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RURAL DEVELOPMENT

Availability of Capital for Agriculture, Business, and Infrastructure

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The Honorable Richard G. Lugar
Chairman
The Honorable Tom Harkin
Ranking Minority Member
Committee on Agriculture, Nutrition,
and Forestry
United States Senate

Because access to capital is a prerequisite for economic growth, you asked us to examine the availability of capital in rural[1] America for agriculture, business, and community infrastructure. Specifically, you asked that we describe the primary financial institutions that are used to finance agriculture, rural businesses, and rural communities' infrastructure, and obtain the views of rural officials on (1) whether rural borrowers have difficulty in obtaining access to capital, (2) whether rural borrowers have adequate knowledge of the availability of financial assistance, and (3) what potential alternatives may be used to improve the availability of capital. To address these questions, we spoke with officials of federal, state, regional, local rural development, and lending institutions in four states—Alabama, Maine, Minnesota, and Washington. Additionally, we spoke with officials of federal agencies and national associations. Furthermore, in October 1996, we surveyed over 700 officials—members of associations involved in rural development and officials of the community and economic development departments in all 50 states—to obtain their views on the availability of capital in rural areas. The groups and individuals surveyed were chosen because of their experience in working with rural lenders and borrowers. Although the survey respondents were located throughout the United States, their responses cannot be generalized to all rural localities.

Results in Brief

Many sources of financial assistance are available to meet rural areas' demand for capital. While commercial banks and the Farm Credit System are the primary providers of capital for agriculture and rural business, rural communities more often turn to the public sector to obtain capital for infrastructure.

[1]For this report, rural refers to locations outside of metropolitan statistical areas. This definition includes counties containing a city or an urbanized area with a population of less than 50,000 and a total area population of less than 100,000.

Most rural business and agricultural borrowers that are creditworthy and rural communities with an adequate tax base generally have little difficulty in obtaining capital, according to rural officials. However, the officials we surveyed believe that certain borrowers in rural areas, such as start-up, expanding, and minority-owned businesses and financially struggling rural communities, have difficulty in obtaining capital. In their view, these borrowers have experienced difficulties because they lack (1) equity or collateral, (2) business or management skills, or (3) an adequate tax base. Rural officials could not quantify the severity of these difficulties. Nonetheless, the officials we surveyed believe that economic development in their areas is hindered by these borrowers' difficulties in obtaining capital.

Rural development and lending officials we surveyed also believe that potential agricultural and business borrowers are not always aware of the range of financial resources available to meet their capital demands. However, these officials do not believe that this lack of awareness should, by itself, prevent borrowers from obtaining capital. Rural development officials believe that the primary providers of capital in rural areas are familiar with alternative sources of funds and can appropriately direct borrowers to these sources.

While the extent of rural areas' difficulties in obtaining capital has not been determined, rural development officials suggested three proposals to make capital more available in rural areas. One proposal would use existing loan guarantee programs and technical assistance entities to target resources to borrowers that are having difficulty obtaining access to capital. Another proposal would modify the charters of some government-sponsored enterprises to expand their loan-making authority and/or require them to lend funds to borrowers that currently have difficulty in obtaining capital. The third proposal would allow community-based revolving loan funds financed with federal dollars to sell their loans into a secondary market. It is unclear, however, whether the potential benefits of these proposals for rural areas would exceed the potential financial losses to the federal government. Moreover, targeting funds to borrowers in rural areas that are having difficulty obtaining access to capital may result in fewer funds being available to creditworthy borrowers.

Background

About 2,300 of the 3,100 counties in the United States are classified as rural. Between 1990 and 1995, the population increased in about

75 percent of these rural counties and decreased in the remaining 25 percent. Growth in rural communities depends in part on the ability of rural borrowers to obtain capital—both debt and equity—for development and expansion. Rural firms need access to capital to start and expand businesses, and rural communities need access to capital to replace or upgrade aging infrastructure. According to studies, such as one published by the Federal Reserve Board of Kansas City,[2] borrowers in rural areas have traditionally had difficulty in obtaining access to capital, when compared with their urban counterparts. According to the U.S. Department of Agriculture's (USDA) Economic Research Service, rural economies are characterized by a preponderance of small businesses, fewer and smaller local sources of financial capital, less diversification of business and industry, and fewer ties to nonlocal economic activity.[3] These rural attributes may exacerbate businesses' funding difficulties. In recent years, a number of changes have occurred that could affect the availability of capital for businesses and communities in rural areas, such as pressures to reduce government spending and mergers of small rural community banks with large banks not located in rural areas.[4]

Wide Range of Commercial Institutions and Government Programs Available to Assist Rural Areas

Many sources of financial assistance are available to meet rural areas' demand for capital.[5] Table 1 shows the primary sources of loans, loan guarantees, equity capital, and grants for business and agriculture and infrastructure in rural America.

[2]Mark Drabenstott, "Capital for Agriculture and Rural America: Redefining the Federal Role," Economic Review. Vol. 80, No. 3, Federal Reserve Bank of Kansas City, Third Quarter, 1995. This article is based on testimony presented to the Senate Committee on Agriculture, Nutrition, and Forestry on Mar. 31, 1995.

[3]Are Revolving Loan Funds a Better Way to Finance Rural Development? Economic Research Service Agriculture Information Bulletin 724-05, (Oct. 1996).

[4]For more information on the issue of bank mergers, see Interstate Banking: Experiences in Three Western States (GAO/GGD-95-35, Dec. 30, 1994). As noted in the report, according to some bankers and focus group participants, in three states visited, large banks were credited with increasing credit availability to those small businesses that met the large banks' lending criteria. Other bankers and participants mentioned, however, that the practices of centralizing and standardizing loan decisions, common to large banks, could result in some small businesses' having difficulty in obtaining credit in markets where there are few alternatives to large banks.

[5]For more detailed information on available programs, see Rural Credit: Availability of Credit for Agriculture, Rural Development, and Infrastructure (GAO/RCED-93-27, Nov. 25, 1992).

Table 1: Primary Sources of Funding in Rural America

Capital sources	Agriculture and business: Loans	Agriculture and business: Loan guarantees	Agriculture and business: Equity capital	Community infrastructure: Loans	Community infrastructure: Loan guarantees	Community infrastructure: Grants
Commercial banks	X			X		
Farm Credit System	X			X		
USDA	X	X		X	X	X
Small Business Administration	X	X	X			
Other federal grant and loan programs	X	X	X	X	X	X
States' programs	X	X	X	X	X	X
Insurance companies	X					
Nonprofit community development corporations	X		X			
Venture capital entities			X			
Merchants and dealers (e.g., leasing/trade credit)	X					

For agriculture and small businesses, the primary sources of capital are commercial banks and the Farm Credit System (FCS). The funds commercial banks use for lending are primarily derived from customers' deposits and are used for short-term loans.[6] The Federal Home Loan Bank System (FHLBS) supplies loans (called advances) to its member banks. In addition, all banks have access to capital from the Federal Agricultural Mortgage Corporation (Farmer Mac), which operates in the secondary market. If the banks receive advances or package their loans and sell them into a secondary market, they can use the capital they receive to make longer-term loans.

