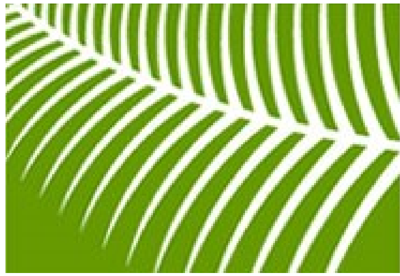


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Thomas F. Stinson and Andrea Lubov

# Minnesota's Nonmetro Cities Use Revolving Loans as a Development Tool

*Nearly 100 of Minnesota's nonmetro towns use revolving loan funds as a way to spur local economic development. Here's how they work: a town makes the initial loans to qualified businesses, and as the loans are repaid, the money is loaned out again and again to other businesses. A few problems need to be worked out: default rates somewhat higher than those experienced by other lenders, slow accumulation of funds needed to make second-generation loans, and slow turnover in "revolving" the funds to the next round of businesses. In city-based programs, there is also the risk that viable projects are going unfunded in towns without access to a revolving fund.*

Locally administered revolving loan funds (RLF's) are increasingly popular tools for providing economic development assistance to nonmetro communities. Such funds promise a self-renewing, locally controlled pool of funding for stimulating the local economy, a very attractive package for most local officials.

In Minnesota, most local revolving funds received their initial capital indirectly, through pass-throughs of State or Federal economic development loans destined for local firms. By channeling those loans through a local RLF rather than making them directly to firms, and by stipulating that all payments of principal and interest (debt service) be made to the local revolving fund to provide funding for future loans, State and Federal agencies have created a strong incentive for cities to establish RLF's as part of their economic development program.

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Nearly 70 percent of the 157 public and nonprofit economic development revolving loan funds identified in Minnesota were organized by local governments outside the State's metropolitan areas (fig. 1). Most of the nonmetro funds (99) were created by cities; 10 were administered by counties. Of the funds in metro areas, 26 were maintained by nonprofit groups or quasi-public bodies, 12 were created by cities in the 7-county Minneapolis-St. Paul metropolitan area, and 10 were created by cities in smaller metro areas.

Finding revolving loan funds in 99 nonmetro cities was a surprise. While only 17 percent of Minnesota's nonmetro cities have established such funds, most of the State's larger nonmetro communities operate an RLF as part of their economic development program. Nearly 80 percent of nonmetro cities with populations greater than 5,000 and approximately a third of nonmetro cities with populations between 1,000 and 5,000 had such funds (table 1).

## State, Feds Provide Most of Initial Funding

While localities must have proper legal authority to establish an economic development RLF, the availability of initial capital is the principal barrier to their formation. A revolving fund must have capital to make its first loan, and the larger the initial loan, the greater the amount of debt service returned each year for recycling into additional economic development loans.

The Minnesota Economic Recovery Fund was by far the largest source of capital for revolving loan funds in nonmetro cities, providing just over 60 percent of initial capitalization (table 2). That program, established in 1984 and administered by the State's Department of Trade and Economic Development, is expressly designed to fill capital gaps where existing public and private financing is inadequate.

Two separate funding sources are available in the Economic Recovery Fund: the Economic Recovery Grant program, which receives an appropriation from the State general fund, and the Small Cities Development Program, which receives Federal funding through the Small Cities Community Development Block Grant program.

All projects funded by the Economic Recovery Fund must meet conditions with respect to job creation, private capital contributions, and private sector financial participation. Those receiving Federal contributions must also meet criteria targeting low- and middle-income residents, the elimination of slums and blight, and other urgent community needs. Minnesota's Economic Recovery Fund channeled nearly $10.8 million in State and Federal funds to local economic development revolving loan funds in 65 nonmetro cities in Minnesota between 1984 and 1989. The average initial capitalization was nearly $166,000. (The characteristics of communities and businesses receiving loans from the Economic Recovery Fund are described in the following article by Margaret Dewar, ed.)

Federally administered Economic Development Administration loans and Urban Development Action Grants (UDAG) provided initial capital for eight nonmetro cities. These grants averaged $325,000, nearly twice as much as the average grant offered by the Economic Recovery Fund.

