRA) changed the nature of financial industry support of the CDFIs. CRA was passed in 1977 to promote lending and investment by depository financial institutions in low- and moderate-income markets. In its early years, however, CRA's effectiveness was limited largely by weak regulatory enforcement. Substantial changes to the CRA regulation in 1995 altered the way banks were monitored for their community reinvestment performance. As related to CDFIs, the updated CRA regulation added specific components that examined banks for their levels of community development lending and investments and grants. This change served as incentive for banks and thrifts to provide low-cost loans and investments to CDFIs who were able to leverage these resources to finance activities that mainstream institutions found too risky to finance directly. CRA has often been credited with spurring the rapid growth of the CDFI industry in the 1990s which saw the establishment of the more new CDFIs than any other decade.[28]

---

[28] The CDFI Data Project. 2005. *Providing Capital, Building Communities, Creating Impact.*

The federal government also established the CDFI Fund in 1994 under the Department of Treasury. It provides financial grants and technical assistance awards to CDFIs and implements the Bank Enterprise Award (BEA) program which rewards banks and thrifts who are active in supporting the CDFI industry. The CDFI Fund also implements the New Markets Tax Credit Program which provides tax credit allocations for community development entities to use in attracting investment in lower-income communities.

The CDFI industry has faced significant challenges recently. Sources of funding have been a particular concern. Government funding for CDFIs from sources such as the CDFI Fund and the SBA have been consistently threatened in recent federal budgets. Foundation support, a traditionally strong source of funding for the CDFI industry, has waned in recent years. Additionally, as mentioned in previous chapters, the Community Reinvestment Act has been weakened. Changes implemented by federal banking regulators put less emphasis on the importance of critical community development loans and investments for many mid-sized banks. The increasingly complex and global financial services industry now requires that CDFIs increase their level of sophistication in accessing capital markets and financing projects. In many markets, CDFIs now compete with the community development corporations of major banks for the best projects.[29] There has also been a growing emphasis from funders to document impact created by their investment.

CDFIs in Appalachia

The Appalachian region has a diverse set of development finance intermediaries. The following section takes a closer look at the CDFI industry in Appalachia.

An analysis of the membership lists of the major trade associations that represent different types of CDFIs gives a sense of the nature of the CDFI industry in Appalachia.[30] Table 5

[29] Moy, Kirsten and Alan Okagaki. July 2001. "Changing Capital Markets and Their Implications for Community Development Finance." Capital Xchange. Brookings Institution. Washington D.C.

[30] The major CDFI trade associations surveyed were Association for Enterprise Opportunity, Community Development Venture Capital Alliance, National Federation of Community Development Credit Unions, National Community Capital Association, National Community Investment Fund, and the CDFI Fund. This list is not comprehensive of all development finance intermediaries. There are many small revolving loan funds or loan funds that are for-profit or government or quasi-government agencies who are not members of these associations. These institutions will be discussed in subsequent sections of this chapter.

shows CDFIs located in the region by state[31] and type of CDFI. There are over 100 CDFIs active in the region. Appalachian Pennsylvania has 29 CDFIs while West Virginia has 14 and Alabama has 11. At the other end of the spectrum, Appalachian South Carolina has no CDFIs and Georgia, Maryland, and Mississippi each have one. Of note, there are no community development banks in the region, although there are 26 community development credit unions. Appalachian Alabama has a high concentration of CDCUs where seven of the area's 11 CDFIs are CDCUs. The most prevalent type of CDFI in Appalachia are loan funds with a total of 71. Pennsylvania has the most loan funds with 21. Kentucky and Tennessee each have high concentrations of loan funds where nine of ten and eight of ten CDFIs respectively are loan funds. Finally, in Appalachia there are 10 institutions set up specifically for community development venture capital investment.

Table 5. Appalachian CDFIs by State and Type[32]

State	Total	CD Banks	Credit Unions	Loan Funds	Venture Funds
Alabama	11	0	7	4	0
Georgia	1	0	0	1	0
Kentucky	10	0	1	9	0
Maryland	1	0	0	0	1
Mississippi	1	0	0	1	0
New York	10	0	3	5	2
North Carolina	9	0	1	6	2
Ohio	5	0	1	3	1
Pennsylvania	29	0	7	21	1
South Carolina	0	0	0	0	0
Tennessee	10	0	2	8	0
Virginia	6	0	1	4	1
West Virginia	14	0	3	9	2
Total	107	0	26	71	10

Community development loan funds offer a diverse array of products and services. Loan funds broadly serve four sectors: microenterprise, small business development, housing, and community facilities. Microenterprise lenders target very small firms, typically those with fewer than five employees, for loans of less than $35,000. These lenders often target minority, women-owned, and start-up businesses and provide high levels of technical

[31]The region represented is only that part of each state within the Appalachian Regional Commission boundaries.

[32] CDFIs were taken from the association membership lists or known sources of funding. Credit Unions were members of the National Federation of Community Development Credit Unions (NFCDCU) . Microlenders were members of the Association of Enterprise Opportunity (AEO) or were a registered SBA microlending intermediary. Loan funds were members of National Community Capital Association (NCCA). Venture capital funds were members of the Community Development Venture Capital Alliance (CDVCA) or received venture capital funding from the Appalachian Regional Commission.

assistance. Other loan funds target larger or more established businesses in distressed markets and provide a mix of loan and equity products with the primary goal of creating or retaining regional jobs. In addition to standard debt products, these loan funds many also operate venture capital funds that provide equity investment to rapidly growing small or mid-sized businesses in distressed communities. Funds that target housing can provide a variety of financing to developers of affordable housing or mortgages to lower-income households for homeownership, home improvement, or refinancing out of troubled loans. Loan funds who specialize in community facilities make funding available for child care centers, clinics, or other types of community service organizations. Analysis of results from the CDFI Data Project Survey show that 58 percent of loan funds participating in the survey served multiple sectors.[33]

The 71 community development loan funds in Appalachia have a strong emphasis on business lending. Table 6 categorizes the services offered by Appalachian loan funds as microlending, small business, housing, community facilities. A category has also been added for loan funds who offer equity-like venture capital financing for business development in addition to an array of other products.[34] Over 70 percent of Appalachian loan funds offer some type of microfinance product, while 35 percent of loan funds make larger small business loans. Just under 27 percent of Appalachian loan funds provide housing finance, while only two loan funds specifically state they do lending for community services such as daycare and health facilities. Within the region, four loan funds operate venture capital investment firms as well as offering an array of other small business lending services. These four loan funds are in addition to the ten stand-alone development venture capital firms identified above in Table 5.

---

[33] CDFI Data Project. *Providing Capital, Building Communities, Creating Impact*

[34] Information on services offered is based on a January 2006 analysis by the authors' of trade association and loan fund web sites.

Table 6. Services Offered by Appalachian Loan Funds

State	Total Loan Funds	Activities Financed: Micro Business	Small Business	Housing	Community Services	Venture Capital
Alabama	4	3	1	0	0	0
Georgia	1	1	0	0	0	0
Kentucky	9	3	6	2	0	2
Maryland	0	0	0	0	0	0
Mississippi	1	1	0	0	0	0
New York	5	5	2	4	1	0
North Carolia	6	4	3	2	0	0
Ohio	3	3	1	0	0	1
Pennsylvania	21	16	6	8	0	0
South Carolina	0	0	0	0	0	0
Tennessee	8	5	3	1	0	1
Virginia	4	3	2	2	1	0
West Virginia	9	6	1	0	0	0
Total	71	50	25	19	2	4

Analysis of Appalachian CDFIs

In order to gain a more complete understanding of CDFI activity in Appalachia, we created a special dataset that combines data from two national surveys of CDFIs. The major dataset used was from the CDFI Data Project (CDP). The CDP is an annual survey conducted by CDFI industry trade associations[35] that collects data on the activities, financial condition, and performance of CDFIs across the country. Where possible we enhanced this dataset with information from the CDFI Fund's Community Investment Impact System (CIIS) survey. This survey collects institution- and transaction-level data from CDFIs who receive awards or New Markets Tax Credit allocations from the CDFI Fund.