Commercial banks and others can have some of their loans guaranteed under federal and state loan guarantee programs, such as USDA's and the Small Business Administration's (SBA) loan guarantee programs for businesses. For example, USDA's Business and Industry Guaranteed Loan Program, targeted to rural areas, was funded at $688 million for fiscal year 1997. To qualify for loan guarantees under these programs, applicants must be unable to obtain financing elsewhere and must demonstrate an ability to repay their loan. In addition to guaranteed loans, USDA provides direct loans targeted to rural businesses and grants to rural entities that

[6]Generally, any loan with a maturity of 1 year or less is considered a short-term loan.

provide financial and technical assistance to rural businesses. SBA also provides direct micro-loan financing to small business borrowers using intermediaries, such as nonprofit community development corporations, and provides grants to these intermediaries for technical assistance to their borrowers. Furthermore, USDA participates with other federal agencies in initiatives such as the Empowerment Zone/Enterprise Community program and the Pacific Northwest Economic Adjustment Initiative, which target federal funds to selected communities.

Like commercial banks, the FCS makes loans to farmers, ranchers, rural homeowners, agricultural cooperatives, rural utility systems, and agribusinesses. However, unlike commercial banks, FCS has its lending authority established by the Congress. As of December 31, 1996, FCS' loan balance was $61.2 billion.

Furthermore, unlike commercial banks, FCS is not a depository institution. Instead, it is cooperatively owned by its members—borrowers—who must buy stock in FCS' entities as a prerequisite for borrowing. FCS' funds for loans are raised through the sale of bonds and notes in global capital markets and are frequently used for longer-term loans for agriculture and agribusiness. FCS, like FHLBS and Farmer Mac, is a government-sponsored enterprise (GSE).

The Congress created GSEs to help make capital available to certain sectors of the economy, such as agriculture and housing, in which the private market was perceived as not effectively meeting capital demands. While the government has no legal obligation to protect GSE investors, the federal ties cause these investors to believe that the federal government would not let the GSE default on its obligations. As a result, GSEs can borrow at interest rates that are usually only slightly higher than those paid by the Department of the Treasury.

In addition to commercial banks and GSEs, nonprofit community development corporations (CDC) are an important source of capital for business entities that are unable to obtain capital from commercial banks and FCS. A large number of rural CDCs have been established since the 1970s. These CDCs are organized as nonprofit entities to promote economic development in certain target areas by providing a range of assistance. They provide financing in their service area to organizations that are unable to obtain commercial or public funds, most typically by establishing revolving loan funds. In making loans, CDCs may participate with other entities, commercial or public, in making loans. Their loan funds are capitalized by grants and/or long-term, low-interest loans from federal agencies, such as the Department of Commerce's Economic Development Administration (EDA); states; and private sources, such as nonprofit foundations and corporations.

Venture capitalists are another source of funding for agriculture and businesses in rural areas. Venture capitalists are private investors and organizations that provide funds and technical and managerial expertise to help start and maintain new and emerging businesses by backing entrepreneurs who have financially sound and marketable ideas. In providing this assistance, venture capitalists seek partial ownership in the business and a return commensurate with their assumed risk.

Merchants and dealers—equipment dealers and other suppliers—are another important source of capital. For these lenders, a borrower's creditworthiness is of less concern because the credit either is secured by the value of the asset provided to the borrower or is protected by a lien against the borrower's business.

For rural communities' infrastructure, such as water and wastewater systems and roads and bridges, state and local governments are the principal source of capital. State and local governments finance infrastructure through taxes, user fees, and bonds. Their funds are supplemented by federal agencies, such as USDA, which, since 1965, has provided about $28 billion in grant and loan funds for water and waste disposal to financially struggling rural communities. Other sources of federal financial assistance are a large number of programs in the Department of Housing and Urban Development and EDA.

Rural Development Officials Report That Certain Types of Borrowers Have Difficulty in Qualifying for Capital

Rural development officials we surveyed reported that creditworthy agricultural and business borrowers and rural communities with an adequate tax base have little difficulty in obtaining capital. However, certain types of rural borrowers, such as start-up, expanding, and minority businesses, as well as financially struggling rural communities, are finding it difficult to obtain access to capital, primarily because they do not have adequate equity, business operating skills, or an adequate tax base. These officials acknowledged that these types of potential rural borrowers consist of those that (1) are never likely to meet traditional commercial lending standards and (2) might be able to meet them. While some rural officials say that concerns over access to capital have increased in recent years, they could not quantify the number of borrowers that have experienced difficulties in obtaining capital. Most survey respondents noted that the difficulties some borrowers experience in obtaining capital not only affects the individual borrowers but also hinders rural communities' economic development. A number of federal, state, local, and private initiatives have been developed to increase the availability of capital.

Certain Types of Borrowers Have Difficulty in Obtaining Access to Capital

As shown in table 2, over half of the survey respondents who claimed to be knowledgeable about rural capital issues reported that start-up and expanding farms and businesses, minority-led enterprises, and financially struggling rural communities find it difficult to obtain debt and equity capital. In addition, according to studies we reviewed, borrowers that are unlike other local businesses, such as a software developer in a community that depends primarily on agriculture, may have difficulty in obtaining capital from local sources.

Table 2: Percentage of Survey Respondents Who Believe That Certain Borrowers Have Difficulty in Obtaining Capital

	Percent responding "moderate to very great difficulty in obtaining capital"[a]	
Type of borrower	**Debt[b]**	**Equity[c]**
Production agriculture		
Beginning farmers	85.7	87.2
Minority farmers	69.8	77.2
Expanding farmers	61.1	71.1
Business		
Start-up	88.6	93.3
Minority-owned	74.5	82.1
Expanding	64.8	75.4
Infrastructure		
Communities	55.2	58.8[d]

Note: Our survey results did not show any significant differences by geographic region.

[a]Percentages are based on the number of respondents who were knowledgeable or had at least some experience with rural capital issues. As shown in app. II, fewer respondents were familiar with production agriculture issues than with business or infrastructure issues.

[b]Debt capital is borrowed funds paid back over time with interest.

[c]Equity capital is ownership funds that become part of the capital base, yielding a return based on the profitability of the business over time.

[d]These represent grant funds, tax revenues, and user fees.

Source: GAO's analysis of questionnaire data.