Other external funding sources, including foundations and private contributions, provided smaller average amounts of startup capital to 13 com-

Figure 1
**Location of revolving loan funds**
*Nonmetro locales account for 70 percent of Minnesota's RLF programs.*

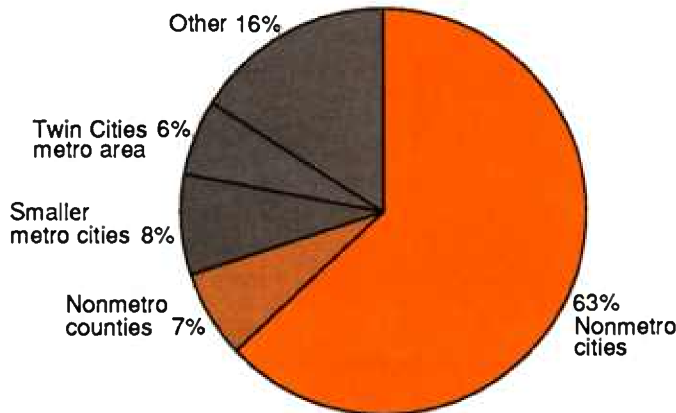



**Table 1—Population of nonmetro cities with revolving loan funds, 1989**

*Most larger nonmetro cities had revolving loan funds in 1989.*

| Population | All cities | Cities with RLF's | |
|---|---|---|---|
| | *Number* | | *Percent* |
| Greater than 10,000 | 17 | 8 | 47.1 |
| 5,000-10,000 | 14 | 14 | 100.0 |
| 2,500-4,999 | 34 | 11 | 32.4 |
| 1,000-2,499 | 89 | 31 | 34.8 |
| Less than 1,000 | 440 | 35 | 8.0 |
| Total | 594 | 99 | 16.7 |

**Table 2—Source of initial funding for RLF's based in nonmetro cities**

*State funds were largest source of capital.*

| Source | Cities that received funds | Total funding | Average funding |
|---|---|---|---|
| | *Number* | *$1,000* | |
| Minnesota Economic Recovery Fund | 65 | 10,769 | 166 |
| Federal EDA-UDAG | 8 | 2,598 | 325 |
| Other external sources | 13 | 821 | 63 |
| Internal sources | 14 | 2,185 | 156 |
| Source unreported | 7 | 1,422 | 203 |

munities. The 14 communities that started their own funds invested an average of $156,000, almost as much as communities that obtained Economic Recovery Fund grants from the State.

### Loan Activity

Nonmetro cities made 365 loans between 1985 and 1988, and an additional 93 loans in the portion of 1989 preceding the survey. Eighty-four of the 99 funds reported making at least one loan during that 4.5-year period (table 3). Nearly all funds made loans for fixed assets; many also made loans for working capital. Few loans were for inventory or equipment purchases.

Many loans were small. Loans of less than $20,000 accounted for 55 percent of all loans, and loans of less than $10,000, 25 percent. But, nearly 25 percent were for over $50,000, and 14 percent were for more than $100,000. The typical fund made an average of 2.5 loans between 1985 and mid-1989 (fig. 2).

Terms for the revolving fund's first loan, the one passing through capital supplied by the State or the Federal Government, are typically set by the originating agency and are favorable to the borrower. Local funds are free to set their own terms for succeeding loans. Those terms also appeared to be more favorable to borrowers than terms available in private capital markets.

RLF's usually charged below-market interest rates. Most loans (72 percent) were made at interest rates between 5 and 8 percent, and 13 percent were made at interest rates less than 5 percent. The prime rate during this time ranged from 8.25 to 11 percent. Interest rates were typically negotiated on a loan-by-loan basis between the fund and the borrower, not set as a fixed percentage of current market rates. Nearly three-fourths of RLF loans were for more than 5 years; 18 percent were for more than 10 years. Only 5 percent were for 2 years or less.

Consistent with the long maturity of most local revolving fund loans, the percentage of loans outstanding was high. More than 85 percent of loans made were still outstanding at the time the survey was conducted.

Sixteen funds made only one loan during 1985-89. More important, over $6 million was available for lending in mid-1989. A lendable balance this large may reflect a substantial untapped resource available for economic development financing in the State. It may also indicate that some funds are finding few local lending opportunities that meet their credit guidelines.

Another reason for that large balance may be that needs in some communities are going unmet while adjoining communities have funds available to lend. But, without knowledge of program goals and capital needs in the localities with current lendable balances, one cannot determine whether lendable balances reflect a lack of lending opportunities or lending standards that are too conservative or restrictive.