Our combined dataset covers FY 2003 and contains information from nearly 468 of the nation's roughly 1,000 CDFIs.[36] The dataset contains information on 47 CDFIs located in Appalachia. Table 7 breaks out the types of CDFIs represented in the sample and compares Appalachia to the nation. Appalachia has a slightly higher percent of total CDFIs that are either loan funds or venture capital funds than the national aggregate. Just under 43 percent of Appalachian CDFIs in the sample are loan funds compared to just over 34 percent for the national aggregate, and six percent of Appalachian CDFIs are venture funds

[35] Participating associations include Aspen Institute, Community Development Venture Capital Alliance, National Federation of Community Development Credit Unions, National Community Capital Association, and National Community Investment Fund.

[36] The CDP contains data on 459 CDFIs, 38 of which are in the Appalachian region. Where possible, we added data on nine Appalachian CDFIs from the CIIS survey that were not included in the CDP.

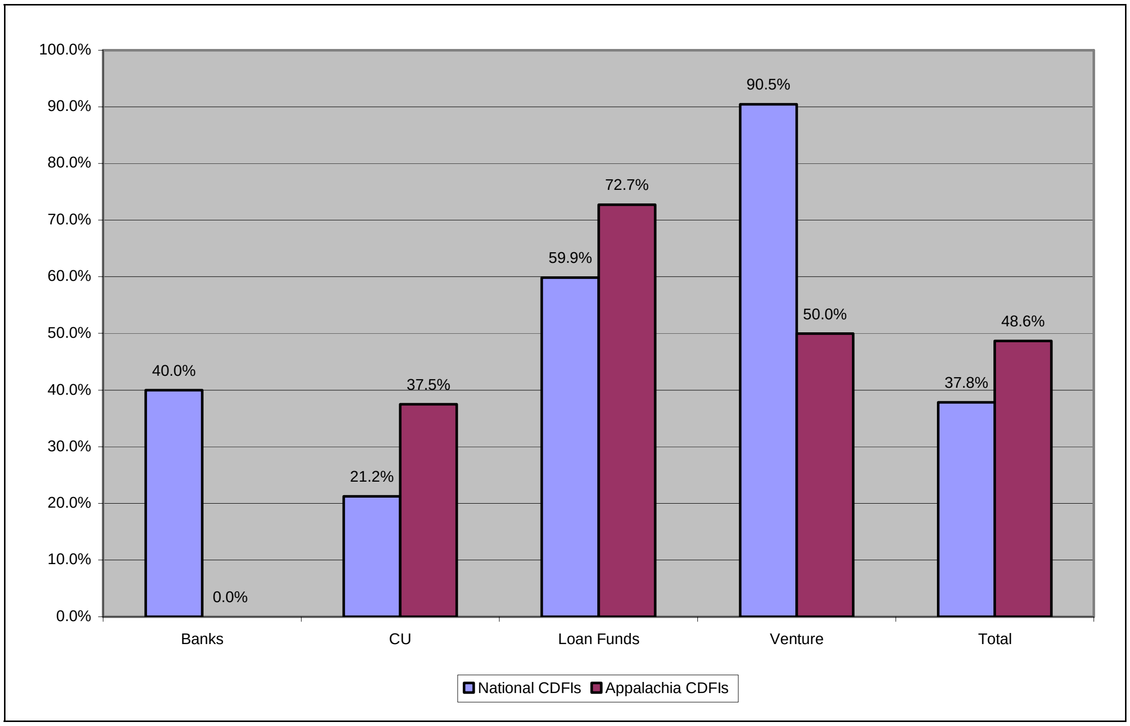
compared to just under 5 percent nationally. Appalachia has a smaller share of CDFIs that are credit unions than the nation. Just under 57 percent of national CDFI sample are credit unions compared to 51 percent for Appalachia. There are no community development banks in Appalachia.

Table 7. Types of CDFIs Represented in Combined Dataset, FY 2003

	Appalachia	National
CDCUs	51.1%	56.6%
CD Banks	0.0%	4.3%
CD Loan Funds	42.6%	34.4%
CD Venture Funds	6.4%	4.7%
Total CDFIs	47	468

The Appalachian CDFI industry is less mature than the national industry. Although Appalachia is home to many well established and influential community development finance intermediaries such as Kentucky Highlands Investment Corporation, the regional industry has developed much more recently than the national industry. Figure 20 shows that just under half of all CDFIs in Appalachia were established after 1990 compared to just under 38 percent for national CDFIs. Community development loan funds and venture capital funds have experienced tremendous growth since 1990. Just under 60 percent of national loan funds have been established since 1990 compared to nearly 73 percent of Appalachian loan funds. Nationally, over 90 percent of community development venture capital funds were established post 1990. Of the two Appalachian venture capital funds in data set, one was established after 1990.

Figure 20. Percent of CDFIs established after 1990



Appalachian CDFIs serve predominantly rural markets. Table 8 shows that in FY 2003 the activity of national CDFIs was fairly evenly distributed between major urban, minor urban, and rural markets while Appalachian CDFI clients were predominantly located in rural markets. On average, just under 50 percent of Appalachian CDFI clients were in rural areas compared to just under 34 percent for national CDFIs. Conversely, an average of less than 20 percent of Appalachian CDFI clients were from major urban areas[37] compared to nearly 38 percent for national CDFIs. On average, 31 percent of Appalachian CDFI clients were in minor urban areas. This reflects the rural character of the region and is consistent with the CDFI mission of targeting underserved markets. Research has consistently shown that rural business owners have difficulty accessing capital due to limited supply and a lack of experience accessing capital markets.[38]

---

[37] The CDP defines a "major urban" area as a metropolitan area with a population over 1 million. In Appalachia, the two "major urban" areas are Pittsburgh and Birmingham. "Minor urban" areas are those metropolitan areas with less than 1 million in population. Rural areas are all non-metro areas.

[38] Markley, Deborah and Don Macke. March 2002. "Capital for Rural Entrepreneurs" Center for Rural Entrepreneurship. Monograph 7.

Table 8. Average Percent of Clients Located in Different Geography Types, FY2003

	Appalachia	National
Major Urban	19.4%	37.9%
Minor Urban	31.4%	28.4%
Rural	49.3%	33.7%
Total CDFIs Reporting	25	273

Appalachian CDFIs are active lenders. When controlling for asset class, Appalachian CDFIs had similar portfolio characteristics when compared to national CDFIs. Table 9 classifies CDFIs into four asset size categories and compares Appalachian CDFIs to similarly sized national institutions.[39] In three of the four asset classes, Appalachian CDFIs, on average, closed fewer loans in FY2003 than their national counterparts, but also made larger average loans and on average had a larger portfolios of outstanding loans. For example, the three Appalachian CDFIs with assets between $10 and $30 million closed an average of 259 loans in FY2003 compared to an average of 367 loans closed by national CDFIs of similar size. However, the average dollar amount of the loans closed in FY2003 by Appalachian CDFIs of this size was slightly larger than national CDFIs at $5.2 million compared to $5.1 million. Additionally, Appalachian CDFIs with assets between $10 and $30 million had average portfolios of outstanding loans of $13.6 million compared to $9.9 million for similarly sized national CDFIs. This indicates that while Appalachian CDFIs may have smaller annual deal flow than similarly sized national counterparts, they are still active lenders who participate in larger projects or take a more substantial stake in projects.

