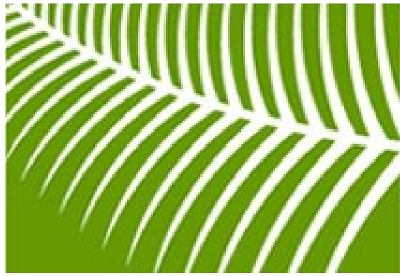

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Community Development Financial Institutions: Insights From Rural EZ/ECs

Lehn M. Benjamin

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Community Development Financial Institutions: Insights From Rural EZ/ECs. By Lehn M. Benjamin, Rural Economy Division, Economic Research Service, U.S. Department of Agriculture. Staff Paper No. AGES-9708.

Abstract

Access to financial capital can be a significant barrier to development in poor communities. To address this problem, 18 of the 33 rural EZ/ECs (Empowerment Zone or Enterprise Community) established a community development financial institution (CDFI) as part of their overall development strategy. Four rural EZ/ECs share their strategies in setting up these institutions and in the process offer insight on the factors necessary to make CDFIs viable institutions and effective community development tools.

Keywords: community development financial institutions, economic development, community development, rural development, empowerment zone, EZ/EC.

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Preface

This report documents an early and preliminary exploration of the use of Community Development Financial Institutions (CDFIs) in six rural communities designated as ECs or EZs. CDFIs are one of the newest tools available to address the capital needs of poor communities. The report was prepared in support of USDA's rural development mission, and as part of ERS's continuing review of the financial and credit needs of rural areas, as well as the adequacy of financial institutions in meeting those needs. It is "early" because it is too soon to evaluate the effectiveness of CDFIs, and "preliminary" because project resources were too limited to make even a complete description of the evolving use of CDFIs. However, more than 200 rural communities applied to USDA for designation as a rural EC/EZ in the first round of that program in 1994. Many of those communities have continued to implement the strategic plans they adopted as part of the application process, and have become part of a network which shares information. Some of them, as well as other communities, will apply to become one of the five new EZs recently authorized. This report is intended to assist in the development of local development strategies and strategic plans, as well providing background for future, more comprehensive studies of CDFIs as well as the rural EC/EZ program itself.

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Summary

Traditional financial institutions often do not do a good job of meeting the financial needs of low-income communities. Community development financial institutions (CDFIs), which include community development banks, community development credit unions, community development revolving loan funds, micro-loan funds, and community development venture capital funds, have emerged in low-income communities as an alternate way of addressing the capital needs of these areas.

CDFIs are operated by community-based organizations or non-profits, or as stand-alone entities. Some forms of CDFIs provide traditional financial services such as savings and demand accounts, while all build on local economic capacity by supporting small business development. Alternative financial institutions have been successful in poor communities outside of the United States, but the different market context in the United States as well as the diverse forms of CDFIs that have emerged in various communities throughout the country raise certain questions. Can CDFIs achieve sustainability in the United States? Are they the most effective mechanism for meeting the financial needs in distressed communities? What CDFI models or methodologies are most effective in revitalizing low-income neighborhoods?

While this study cannot fully answer these questions, it offers some insight into how CDFIs are being designed to meet the needs of low-income rural communities. It reviews the literature on CDFIs and then, based on interviews in selected rural Empowerment Zones and Enterprise Communities (EZ/ECs), examines the experience of EZ/ECs in establishing CDFIs to meet development finance needs. The EZ/EC program currently provides comprehensive Federal assistance to 33 low-income rural areas.

CDFIs appear to be well suited for rural EZ/ECs, as their small scale, less diverse economies, and remoteness make these areas vulnerable to credit access problems. Although it is too early to judge the success of the rural EZ/EC-sponsored CDFIs, they have taken some specific approaches aimed at making themselves successful and sustainable.

A critical element in the sustainability of CDFIs is to make sure that the interest rate charged for the loan exceeds the cost of obtaining that capital for the CDFI, enabling the CDFI to cover expected losses and administrative costs. Among several approaches used by CDFIs, linked-deposits are used by one EZ/EC to help cover its cost and ensure its sustainability. In addition to providing capital, the CDFIs created by the rural EZ/ECs provide training and technical assistance to improve the business's likelihood of survival, building the capacity of borrowers and hence increasing the probability of loan repayment. In addition, CDFIs draw on the social capital, or the relationship resources, within the community to improve their sustainability. The CDFIs in EZ/ECs do not stand alone, but work along with other development entities to enhance entrepreneurs' success. These approaches appear well conceived, given the inherent difficulties faced by businesses operating within these communities.

Community Development Financial Institutions:

Insights From Rural EZ/ECs

Lehn M. Benjamin

Introduction

Community development financial institutions (CDFIs) have emerged in low-income areas around the country and are playing an increasingly important development role in these communities.[1] These institutions include: community development banks, community development credit unions, revolving loan funds, microenterprise loan funds, and community development venture capital funds.[2] While differing in the types of services they provide, the ease of startup, and regulatory requirements, these institutions all provide financing critical for small business development.[3]

This report reviews some of the literature on CDFIs, focusing on their potential usefulness in low-income and rural areas. Insights are sought from how CDFIs are being implemented in the rural Empowerment Zones and Enterprise Communities (EZ/ECs). Between July 6, 1996, and August 1, 1996, interviews were conducted in six rural EZ/ECs. These six communities were chosen for case study sites based on the significant amount of progress (over 80 percent) that they had made on at least one economic development benchmark set in their initial comprehensive plan for community revitalization. It is hoped that other EZ/ECs may glean lessons or insights from these case studies of successful communities. Four of the six had initiated some type of community development financial institution and are discussed in this report.