According to rural development officials we spoke with and the studies we reviewed, a number of factors account for the difficulties certain borrowers face. (See bibliography for a listing of the literature reviewed.) First, the borrowers that are having difficulties obtaining access to capital, such as beginning farmers and start-up businesses, lack sufficient equity or collateral to qualify for debt capital at most banks. Therefore, these borrowers have to turn to lenders that specialize in providing capital to higher-risk ventures, such as venture capitalists, for their primary funding. Similarly, financially struggling rural communities have difficulty financing their infrastructure requirements because their declining tax base makes it difficult to incur debt.

Second, those we surveyed and the studies and testimonies we reviewed, such as a 1995 Washington State Development Finance Report and a 1996 testimony by a researcher on rural capital markets, suggest that the lack of business skills is a major impediment for start-up and expanding businesses. These potential borrowers cannot effectively prepare sound business and marketing plans, financial statements, applications, and other documents required to secure the capital they seek. Likewise, many small communities do not have, nor can they afford, professional managers who know how to identify and apply for the financing programs available to the communities and how to comply with the programs' rules and regulations. In the view of those we interviewed, many of the traditional lenders do not have the time or inclination to provide these borrowers with the level of attention needed to make them successful. Furthermore, even when dealing with a loan guaranteed by a federal or state guarantee program such as SBA's, the borrowers are not required by the guarantor agencies to obtain technical assistance as a precondition for qualifying for the loan.

Third, borrowers seeking funds for nontraditional businesses may not be able to obtain capital because commercial banks in rural areas may be unable or unwilling to evaluate these lending opportunities. For example, several studies we reviewed reported that while local bankers may thoroughly understand lending for production agriculture, they may not have the management expertise to evaluate the profitability of loans to a software developer.

Finally, several studies, such as the 1995 Washington State Development Finance Report and a 1993 report on minority and seed capital, report that some minority borrowers may not be able to obtain capital, even though they meet commercial lending standards. Some officials who assist minority agricultural and business owners have charged that discrimination prevents some minority borrowers from obtaining capital.

Survey Respondents Believe That Problems in Obtaining Capital May Hinder Economic Development

The majority of those we surveyed who were familiar with rural capital issues reported that economic development in rural areas is at least moderately hindered by the difficulties agriculture, businesses, and communities face in obtaining capital. Table 3 reports the percentage of respondents who believe that limitations on the availability of capital hinder rural economic development.

Table 3: Percentage of Survey Respondents Reporting That Limitations on Capital Availability Hinder Economic Development in Rural Areas

	Percent responding that economic development is hindered to a moderate or very great extent[a]	
Type of borrower	**Debt**	**Equity**
Production agriculture	57.4	67.6
Business	73.0	78.1
Community infrastructure	64.9	68.6

[a]Percentages are based on the number of respondents who were knowledgeable or had at least some experience with rural capital issues. As shown in app. II, fewer respondents were familiar with production agriculture issues than were familiar with business or infrastructure issues.

Source: GAO's analysis of questionnaire data.

A January 1997 report by the Rural Finance Task Force of the Rural Policy Research Institute is consistent with our questionnaire results.[7] The Institute reported that difficulties in obtaining access to debt capital present a significant impediment to broadening the economic base of a rural community.

[7]The Current Adequacy of Rural Financial Markets: Rural Economic Development Impacts of Seven Key Policy Issues. This report was prepared for the Senate Committee on Agriculture, Nutrition and Forestry, the House Agriculture Committee, and the USDA. Rural Policy Research Institute. Columbia, Mo.: Jan. 1997.

Initiatives to Help Increase Capital Availability

To attempt to overcome the difficulties that potential borrowers encounter, several initiatives are either planned or ongoing. To help borrowers that are having difficulty obtaining access to capital, federal and state governments have set up programs to assist beginning farmers, start-up businesses, and small communities that want to fund water and sewer projects. For example, although no funds have been appropriated, the 1996 farm bill established in USDA a venture capital demonstration program for rural America. The program would fund up to 10 venture capital organizations for community development to provide capital to private business enterprises.

Similarly, Minnesota created Minnesota Technology, Incorporated, in 1992 with $7 million to provide equity capital to start-up, small, and expanding businesses located predominantly in rural areas. As of June 1996, this fund had invested about $2.6 million in 10 firms.

At the local level, hundreds of revolving loan funds have been established to help start-up and expanding businesses eventually obtain capital from commercial lending sources. For example, in Minnesota alone, about 180 community-based revolving loan funds have been established to provide financial assistance to small rural businesses.

In Fayetteville, Arkansas, the Community Resource Group, Incorporated, created a community loan fund in 1992 with funds primarily from USDA and a major private foundation to provide capital for water and wastewater projects. The fund's efforts are targeted to financially struggling small rural communities in seven southern states. Since 1992, the fund has made 66 loans that have a total value of over $3.2 million.

Several federal, state, and private programs, such as SBA's Small Business Development Centers, have been developed to provide technical assistance to prospective borrowers. However, the majority of rural development officials we surveyed did not believe that these programs were sufficient. Our questionnaire showed that 59 percent of those surveyed believe that the technical assistance provided to agricultural and business borrowers is marginal or inadequate. According to several rural development officials we interviewed, this negative response may be due in part to the fact that technical assistance resources are insufficient to meet the demand.

Finally, to help minority borrowers, numerous federal and state programs have been targeted to these borrowers. For example, SBA has set-aside programs for minority-owned businesses, and states, such as Alabama, have loan programs targeted to minority-owned enterprises.

Rural Officials Believe That Many Potential Borrowers Are Not Aware of the Variety of Financial Resources Available

Many rural development officials we surveyed reported that potential borrowers were unaware of available financial resources and did not know how to apply for debt and equity capital.[8] According to these officials, this was particularly the case for borrowers seeking assistance for businesses. (See table 4.)

Table 4: Views of Rural Development Officials on Potential Rural Borrowers' Awareness of and Knowledge of How to Apply for Financial Assistance

Type of financing sought	Percent responding "probably or definitely unaware of availability of financial assistance"[a]	Percent responding "probably or definitely do not know how to apply for financial assistance"[a]
Production agriculture	47.4	64.1
Business	55.9	70.1
Community infrastructure	31.0	49.7

[a]Percentages are based on the number of respondents who were knowledgeable or had at least some experience with rural capital issues. As shown in app. II, fewer respondents were familiar with production agriculture issues than with business or infrastructure issues.

Source: GAO's analysis of questionnaire data.

This perceived lack of awareness of financial assistance occurs even though federal and state agencies and commercial entities have made considerable efforts to better inform rural public and financial institutions about available assistance. For example, the federal government publishes The Catalog of Federal Domestic Assistance, which details federal assistance programs, and agencies supplement this publication with information on their own programs.