Table 9. Average CDFI Portfolio Characteristics by Asset Category, FY2003

	<$1M		$1M-$10M		$10M-$30M		$30M-$70M	
Averages	ARC	National	ARC	National	ARC	National	ARC	National
Loans Closed	56	62	228	215	259	367	975	1,632
$$ Loans Closed	$272,527	$162,776	$1,344,519	$1,396,601	5,208,393	$5,101,214	17,878,528	14,595,684
Assets	$574,901	$521,895	$4,181,312	$4,266,619	20,551,788	$16,668,958	51,766,384	46,239,734
Portfolio Outstanding	$324,708	$222,969	$2,464,277	$2,528,346	13,625,475	$9,894,197	36,245,748	26,761,531
CDFIs	14	120	16	195	3	60	3	36

Appalachian CDFIs placed a heavy emphasis on lending for business development. Tables 10 and 11 examine the types of CDFI financing outstanding in terms of loans and

[39] We limited out asset categories to institution below $70 million because the largest Appalachian CDFI is at $64 in assets.

dollars in FY 2003. Appalachian CDFIs placed a stronger emphasis on business financing than national CDFIs.[40] Four percent of Appalachian CDFIs' financings outstanding were for business development in 2003 compared to three percent for national CDFIs. However, over 32 percent of dollars loaned went to business development compared to only 18 percent for national CDFIs, a difference of nearly 14 percentage points. This indicates that Appalachian CDFIs made larger loans or investments in business development than their national counterparts. In 2003, the percent of loans and dollars outstanding for microenterprise lending in Appalachian and national CDFIs were similar. However, for both CDFI groups, microfinancing accounted for a small share of the total outstanding loans pools.

Table 10. Breakout of Direct Financing Outstanding (Number of Loans), FY2003

	Appalachia	National	Difference Between App. and Nation
For Businesses #	4.0%	3.0%	1.0%
For Housing #	17.1%	12.0%	5.2%
For Microenterprise #	3.1%	3.3%	-0.2%
For Other #	5.9%	6.0%	0.0%
For Personal Development #	69.6%	75.1%	-5.5%
For Community Facilities #	0.2%	0.7%	-0.5%
Total Financing Outstanding #	13,877	282,164	NA
Total CDFIs Reporting	34	294	NA

Table 11. Breakout of Direct Financing Outstanding (Dollars Loaned), FY 2003

	Appalachia	National	Difference Between App. and Nation
For Businesses $	32.2%	18.4%	13.8%
For Housing $	40.3%	45.1%	-4.8%
For Microenterprise $	1.9%	1.4%	0.5%
For Other $	4.4%	3.1%	1.3%
For Personal Development $	20.1%	23.3%	-3.2%
For Community Facilities $	1.1%	8.7%	-7.6%
Total Financing Outstanding $	$200,618,712	$4,862,012,489	NA
Total CDFIs Reporting	34	294	NA

[40] Business financing represents debt and equity financing to small or mid-sized businesses. Loans to micro businesses are considered separately.

Appalachian CDFIs' emphasized lending to larger businesses and assist more jobs per loan.[41] In FY 2003, less than 39 percent of businesses financed by Appalachian CDFIs were microbusinesses compared to over 77 percent for national CDFIs (Table 12). Therefore over 61 percent of the businesses financed by Appalachian CDFIs were larger enterprises. By focusing on financing larger businesses, Appalachian CDFIs reported being able to create or retain over 3,300 jobs in the region in FY 2003. This averages to over 11 jobs assisted per business financed. By comparison, national CDFIs, report assisting 2.8 jobs per business financed. Jobs assisted are not necessarily new jobs created, but rather a combination of jobs created and jobs retained over a given period.

Table 12. Types of Businesses Financed and Job Outputs, FY2003

	Appalachia	National
Total Businesses Financed	292	8,366
Micro Businesses Financed	113	6,477
Share Micro	38.7%	77.4%
Total Jobs Assisted	3,315	23,022
Jobs Assisted per Business Financed	11.35	2.75
CDFIs Reporting	21	168

Appalachian CDFIs were heavily reliant on the government funding for debt or investment capital. As mentioned previously, CDFIs receive debt or investment capital from a variety of sources such as depository and non-depository financial institutions; federal, state, and local governments; and foundations. CDFIs are typically heavily dependent on external sources of lending capital. Table 13 breaks out sources of capital by type of CDFI in FY 2003. Individual deposits comprised the majority of debt capital for both Appalachian and national credit unions.

[41] The CDFI Data Project defines a microbusiness as firm with five or fewer employees or one receiving a loan for $35,000 or less. 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.

Table 13. Sources of CDFI Debt Capital by CDFI Type, FY 2003[42]

	CDCUs			CDLFs			CDVCs		
	App.	National	Ratio	App.	National	Ratio	App.	National	Ratio
Banks Thrifts and Credit Unions $	2.4%	2.4%	1.01	37.0%	46.7%	0.79	12.5%	26.0%	0.48
Corporations $	0.5%	1.1%	0.43	0.3%	1.7%	0.15	0.0%	2.2%	0.00
Government $	1.1%	0.7%	1.53	43.9%	13.8%	3.17	46.8%	23.4%	2.00
Foundations $	0.9%	0.4%	2.38	6.7%	14.7%	0.46	27.7%	43.4%	0.64
Individuals $	82.7%	88.9%	0.93	1.7%	2.9%	0.59	0.0%	0.0%	NA
National Intermediaries $	1.7%	0.6%	2.96	2.7%	2.9%	0.92	6.6%	2.0%	3.37
Non-Depository Financial Institutions $	0.1%	0.1%	1.26	0.0%	6.6%	0.00	6.2%	2.9%	2.17
Other $	8.9%	4.6%	1.93	3.5%	5.5%	0.64	0.2%	0.1%	3.37
Religious Institutions $	1.7%	1.2%	1.35	4.2%	5.2%	0.81	0.0%	0.0%	NA
Total CDFIs Reporting	13	116	NA	19	157	NA	2	19	NA

Appalachian community development loan funds and venture capital funds both received the largest share of debt or investment capital from government sources. 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. 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 of investment capital from the government.