EZ/ECs are high-poverty areas (over 20 percent poverty in each census tract, 25 percent in 90 percent of census tracts, and 35 percent in at least one census tract) which receive special Federal grants and tax incentives to help them achieve economic and community revitalization as part of the Empowerment Zone and Enterprise Community Program. Following legislation in 1993, high-poverty areas were invited to apply for the program. Applications required each community to conduct strategic planning that drew on input from the low-income population as well as other parts of the community. The plan included goals, strategies, and benchmarks for measuring progress. In December 1994, 105 places were designated as

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[1] In 1994 Congress passed the Community Development Banking and Financial Institution Act. This Act created a Community Development Financial Institution (CDFI) Fund to provide grants, loans, technical assistance, and equity investment on a competitive basis to existing financial intermediaries whose primary mission is community development. To date, the CDFI fund has awarded $35.5 million in grants and loans to 32 organizations. Some of these were awarded to CDFIs in EZ/ECs. It is important to note that the term CDFI applies to all community development financial institutions and not only those awarded grants from the CDFI Fund.

[2] In addition to the five types described, other community development financing sources include: Electric Cooperative Investments; intermediaries such as the Local Initiatives Support Corporation (LISC), the Enterprise Foundation, and Neighborhood Reinvestment Corporation (also a Government Sponsored Enterprise); certain federal initiatives like the National Cooperative Bank and SBA-supported Small Business Investment Companies; and mainstream financial intermediaries such as banks, S&Ls, thrifts, pension, insurance, and mutual funds.

[3] Here, I focus on the economic development role of CDFIs. While all development finance contributes toward economic development, I do not discuss the housing and infrastructure financing that these institutions undertake.

EZ/ECs, including 33 rural EZ/ECs. Three of the rural EZ/ECs were designated as Empowerment Zones (EZs), which receive substantial grants ($40 million) and tax incentives. The remaining 30 rural EZ/ECs were designated as Enterprise Communities (ECs), each of which receives about $3 million in grants. Both EZs and ECs are encouraged to apply for additional Federal assistance from standard development programs, including some funding earmarked specifically for EZ/ECs.

More than half (18 of 33) of the rural EZ/ECs are establishing some type of community development financial institution as part of their overall development strategy. For these rural EZ/ECs, establishing a CDFI accomplishes two primary goals: (1) providing much-needed capital to local entrepreneurs for economic development and (2) enabling EC funds to be sustainable and to continue to circulate within the community. As one EC member in South Dakota stated, "We don't want to eat our seed corn." Understanding what factors will sustain these programs as well as how they facilitate economic development will be critical for the overall success of these EZ/ECs. However, before examining some of these factors, this report briefly outlines some of the trends feeding into these emerging financial institutions and then discusses the work of four EZ/ECs and the CDFI models they are using.

Traditional financial institutions are not meeting the financial needs in low-income communities. In an extensive community survey, Flora et al. conclude that access to capital is the major obstacle facing local development projects. They argue, "new community-oriented institutions such as rotating credit funds and locally controlled development banks should be encouraged" (1992, p. 286). Community development financial institutions fill a market niche not easily served by traditional lenders. This market niche reflects both credit market realities and broader investment trends. For traditional financial institutions, lending relatively small amounts of money to customers who lack collateral and credit history is risky and not profitable. Shaffer (1989, pp. 166-177) explains that regulation, information costs, and liability mean that banks tend to favor real estate, consumer products, and low-risk business loans. Consequently, the new small businesses so critical to community economic development become unacceptable at the neighborhood bank.

Banks play an important role in economic development. As intermediaries, they reallocate excess capital of savers to development needs in the community. How and where this financial capital is reallocated and invested has important implications for the development trajectory of a locality--town, region, or nation. Schaffer cited Baumol as follows:

> The allocation of a community's capital resources is among the most important decisions which must be made by any economy. For unless the flow of capital is responsive to the goals of the members of the public, the community will only be able to exercise a very short run temporary control over the composition and output of its activities (Shaffer, p. 158).

Investment trends in the U.S. banking industry show increasingly uneven reallocation patterns.[4] When financial institutions concentrate their investments on economically vibrant regions and markets, these areas receive more capital than they can efficiently use, while declining regions and markets receive less than they can use (Parzen and Kieschnick, p. 10). While legislation like the Community Reinvestment Act (CRA) requires banks to invest some of their funds locally, counteracting some of the geographical disparity in lending, more recent deregulation of financial institutions no longer ties banks to a particular locality as they are increasingly free to target investments which yield higher returns and less risk (Christopherson). This has at least two potential consequences. First, there may be an overall

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[4] Flora explained these spatialized patterns of development as the new pattern of social structures of accumulation--where formal and informal rules governing allocation of resources result in certain forms of development (1995).

disinvestment in poorer communities, both rural and urban.[5] Second, traditional banks may be less willing to lend to micro and small businesses, which are high risk and too small to be profitable, at least with present financial services and products.[6]

Rural areas may face particular obstacles in this regard. Wortman (1996) explains that financing the needs of the rural entrepreneur is far more difficult than doing so for the urban entrepreneur because financial institutions in rural areas are generally considered conservative and not willing to take much risk to support rural entrepreneurs. The net effect is an uneven pattern of development where the location of employment, products, and services is increasingly concentrated in certain areas (Christopherson). In the end, low-income rural communities increasingly rely on alternative financial structures to meet their community-development needs.

CDFIs build local capacity and support small business development. CDFIs are one part of a broader economic development strategy to build on local resources and encourage small business development--a bottom-up approach to community revitalization. In the EC/EZs described below, CDFIs are used to encourage microenterprise development, small business development, crop diversification, and existing minority contractors--all efforts to build local economic capacity and small businesses. Mobile capital and increasing economic uncertainty have made local entrepreneurial development an attractive option for distressed communities. CDFI's are part of a growing trend in the U.S. toward entrepreneurship and self-employment. According to Wortman (1996, p. 47), rural entrepreneurship is one of the primary ways to achieve economic development in rural areas. He further argues that rural economic development in the 1990's across the globe may depend on understanding and encouraging rural entrepreneurship. However, encouraging entrepreneurs and small business development is not the panacea for local economic development problems. Long hours, rapid turnover, and lack of benefits are just a few reasons why these ventures do not necessarily provide economic stability.