Similarly, states and commercial entities, such as banking associations and utility companies, have developed and disseminated numerous publications to advertise the financial resources and programs available to

[8]For more information on this issue, see Rural Development: Patchwork of Federal Programs Needs to Be Reappraised (GAO/RCED-94-165, July 28, 1994).

assist rural borrowers. They also conduct outreach workshops, seminars, and other types of meetings to inform prospective agricultural, business, and community customers of the sources of available assistance.

According to rural development officials we interviewed, banks and other capital providers are generally knowledgeable about available sources of capital and can refer borrowers to these sources. They also believe that borrowers' need for business operating knowledge is often greater than their need for more knowledge about how to find capital. Finally, these officials believe that, in financing infrastructure, rural areas have great difficulty in discovering the types of support potentially available and completing the documentation required to apply and qualify for loan and grant assistance.

Alternatives Have Been Proposed for Improving the Availability of Capital in Rural Areas

In the view of many rural development officials, including respondents to our survey, funding for existing federal grant and loan programs is insufficient to satisfy the potential rural borrowers not served by available capital sources. However, given current budgetary constraints, most officials we interviewed believe that additional federal support is unlikely to be forthcoming. Consequently, rural development officials proposed three alternatives that could improve the availability of capital for certain borrowers that are experiencing difficulty in obtaining capital. While these alternatives may not require federal appropriations, these officials acknowledged that these alternatives present risks to taxpayers that may result in some future costs. These alternatives are (1) using existing loan guarantee programs and technical assistance entities to target resources to borrowers having difficulties obtaining access to capital, (2) expanding the charters of some GSEs and/or requiring them to target some of their funds to borrowers having difficulties obtaining access to capital, and (3) authorizing federal agencies that have provided capital to state- and community-based revolving loan funds to allow these revolving loan funds to sell their loans into a secondary market. It is unclear, however, whether the potential benefits of these proposals for rural areas would exceed the potential financial losses to the federal government. Moreover, targeting funds to borrowers in rural areas having difficulty obtaining access to capital may result in having fewer funds available to creditworthy borrowers.

We have not performed a detailed analysis of the needs for or merits of these alternatives because adequate historical information is not available. However, we discussed their potential benefits, limitations, and risks with knowledgeable officials in the Department of the Treasury, FCS, the Farm Credit Administration, and the federal agencies that initially provided grants to the community-based revolving loan funds. Each alternative is discussed below.

Changing the Federal Loan Guaranty Program(s) and Linking Them to Technical Assistance

Rural development and lending officials we interviewed suggested that existing loan guarantee programs, such as SBA's Business Loan Guarantee Program, be modified to require that a small percentage of their guaranteed loan funds be targeted to those borrowers that are having difficulties obtaining access to capital, such as start-up and expanding businesses. This program change would require that guarantor agencies apply less stringent lending standards to these applicants. However, because of the higher risk associated with these borrowers, the officials suggested that loan approval be contingent on a borrower's agreeing to work closely with a technical assistance provider, such as SBA's Small Business Development Centers. Technical assistance has been beneficial in other loan programs. For example, revolving loan fund officials told us that they have been able to reduce their loan default rates by providing extensive technical assistance.

We identified two consequences of applying less stringent lending standards. First, the risks of financial losses to the federal government could increase. Second, because a share of funds would be targeted to borrowers in rural areas having difficulty obtaining access to capital, fewer funds might be available for guaranteed loans to creditworthy borrowers.

In commenting on a draft of this report, SBA stated that it believes that insufficient resources are available to meet the technical assistance needs of rural America's small businesses. To ensure that borrowers needing technical assistance are aware of its partners' services and locations, SBA currently notifies all its guaranteed loan recipients of the services and location of its nearby technical assistance partners. However, given the limited funding currently available to the Small Business Development Centers, SBA believes that this alternative's requirement that all borrowers receive technical assistance would not be cost-effective.

Changing Federal Government-Sponsored Enterprises

Rural development and lending officials we interviewed told us that the charter of FCS and the FHLBS could be revised to expand the availability of capital in rural America. While these proposals may have merit, they also have limitations.

The ideas proposed for revising FCS include (1) providing capital to nonagricultural businesses and/or (2) requiring that a certain amount of FCS' portfolio include loans to borrowers that have encountered particular difficulty in obtaining access to capital, such as beginning farmers; start-up and expanding businesses; and small, financially struggling rural communities. FCS has also proposed legislation that would give it authority to provide capital to nonagricultural businesses. However, this proposed legislation did not seek authority for targeting loans to borrowers that have encountered difficulties in obtaining access to capital.

According to rural development officials, both ideas have merit because FCS has an important presence in rural America, with 1,476 offices and more than 80 years of experience in serving agriculture and agriculture-related cooperative business entities. Furthermore, FCS already has access to global capital markets.

However, according to officials we spoke with, these two ideas present some financial risk to the federal government. Allowing FCS to lend to nonagricultural businesses may increase its exposure to losses because its loan officers may not have the expertise necessary to evaluate the risks associated with business or infrastructure projects unrelated to agriculture. FCS officials acknowledge the limitations of their current staffing but believe that they could overcome this limitation by developing or hiring the staff needed to implement any new authority.

A proposal that a certain amount of FCS portfolio include loans to borrowers that have had difficulties in obtaining capital also presents financial risk to the federal government because it would increase the FCS' exposure to losses. Additionally, targeting a share of FCS' funds to borrowers having difficulty obtaining access to capital may result in fewer funds being available to lend to creditworthy borrowers. Furthermore, FCS may be reluctant to make such loans because doing so conflicts with regulatory requirements to ensure that funds are loaned to borrowers that are likely to repay their loans.

Similarly, the rural development and lending officials' proposed revision to the charter of FHLBS would have limitations. The proposed revision would expand FHLBS' authority beyond providing advances to members for home mortgages to include providing advances for loans for rural development activities, such as financing smaller businesses and communities' infrastructure. This proposal also raises concerns about exposure to loss, lack of expertise in evaluating loan applications outside the historical experience of FHLBS and its member institutions, and potential unwillingness to lend to higher-risk borrowers. In addition, fewer funds may be available to borrowers that have traditionally borrowed from FHLBS' member institutions.

The proposal to revise FHLBS is similar to changes specified in H.R. 3167, "The Enterprise Resource Bank Act of 1996," which we examined in a June 1996 letter to the Chairman of the House Committee on Banking and Financial Services.[9] We concluded that the proposed mission is broader than FHLBS' original mission, which focused the GSE's activity on a specific sector of the economy that the Congress perceived as being characterized by some degree of market failure. We concluded that the broader mission, expanded membership, and additional eligible collateral proposed under the bill could lead to an increase in taxpayers' exposure to risk because the proposal is likely to lead to expanded activities by FHLBS. We also noted that the government would have little assurance that FHLBS would use this expanded authority to actually channel significant amounts of additional credit to the new mission-related activities.