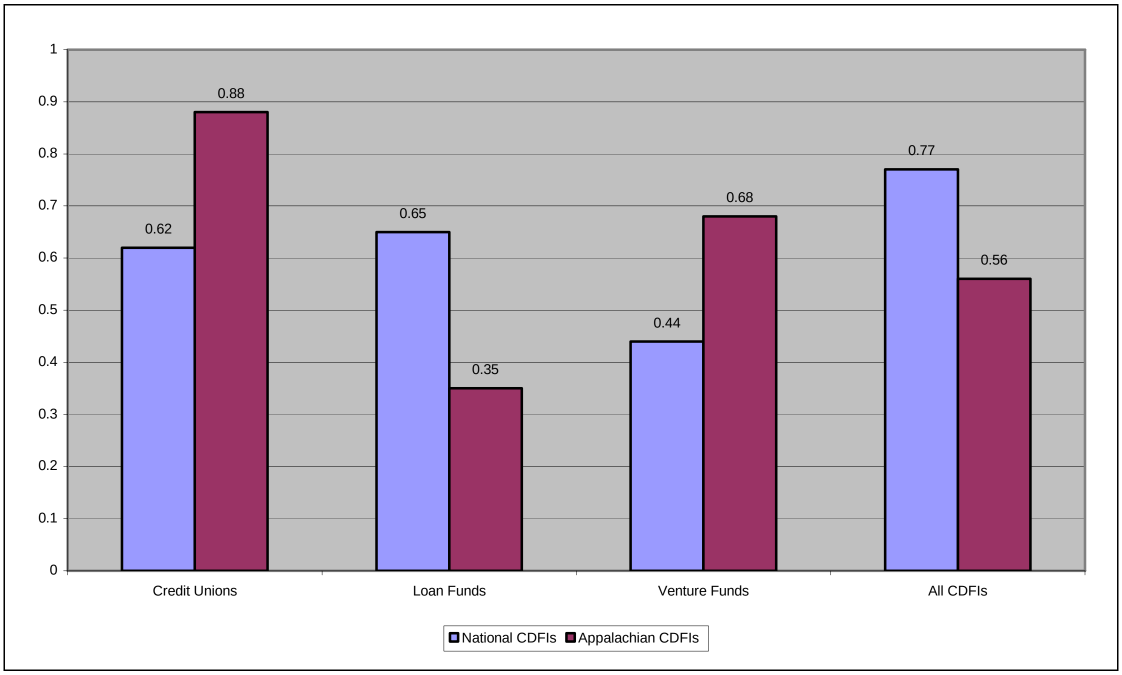
Appalachian loan funds had a smaller share of debt capital from all non-government sources than their national counterparts. Nationally, community development loan funds received a larger share of lending capital from depository financial institutions, foundations, and non-depository financial institutions than Appalachian loan funds. In particular, only 37 percent of debt capital for Appalachian loan funds came from banks and thrifts as opposed to 47 percent for national loan funds. Appalachian development venture capital funds received a larger share of investment capital from national intermediaries and non-depository financial institutions than national funds. National peer development venture capital funds, however, received much more investment capital from depository financial institutions and foundations than Appalachian funds.

[42] One outlier loan fund was removed when calculating sources of debt capital. This loan fund received a disproportionately large amount of capital from non-depository financial institutions.

Appalachian loan funds should diversify their sources of debt capital. As mentioned previously, funding for CDFIs has consistently been threatened in recent federal budgets. Government sources along with regulated financial institutions accounted for 81 percent of Appalachian community loan fund lending capital. These same sources accounted for roughly than 60 percent national community development loan fund lending capital. This heavy dependence on government and financial institution resources may make Appalachian loan funds more vulnerable to changes in government funding cycles or bank investment in community development than their national counterparts. As mentioned previously, however, Appalachian loan funds received limited funding from foundations and no debt capital from non-depository financial institutions, while these are second and fourth largest sources of capital for national community development loan funds.

Appalachian CDCUs and CDVCs have higher levels of self-sufficiency than national peers. Given the scarcity of funding sources and the intense competition for available capital, one of the key concerns of the CDFI industry today is improving self sufficiency. One way to measure self sufficiency is to look at the percent of an institution's expenses that can be covered by earned revenue (i.e. revenue generated through lines of business and not grants or investments). A ratio of earned revenue to total expenses of 1.0 or greater indicates that an institution could support itself on earned revenue alone. Figure 21 compares the self-sufficiency of Appalachian and national CDFIs by type in FY 2003. The average self sufficiency ratio of Appalachian CDFIs was .56 compared to .77 of the national aggregate. However, this aggregate number masks the fact that Appalachian credit unions and venture capital funds had higher self-sufficiency ratios than their national counterparts. 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 of .62 and .44 for credit unions and venture capital funds respectively.

Figure 21. Self Sufficiency Ratios by CDFI Type, FY2003



Appalachian community development loan funds lagged national numbers in the ability to support themselves through earned revenue. Unlike community development credit unions and venture capital funds, Appalachian community development loan funds had a low levels of self sufficiency. Figure 21 shows that regional community development loan funds had a self-sufficiency ratio of .35 indicating that only 35 percent of total expenses could be covered by earned revenue. This number is well below that of national loan funds. This low level of self-sufficiency paired with the heavy reliance that Appalachian loan funds have on government sources for debt capital, should raise some concerns about the long term viability of Appalachian community development loan funds.

