Ohio State University Extension Fact Sheet

Community Development

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Establishing a Revolving Loan Fund

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Small Business Series

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Introduction

The establishment of a revolving loan fund within a community is one of several tools available to encourage small business development.

This fact sheet provides basic information on developing a Revolving Loan Fund program utilizing public funds, and is targeted toward economic development practitioners. These programs may be found in communities throughout the State of Ohio, capitalized by a variety of public sources, each with its own unique structure and set of criteria. When setting up a program, administrators should: research the different programs which exist; collect samples of application forms, legal documents, program guidelines, and other materials; and, network with other loan administrators on a regular basis. More often than not, people are thrilled to share positive experiences and are willing to discuss "areas of caution" within their Revolving Loan Fund program.

What is a Revolving Loan Fund?

A Revolving Loan Fund, otherwise known as an "RLF," is a source of money from which loans are made for small business development projects. The fund is capitalized with dollars which generally do not need to be repaid. A loan is made to a business and as repayments are made, funds become available for new loans to other businesses.

What is the Purpose of an RLF?

RLF's are established to provide a source of financing, which may not otherwise be available within the community, for local, expanding, or start-up businesses. Often, they are used to fill a "financing gap" in a business development project. A gap occurs when the business lacks the funds to meet the equity requirements of bank financing or needs a lower interest rate.

A Revolving Loan Fund within a community enhances the "tool chest" of the local economic development agency. Incentives such as fixed rate, low interest, and/or long-term financing are important to a business wanting to locate or expand within the area. Although the RLF is not the primary source of financing for a project, the combination of public and private financing lessens the risk for the primary lender (by decreasing their exposure) and yields an overall lower cost of money for the borrower.

Most government financing programs require that jobs be created in direct proportion to the amount of public dollars loaned in a project. A Revolving Loan Fund may provide incentives for job creation to businesses locating or expanding in the community.

Finally, the existence of an RLF promotes goodwill for the local community. Businesses are encouraged by programs which support retention and expansion, utilizing flexible, locally controlled funds. This demonstrates a pro-business attitude, which is critical when developing partnerships between the public and private sectors.

The Basic Steps in Designing a Revolving Loan Fund Program

Step One

The first step in creating an RLF for a community is to assess the need for such a program. Is there a "gap" in the current sources of financial assistance offered, either in the public or private sectors? Are the financing needs of local businesses being met by existing programs? Talk to bankers, business owners, Chambers of Commerce, elected officials, and economic development professionals. Ask questions of a specific nature. For example, Who should the program serve? What type of financing is needed? Loan size? Loan term?

With answers to these questions in hand, go back to the bankers, elected officials, and others and refine the need. Build consensus through the process of designing, testing, redesigning, and retesting. At some point, a set of specific issues will emerge from which a program may be developed.

Step Two

The next step is to identify a set of criteria necessary for program design. In other words, define the following parameters:

- Eligible borrowers-type of busiess (manufacturers, retail, service, etc.- are they included or excluded?), existing or start-up? size, location
- Eligible use of funds-working capital or fixed asset?
- Loan amounts-maximums, minimums, job/cost ratio, percent of project, equity requirements
- Underwriting policies-cash flow coverage, loan to value ratio, collateral requirements
- Interest rate-variable or fixed? Is there a standard rate or does this vary with the project?
- Loan term-the length of the loan in years
- Are personal guarantees required?
- Define the default and delinquency terms. Will there be a grace period for loan payments? When do foreclosure proceedings commence on a delinquent loan?
- Define the loan loss reserve which shall be maintained in the portfolio to cover situations of default.

Keep in mind that the source of capitalization (the funds used to create the RLF) may have regulations governing program design. For example, RLF's which are capitalized with Community Development Block Grant (CDBG) funds must follow the rules and regulations established by the U.S. Department of Housing and Urban Development (HUD). HUD funded projects require that fifty-one percent of the full-time equivalent jobs created as a result of the project must benefit persons of low- moderate income households.

In addition, any project involving construction or remodeling must follow the "Davis Bacon" Federal wage standards. An environmental review is required for each project. And, no more than 50% of the total project may be financed with CDBG funds.

Step Three

Once a set of criteria for the program is drafted, review the materials with lenders and potential borrowers. Will this program be beneficial to local businesses? Is it accessible and adequate to fill the current needs of the financial market? Remember, offering "cheap" money (below market interest rates) does not automatically lead to good program design and fill the void in the current lending arena.