Alternative financial institutions in other countries are successful. While not directly translatable to the United States, the success of banks which serve microenterprise entrepreneurs such as the Grameen Bank in Bangladesh, BankSol in Brazil, and the ADEMI in the Dominican Republic offers insight for alternative financial institutions in the United States. These banks have proven that providing access to credit and supporting microenterprise development for low-income people can be viable, sustainable, and an important part of a larger development strategy. The banks are also credited with avoiding huge loan defaults encountered by other development banks, effectively linking credit with savings, significantly increasing family incomes, and organizing low-income people (Rhyne and Otero).

Establishing alternative financial institutions in the United States is only one response to capital access needs of low-income communities. Encouraging traditional financial institutions, through Community Reinvestment Act regulations, to meet local capital needs and convincing government organizations to create new financial institutions and programs such as revenue bonds, tax-increment financing, loan-guarantee programs, or direct loan funds are also important options (Parzen and Kieschnick). But Parzen and Kieschnick explain that communities in areas experiencing dramatic disinvestment, or in rural areas served by few financial institutions, often choose to create their own financial institutions. The rural EZ/ECs described below are taking this step.

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[5] *U.S. News and World Report*, April 17, 1995, reported that from 1970 to 1993, the number of bank branches in a sample of white suburban neighborhoods grew three times faster than branches in minority inner-city areas.

[6] Some would argue that banks serve small business indirectly through credit cards and home equity loans. However, these sources of credit are not necessarily ideal for low-income areas where small entrepreneurs may not have credit cards or where business prospects require a more patient source of financing.

Examples from Rural EZ/ECs

The CDFIs in the EZ/ECs are not homogeneous but rather reflect the diversity of the communities in which they operate and represent only a snapshot of the work being carried out by these EZ/ECs. However, the work of the four EZ/ECs described below reflects the capital needs in low-income communities and begins to shed some light on one strategy to address this need: establishing a community development financial institution. One EZ/EC established a microenterprise loan fund, one, a community development venture capital fund, and two, some type of community development revolving loan fund. Appendix I briefly describes community development banks and community development credit unions as the other main CDFI models.

Microenterprise Loan Funds. An example of a microenterprise loan program is from the Virginia Eastern Shore Economic Empowerment and Housing Corporation (VESEEHC's), the lead entity for the Accomack/Northhampton EC (see box). This microenterprise program, modeled after the successful Grameen Bank in Bangladesh, is part of a growing movement of microenterprise programs in the United States. Over 500 programs operate across the country today, up from a handful in the mid-1980s.[7] Despite this mushrooming, the U.S. microenterprise field is quite new in relation to institutions, like the Grameen Bank, which have developed sophisticated methods and products to meet the needs of their low-income clients. At this early stage, U.S. programs are experimenting with sustainable methods and products and thus the field reflects the diversity of communities and contexts in which they have developed.

The Association for Enterprise Opportunity (AEO) outlines three program models that have emerged in the United States to date: credit-led individual loans, training-led programs, and peer-lending programs. The credit-led programs focus primarily on the issue of access to capital and provide loans to clients on a one-to-one basis. The training-led programs provide substantive training and technical assistance to clients before providing a loan or referring them to a traditional lender. Peer-lending programs were originally developed overseas as a way of managing the risk of lending to low-income borrowers. With this model, loans are made to a peer group which in turn lends to the individuals in its group. The peer group sets its own repayment terms and provides support and assistance to members. If one member in the circle defaults, then no other member may be funded until the loan is repaid. Wells and Jackson explain, "It is an extensive incentive to repay" (p. 129).

In addition to the various program types, microenterprise loan funds vary in the size of the loans they provide, interest rate, repayment period, and primary target group. Loan size can be as little as $50 and as large as $25,000.[8] In an Aspen Institute survey of 194 microenterprise organizations, the average loan size for group lending was $1,983, and $8,692 for individuals (Clark et al.). Repayment periods can range from 3 months to 5 years, depending on the program and purpose of the loan. Programs target a range of clients including women, AFDC recipients, immigrants, minorities, and the working poor. Rhyne argues that this diversity is needed as practitioners continue to strive to understand what works, what is sustainable, what lessons can be extracted from overseas, and what methods/models suit the U.S. context (Rhyne, 1993).

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[7] The Association for Enterprise Opportunity is a member-based U.S. trade association of microenterprise development organizations. Their membership includes over 500 programs.

[8] Small Business Administration loans can go as high as $25,000.

Virginia: Accomack/Northhampton EC

"For the first time, low-income folks have an opportunity to create their dreams for self-sufficiency" (Anonymous interview 6a).

Virginia Eastern Shore Economic Empowerment and Housing Corporation (VESEEHC), the lead entity for this enterprise community in Accomack/Northampton, established a microenterprise loan fund to foster small business development and build the capacity of local entrepreneurs. To capitalize the microenterprise loan fund, VESEEHC leveraged and pooled Community Development Block Grant funds and Rural Business Enterprise Grants and EC funds. In addition, VESEEHC built a partnership with a local bank, which agreed to provide service support for these entrepreneurs. Eventually, VESEEHC hopes to partner with the bank in the lending process.

VESEEHC uses a combination of the training-led and peer-lending programs. If small entrepreneurs borrow as individuals they have access to $10,000; peer-lending groups can borrow up to $15,000 from the EC to back the enterprise of individual group members. All prospective entrepreneurs go through a seven-part training session, which includes assessing personal assets, business planning and management, cost-benefit analysis, and cash-flow projections. At the end of the training, residents present their proposal to a loan review board made up of community residents, a banker, and organizational representatives. The loan review board examines the risk and viability of the project. A VESEEHC representative explained that by the time borrowers complete the training and business plan, they have carefully considered the feasibility of their ideas. Throughout the process, VESEEHC provides ongoing support. As of July 1996, nine microenterprise borrowing groups had formed and six loans had been made. As one member of VESEEHC explained, "This money will continue to circulate and support entrepreneurial development in this EC for a long time" (Anonymous interview 6a).