### Additions to Capital Slow to Come

If revolving funds are to fulfill their potential as a self-renewing source of

**Table 3—Number of loans made by RLF's in nonmetro cities, 1985-89**

*Only 60 percent of the RLF's made more than one loan in 4.5 years.*

| Population | Number of loans made | | | |
|---|---|---|---|---|
| | 0 | 1 | 2-5 | 6+ |
| | *Number of cities* | | | |
| Greater than 10,000 | 1 | 0 | 2 | 5 |
| 5,000-10,000 | 1 | 4 | 5 | 4 |
| 2,500-4,999 | 2 | 0 | 5 | 4 |
| 1,000-2,499 | 3 | 11 | 10 | 7 |
| Less than 1,000 | 8 | 11 | 12 | 4 |
| Total | 15 | 26 | 34 | 24 |

financing for local economic development, they must generate new revenues. Either debt service payments must be sufficient to provide capital for future loans, or the fund must attract additional sources of financing. Most revolving funds in Minnesota's nonmetro cities have done neither.

Funds available from recycling debt service payments were not large. A $100,000 loan made at 8 percent interest for 10 years, for example, generates less than $15,000 per year in debt service, too little to fund a second major project until several years after the first loan is made. Of the 77 funds reporting earnings for 1988, nearly two-thirds reported less than $25,000 in receipts from debt service on outstanding loans. Nine funds, however, reported more than $100,000 in receipts (fig. 3).

Nor were city-based RLF's particularly successful in adding to their lending capacity by obtaining additional grants. Only 24 funds had supplemented their original capital. But, those that had obtained further funding benefited substantially, raising, on average, slightly more than $220,000 each. Four cities added to the lending capacity of their RLF by making a direct contribution of revenue. Those internal contributions were substantial, averaging more than $600,000.

## Default Rates Somewhat Troubling

Default and delinquency rates play a key role in determining whether local revolving loan funds will fulfill their promise of providing a renewable source of economic development assistance. With most nonmetro funds started by pass-through of a State or Federal loan, default on that initial loan will wipe out the fund, providing no debt service to recycle.

The credit histories of initial loans and of loans made with recycled funds show how vulnerable the funds are. And, since much of the credit analysis for the original loan is done by the State or Federal agency providing the funds, while later loans were made using the fund's own credit guidelines, default experience for the recycling loans differs from that on the original loan.

The default and delinquency rate found for original, pass-through, loans was higher than that for recycling loans. Of the original loans made by the revolving funds, 13 percent were either delinquent or in default by September 1989. For loans made with recycled funds, the default and delinquency rate was 8.5 percent.

Default rates for the recycling loans varied considerably depending on the group responsible for the credit analysis. When local elected officials or their appointees to the fund's board were involved in evaluating credit quality, default rates were nearly 14 percent. Loans evaluated by either the local bank, fund staff, or some combination of bank and fund staff had default rates of less than 8 percent. When a local bank actually participated in the loan, the default rate fell to 4 percent.

Figure 2

**Number and size of loans by nonmetro RLF's 1985-89**

*Most loans made by RLF's were for less than $20,000.*

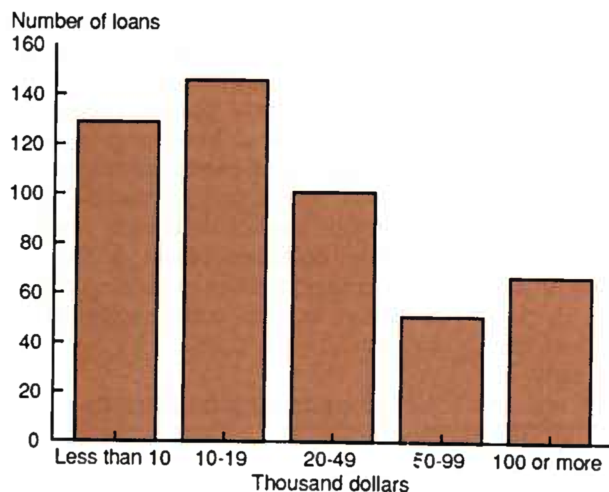
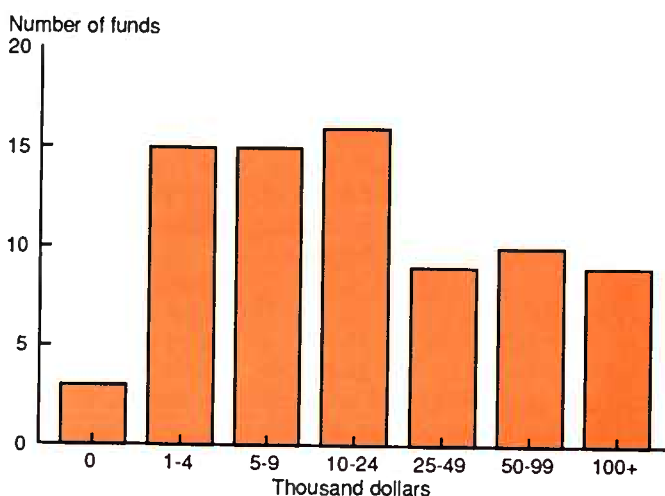



Figure 3

**Debt service received by nonmetro RLF's in 1988**

*Debt service received varied widely.*




Note: Seventy-seven RLF's responded to this question; 22 cases are missing.