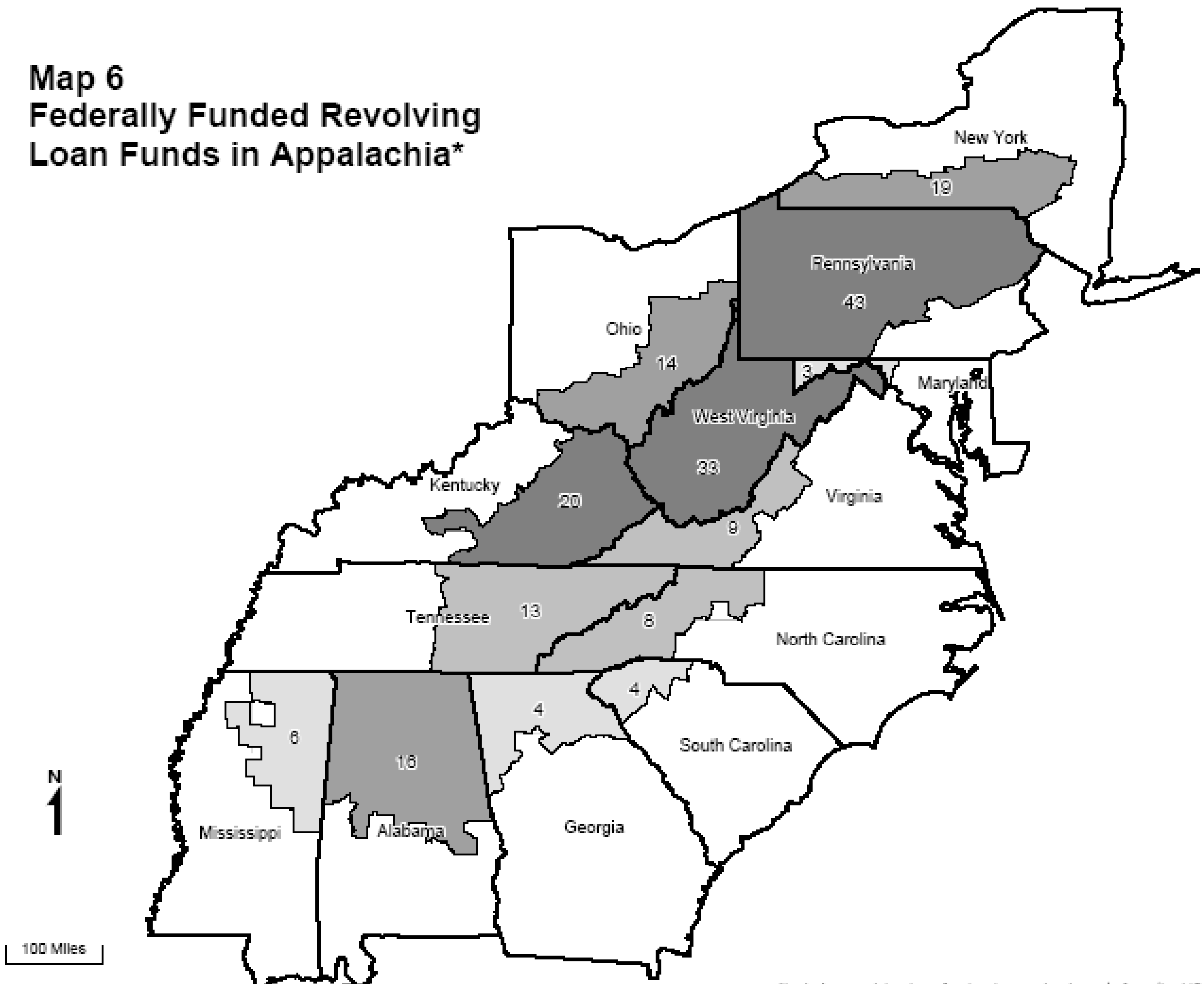
Revolving Loan Funds

Revolving loan funds (RLFs) are pools of capital provided by the public and private sectors for the purpose promoting economic development in distressed and underserved markets. RLFs are among the oldest types of development finance intermediary. Federal government agencies began funding revolving loan pools in the mid-1960s in response to losses in jobs, tax revenue, and private investment in many urban and rural markets.[43] RLFs are typically capitalized by grants from federal, state, and local governments. Loans are made to business owners in distressed markets, usually at interest rates below the market rate. As the loan principal and interest are paid back to the RLF, funds are available to be re-loaned. Borrowers who receive RLF loans are often able to leverage these loans to access additional capital from private market sources. One of the main social impact goals of RLFs is job creation and retention.

The Appalachian region is rich in RLFs. An analysis of loan funds receiving federal grants show that over 190 exist in the region. The three main federal agencies who fund revolving loan funds targeted towards economic development are the US Department of Agriculture (USDA), the Economic Development Administration (EDA) and the Appalachian Regional Commission (ARC). Through its Intermediary Relending Program (IRP), Business Enterprise Grant Program, Economic Development Grant Programs the USDA has provided grants to 146 RLFs in Appalachia. The EDA has provided grants to 59 RLFs in Appalachia through its revolving loan fund program. Since 1977, the Appalachian Regional Commission has provided grants to 38 RLFs in the region. ARC loan funds will be discussed in more detail below. Map 6 illustrates the number of loan funds who received grants from the USDA, EDA, and ARC by state in Appalachia. In addition to federally funded RLFs, there are numerous revolving loan funds capitalized through state and local funds not included in this analysis.

[43] National Council on Urban Economic Development. October 1995. *Revolving Loan Funds: Recycling Capital for Business Development*. Washington D.C.

Map 6
Federally Funded Revolving Loan Funds in Appalachia*



*Includes revolving loan funds who received grants from the USDA, EDA, and ARC.

ARC revolving loan funds have been active lenders in the region since inception. ARC made the first grant in its revolving loan fund program in 1977. Since that date, the 38 ARC capitalized loan funds have made 1,570 loans for over $104 million. Only one loan fund that has received an ARC grant has failed to make a loan. The median loan fund received its first ARC grant in 1993. ARC loan funds have made a median of 25.5 total loans and loaned a median of nearly $1.8 million. As of the first quarter of 2006, the median loan fund had 10 loans outstanding and a median of just over $607,000 in loans outstanding. On average, ARC loan funds had over $845,000 in loans outstanding and over $200,000 in funds available to lend for an average loan pool size of just over $1 million. The pool of ARC grantees had, on average, 19.3 percent of their funds available to lend. In aggregate, ARC loan funds have written off 3.8 percent of dollars loaned. The highest percent of loans written off was 12.6 percent. Eleven of the 38 ARC loan funds had zero write-offs. These write off numbers are comparable to industry averages for rural loan funds. A survey of rural EDA RLFs indicates a 5.5 percent of loans were written off with 28 percent of loan funds surveyed having no write offs. [44]

The average deal flow of ARC revolving loan funds has declined since 2000, but their level of participation in deals has increased. Figure 22 tracks average number of loans by ARC RLFs over a seven year period starting in 2000. It shows that the average number of loans originated by ARC-funded RLFs has declined since 2000 when an average of over four loans were originated per fund. This number declined to a low of 2.6 loans per fund in 2005. In 2006, ARC RLFs made an average of 3.4 loans per fund.[45] This level of annual deal flow somewhat lags industry benchmarks. A 2002 analysis of rural EDA revolving loan funds found average deal flow of 6.1 loans per year.[46] However one important distinction to consider when examining the deal flow of ARC-funded RLFs is that they are gap lenders that provide the portion of debt in a project financing package that a bank will not. It is very rare that an ARC-funded RLF would make a loan without a bank also providing project financing with the bank almost always acting as the primary lender.

---

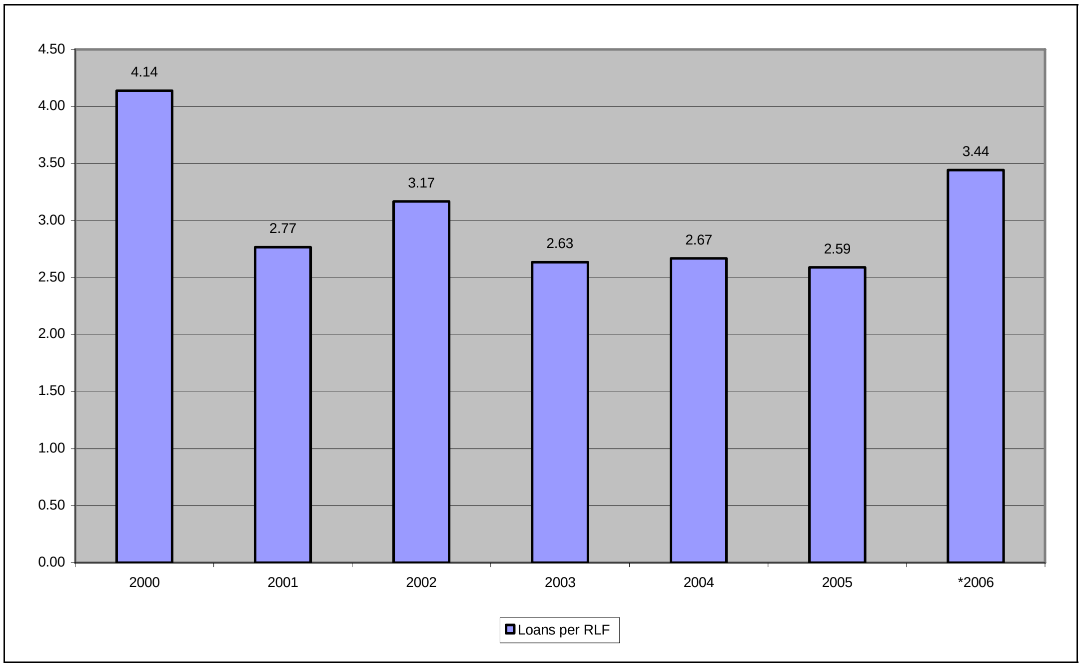
[44] National Association of Economic Development Organizations Research Foundation. March 2003. *Organizations that Manage Loan Funds Create Rural Jobs Efficiently*. Washington D.C

[45] RLF lending data for 2006 is annualized using data through April 2006.

[46] National Association of Economic Development Organizations Research Foundation. March 2003. *Organizations that Manage Loan Funds Create Rural Jobs Efficiently*. Washington D.C.

Because of this distinction, ARC-funded RLF lending almost always tracks trends in bank lending.

