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Community Investments Vol. 11, Issue 1 Counting on Local Capital: Evolution of the Revolving Loan Fund Industry

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Since 1996, the Corporation for En- terprise Development (CFED) has managed the “Counting on Local Capital” initiative, a national research and policy project designed to build knowledge about the size, lending performance, and development impact of revolving loan funds (RLFs). The Counting on Local Capital initiative enabled CFED to piece together the first comprehensive picture of RLF capacity and performance on an industry-wide level.

The following article offers an overview of the Counting on Local Capital research, including selected highlights from the Washington State RLF Profile. In addition, the story of the Washington State Lender’s Network serves as an example of how people and organizations can unite to improve the capacity and impact of a large, geographically-diverse network of RLFs.

The State of the RLF Industry

It is a time of extraordinary opportunity for RLFs working in urban and rural communities throughout the United States. The size of the industry has doubled in the past five years, with RLFs now managing more than $8 billion in financial assets. Practitioners have reached new levels of sophistication, demonstrated by their entry into new markets, design of innovative loan products, and creation of new administrative and managerial economies-of-scale. Revolving loan funds report repayment rates ranging from 85% to 95%, evidence that small businesses and low-income borrowers are reasonably good credit risks. Furthermore, links to private capital markets are beginning to emerge, primarily through the sale of economic development loans on the secondary market.

There remain several challenges facing the RLF industry. Despite individual RLF success in working with small businesses, the field is highly fragmented, with few incentives for organizing collectively to strengthen the industry. The quality of data to document the performance of RLF portfolios is generally inadequate, and suffers from a lack of standard performance measures and common reporting formats. The size of the median RLF (at $500,000) is too small to be financially sustainable. Furthermore, lending and management capacity within RLFs continues to be highly uneven. This capacity-gap stems in part from their origin: many RLFs are funded by a single public agency with an interest in program outcomes, not organizational evolution. As a result, few funders complement their capital investments with operating funds which could support training and technical assistance services to strengthen the capacity of RLFs.

Banks and RLFs

One of the most important findings from the Counting on Local Capital initiative is that bank investment is the fastest growing source of capital for RLFs. There are multiple factors responsible for this finding. Certainly, the Community Reinvestment Act (CRA) is a major force in encouraging bank investment in RLFs. However, while the CRA may be what motivates banks initially, it is not necessarily what keeps them invested over time. Bankers often view RLFs as institutions that create future customers and lending markets by making start-up loans that commercial banks could not. In describing bank support of the California Economic Development Lending Initiative, a statewide RLF, Richard Hartnack, Vice Chairman of Union Bank of California, expressed his perspective clearly: “We in the banking industry, from small, local banks to large statewide banks, have come together through CEDLI to serve credit needs that individually none of us could have addressed.”

What are RLFs?

Revolving loan funds (RLFs) are community-based financing organizations that provide access to capital for individuals and communities underserved by private financial institutions. They provide loans to local businesses that cannot attract private financing, and then recycle the repayments by relending the capital to other businesses. With a 25-year track record, RLFs have proven to be a flexible and effective tool for promoting business development, job creation, and economic self-sufficiency in low-income communities.

The growth of the RLF industry in both size and financial sophistication presents new opportunities for collaboration with banks. Commercial banks are purchasing seasoned RLF loans as a strategy for enhancing their liquidity without incurring the expense of securitization. RLF administrators are purchasing portfolio management services from commercial banks to lower operating costs and increase the sus-tainability of their funds. Commercial lenders and RLFs are jointly developing training, technical assistance and mentoring programs that strengthen the ability of small businesses to survive the risky start-up stage and succeed in graduating to private financial markets. Finally, as RLFs are beginning to address the need to mobilize savings and build equity among low-income individuals and communities, entirely new avenues of collaboration are emerging with savings and investment vehicles.

Building the RLF Industry

Across the United States In 1997, seven states (including California and Washington) were selected through a national competition as sites for comprehensive surveys of state RLFs. Working in collaboration with economic development organizations, economic development trade associations and private sector financial institutions in each state, CFED surveyed the RLFs between November 1997 and May 1998. Findings from the research were released in October 1998 at the National Counting on Local Capital Institute. The final reports (RLF Profiles) provide the first complete picture ever presented of the size, lending activities and development impact of the RLFs in these states.

The following pages present highlights of the Washington State RLF Profile. For copies of the full report or for profiles of other states, please contact Linda Keeney at CFED, (202) 408-9788.

Ingredients for RLF Success

CFED has identified six strategies that outline how the RLF industry can build upon its foundation to strengthen performance and development impact.

1 RLFs should develop their own financial markets.

Counting on Local Capital revealed that there are both considerable capital reserves within the industry and a significant demand for additional capital. There is a clear opportunity for developing statewide or regional financial intermediaries that could act as "private capital markets" by pooling and allocating capital based on market need and institutional performance.

2 RLFs should be designed and funded to be financially sustainable.

Counting on Local Capital identified that the median RLF size of $500,000 was too small to be financially sustainable. A significant number of RLFs lack a diversified capital base, with 43% relying on only one or two funding sources. The industry should identify minimum loan fund size and key efficiencies of scale that are required to diversify risk and operate on a sustainable basis.

3 RLFs should strengthen their role as product innovators for underserved markets.
The mission of RLFs is to offer loan products that fill gaps in the private capital markets. The dramatic and ongoing changes in the financial services industry have enormous implications for the nature of these capital gaps. As a core competency of their institutions, RLFs need to build capacity in order to analyze and design new products that meet these changing market needs.