Inherent within the emerging models is a tension between lending and training. Bates states that the different models in part reflect a dual clientele:

> "The larger (clientele) is more advantaged and is ready to borrow. The smaller client pool is less advantaged and not ready to borrow. Choosing to serve one of those markets often means choosing between training and lending" (p. 28).

The client profiles of various programs reflect this duality. Some programs serve primarily middle-income microentrepreneurs (55 percent of Working Capital clients have an income over $20,000), while others work primarily with the poor, such as Women's Self Employment Project (30 percent AFDC, 60 percent low-income) (Clark et al.). Yet the Association for Enterprise Opportunity argues that financial assistance alone will not work in the United States, as microentrepreneurs face complex economic and regulatory structures not present overseas. Similarly the Small Business Administration states, "Technical assistance is the factor that makes the difference between successful and unsuccessful borrowers." Thus, the tension between lending and training reflects the broader question--is microlending a poverty-alleviation strategy or is it filling a market gap for small business owners who are not easily served by traditional financial institutions? Is the purpose of microlending programs to build the capacity of borrowers or to provide financial assistance? Right now, U.S. programs do both. However, Rhyne argues that an overemphasis of funders on program sustainability will prematurely lead to serving only the high end of the microborrower spectrum. She explains that, as happened overseas, it will take time to develop methods and techniques for serving the very poor while maintaining program self-sufficiency (1993).

***Community Development Revolving Loan Funds*.** Community development loan funds (CDLFs) like the ones established by the BASEC and Portsmouth ECs (see boxes) are the most diverse CDFI model and have emerged in different ways as a simple mechanism to recycle capital for continual support of community development initiatives.

Case One

South Dakota: Beadle/Spink (BASEC) EC

"It is hard to explain but it is like it's a phenomenon--people have dreams and passion, we really don't have to do much, people are the ones with the ideas" (Anonymous interview 4b).

The Beadle and Spink Enterprise Community (BASEC) established a community development revolving loan fund described by people at BASEC as a "working partnership" between the bank, the borrower, educators, and the EC. The bank and the EC jointly finance the loan, with the bank financing two-thirds of the loan and the EC financing a third. Using the funds allotted to the EC, the EC purchases a CD from the bank at a certain interest rate (e.g., 5 percent). The bank then relends this money at a slightly higher interest rate (e.g., 7 percent) and combines it with two-thirds financing from the bank at market rates (11 percent). The result? The borrower's loan is financed at a blended interest rate (e.g., 9 percent), slightly below market rate, while the bank and the EC share the risk. This linked-deposit strategy, where depositors like the EC accept less than the highest returns for their investment in exchange for assurance that the funds go toward community development, is one tool used by other CDFIs.*

In addition, BASEC requires that potential borrowers participate in business management and planning courses offered through local educational institutions. Here they assess the viability of the project and examine accounting and marketing, time commitment, cash requirements, etc. Borrowers who so choose proceed with a loan specialist on cash-flow projections and the loan application. The EC board then reviews the applications using a blind review process. As of July 1996, the pledge program had assisted 20 businesses with startup or expansion financing and provided technical assistance to 21 entrepreneurs. Some of the borrowers had already payed back their loans, making the capital available for others. BASEC sees the CD Pledge program as a way to ensure self-sufficiency of the fund, using the interest earned on the CD to cover the operating costs of the fund while providing a continual source of development financing.

* Shorebank in Chicago, the first community development bank in the United States, originated the concept of development deposits, a linked-deposit program where social investors buy CDs at a certain return rate knowing that their money is going toward development in the South Shore area.

Grossman et al. (p.1) state that revolving loan funds "are one of the most enduring policy innovations in the economic development field." Over 200 revolving loan programs are run through the government alone, and Lenzi notes that most revolving loan funds have been established under the direct auspices of a city or county or its designated economic development agency.[9] Similar to microenterprise programs, CDLFs are generally nonprofit, unregulated, and dependent on below-market-rate loans and grants from individuals and institutions. CDLFs then re-lend these funds to nonprofit housing and business developers (Vidal). One study reports that loan recipients were predominantly small businesses with fewer than 10 employees, with an average loan size between $33,500 and $247,606 depending on the type of borrower and the purpose of the financing (Grossman et al.).

[9] The government agencies include the Economic Development Administration, the Department of Housing and Urban Development, the Department of Agriculture, as well as numerous State and local government agencies (Parzen and Kieschnick).

Case Two

Ohio: Portsmouth EC

"This program is significant--it keeps people's jobs, keeps people in business--then these folks can turn around and hire other people" (Anonymous interview 5b).

The minority contracting program, a community development revolving loan fund established by the Portsmouth EC, is proving to be vital in the survival of small construction contractors in the community. The contracting program, in partnership with the Ohio Valley Minority Business Association, provides short-term loans to minority construction contractors. These contractors often face the predicament of having to buy construction material when beginning a project but not receiving payment until completion of the project. Coming up with large sums of capital to buy materials has put several small entrepreneurs out of business in the past. In its first 4 months, the Portsmouth EC helped four local contractors stay in business. Two have already repaid their loans, enabling the money to be recycled.

The vision and success of the minority contracting program came from one of the EC partners, the Minority Business Association. With almost a 20-year history of working in the community, MBA saw the need for timely financing, with minimum paperwork, as the key to sustainability for these entrepreneurs. The 60-day loans can be for up to $10,000, and the interest rate is two-thirds the market rate. To secure the loan, the contractor must show the legal construction work contract and be willing to have the payment check authorized to both themselves and MBA. Once this is in place, MBA requests a loan from the EC and then re-lends this to the contractor. The contractor later repays the MBA, which in turn repays the EC. The advantage of the intermediary role of the MBA is that "the MBA knows the community and the contractors--what their needs are and the risk involved" (Anonymous interview 5a). In addition, the MBA provides technical assistance to contractors if needed, as well as to the larger community (e.g., business planning, management, startup loan packages, computer software training for small businesses). Eventually, the MBA would like to see these contractors build relationships with traditional financial institutions.