Figure 22. Change in Average Annual Lending Activity by ARC-funded RLFs, 2000-2006

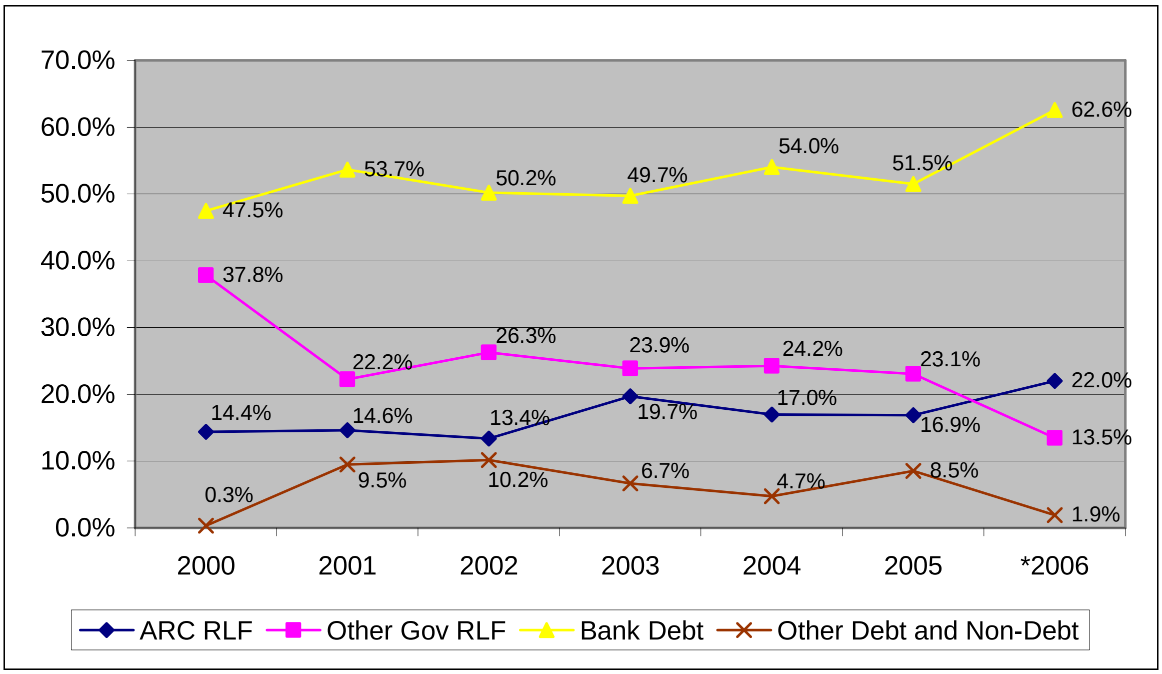


Despite a decline in deal flow for ARC RLFs, these funds have increased their average level of participation in deals particularly relative to other government RLFs. Figure 23 charts the sources of financing for projects were ARC RLFs participated between 2000 and 2006. On average loans by ARC RLFs gained an increasing share of total outside project financing[47] between 2000 and 2006. In 2000, loans from ARC RLFs made up an average of 14.4 percent of outside project financing. These levels have generally tracked upward and peaked in 2006 where on average loans by ARC RLFs accounted for 22 percent of outside project financing.[48] In fact, bank debt and ARC RLF participation were the top two sources of outside project financing in 2006 and have followed the same general upward trend over the 2000 to 2006 time period. This growing level of project participation by ARC RLFs is in contrast to declining levels of participation by RLFs

[47] "Outside project financing" includes all sources of project financing except for borrower equity.
[48] RLF loan data for 2006 based on lending through April 2006.

funded by other government agencies. In 2000 loans by RLFs funded by other government agencies were the second largest source of outside project financing making up nearly 38 percent of total outside project funds. These numbers declined through 2006 when loans by other federally funded RLFs made up 13.5 percent of total outside project financing. This indicates that despite declining deal flow, ARC RLFs have been able to play an increasingly significant role in projects where they choose to be active.

Figure 23. Change in Percent Contribution to Total Outside Project Funding by Financing Type, 2000-2006



The lending of 38 ARC capitalized revolving loan funds have created or retained a substantial number of jobs in the region.[49] A fundamental goal of RLF lending is the creation or retention of local employment. 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. The number of jobs created increased from 920 to 968 and the number of jobs retained increased from 1,365 to 2,761. All but one of the 38 ARC loan

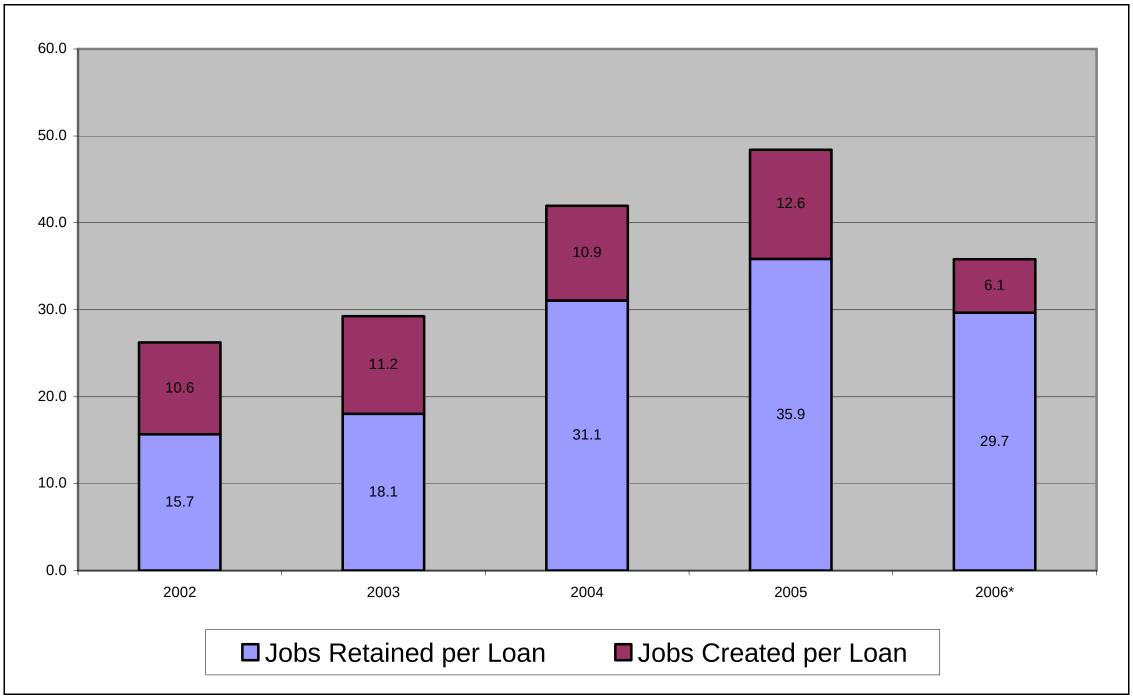
[49] "Jobs created" represent new jobs that did not exist at a firm prior to receiving financing. "Jobs retained" represent jobs that existed prior to financing and remained after financing. There is a debate about the use of "jobs retained" statistics to measure the impact of RLF lending. Some feel that it is difficult to directly tie the retention of existing jobs to RLF financing and that these numbers are used to inflate the impact of RLF lending. Others feel that it is important to measure the number of jobs influenced by RLF loans whether or not the loan was directly responsible for the retention of a specific job.

funds reported influencing at least one job. On average, ARC RLFs influenced an average of 315 jobs during this period. The median number of RLF jobs influenced was 263. The number of RLF jobs influenced ranged from 4 to 1,452.