## About the Survey

During the summer of 1989, we conducted a comprehensive survey of all public, economic development revolving loan funds operating in Minnesota, identifying how they were organized and funded and collecting data on loan experience from 1985 through mid-1989. Although information was collected from all 157 public and nonprofit revolving loan funds in existence when the survey was conducted, the 99 funds in nonmetro cities are the focus of this article.

## Implications

Revolving loan funds have been an effective conduit for directing capital into Minnesota's nonmetro communities. Testimony to their power is the fact that 18 communities used their own funding, and 17 raised funds from sources other than State and Federal agencies to provide the initial capital for their funds. This is impressive evidence that there is both a belief that additional sources of financing are needed in nonmetro areas, and a local willingness to commit the time and effort needed to establish them.

Results from this survey of RLF activity in Minnesota's nonmetro cities, however, raise some doubt about whether these funds in their present form are as effective as they might be in solving economic problems in small communities. The most important concern is that revolving funds appear not to have been particularly successful in recycling debt service on existing loans into others. Nearly half the funds had made only one loan or had made no loans between 1985 and 1989. And, a significant amount of lending capacity was available but going unused. Default and delinquency rates, particularly on loans made by funds where professional or bank staff were not involved in the credit analysis, appeared high.

However, neither of these findings is inconsistent with responsible management practices. For example, if a fund's initial capitalization is in the form of a single large loan made on favorable terms to a local business, it will take some time before accumulated debt service payments are large enough to fund another loan. In smaller communities, especially those with fewer than 1,000 residents, the number of opportunities for funding is likely to be limited. And, no matter what size the community, there may be periods when no applicants for funding meet lending guidelines. Even high default rates, although worrisome, are not necessarily indications of poor management, but rather of the high-risk pool of loans being made.

Most troubling are the questions these results raise about whether city-based revolving loan funds are the best means for distributing funding for economic development. By focusing on cities and encouraging establishment of many city-based funds, officials may be creating barriers to the efficient use of State funds for nonmetro economic development. Funds may be sitting idle in one community while good projects go unfunded in a neighboring community. Equally disturbing is the ultimate inequity of the funding. A locality whose first RLF-funded project is successful automatically gains access to a pool of additional funds. A locality whose initial project fails is left with nothing.

Defaults are to be expected. And, in any loan portfolio of sufficient size, a reasonable number of defaults will not bring the program to a halt. But, when a city portfolio contains only one loan, default is catastrophic since it destroys the program. Under the existing RLF program, many small communities are faced with a one-shot development effort. Should that effort fail, there is a long wait before a second infusion of capital arrives. Although winners in this system benefit handsomely, there is a question of whether this wheel-of-fortune approach is in the long-term best interests of Minnesota's nonmetro residents.

It appears time to reexamine the goals of locally administered economic development revolving loan funds to see if there are not better ways of encouraging local economic development. There is much to be said for a local revolving fund approach to economic development financing, but advantages depend greatly on the existence of a large and diversified loan portfolio. Many RLF's currently have far too few loans to provide the diversification needed to offer a reasonable likelihood of success.

New institutional arrangements are being tried in some places, and those efforts should be encouraged. For example, a private foundation in Minnesota has provided funding for several regionally based revolving funds, and Vermont has experimented with a revolving fund serving a consortium of five small towns. Pools and geographic areas need not be large, but revolving loan funds serving nonmetro communities may need to extend beyond municipal boundaries if they are to attain the size and stability necessary to achieve their promise.

Creating larger, more diversified funds might also allow increased use of full-time development specialists to monitor the existing loan portfolio and provide technical assistance when needed. That action might also increase the success rate for firms receiving RLF assistance.

### For Additional Reading...

Julia Friedman, "Improving Capital Market Efficiency Through State Programs," *The Report of the Governor's Commission on the Economic Future of Minnesota*, State of Minnesota, St. Paul, MN, 1987, pp. 147-150.

National Association of Development Organizations, "America's Flexible Revolving Loan Funds," *Economic Development Digest*, Washington, DC, April 1992, p. 7.

John Sidor, "Vermont Tries a Regional CDBG Approach to Micro-Enterprise Development," *The State Line*, Council of State Community Development Agencies, Washington, DC, May/June 1992, pp. 2-4.