Our concerns over the potential risk to taxpayers of expanding the role of GSEs are not new. In a December 1993 report on FHLBS,[10] we developed criteria to be used in judging whether such activities are appropriate. Among these criteria are (1) the new activity should be consistent with the FHLBS' mission, (2) the GSE should have the expertise needed for the new activity, and (3) any new activity should be properly priced after any risk adjustments. According to a Department of the Treasury official, the expansion of GSEs raises a broader policy question about whether GSEs should be used solely to correct for market imperfections or also to subsidize credit to borrowers that would not obtain credit in the private market.

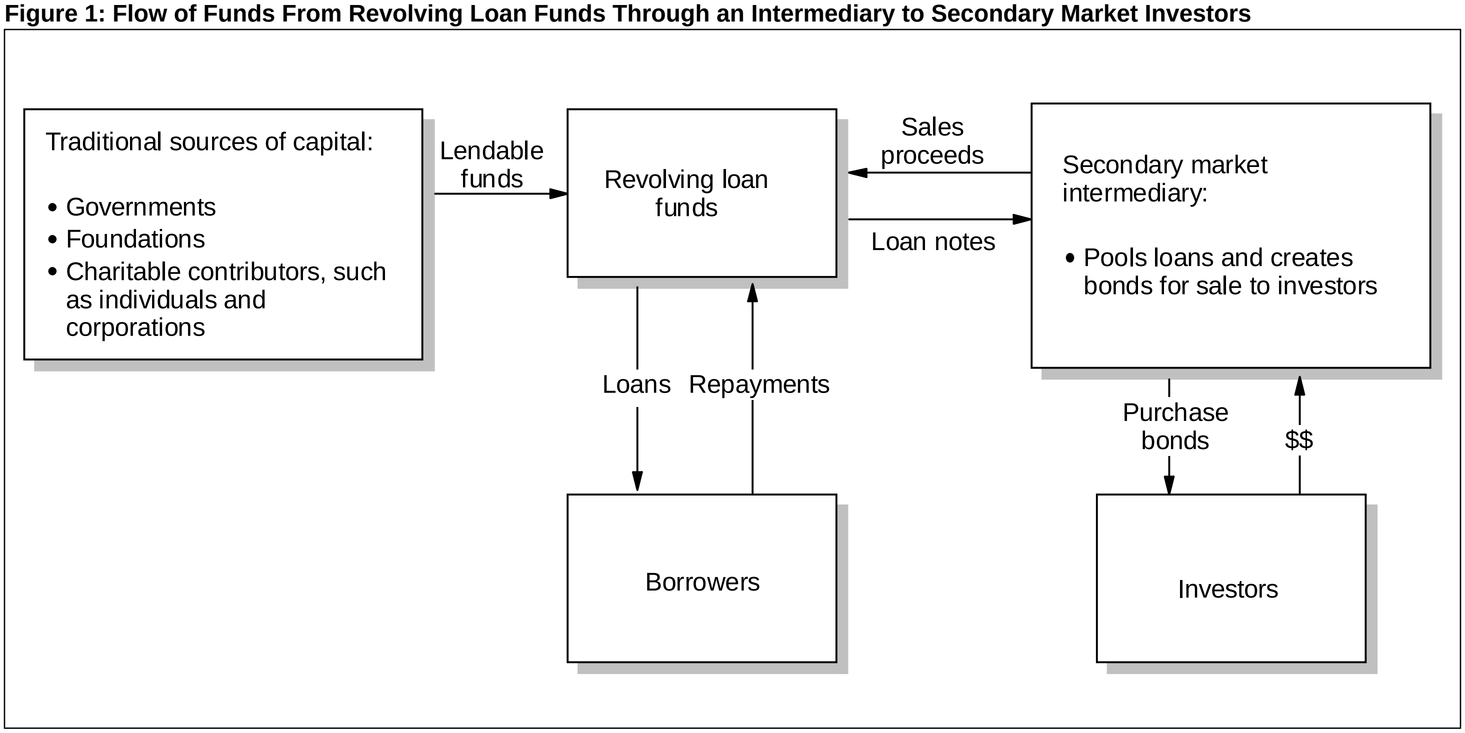
[9]Enterprise Resource Bank Act (GAO/GGD-96-140R, June 27, 1996).

[10]Federal Home Loan Bank System: Reforms Needed to Promote Its Safety, Soundness, and Effectiveness (GAO/GGD-94-38, Dec. 8, 1993).

Allowing the Sale of Federally Subsidized Community Development Loans

Officials we interviewed, as a well as a 1991 study by the Federal Reserve Bank of Kansas City, have proposed creating secondary markets for rural businesses and community infrastructure loans as a way of increasing capital availability in rural areas while allowing market forces to operate.[11] Under this proposal, rural, community-based revolving loan funds would be able to sell their loans into a secondary market, thereby making funds currently tied up in existing loans available for new loans. Figure 1 shows the flow of funds from revolving loan funds through an intermediary that packages the loans for sale to investors in the secondary market.

Figure 1: Flow of Funds From Revolving Loan Funds Through an Intermediary to Secondary Market Investors



While some rural, community-based revolving loan funds now sell into a secondary market, most do not. The revolving funds that do not sell into a secondary market are often partially capitalized with federal funds that cannot be sold at a discount from face value unless the managers of the revolving funds receive permission from the concerned federal agencies. USDA officials told us that even though selling these loans into a secondary market could make more funds available, they hesitate to provide

[11] Regional Economic Development and Public Policy, Federal Reserve Bank of Kansas City, May 1991.

permission because of the potential adverse public reaction to selling federally subsidized loans at less than face value.

According to rural development officials, allowing the sale of federally subsidized community development loans could make a substantial amount of additional capital available to rural areas. Studies by EDA and a privately sponsored secondary market entity state that funds invested in economic development loans might be freed up for further investments. According to an official of a privately sponsored secondary market entity, these loans would represent a major untapped source of potential financing for community development initiatives across the country if they were sold in a secondary market. For example, a privately sponsored survey of revolving loan funds in 15 states identified more than 24,000 economic development loans, totaling more that $1.2 billion. According to EDA, another study suggested that as much as $6 billion in economic development loans may be available for sale in a secondary market.