The program must be evaluated in terms of its accessibility. Is it too restrictive by only serving existing businesses, when there is a need in the community to encourage start-ups? Are the collateral coverage requirements excessive? Typically, the RLF is the subordinate lender in a project. Is there flexibility in the program design to consider other types of collateral to secure the loan?

Step Four

A set of criteria has been drafted and reviewed for responsiveness to current market needs and regulations governing the source of funds. The next step is to create an operational plan. The plan should address**in detail** the administrative aspects of the revolving loan fund program, including:

- Who will administer the program?
- Staff capacity and responsibilities
- Marketing strategies
- Loan selection and approval process
- Loan servicing
- Capital management strategy
- Sources of funding to cover administrative costs
- Loan Review Committee
- Person(s) responsible for completing the environmental review, compliance with Davis Bacon requirements, and other Federal/State regulatory terms and conditions.
- Other requirements

Each of these items is a separate section in the operational plan, which will serve to guide the administrator and Loan Review Committee through the decision-making process.

The structure of the Loan Review Committee may take many forms. It could be a function of an existing group or be established specifically for the Revolving Loan Fund program. The committee may serve in an advisory capacity, or be appointed by resolution of local government with broader powers and responsibilities. Whatever the case, the committee should be composed of individuals capable of evaluating project proposals and making good loan decisions, based on the program criteria and any rules or regulations from the funding source.

Often, Loan Review Committees consist of a broad base of individuals, including an attorney, at least one private lender, a business person, a low-income/minority representative, an economic development professional, and an elected official. The size of the group varies, however, a small group with an odd number of people is preferred. Limiting the size will make it easier to assemble the members and keep participants "on task" during important decision-making meetings.

Participation by an elected official is suggested when the source of capitalization for the RLF is state or federal dollars, such as through the Community Development Block Grant Program or through the Economic Development Administration. Ultimately, the mayor or county commissioners are responsible for the fiscal and programmatic accountability of the program because they are the "grantee" (the State or Federal agency being the "grantor"). Local officials need to remain in touch with program operations, often serving as ex-officio members on the Loan Review Committee with no voting rights.

Step Five

The final phase is implementation of the Revolving Loan Fund plan. Once individuals have agreed to serve on the Loan Review Committee, a resolution should be adopted by the local governing body formally creating the board and establishing positions (i.e., representing small business, financial institution, utilities, etc.). With most publicly-funded RLF's, the committee serves in an advisory capacity and makes recommendations for the approval or disapproval of a project proposal. Final decision-making authority and signatory power rests with the mayor, county commissioners, or director of the development organization, as grantee for the program.

The draft plan is then presented to the Loan Review Committee for review and final comment. Once refined, the plan should be formally adopted by the committee and in addition, adopted by resolution or ordinance by the governing body. This serves to legitimize the plan, including the policies and operating procedures contained therein.

To administer the RLF plan, existing personnel could be designated or the administration of the program could be accomplished on a contractual basis. The costs of administration will have been defined and accounted for in the plan as well as the position qualifications and responsibilities. Often, the staff for the RLF program is formally designated by the governing body, through a legally binding contract, resolution, ordinance, or similar motion of the grantee.

Where to Go for Help

The Ohio Department of Development, Office of Housing and Community Partnerships, has a Revolving Loan Fund Coordinator who is responsible for overseeing RLF's capitalized with Community Development Block Grant funds within Ohio. Sample guidelines and forms are available, as well as a listing of the counties and cities that have Revolving Loan Fund programs.

The National Association of Development Organizations (NADO) conducts two training courses on revolving loan funds. One focuses on "Program Development," which explores the strategic decisions used in setting up a program. The other concentrates on the variety of tasks involved in "Program Management." For more information on these courses and others, contact:

Jonathan Corso
NADO
444 N. Capitol
Washington, DC 20001
Phone: (202) 624-7806
Fax: (202) 624-8813

In addition, a three-day training course entitled, "Revolving Loan Funds: Design, Documentation, and Administration" is offered through the National Development Council (NDC). This in-depth program covers such topics as: Revolving Loan Fund Design; Credit and Collateral Analysis; Closing and Documenting Loans; Servicing and Portfolio Management; and Workout Strategies. For more information, contact the Training Division, National Development Council, 211 E. Fourth Street, Covington, KY 41011, (606) 291-0220, FAX (606) 291-3774.