The National Association of Community Development Loan Funds (NACDLF) is the national member organization of these funds, representing 42 private, not-for-profit revolving loan funds that lend capital and provide training and technical assistance in support of community development. NACDLF reports $120 million loaned through its membership with an average leverage of 10 to 1, helping to put $1.5 billion from conventional lenders and public agencies to work in distressed and disenfranchised communities. In addition to providing financing for members, NACDLF offers technical assistance, performance assessment, and equity grants to help members increase their net worth and thus sustainability.

There have been various attempts to understand the sustainability of CDLFs, one of the oldest forms of CDFIs receiving government resources, and their effectiveness as community development tools. A literature review conducted by the Corporation for Enterprise Development (CfED) states, "The collection of articles, studies, and reports does not yet provide a comprehensive picture of the breadth or effectiveness of federally capitalized revolving loan funds (RLF)" (Grossman et al., p. 1). However, CfED does conclude that the survival of revolving loan funds depends on loan loss reserves and the management of the loan fund (Grossman et al.).

Another study by Mikesell and Wallace examined government-sponsored revolving loan programs. These revolving loan fund programs lend at well below market rates, which, Mikesell and Wallace argue, has negative consequences including unsustainability of the fund, erosion of the loan fund's capital base, and distortion of resource allocation as firms with access to less costly credit borrow more than they would at market rates. In response, they argue for market rate lending to enhance the viability of revolving loan funds.

Community Development Venture Capital Funds. Traditional venture capital funds are unlicensed, unregulated capital pools that offer patient equity investment to emerging businesses. Most are organized for profit and make equity investments of at least $500,000 for 3 to 10 years, with these investments ending through public stock offerings, acquisitions, or liquidation. In return, venture capitalists normally enjoy a high return through an eventual share of the profits and are involved in the management decisions of the company, usually through a seat on the board of directors or a controlling share of the preferred stock (Henderson).

In relation to other CDFI models, venture capital plays a very important role in local economic development as one of the only forms of equity finance. Parzen and Kieschnick state, "In the United States, small businesses are overburdened with debt financing. Increasing the availability of small-scale venture capital will make the greatest contribution to the growth of any economic development strategy" (p. 106).

KENTUCKY: KENTUCKY HIGHLANDS EZ

"The venture capital fund enables farmers to risk trying other alternative crops besides tobacco" (Anonymous interview 3b).

In a largely tobacco-dependent growing area (Clinton, Jackson, and Wayne Counties), the Kentucky Highlands Investment Corporation (KHIC) is taking a number of steps to support farmers while promoting agricultural diversification. With a successful 25-year history in venture capital, KHIC has initiated an alternative crop venture fund that provides small equity investments to farmers for crop diversification. Interested farmers submit an application for committee review. A 20-member Agriculture Diversification Committee, which includes local farmers, extension agents, and KHIC members, reviews the application and proposed growing methods, checking viability of the crop and the past success of the farmer. Once approved, farmers can draw on the expertise of the extension agents regarding pest and disease control, fertilizer, and crop varieties. One person described the alternative crop venture fund, while still very much in the experimental stage, as a small change that can help pave the way for larger ones: "When you have been growing a crop for a long time you become entrenched in it. It is costly to change" (Anonymous interview 3b). Eight deals have already closed, with several farmers beginning to diversify with cabbage, ginseng, and Asian pears. In the long term, folks at Kentucky Highlands hope to link their agricultural production with value-added processing.

The rise of venture capital has coincided with a period of rapid growth in new and small businesses, especially knowledge-intensive industries. Yet, recent trends indicate a shift in conventional venture capital pools toward larger deals, business expansions versus startups, and later stage development of companies.[10] The New York Times (1989) reported an analyst saying, "Venture capitalists have more money than ever but start-ups find it harder to find backing." Not only are small startup companies finding it difficult to attract venture capital pools but certain geographical areas also see a dearth of this equity. Lenzi notes that rural areas face a particular disadvantage when it comes to accessing venture capital: "Venture capitalists do not have a cost-effective network through which to identify potential rural investments as they do in urban centers" (p. 20).

However, Kentucky Highlands represents a growing association of venture capital funds that seek to marry the notion of investment partnerships and community development (see box). The Community Development Venture Capital Alliance (CDVCA) is a 34-member association that seeks to address the

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[10] In this way the venture capital arena reflects the tension in the microenterprise field--higher returns and sustainability issues steer funds toward the upper end of the spectrum.

dearth of patient capital devoted to equity investments in early-stage companies serving low-income areas. The CDVCA states a commitment to balance community and environmental concerns into professionally managed venture capital portfolios.

Insights

Improving access to capital is clearly important for developing distressed, low-income communities like the rural EZ/ECs. Understanding the role CDFIs can play in the overall development of these areas requires attention to at least three broad questions:

1. What factors enable alternative financial institutions, like the CDFIs described above, to be sustainable while meeting the needs and goals of low-income communities?

2. What factors enable micro and small businesses to foster local economic development?

3. What factors contribute to viable rural areas, and how do CDFIs and micro and small business development fit in?

The answers to these questions are complex, and a plethora of literature exists on each. This paper highlights a few critical factors based on the early experience of rural EZ/ECs.

What factors enable alternative financial institutions, like the CDFIs described above, to be sustainable while meeting the needs and goals of low-income communities? Sustainability of CDFIs requires generating enough revenue from investments and loans to cover the initial loan principal, loan losses, operating costs, and a return for investors. The costs depend on the CDFI model used, the losses on how well risk is managed (liquidity, credit, and interest rate risks), and the return on what kind of investors the CDFI is able to attract--for example, social investors accept less than the highest return knowing that their investments will generate both social and financial returns. While it is beyond the scope of this paper to detail how these factors interact to increase or decrease the likelihood of a CDFI's sustainability, a brief examination of the interest rate these institutions charge for use of their funds is given below.[11]

While some CDFIs charge market rates for the use of their funds, historically, many CDFIs charged below-market rates for their services, which included an integrated package of credit and training for small- and microenterprise development.[12] As previously mentioned, with extremely low interest rates, a CDFI cannot generate enough money to cover its operating expenses as inflation erodes its capital base. Thus, low-interest-rate programs require periodic injections of additional capital to sustain their activity levels. In addition, Mikesell and Wallace found that revolving loan funds in general tend to require periodic refunding because they often experience high loan losses due to the high-risk nature of their loans.