However, according to the official of the privately sponsored secondary market, uncertainty exists about whether this secondary market proposal would be successful without federal financial assistance. This uncertainty occurs because revolving loan funds make some loans at less than market rates and/or for more lengthy terms to certain borrowers. Therefore, because of the additional risk and the lack of higher interest rates to compensate investors for this risk, these loans would have to be purchased at a discount so that investors could earn a return that is competitive with current market rates. This discount would have to be subsidized by either the private or public sector, or both, in order to encourage revolving loan funds to sell these loans. According to this official, if the private sector is unwilling to provide these funds, a federal subsidy might be required.

Another limitation of this proposal, according to some rural officials, is that revolving loan fund managers might be reluctant to sell more of their loans to a secondary market. Currently, these managers rely primarily on an infusion of capital from federal and state government, foundations, and charitable contributors to make new loans. Managers we interviewed said that they are reluctant to sell their loans because they need the income from their existing loan portfolio to fund their administrative expenses.

Furthermore, rural development officials expressed concerns about the adequacy of revolving loan funds' loan-making and -servicing practices and the existence of an active demand for capital from these institutions, which are funded in part by federal agencies, such as USDA and EDA. They told us that many of these revolving loan funds may not have sufficient management expertise to evaluate the risk associated in lending to borrowers that cannot obtain capital from traditional sources or meet demand for capital and technical assistance. A potential benefit of a secondary market of this type may be its ability, over time, to develop information on the performance of revolving loan funds. This information could be useful in evaluating whether federal financial assistance to these entities should be continued.

In commenting on our draft report, USDA noted that, in support of this concept, it is considering providing additional capital in rural areas through a demonstration project that would allow the sale of third-party recipient loans by lenders in the Department's Intermediary Relending Program. Under this program, USDA lends funds to intermediaries, that, in turn, provide loans to recipients who are developing business facilities or community development projects in rural areas. Eligible intermediaries include public bodies, nonprofit corporations, Indian tribes, and cooperatives.

EDA, in commenting on the draft report, stated that while it is aware of the drawbacks and barriers associated with the development of a secondary market, it is eager to further explore securitization by pursuing a demonstration program involving the sale of securities in a secondary market. EDA believes that the risks related to such a demonstration are more than offset by the potential to accelerate the development of a secondary market for economic development loans and the benefits of private investment in economic development lending programs. Accordingly, EDA, pursuant to discussions with Treasury officials and other agencies that sponsor revolving loan fund programs, and in consultation with congressional oversight committees, is poised to undertake a demonstration of actual securitization transactions.

In seeking to demonstrate securitization, EDA reported that it plans to allow the transactions to occur without influencing the pricing of the transactions—that is, EDA is not planning to permit its funds to be used for credit enhancement or other schemes designed to influence the pricing of the transactions. In this way, EDA hopes that the demonstration will reveal the true value of economic development loans and give a realistic picture of the investor community's interest in seeking out loan-backed securities for economic development.

Agency Comments

We provided copies of a draft of this report to USDA, SBA, and the Department of Commerce for their review and comment. Their comments and our responses are in appendixes III, IV, and V.

In commenting on the draft report, USDA noted that its Rural Business-Cooperative Service programs, while relatively small when compared with SBA's programs, are, in some localities, the only source of federal funding for business and economic development activities. With respect to the alternative proposed by rural development officials to allow the sale of federally subsidized community development loans in a secondary market, USDA stated that it is currently developing a memorandum of agreement to initiate a demonstration project that will allow the sale of loans into a secondary market. We incorporated USDA's comments into our report where appropriate.

SBA, in commenting on the draft report, agreed that certain borrowers in rural areas, such as start-up, expanding, and minority-owned businesses have difficulty in obtaining capital, and stated that, in some areas, insufficient resources are available to meet technical assistance requirements. SBA noted, however, that given its limited funding for technical assistance, SBA's approach of notifying borrowers of available services and locations is significantly more cost-effective than requiring that all borrowers receive technical assistance as a condition of receiving a loan. We incorporated these comments where appropriate.

In commenting on the draft report, the Department of Commerce's EDA stated that the report did not provide a balanced assessment of the potential for secondary marketing of economic development loans. EDA stated that the potential benefits of developing such a secondary market outweigh the possible shortcomings. In our report, we discuss both potential benefits and limitations of the alternatives and do not take a position on this matter. We incorporated EDA's comments where appropriate.

Scope and Methodology

We conducted our review from May 1996 through April 1997 in accordance with generally accepted government auditing standards. Our scope and methodology are discussed in detail in appendix I. The reports we reviewed concerning rural capital are listed in a bibliography.

As agreed with your offices, unless you publicly announce its contents earlier, we plan no further distribution of this report until 30 days from the date of this letter. At that time, we will send copies of this report to the House Committee on Agriculture, other interested congressional committees, the Secretaries of Agriculture and Commerce, and the Administrator of SBA. We will also make copies available to others upon request.

If you have any questions about this report, please call me at (202) 512-5138. Major contributors to this report are listed in appendix VI.

Robert A. Robinson
Director, Food and
Agriculture Issues

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Abbreviations

CDC	community development corporation
EDA	Economic Development Administration
FCS	Farm Credit System
FHLBS	Federal Home Loan Bank System
GSE	government-sponsored enterprise
SBA	Small Business Administration
USDA	U.S. Department of Agriculture

Scope and Methodology

To describe the primary financial institutions that are used to fund rural agriculture, business, and infrastructure, we reviewed the literature on economic development in rural America and obtained information from federal, state, and local officials concerned with rural development.

To obtain the views of rural officials on potential borrowers' awareness of the sources of finance, the availability of capital, and possible legislative proposals for closing identified gaps, we sent a questionnaire to over 700 rural development officials who are members of the National Association of Development Organizations; the National Association of Regional Councils; and the agricultural and rural affairs steering committee of the National Association of Counties. We also surveyed all 50 state departments of community and economic development, or their equivalents.[1] Our survey questionnaire was designed to obtain information on rural capital issues for production agriculture, businesses, and community infrastructure. We did not include commercial banks and the Farm Credit System in our survey because surveys performed by others had included these traditional suppliers of capital.

Before mailing our questionnaires, we solicited expert review to determine the validity of the instrument by pretesting a preliminary version on officials from selected state, local, and other community organizations of varying size and in different parts of the United States. We pretested in four cities: Richmond, Virginia; Jackson, Mississippi; Boise, Idaho; and Indianapolis, Indiana. On the basis of the comments from these four pretests, we revised the questionnaire so that the questions would be uniformly interpreted and understood. Once we were confident that the questionnaire was free of any design flaws, we conducted a first mailing to officials from state, local, and community organizations.

The officials were given approximately 10 days to complete and return the questionnaire. After a 2-week period, we sent out a "follow-up" letter to those recipients who had not yet returned their questionnaire. After another 2-week period, if questionnaires were still not returned, we mailed reminder postcards requesting the return of the questionnaires.

