Executive Summary

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

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

The study used a number of databases including the Community Reinvestment Act (CRA) data on small business lending, data on bank branching obtained from the Federal Deposit Insurance Corporation, data from CRA exams, and data on Community Development Financial Institutions (CDFIs). The data also included U.S. Census data on population trends and Dun and Bradstreet data on the characteristics of small businesses. Based upon the report's findings, policy options are presented to address financing gaps in non-metropolitan areas and distressed counties, and among small businesses.

This policy options focus on three broad areas:

- Providing support and incentives for the development of bank branches and the growth of the community banking sector in non-metropolitan and distressed counties;
- Increasing the capitalization and sustainability of Community Development Financial Institutions operating in the region, particularly loan funds and development venture capital funds; and
- Ensuring the continued efficacy and impact of the CRA program and examinations.

Many of these recommendations can be implemented by ARC working together with stakeholders in the Appalachian region. These stakeholders include state agencies, elected officials, lending institutions, federal regulatory agencies, the U.S. Department of Treasury, financial intermediaries, public finance markets, Federal Home Loan Banks, development organizations, and the Federal Reserve Banks.

Findings

The reasons for an optimistic assessment of the ability of the Region to close identified capital and credit gaps include a favorable comparison between Appalachia and the nation on some indicators of lending. In addition, Appalachia has a lending infrastructure that includes about 227 banks and savings and loans with more than $500 billion in assets, and a sector of alternative lending institutions featuring over 100 community development financial institutions (CDFIs).

The Community Reinvestment Act (CRA) has had a substantial impact in leveraging increases in community development lending and investing in the Appalachian Region. This study finds that banks and thrifts headquartered in Appalachia issued about $5.4 billion in lending and investing for affordable housing, small business development, and economic revitalization each CRA exam cycle (about 2.5 years). In addition, the small business loan-to-deposit ratio for Appalachia was 35% higher than national levels. And, in contrast to most other regions in the country, small business lending was higher in counties with greater minority populations in Appalachia.

Some additional positive indicators include:

- Small and mid-sized banks in Appalachia (with assets less then $1 billion) were particularly oriented to the needs of small businesses in distressed and rural areas, having a higher market share of loans in economically distressed and rural counties.
- Small business lending was higher in the Region in counties with higher levels of bank branches.

Within Appalachia, small business lending was less accessible in non-metropolitan counties and counties experiencing economic distress. In addition, the smallest businesses with revenues under $1 million and businesses in low- and moderate-income communities experienced the least access to credit. In order to narrow differences in access to small business lending within Appalachia, concerted and persistent stakeholder efforts must be undertaken over a multi-year time period. Increasing access to small business lending would build the small business sector, create wealth, and stimulate job creation and economic development in Appalachia.

Additional challenges include:

- Non-metropolitan and distressed counties had considerably smaller shares of bank assets, which translated into non-metropolitan and distressed counties receiving less community development financing than metropolitan counties.
- A relatively small amount of community development financing was devoted to small business development when compared to housing activities.

This study also reviewed the role of alternative financial institutions in the Region, including Revolving Loan Funds (RLFs), microenterprise lending programs, community

development credit unions and development venture capital funds. Overall, these community development financial institutions placed a strong emphasis on business lending, but were not financed by banks to the same extent as their national peers. Instead, these institutions relied to a much greater degree on capital from government sources.

Related findings include:

- Appalachian community development credit unions and venture capital funds were more self-sufficient than their national peers, while Appalachian community development loan funds and RLFs had lower self-sufficiency rates than the national averages.
- ARC RLFs demonstrated declining deal flow while showing an increase in participation in individual loan transactions.
- No Small Business Administration (SBA) 504 loans were originated to minority- or women-owned businesses in Appalachian distressed counties.

This study updates the report commissioned by ARC in 1998 and conducted by Mt. Auburn Associations entitled *Capital and Credit Needs in the Appalachian Region*. Key findings of the Mt. Auburn report included that "insufficient financing appears to have a serious impact on the investment decisions of about one in five established companies," and that small firms with less than 10 employees had higher levels of unmet funding needs than their larger counterparts. In addition, significant gaps were found in the provision of equity capital to growing firms in the Region.