Figure 24 charts the change in jobs created and retained per loan by ARC RLFs between 2002 and first quarter 2006. In 2002, ARC RLFs influenced 26.1 jobs per loan and loaned $3,254 per job. In 2005, ARC RLFs influenced 48.4 jobs per loan and loaned $1,797 per job influenced. Between 2002 and 2005, the number of jobs retained per loan increased from 15.7 to 35.9 jobs retained per loan. Over this same period, the number of jobs created per loan increased from 10.6 to 12.6. The efficiency of ARC RLFs at influencing local employment is on par with or exceeded other government funded RLF pools. An analysis of rural EDA RLFs conducted by the National Association of Development Organizations (NADO) showed that they on average created or saved 16 jobs per loan with 20 percent of rural RLFs creating or saving more than 30 jobs per loan. The same analysis showed that each job created or retained cost the loan fund $4,502.[50] The increased ability of ARC loan funds to affect job retention and creation may be tied to the growing level of participation ARC RLFs are taking in projects they finance.

[50] National Association of Economic Development Organizations Research Foundation. March 2003. *Organizations that Manage Loan Funds Create Rural Jobs Efficiently*. Washington D.C.

Figure 24. Jobs created and retained per loan, 2002-2006 YTD



On a state by state basis, loan funds in Pennsylvania impacted the most regional jobs, but Kentucky and West Virginia funds created and retained jobs at the highest rate. Table 14 breaks out the state-by-state impact of ARC RLFs. Pennsylvania loan funds impacted 567 jobs per fund between 2002 and 2006 1Q. However, loan funds in Kentucky were the most efficient at impacting jobs by influencing nearly 110 jobs per loan and costing roughly $700 per job over this period. West Virginia funds were also efficient, influencing nearly 50 jobs per loan and costing less than $1,300 per job. On average, ARC loan funds created nearly 315 jobs per fund and influenced 32 jobs per loan at a cost of under $2,700 per job.

Table 14. Jobs Impacted by ARC RLF Lending by State, 2002-2006 1Q

State	ARC RLFs	Jobs Impacted Per RLF 2002-2006 1Q	Jobs Impacted Per RLF Loan 2002-2006 1Q	Dollars Loaned Per Job Impacted 2002-2006 1Q
Alabama	3	67.3	22.4	$2,129
Georgia	1	151.5	25.3	$7,789
Kentucky	3	401.7	109.5	$704
Maryland	1	172.0	21.5	$3,756
Mississippi	4	216.3	18.4	$4,473
North Carolina	1	37.0	12.3	$10,270
New York	5	230.8	25.1	$3,049
Ohio	4	107.8	13.1	$5,102
Pennsylvania	8	567.4	44.5	$1,854
South Carolina	3	506.3	20.8	$5,448
West Virginia	5	336.2	49.4	$1,277
ARC Total	38	314.6	32.1	$2,669

Community Development Venture Capital Funds

A significant and growing subset of the CDFI industry are community development venture capital funds (CDVCs). These institutions specialize in providing equity or equity-like investments to businesses in distressed or underserved communities. Such equity products differ from the more traditional loan products offered by banks and many community development loan funds and are a significant driver of business growth. An expanding business needs significant capital to grow, but may not have a regular cash flow that would allow the firm to repay a substantial monthly debt service. Venture capital firms provide such businesses with a direct infusion of cash in exchange for a share of ownership. Such investments provide firms with the necessary capital to grow as well as the increased participation and expertise of the venture capital firm who are typically specialists in a given industry. CDVCs differ from traditional venture capital firms in their focus on financing businesses in distressed communities.

Access to traditional venture capital has been limited by industry type and firm location. Venture capital firms typically focus on financing a small number of high growth industries often in high technology sectors. More traditional sectors of the economy such as manufacturing are slower growth industries and rarely benefit from venture capital financing. Additionally, venture capital financing is highly geographically concentrated. States with high concentrations of technology firms are regions that have benefited most from venture financing. A report from the Community Development Venture Capital Alliance (CDVCA) shows that between 1991 and 2000, over 65 percent of all venture capital financing went to five states (California, Massachusetts, New York, Texas, and Colorado) with well established technology sectors.[51] In additional to high levels of concentration in a few states, traditional venture capital financing also has a very strong urban focus. A rule of thumb is that venture capital firms rarely invest in companies more than a two hour drive away giving a distinct disadvantage to more geographically dispersed non-metropolitan firms. The same report by CDCVA shows that of all firms receiving investment from traditional venture capital firms in 2001, over 98 percent were in metropolitan counties while less than two percent were in semi-rural counties and none were in rural areas.

In Appalachia, the dearth of available equity capital was identified in a report produced by Mt. Auburn Associates for the Appalachian Regional Commission (ARC). The report identified gaps in capital needs for regional entrepreneurs. While a small subset of firms in the region sought some type of equity or risk capital, these firms had substantial difficulty in obtaining it.[52] Limited access to equity capital can affect the ability of the region to develop, attract, or retain small- or mid-sized firms in high growth industries. The report recommended that ARC invest in socially oriented venture funds.

In response to this recommendation, ARC began an entrepreneurship initiative that focused on promoting the growth of CDVCs in the Appalachian 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

---

[51] Schmidt, Brian. May 2003. "Assessing the Availability of Traditional Venture Capital in the U.S.: A Preliminary Analysis." Community Development Venture Capital Alliance: New York, NY.
[52] Mt. Auburn Associates. February 1998. *Capital and Credit Needs in the Appalachia Region*. Appalachian Regional Commission: Washington, DC.

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 have a total capitalization of $96 million and have invested $13.6 million in 59 regional businesses. These investments have created over 1,000 jobs in the region.[53]

The previous analysis of CDFIs in Appalachia identified some key issues in CDVC sources of capitalization and levels of self-sufficiency. Appalachian CDVCs received twice as much funding from government sources as national CDVCs, while national CDVCs were more heavily capitalized by depository financial institutions and foundations than Appalachian funds (see Appendix Table 9). This indicates there may be opportunity for Appalachian CDVCs to diversify into these sources of investment capital. Additionally, the above analysis showed that Appalachian CDVCs had a higher level of self-sufficiency that their national counterparts. Appalachian CDVCs had a .68 self sufficiency ratio compared to .44 for national CDVCs. This means that Appalachian CDVCs could support 68 percent of their operating expenses through earned revenue. While this is not the optimal level of 1.0 or greater, it shows that Appalachian CDVCs perform at a high level relative to national peers.

SBA Loan Programs

The U.S. Small Business Administration administers a number of programs to help businesses in underserved markets access necessary capital. The SBA's 7(a) program has been discussed previously. This section takes a closer look at two programs that require the presence of an intermediary: the SBA Microloan Program and the 504/CDC Loan Program.

The SBA Microloan program makes funds available to non-profit community-based intermediaries for the purpose of making very small loans (under $35,000) to businesses. These loans are intended to go to very small firms and target business owners who traditionally have difficulty accessing capital such as start-up businesses and minority- and

[53] Source: Internal ARC data on Development Venture Capital Funds in Appalachia.

women-owned firms. The SBA disperses funds to community based, non-profit lending intermediaries. These intermediaries make all credit decisions and have some discretion over loan terms. In recent federal budgets, funding for the SBA Microloan program has been eliminated only to be later returned. The future of the program remains uncertain.[54]

SBA microlending intermediaries are effective at serving distressed counties, but have difficulty reaching minority-owned businesses. Table 15 shows the number of microloans per 10,000 businesses and per 10,000 microbusiness (fewer than 5 employees) in 2003-2004. The analysis shows that in Appalachia distressed counties have high levels of SBA-guaranteed microlending compared to non-distressed counties. Distressed counties received 10.1 microloans per 10,000 microbusinesses compared to 5.6 per microloans per 10,000 microbusinesses in non-distressed counties. Overall, Appalachia had high levels of SBA-guaranteed microlending. The region had 6.1 loans per 10,000 microbusinesses compared to 4.6 per 10,000 microbusinesses nationally. In distressed counties, start-up businesses and those that are majority women owned received loans at levels comparable to the rest of the region and nation. Minority-owned businesses, however, seem to have more limited access to microfinance, particularly in distressed counties. Only 8.3 percent of microloans in distressed counties went to minority-owned businesses compared to 21.3 percent in the region and 50 percent for the nation. Map 7 shows microlending in the region and plots the locations of intermediaries serving Appalachia. The highest levels of microlending appear in parts of central Appalachia, particularly in parts of Virginia, Kentucky, and North Carolina. New York also has high levels of microlending. Businesses in the southern part of Appalachia would appear to have more limited access to SBA-guaranteed microfinance with many parts of the region having zero microloans.