[1]The National Association of Development Organizations' goals include promoting economic development, focusing primarily on rural areas and small towns and providing technical assistance to its members. These members are drawn primarily from multicounty planning and development agencies. The National Association of Regional Councils' principal mission is advocacy on behalf of regional councils, both rural and urban, at the national level. The National Association of Counties provides research and reference services for county officials and represents county officials at the national level.

We edited the returned questionnaires to ensure that they were complete and filled out correctly. The questionnaire data were then converted into electronic data for statistical analyses.

We received responses from about 67 percent of those surveyed. In presenting the survey results, we only included the responses from those who claimed at least some experience in agriculture, business, or community infrastructure, which accounted for about 74 percent of those returning the questionnaire. Our survey results are shown in detail in appendix II.

We also interviewed rural development officials in four states—Alabama, Maine, Minnesota, and Washington. These officials included bankers and representatives of community development organizations; venture capitalists; members of the rural finance task force of the Rural Policy Research Institute; and representatives of federal and state governments.

Furthermore, we interviewed officials of federal agencies in Washington, D.C., that provide capital to rural America. These agencies included USDA, the Department of Commerce's Economic Development Administration (EDA), and the Small Business Administration (SBA). We also interviewed officials of national associations in Washington, D.C., that represent the interests of businesses, farmers, lenders, developmental organizations, and local communities across the country. These associations included the American Bankers Association, Independent Bankers Association of America, Farm Credit Council, Farm Credit Administration, National Federation of Independent Businesses, National Small Business United, the American Farm Bureau Federation, the National Farmers Union, the National Association of Development Organizations, the National Association of Regional Councils, the National Association of Counties, the Council of State Community Development Agencies, and the National Association of Towns and Townships.

Summary of Responses to Questionnaire to Rural Development Officials

United States General Accounting Office

GAO

Survey on Available Credit And Equity Capital In Rural America.

SECTION 1: INTRODUCTION

GAO has been asked by a congressional committee to develop information on the availability of credit and equity capital in rural America. To this end, we want to obtain the views of state, local, and other community officials who are knowledgeable of rural credit and equity capital issues.

We want to identify whether these officials believe principal financial problems, known as "gaps", exist in rural credit and equity capital availability and the extent to which such gaps are causing difficulties in rural development. In addition, we want to determine the views of these officials on what needs to be done, if anything, at the federal, state, and private levels to improve the rural credit and equity capital situation.

Our study will cover the general availability of credit and equity capital in rural America for borrowers in production agriculture, business, and community infrastructure.

This questionnaire is being sent to approximately 600 state, local officials and rural development organizations and covers a range of topics. It is very important that each question is answered.

Please feel free to consult with other persons within your state government or organization who are most knowledgeable about the availability of credit and equity capital for production agriculture, business, and community infrastructure in rural areas.

Important! If you do not serve rural borrowers or rural communities, do not complete this questionnaire! Check the box below and return the unanswered questionnaire to us in the enclosed return address envelope. Thank you.

[ ] Do not serve rural borrowers/rural communities.

Please complete the questionnaire and return it to us within 10 days after receipt. We have provided a postage-paid business reply envelope to facilitate the return of your questionnaire. In the event that the return envelope is misplaced, please send the completed survey to:

U.S. General Accounting Office
Attn: Mr. Jerry Coffey
2635 Century Parkway, Suite 700
Atlanta, GA 30345

If you have any questions and your state is east of the Mississippi River, please contact either Jerry Coffey or Fred Mayo at 1-800-477-2842, ext. 1825 or 1841.

If your state is west of the Mississippi River, please contact either Dale Wolden or John Smith at 1-800-288-7457, ext. 7410 or 7506.

If any of the information on the mailing label is incorrect, please provide the correct information on the label. We may need to contact you by telephone if clarification or follow-up to any of your answers is necessary.

MAILING LABEL

DEFINITIONS OF TERMS USED IN THE QUESTIONNAIRE:

Agriculture bonds/beginning farmers: State programs based on federal tax-exempt bonds issued by states to private lenders, normally commercial banks, who pass on their tax savings in the form of reduced interest rates to the beginning farmer borrower.

Bank Community Development Corporation (Bank CDCs): Bank CDCs are funded by banks or bank holding companies under special regulatory provisions that encourage investments in community and economic development projects.

Business: any rural business activity other than production agriculture, but would include businesses related to value-added agriculture operations such as warehouses, gins, etc.

Community Development Corporations: Community Development Corporations, which were originally funded in the 1960s by the Office of Economic Opportunity (OEO), are currently funded by the Community Services Administration (CSA) in the Department of Health and Human Services and other federal, state, and local programs and foundations.

Community Infrastructure: permanent physical installations and facilities supporting socio-economic activities in a community (e.g., water/wastewater, hospitals, industrial parks, etc.)

Credit: borrowed funds paid back over a period of time with interest.

Equity: ownership capital invested either by the proprietor/management or by outside investors; money that becomes part of a business' capital base, yielding a return tied to the profitability of the business over time.

Gaps: a shortage of credit and/or equity for the borrower or recipient; not necessarily shortage of funds, but a demand for credit or equity not being met by existing federal, state or private sources.

Production Agriculture: activities related to the producing of agricultural products and includes farm and equipment ownership, as well as operation.

Revolving Loan Funds: Revolving loan funds are independent, unregulated financial entities designed to fill gaps in the private capital markets and may be wholly or partially funded with federal funds.

Rural: counties with urban populations of less than 20,000.

SBA 504 Certified Development Company: The 504 loan program provides long term, fixed rate loans to small businesses through certified development companies (CDCs) which are non-profit organizations sponsored by private interests or by state or local governments.

Small Business Investment Companies (SBICs) and Specialized Small business Investment Companies (SSBICs): SBICs and SSBICs (socially or economically disadvantaged) provide equity capital, long-term loans, debt-equity investments and management assistance to qualifying small business in all types of manufacturing and service industries.

We realize that the respondents to this questionnaire, as state and local (county) officials, regional and rural development organization members have different perspectives concerning rural development, and that many of you may hold positions and/or memberships in more than one of these categories. For purposes of this questionnaire, if you are a state official, please base your responses to the questions on your knowledge and experience of rural development issues on a state-wide perspective for your state. If you are a local (county) official, base your responses on your knowledge and experience of these issues from a local/community perspective from your local/community. And, if you received this questionnaire as a regional or rural development organization member, base your responses on your knowledge and experience of rural development from your regional perspective.

SECTION 2: GENERAL INFORMATION

Organization name:

Name:

Job title:

Telephone/Fax/Email:

1. In the table below, indicate the level of your experience working with lenders and borrowers within production agriculture, business, and community infrastructure. In this case, "your experience" includes the collective experience of all persons who will collaborate on this questionnaire.