Policy Options

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

- *Increase Branch presence, particularly in non-metropolitan areas and distressed counties* – Since lending is higher in counties with higher number of branches, building bank branches, particularly in non-metropolitan and distressed counties, should be regarded as an important part of an economic development program. ARC, state agencies, and lending institutions should investigate New York State's Banking Development District (BDD) Program. Begun in 1998, the BDD program offers partial property tax exemptions and encourages local public deposits for banks opening branches in geographical areas in need of banking services.[1]

[1] See http://www.banking.state.ny.us/pr980226.htm and http://www.banking.state.ny.us/pr050810.htm. Last accessed July 3, 2006.

- *Growth of the Community Banking Secto*r – Mid-size banks with assets between $250 million to $1 billion played important roles in small business financing, and focused their lending in non-metropolitan and distressed counties. Stakeholders should ensure that the mid-size and smaller bank sector remain viable and vibrant. Incentives could be developed to support existing mid-sized banks, or encourage the formation of new banking institutions in underserved areas. For example, the Federal Home Loan Bank System should consider additional advances and other incentives to support the small business lending of mid-size banks. Currently, the Federal Home Loan Bank of Pittsburgh operates a Banking on Business (BOB) program that provides financing for bank loans that would not otherwise be made due to insufficient cash flow from the small business. Since its inception, BOB has provided $20.5 million in funding, creating and retaining 3,500 jobs.[2] Likewise, the Federal Home Loan Bank of Atlanta runs the Economic Development Program that helps provide financing to small businesses.[3]

- *Increase levels of community development financing for small business development –* Banks located in Appalachia devoted significantly higher levels of community development lending and investing for affordable housing than small business development. This finding does not mean that community development financing levels for affordable housing should go down so that levels for small businesses can go up. Instead, it suggests that banks should be encouraged to increase their overall levels of community development financing and devote substantial portions of the increases towards small business development.

- *Support alternative financial institutions* - Alternative financial institutions such as Community Development Financial Institutions (CDFIs) are important for increasing access to small business lending. Therefore, policy options include:

  - <u>Expand sources of debt and investment capital for community development loan funds and venture capital funds</u>. Appalachian Community Development Financial Institutions (CDFIs) and other community development financing entities need to expand their funding base. Community development loan funds and venture capital funds in the Region are heavily reliant on government sources for debt and investment capital. ARC can develop relationships with potential investors and regulatory agencies to encourage increased investment within Appalachia, including partnerships with financial intermediaries, participation in public secondary markets, and use of tax credit financings.

  - <u>Appalachian loan funds must increase operational self sufficiency</u>. Appalachian loan funds, both RLFs and microenterprise funds, should

[2] See http://www.fhlb-pgh.com/housing-and-community/real-life-stories/banking-on-business.html, last accessed December 21, 2006.
[3] http://www.fhlbatl.com/fhlb_content.cfm?lev1=5cis&lev2=bcedp&lev3=2edp, last accessed December 21, 2006.

increase levels of self sufficiency by reducing operating costs or increasing revenues.

- Increase depth of product offerings by community development lenders. To reach the smallest businesses with less than $1 million in revenues, the Appalachian community development lenders should increase their financing products beyond gap financing. These new products would target the smaller businesses that the banks currently have difficulty servicing.

- Continue to grow capacity of Appalachian development venture capital funds. Available literature shows that there remains a significant gap in access to equity financing in non-metropolitan markets. ARC's efforts to develop regional equity investment funds are important in bridging this gap and increasing regional entrepreneurship levels.

- *Maintain Integrity of CRA Exams and Data* – The federal regulatory agencies have implemented new CRA exams for mid-size banks. Stakeholders should ensure that the integrity of CRA exams is preserved so that mid-size banks maintain and increase their levels of community development financing in Appalachia. In 2005, federal regulators also deleted the small business loan data reporting requirements for mid-size banks. Federal regulators should consider ways to continue to collect this data so that future studies can systematically examine the lending patterns of mid-size banks. Mid-size banks should continue to be encouraged to voluntarily report the data as many chose to do for the 2005 data submissions. While data collection imposes costs, the benefits can exceed those costs. The data can document positive trends and highlight new opportunities as revealed by this study. Moreover, data reporting motivates banks to maintain and increase their lending levels to small businesses.

- *Encourage Small Business Administration (SBA)-guaranteed lending to Minority-Owned Businesses* – The SBA should investigate ways to increase SBA-guaranteed lending to minority-owned businesses and in minority counties. It is possible that the relatively low levels of SBA-guaranteed loans to minority-owned businesses or businesses in minority counties were due to the relatively high levels of conventional lending to these businesses. Alternatively, it is possible that there are still certain types of credit needs that are not being filled by the conventional lending, opening up new opportunities for SBA-guaranteed lending.