Development banks overseas have found that easy access to financial capital with simple applications and fast turnaround is more important to micro and small businesses than low rates of interest (Houser; Mikesell and Wallace). Alternative financial institutions in other countries charge interest rates that reflect

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[11] For an excellent description, see Parzen and Kieschnick.

[12] Low-interest loans can be critical for financing a mortgage for a low-income family or individual, as a large chunk of the payment over the 20-30-year period is interest. However, for small businesses, a low-interest-rate loan may not be necessary as the loan payments are primarily paying the principal--assuming shorter term maturities than a mortgage.

the market rate of the risk and costs of the loan, enabling the financial institution to turn enough profit to sustain itself and thus become more attuned to its clients' needs rather than funders' requirements (Adams and Von Pischke). Rhyne and Otero explain that this approach, which they call a financial systems approach, changes the focus from "programs to assist the poor" to financial systems that provide sustainable and widespread services to an unserved market.

However, the CDFIs in the United States cannot be directly compared to the models overseas, as the economy in which they operate is larger and more complex. In addition, CDFIs in the United States have a more recent history and are in a different stage of development than their overseas counterparts. Rhyne explains that the diversity of the U.S. models reflects an experimental stage where CDFIs are figuring out what models and methodologies work best as they seek to balance the tension between serving low-income customers and communities achieving self-sufficiency. For now, the rural EZ/ECs appear to have designed their CDFIs, specifically with respect to interest rates charged, to be at least partially sustainable. For example, BASEC, the EC in South Dakota, charges two points above the CD interest rate on the loans they make. This enables them to cover at least part of the operating expenses of their revolving loan fund, assuming their loan losses remain low.

What factors enable micro and small businesses to foster local economic development? Many CDFIs, including those in the EZ/ECs, are set up to encourage new micro and small business development as well as to increase the sustainability of existing businesses. Whether a restaurant producing primarily for local consumption or a small processing plant exporting its product, survival depends, in part, on being able to assess the opportunities and constraints presented by available resources and markets. Yet it also requires attention to broader development trends (e.g., migration and commuting patterns, the reorganization of production, industrial mix, etc.). Hoy (1996) identifies four key consistent variables that determine the success of entrepreneurs in rural development: availability of capital, services, and supplies; market opportunities for products and services; incubator organizations and the presence of related businesses and industries; and previous business experience.

The EZ/ECs described above take steps, like providing technical assistance, to help ensure the success of businesses that receive capital assistance. The technical assistance provided by the EZ/ECs range in intensity depending on the borrower. For seasoned farmers in Kentucky, extension agents provide specialized technical assistance (marketability of a crop, pest control, fertilizer) to farmers branching into alternative crops. For new micro-entrepreneurs in Virginia, a seven-part training course that translates ideas into feasible business plans is required before a loan application may even be submitted for possible approval.

Parzen and Kieschnick (1992) argue that technical assistance (e.g., business planning, market analysis, leadership training) enhances the creditworthiness of borrowers, as it increases their chances for success as entrepreneurs. Providing training and technical assistance is costly, and some question its effectiveness when hostile economic environments erode the return on training and technical assistance (Adams and Von Pischke). However, *not* providing some form of technical assistance may reduce overall program effectiveness by decreasing the likelihood of small business survival, which in turn increases the risk of making the loan. Considering the CDFIs' sustainability, technical assistance may best be provided under different auspices than the CDFI, such as through not-for-profit organizations, extension services, small business development centers, or community development organizations (Parzen and Kieschnick). In this regard, the partnerships established in each of the EZ/ECs are conducive to such an arrangement. Flora reminds us that human capital investment, like technical training (skills, leadership, education, knowledge, etc.), makes financial and manufactured capital more valuable (1995).

Part of this technical assistance involves examining the market viability of the business. As mentioned above, this requires attention to local resources and global trends. Flexible production, a highly skilled educated labor force, technology, industry clusters, and niche markets are the buzzwords for competitiveness and survival in today's economy. While these communities are familiar with the demands of the global economy, they are also familiar with the obstacles they face, such as population decline,

mobile industry, and low skill/uneducated workforce. What may be more difficult to assess is the range of options for change. As an individual in the Kentucky EZ explained, "Change is slow. It is hard for people to see outside their old paradigm which only allows for a certain set of choices" (Anonymous interview 3e). On this note, Brown and Warner argue that understanding persistent poverty requires "not only attention to markets, location, resource availability, technology, and institutions.... (but also)... the historical development of social production and exchange relationships on characteristics of a region's economic structure" (p.35).

Comparative analysis can be helpful in terms of seeing a broader range of options. More than an understanding of global trends and local resources, comparative analysis is about how localities "fit" in relation to surrounding areas and regions. How do a community's vertical and horizontal linkages within certain production processes compare with those of other localities of similar character? For example, Boomgard et al. use sector analysis to understand the competitive context in which small businesses operate. First, they assess a product group in which small enterprises are important, usually based on their size, location, equity implications, or expected patterns of change. Sector analysis then looks at where small businesses fit in the production process, inputs and markets, and alternative supply channels that compete in the same sector. The goal is to understand the growth opportunities and constraints within a given sector. Seeing beyond the past to the present possibilities will be critical for both entrepreneurs and community organizations in persistently poor places. However, the success of the small businesses helped by CDFIs cannot be the sole measure of the institution's effectiveness. The character of micro and small business is turbulent, with many starting and failing each year (Liedholm and Mead). What seems more important in this regard is the contribution CDFIs make to the economic development and overall viability of the community.