[54] Bernard, Tara Siegel. April 25, 2006. "Microloans are Again a Point of Budget Dispute." *American Banker*.

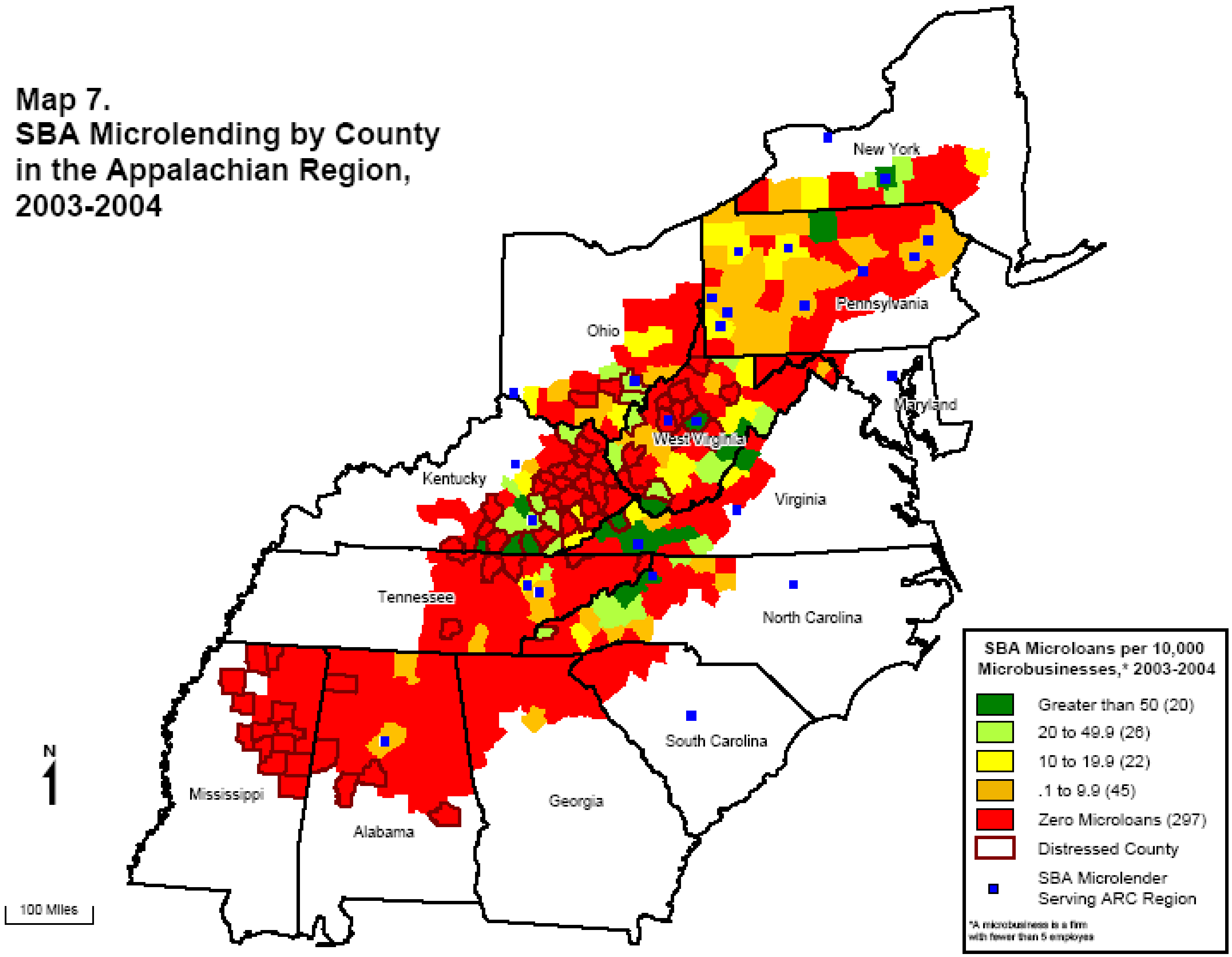
Table 15. SBA Micro Lending Activity in Appalachia, 2003-2004

	Appalachia			
	Distressed Counties	Non-Distressed Counties	All	USA
Loans per 10,000				
Micro Business (1-4 employees)	10.1	6.0	6.1	4.6
All Businesses	6.0	3.5	3.6	2.7
Percent loans made to:				
Start-ups	36.1%	43.8%	43.2%	43.5%
Minority-Owned Business	8.3%	22.4%	21.3%	50.0%
Majority Woman-Owned Business	41.7%	38.8%	39.0%	44.9%

The SBA 504 loan program provides long term financing for large fixed costs such as a land acquisition, construction, infrastructure improvements or large equipment. Loans through the 504 program are structured to require a private lender to be senior lien holder and to finance up to 50 percent of a project. A Certified Development Company (CDC) serves as junior lien holder for up to 40 percent of the project cost. The CDC loan is guaranteed 100 percent by the SBA. The business is required to produce at least 10 percent of project costs. Generally, businesses are required to create or retain at least one job per $50,000 guaranteed by the SBA Use of the 504 loan program varies widely regionally. In many regions of the country the product is not well known. Smaller community banks have constraints on the size of loans they can make. The loan fees are high, and some lenders feel that the SBA paperwork and approval process slows down deals.[55]

[55] Office of the Controller of the Currency. February 2006. "SBA 504 Loan Program: Small Businesses' Window to Wall Street" *Community Development Insights*. Washington D.C.

Map 7.
SBA Microlending by County in the Appalachian Region, 2003-2004



There were few SBA 504 loans to distressed counties and minority and women-owned businesses received no 504 loans in 2003-2004. Table 16 shows that 504-guaranteed lending levels in Appalachia lags national averages except in lending to majority women-owned businesses. Within Appalachia, lending in distressed counties substantially lags that in non-distressed counties. Distressed counties received 1.2 504 loans per 10,000 business compared to 4.1 for the region. Although minority- and majority-women owned businesses in non-distressed Appalachian counties had access to 504-guaranteed lending on par with or well above national averages, similar businesses in distressed counties received no 504 loans. Map 8 illustrates levels of 504 lending in the region. Unlike microlending, southern Appalachia has high levels of 504 lending, particularly in Alabama, Georgia, and South Carolina with the lowest levels of 504 lending seen in Virginia, West Virginia, and Kentucky.

Table 16. SBA 504 Lending Activity in Appalachia, 2003-2004

	Appalachia			
	Distressed Counties	Non-Distressed Counties	All	USA
504 Loans per 10,000 Businesses	1.17	4.27	4.13	8.14
Percent of Loans to:				
Minority-Owned Business	0.0%	21.4%	21.1%	21.9%
Majority Woman-Owned Business	0.0%	35.1%	34.6%	16.9%

Map 8.
SBA 504 Lending by County in the Appalachian Region, 2003-2004