4 RLFs should invest for performance.
Strong institutional performance requires investments in human capacity and organizational systems. Many RLFs lack the basic infrastructure necessary to support performance, such as common performance measures, high quality operating data, access to training and technical assistance, and operating funds for organizational investments. The industry should develop a comprehensive database that allows RLFs to benchmark themselves against their peers, and should provide financial incentives that support RLFs in their efforts to improve performance.

5 RLFs must improve how they demonstrate impact.
Impact measures for the industry are largely funder-driven, and most funders don't agree on key definitions. Yet Counting on Local Capital discovered that when RLFs take impact measurement seriously, the results are impressive. The industry must come to agreement on common impact measures and invest in the capacity to report them.

6 State and Federal policy should build RLFs as institutions.
State and Federal agencies are the primary funders of RLFs, and their policies and management practices have a major effect on RLF performance

and sustainability. Thus, these agencies must support the effort of practitioners to build the industry by:

- developing common reporting forms;
- allowing the reallocation of capital to meet changing market demands;
- supporting efforts to pool RLF capital and connect to private capital markets; and,
- providing operating funds for market development and capacity-building.

RLF Evolution in Action

The Washington State Lender's Network

CFED's Counting on Local Capital initiative provided the platform from which the WSLN leadership constructed a five-year action plan to address the capacity and equity needs of Washington State's revolving loan funds. The plan integrates a number of the components identified as critical to the long-term success of Washington's forty-one RLFs. The plan presents the following key objectives:

- Create an efficient delivery system for technical assistance and best practices;
- Produce quarterly workshops which will bring nationally recognized trainers and RLF practitioners to the Northwest;
- Offer electronic (Internet) networking, information exchange and learning opportunities to overcome the geographic barriers of Washington State;
- Continue the industry research and data collection services begun though the Counting on Local Capital project. This will provide impact information for practitioners, policymakers and funders, and will help identify best practices throughout the State;

- Become a regional intermediary and investment manager for RLFs; provide operating equity and debt capital which will help stabilize and expand RLF industry;
- Initiate research to reduce expensive RLF operating costs by "aggregating demand" and increasing buying power (e.g. standardized loan documentation, legal services, bonding, insurance, auditors, employee benefits, etc.); and,
- Become self-sustaining within five years from revenues generated through planned activities. The plan is separated into two phases beginning in 1999. Phase I will last two-to-three years and will include:
- WSLN organizational development (staffing and membership structure);
- Implementation of technical assistance, training, data collection and electronic networking programs; and,
- Potential membership expansion into Oregon and Idaho.

In addition, RLF "best practice" criteria will be developed as a means of qualifying members for WSLN pass-through funding which will be implemented during Phase II. Phase II will begin in year three or four, and will implement the WSLN intermediary function as a conduit of loans and investment capital for member RLFs. The intermediary functions will serve the capital needs of member RLFs and will generate revenue through which WSLN can become self-sustaining.

Access to Capital
During the first two years of the plan, the intermediary capacity of WSLN will be tested through the initiation of participation loans with local RLF's. Both "liquidity" and "origination" participations are anticipated. The WSLN is looking for funds to purchase 49% (or less) of existing RLF loans which will provide additional lending capital for under-funded RLFs with strong loan

demand. Washington State's Development Loan Fund is also available to participate with RLFs in larger loan transactions.

The State Development Loan Fund will share finder and/or loan fees with the WSLN and the local originating RLF. This will prepare both WSLN and member RLFs for more sophisticated secondary-market transactions. The goal is that WSLN will become a CDFI intermediary by the third year, and will initiate three other conduit of funds' programs: 1) Operating Capital Fund, 2) Equity Capital Fund and 3) Loan/Debt Capital Fund. These programs will focus initially on smaller RLFs to help them stabilize their balance sheets and reach a sustainable level of operations. It will also help expand mature RLFs.

How Can Financial Institutions Participate?

Plans for bank participation have not yet been finalized. However, proposed options include:

- Help in funding and locating partners for the WSLN Liquidity Participation program;
- Provision of CRA, community development and commercial lending staff to local RLFs;
- Participation in the WSLN planning process and service on the board of directors;
- Identification of resources for local RLFs;
- Participation in long distance/Internet learning and "best practice" sharing; and,
- Identification and referral of potential deals.

The Washington State Lender's Network

WSLN was formed as a trade organization in 1993 to represent the interests of revolving loan funds in Washington State. To date, its primary roles have been sponsorship of training seminars and the production of a quarterly newsletter. WSLN is currently managed by a seven member board of directors that has over eighty years of collective experience in banking and economic development finance. The implementation of the five-year plan will move WSLN into a new era of organizational growth and value-added services to its RLF members.

For more information about Washington State Lender's Network and its five-year plan, contact:
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Levere was a director with the National Development Council (NDC) for nine years. At NDC, she was a lead trainer for the Economic Development Finance Certification Program. Ms. Levere received a B.A. from Brown University and a M.P.P.M. from the Yale School of Management.

Dave Wingate has over 25 years experience in banking, commercial finance and rural economic development in the private and public sectors, including Seattle First National Bank, SAFECO Commercial Credit Co., Inc, the National Consumer Cooperative, and United Security Bank, a small, rural, community-owned bank. For the last four years, Mr. Wingate has worked for the Washington State Department of Community, Trade and Economic Development as an economic development finance coordinator. His territory covers seven counties in Northeastern Washington. Mr. Wingate helps small businesses access capital where jobs are created or retained, primarily in timber dependent, high-unemployment communities.