What factors improve the viability of communities in rural areas and how do economic strategies such as RLFs and micro and small business development fit in? Community development is a dynamic process involving micro resources (leadership, human capital, physical resource base, local institutions, etc.) and macro processes (changing patterns of production, global markets and mobile capital). Advocating specific approaches and identifying key indicators or critical factors for successful community development is always tenuous at best. However, two messages resonated loudly in the EZ/ECs' work. First, the challenge that these communities face, "to create economic institutions that cannot move away, and that are responsive first and foremost to community interest," in the wake of rapidly changing production processes is neither easy nor simple (Nakano and Williamson, p. 1). Second, the progress these EZ/ECs achieved was attributed largely to the relationships, networks, and people--what Flora and Flora call social capital, "that trust and reciprocity, shared symbols and collective identity (1993)," or what Swanson terms social infrastructure, "the capacity or will of individuals and communities to provide or take advantage of opportunities that enhance their economic well being" (p.104). A South Dakota EC member explained "It's hard to put your finger on it, it's intangible but it's a resource we have and it's as critical as the financial resources we are trying to build" (Anonymous interview 4b).

In Virginia, the microenterprise lending program depends on social capital. The peer groups function as a source of support and also as a source of risk insurance, enabling the EC to make credit available with less risk. As Flora explains, "Social capital makes other forms of capital, like financial, manufactured, or human capital, more efficient... reducing transaction costs" (1995, speech). Houser explains how social capital in peer group lending translates into a supportive context for economic development:

> The process requires that micro-entrepreneurs rely on their own assessments of each other's character, integrity, and credit-worthiness. Everyone has a direct stake in the success of each other's business. The stake is reflected in the active interest members take in each other's businesses and the support and advice that they regularly provide to each other (pp. 214-215).

Moreover, Houser reports that loan programs that use group lending techniques regularly report higher repayment rates than programs that make loans to individuals.

Social capital can be an obstacle to change as well. Flora terms this "hierarchical social capital--where few people control all of the resources... and social capital functions to maintain the power relations, or the way things are" (1995 speech). Some ECs took deliberate steps to counter hierarchical capital; VESEEHC undertook a 5-month community participation process described as "critical, as it has ensured the involvement of low-income folks from the beginning--ideas coming from them versus top down" (Anonymous interview 6a). Flora and Flora argue that if social capital is to contribute to the development of a community, then this requires building entrepreneurial social infrastructure (1993). Entrepreneurial social infrastructure includes three elements: symbolic diversity, resource mobilization, and quality networks.

Flora and Flora emphasize that quality networks involve diverse and expansive leadership, horizontal linkages (relationships with other similar communities), and vertical linkages (links made to public and private resources outside the community). These factors are unfolding in the EC/EZ communities. One EC member explained the inclusiveness of the EC board leadership: "They are really committed to the community and their ideas. They see themselves as offering an opportunity, but rely on community members to initiate change. This seems to be working well, as the board is not the one dictating the change" (Anonymous interview 4b). Another EC member in a different area emphasized the role of horizontal linkages: "Part of our success has to do with the partnerships that have been formed with other agencies and with financial and banking institutions" (Anonymous interview 5c).

Social capital will continue to play an important role in enabling these communities to translate financial capital into community sustainability. As one EC member claimed, "The EZ/EC process brought everyone to the table now. Now, we don't want to let each other down--we are all accountable to each other. The key is relationships" (Anonymous interview 5a). But, as Swanson notes, social infrastructure is a necessary condition for economic development, but not a sufficient condition.

Conclusions

This paper discusses three factors--interest rate, technical assistance, and social capital--that will enable the EZ/ECs to use CDFIs as a tool to facilitate viable communities. CDFIs clearly are not an all-purpose tool for delivering funds to promote community development. Development depends on much more than financial capital. CDFIs provide financing when access to capital is a problem, as is often the case in low-income communities. In this regard, CDFIs may be particularly well suited for rural EZ/ECs as their small scale, less-diverse economies, and remoteness make these areas vulnerable to credit-access problems (Mikesell and Wallace). The work of these EZ/ECs demonstrates that development, particularly in distressed areas, requires attention to all forms of capital--financial, manufactured, human, and social. Through the EZ/EC process, which incorporates a comprehensive approach to community development, these distressed, low-income communities have begun to build on the social and institutional relationships necessary for community viability, with CDFIs being part of an overall revitalization strategy.

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Appendix I

Community Development Banks and Community Development Credit Unions: A Brief Description

Community Development Banks

Community development banks date back to 1866 in the United States, when the first minority banks formed to serve the development needs of primarily African-American communities (Wells and Jackson). Today, there are at least eight community development banks as well as a handful of union-owned and 106 minority banks.[13] These banks are regulated by the Office of the Comptroller of the Currency (OCC) if they are nationally chartered banks, or by the Federal Reserve if they are State-chartered banks and members of the Federal Reserve System. State-chartered banks that are not members of the Federal Reserve System are regulated by the Federal Deposit Insurance Corporation.

Community development banks operate much like traditional commercial banks, offering a range of services including savings and demand-deposit accounts along with consumer, business, and housing loans. They are for-profit depository institutions backed by the Federal Deposit Insurance Corporation. In return they are subject to the same Federal regulations as other commercial banks (Vidal). A community development bank may operate as a holding company, as South Shore Bank does in Chicago or as a stand-alone entity, like the Community Capital Bank in Brooklyn, NY.[14] As a holding company, community development banks may form subsidiaries to undertake certain activities that cannot be offered by the bank itself (Parzen and Kieschnick). For example, South Shore Corporation controls the following: South Shore Bank; City Lands Corporation, a real estate development company; Neighborhood Fund, a Small Business Development Corporation secured by the Small Business Administration; The Neighborhood Institute, a nonprofit that operates economic and social development programs; and Shorebank Advisory Services, a consulting firm on development banking (Grzywinski). Community Capital Bank, a stand-alone community development bank, has developed a working partnership with a technical assistance agency to serve the capacity needs of its customers (Kane).