- *Financial Counseling and Technical Assistance for Small Businesses* – The study found that lending was higher in counties with higher portions of small businesses with the lowest risk credit scores. This suggests that lending will increase to small businesses overall if small businesses improved their credit scores. High quality financial counseling efforts are therefore important in Appalachia as a means to improve the credit scores of small businesses. In addition, technical assistance should be provided to improve the knowledge and skill level of small business entrepreneurs regarding cash flow, understanding financials, business planning and

taxation issues. ARC, state officials, lending institutions, and community organizations should work together to intensify financial counseling directed towards small businesses in Appalachia.

- *Better Understanding of Lending in Minority Counties in Appalachia* – The report's finding about higher levels of lending in counties with higher levels of minorities was a surprising and positive finding. Future research should be conducted to more fully understand why lending is unusually successful in reaching firms in counties with high levels of minorities in Appalachia. Lessons from this research should be applied to other regions of the country since the literature overall suggests serious barriers in access to small business lending for minority-owned firms.

Overview of the Background, Motivation and Methodology for the Study

The Appalachian Regional Commission (ARC) contracted with the National Community Reinvestment Coalition (NCRC) to conduct this study as part of ARC's effort to develop Appalachia through increasing access to credit and capital for small businesses. ARC is a federal-state partnership established in 1965 by the Appalachian Regional Development Act to promote economic and social development of the Appalachian Region. The Act, as amended in 2002, defines the Region as 410 counties comprising all of West Virginia and parts of Alabama, Georgia, Kentucky, Maryland, Mississippi, New York, North Carolina, Ohio, Pennsylvania, South Carolina, Tennessee, and Virginia—an area of 200,000 square miles and about 22.9 million people.

For 41 years, the Commission has funded a wide range of programs in the Region, including highway corridors; community water and sewer facilities and other physical infrastructure; health, education, and human resource development; and economic development programs. The rationale for ARC's Area Development program is to provide the basic building blocks that will enable Appalachian communities to create opportunities for self-sustaining economic development and improved quality of life. ARC goals particularly relevant for this study include increasing job opportunities and per capita income in Appalachia to reach parity with the nation, and strengthening the capacity of the people of Appalachia to compete in the global economy.

Small business growth and development is integral to the efforts of ARC to increase employment and competitiveness. In Appalachia, primary metals sectors, such as steel, have lost over 20,000 jobs since 1994. Many of these losses have resulted from import penetration and plant relocations overseas. The Appalachian apparel industry has lost 110,000 jobs since 1994, and the textile industry has lost 83,000. Over the last decade, one out of five jobs lost in textiles nationally occurred in Appalachia, and one out of three jobs lost in apparels occurred in Appalachia.

In the face of large economic forces, ARC has been remarkably successful in channeling economic development investments. ARC's investments have reduced the region's poverty rate by one-half, from 31 percent to 13 percent. Likewise, ARC has helped to lessen the

per capita income gap between Appalachia and the rest of the U.S from 22 percent below the national average to 18 percent. This study provides critical insights into how and why ARC should leverage additional investments for small business development and growth.

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

The Mt. Auburn study broke important ground through its use of surveys of Appalachian small businesses. The study did not benefit, however, from publicly available data on CRA small business lending. The CRA data for the year 1996 first became available in summer of 1997 when the Mt. Auburn study was well underway. In addition, researchers became much more familiar with the strengths and weaknesses of the database over the next several years. Thus, this study provides an important update to the Mt. Auburn report by utilizing the small business lending data and probing to what extent the unmet credit needs overall and for very small businesses still exist in Appalachia.

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

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

Methodology

This report employed a number of datasets and created datasets for the quantitative analysis. For the analysis of small business lending trends, NCRC used the publicly available data on CRA small business lending. This data was combined with U.S. Census

data on population demographics and Dun and Bradstreet data on business demographics and credit scores. In addition, data was obtained from the Small Business Administration (SBA) on SBA lending programs. Branch and deposit data was obtained from the web page of the Federal Deposit Insurance Corporation (FDIC). The section of the report analyzing community development lending and investing created a database consisting of data pulled from CRA exams of banks and thrifts located in Appalachia. Finally, the chapter on alternative financial institutions used data collected by public agencies, ARC, and trade associations of Community Development Financial Institutions (CDFIs).

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