Conventional banks may also establish subsidiary community development corporations in an effort to meet their Community Reinvestment Act (CRA) requirements. For example, the Bank of America in San Francisco established a community development bank subsidiary to make community development loans (Colby). Vidal explains, "These bank-owned Community Development Corporations (CDCs) are different than the CDCs that operate in communities across the country. They are financial institutions that have the flexibility to make loans and/or equity investments that banks are normally restricted from making" (p. 194). Essentially, bank CDCs allow banks to carry equity and unsecured investments on their books as assets as long as there is a social and economic benefit to the community (Lenzi). In June 1993, the Office of the Comptroller of the Currency (OCC) and the Federal Reserve reported banks investing in 121 CDCs, with the numbers increasing (Vidal).

In addition to the models above, banks may also work in cooperation with municipalities to meet community development needs. Here, Colby explains, "The municipality would deposit money into the bank and take a reduced interest rate in exchange for letting the bank lend it out at below-market rates for

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[13] South Shore Bank is the oldest and the most well known. Other community development banks include: Southern Development Bancorporation, Blackfeet National Bank, Ameritrust State Bank, Bank of America State Bank, Louisville Development Bankcorp, Detroit Development Bankcorporation, and Community Capital Bank (Parzen and Kieschnick; Wells and Jackson).

[14] Parzen and Kieschnick explain that a bank holding company technically owns or controls one or more banks.

community development purposes" (p. 27). Finally, some small traditional banks with assets of $100-$300 million would argue that they are the true community development banks, with 94 percent of them making commercial loans to small businesses and small farms (Colby).

Initial capitalization and achieving a sustainable scale are challenges for all community development financial institutions. However, community development banks, as for-profit, FDIC-insured institutions, must meet certain equity requirements within a specific time frame. The equity will vary depending on their location, population, and regulator, but it is rarely less than a million dollars (Parzen and Kieschnick). They also incur substantial costs in obtaining a charter, incorporation, printing, and legal fees (Parzen and Kieschnick). With higher costs, community development banks have higher break-even points (where their revenues exceed fixed and variable costs). Thus, community development banks are more difficult to establish. In spite of these limitations, Parzen and Kieschnick argue that the community development bank holding company is an ideal model. It meets both the savings and credit needs of the community, and can strategically allocate profits to non-profit subsidiaries or to support certain desirable but more risky development projects. Other CDFI models may be more appropriate when there is not enough money to meet equity requirements.

Community Development Credit Unions

Like banks, credit unions provide basic financial services, but most operate on a smaller scale. They also offer deposit insurance and are regulated either on the Federal level by the National Credit Union Administration or by a State agency if they are a State-chartered credit union. Yet, unlike banks, they are nonprofit, tax-exempt institutions whose members share a common bond. The common bond can either be occupational, residential, or by association. About 78 percent of credit unions share an occupational bond while 14 percent are associations and 6 percent are residential (Brown).

Credit unions classified as community development credit unions (CDCUs) serve areas where more than half, and sometimes more than 90 percent, of the residents are classified as low-income (Bankston). They have average assets of around $2 million and a typical staff of four or fewer (Bankston). CDCUs have existed for up to 50 years, with the Self-Help Credit Union in North Carolina being the largest and probably the most well known (Wells and Jackson). About 300 low-income credit unions around the country now promote savings and ownership of assets and provide affordable credit and retail financial services to low- and moderate-income people (Vidal). Cliff Rosenthal, executive director of the National Federation of Community Development Credit Unions, explains, "CDCUs differ from other credit unions... they have a broader social mission" (Bankston, p.10). In addition, CDCUs have a few advantages not shared by traditional credit unions. They can raise up to 20 percent of their deposits from non-members to bolster their assets, which is critical given the small asset base of their low-income members, and they can qualify for below-market-rate loans up to $200,000 through the Community Development Revolving Loan Program administered by the National Credit Union Administration (NCUA).

CDCUs differ from community development banks in some ways. For example, their nonprofit status provides greater flexibility than banks in working with businesses that have insufficient equity or collateral, weak credit histories, or other problems that prevent them from qualifying for conventional loans (Romani). The requirements that they must meet before being chartered by NCUA or a State agency are less arduous than those faced by community development banks. For example, CDCUs do not have initial equity requirements but simply have to show sufficient member interest to sustain the credit union--usually around 1,000 members (Parzen and Kieschnick). However, credit unions are more restricted in their ability to form affiliates or subsidiaries. A common strategy for CDCUs is to find partners to meet their development goals. For example, the Self Help Credit Union has two nonprofit sister facilities, the Self Help Venture Fund and the Center for Community Self-Help.

Appendix II

Other Programs EZ/ECs Can Access Related to CDFIs

1. Microloan Demonstration Program: The Small Business Administration (SBA) makes direct, 10-year loans to private, nonprofit intermediaries experienced in making and servicing small business loans successfully and in providing business management counseling. Intermediaries can borrow up to $2.5 million over the life of their program participation. Intermediary lenders use these funds to make loans of up to $25,000 to entrepreneurs for establishing or expanding their businesses.

2. Small Business Investment Companies (SBICs): These SBA-licensed entities provide equity financing to small businesses. Specialized SBICs serve small businesses owned by socially or economically disadvantaged individuals.

3. Minority Enterprise Development (MED): Through the SBA and in conjunction with nonprofit, for-profit, and minority educational institutions, MED provides technical assistance to small businesses which are majority owned and controlled by disadvantaged individuals; they are located in areas of high unemployment and in areas with a high concentration of low-income people.

4. U.S. Dept. of Agriculture: Rural Business and Cooperatives Service (RBS) finances business facilities and community development projects not within the outer boundary of any city having a population of 25,000 or more. This is achieved through loans made by RBS to intermediaries that provide loans to ultimate recipients for business facilities and community development projects in rural areas.

5. Guaranteed Loans through the SBA: Participating lenders provide loan funds and SBA guarantees a portion of the loan. The maximum loan amount covered is $500,000. Loan proceeds may be used for any legitimate business purpose such as machinery and equipment, inventory, working capital, etc.

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