Group	Check One For Each			
	Little or no experience (1)	Some experience (2)	A lot of experience (3)	Missing (4)
Production Agriculture				
1. Borrowers	61.7	24.0	12.3	2.0
2. Lenders	61.7	22.9	12.6	2.9
Business				
3. Borrowers	8.0	36.9	54.0	1.1
4. Lenders	7.7	37.1	52.6	2.6
Community Infrastructure				
5. Borrowers (i.e., communities)	9.4	32.9	56.6	1.1
6. Lenders	13.1	43.7	40.6	2.6

SECTION 3: RURAL CREDIT AND EQUITY CAPITAL GAPS

In this section, we would like to know whether or not you believe that problems, or "gaps" exist that restrict the access that potential borrowers have to rural credit and equity capital. In this context, a gap is a shortage of credit and/or equity capital for the borrower or recipient.

2. In your opinion, to what extent, if at all, does a gap currently exist for each of the following categories?

	Check One For Each Category											
	Credit Gaps						Equity Gaps					
Categories	Little or no extent (1)	Some extent (2)	Moderate extent (3)	Great extent (4)	Very great extent (5)	# of responses (6)	Little or no extent (7)	Some extent (8)	Moderate extent (9)	Great extent (10)	Very great extent (11)	# of responses (12)
1. Beginning farmers	3.4	10.9	20.1	35.1	30.5	174	1.8	11.0	12.2	33.5	41.5	164
2. Expanding farmers	14.9	24.0	39.4	19.4	2.3	175	5.5	23.3	37.4	23.9	9.8	163
3. Established farmers	28.1	36.5	27.0	7.9	.6	178	16.8	41.3	26.3	10.8	4.8	167
4. Minority farmers	8.5	21.7	29.2	25.5	15.1	106	2.0	20.8	21.8	29.7	25.7	101
5. Start-up businesses	.3	11.1	22.9	38.3	27.4	332	.3	6.4	16.0	34.7	42.6	326
6. Expanding businesses	6.3	28.8	38.4	21.3	5.1	333	3.7	20.9	42.2	24.9	8.3	325
7. Established businesses	19.4	45.5	27.9	4.8	2.4	330	12.8	43.9	29.9	9.7	3.7	321
8. Minority businesses	5.4	20.1	31.3	30.1	13.1	259	1.2	16.8	27.0	27.0	28.1	256
9. Communities	14.9	29.9	27.6	15.9	11.7	308	12.9	28.3	24.0	18.3	16.5	279
10. Other (Please specify)												

3. In your opinion, to what extent, if at all, has the ***lack of credit and equity capital*** hindered development of production agriculture, business, and community infrastructure in your state or community?

	Check One For Each Category											
	Credit						Equity					
Categories	No extent (1)	Some extent (2)	Moderate extent (3)	Great extent (4)	Very great extent (5)	# of responses (6)	No extent (1)	Some extent (2)	Moderate extent (3)	Great extent (4)	Very great extent (5)	# of responses (6)
1. Production Agriculture	9.8	32.8	32.2	17.2	8.0	174	6.1	26.2	33.5	25.0	9.1	164
2. Business	3.0	24.0	42.1	22.6	8.3	337	1.2	20.7	40.1	26.9	11.1	324
3. Community Infrastructure	8.9	26.2	30.4	22.7	11.8	313	7.6	23.8	28.9	25.6	14.1	277
3a. Hospitals	23.0	31.6	29.6	9.7	6.1	196	21.6	33.0	29.5	9.1	6.8	176
3b. Industrial parks	7.7	22.9	32.9	25.2	11.3	310	5.2	21.7	31.1	29.0	12.9	286
3c. Roads & bridges	13.4	24.0	26.9	21.6	14.1	283	14.3	20.5	27.0	21.6	16.6	259
3d. Water & waste disposal	7.1	23.0	32.4	21.7	15.9	309	7.5	22.1	27.4	26.0	17.1	281
3e. Other (please specify)												

4. If you answered ***"to a great extent"*** or ***"to a very great extent"*** in the previous question, please provide a brief example of the extent to which the lack of credit and/or equity capital has hindered rural development of production agriculture, business, and community infrastructure in your state or community. If you need additional space to answer this question, please use separate sheets of paper and attach to the end of this questionnaire.

SECTION 4: FINANCIAL INSTITUTIONS & PROGRAMS

How adequate, if at all, do you believe the following institutions/programs are in meeting the financial needs of rural borrowers in your state for production agriculture, business, and community infrastructure? ***In this context, adequate means, for example, that sufficient funds are available and that eligibility criteria are satisfactory.***

5. How adequate or inadequate are these financial institutions/programs in providing needs for ***"Production Agriculture"?***

Financial Institution/Program	Check One For Each: Inadequate (1)	Marginal (2)	Adequate (3)	# of Responses (4)
Production Agriculture				
1. Commercial banks	15.0	48.3	36.7	60
2. Farm Credit System	2.4	56.1	41.5	41
3. Life insurance companies	44.4	38.9	16.7	18
4. Captive financing arrangements (e.g., vendor financing)	7.7	50.0	42.3	26
5. Credit unions	33.3	60.0	6.7	30
6. Foundations	58.1	38.7	3.2	31
7. USDA Farm Service Agency (formerly FmHA)	11.5	44.3	44.3	61
8. Small Business Administration (7(a) guaranteed loans)	21.4	50.0	28.6	56
9. Small Business Administration (LowDoc)	25.5	45.1	29.4	51
10. Small Business Administration (504 certified development companies)	27.3	49.1	23.6	55
11. Beginning farmer programs (agriculture bonds)	38.9	50.0	11.1	18
12. Revolving loan funds	42.6	40.7	16.7	54
13. Other federal programs (please specify)				
14. Other state programs (please specify)				
15. Other private programs (please specify)				

6. If you checked ***inadequate*** for any of the institutions/programs for production agriculture, which reason(s) best describes why you believe a program is inadequate?

Financial Institution/Program	Check All That Apply: Not enough funds (1)	Too much paperwork (2)	Restrictive eligibility criteria (3)	High interest rates (4)	High minimum loan amount (5)	Other (specify below) (6)
Production Agriculture						
1. Commercial banks (n=30)	20.0	6.7	80.0	30.0	16.7	10.0
2. Farm Credit System (n=7)	0	28.6	57.1	14.3	0	28.6
3. Life insurance companies (n=39)	20.5	10.3	46.2	10.3	33.3	12.8
4. Captive financing arrangements (e.g., vendor financing)(n=7)	42.9	0	14.3	14.3	0	28.6
5. Credit unions (n=48)	39.6	2.1	47.9	6.3	0	22.9
6. Foundations (n=62)	48.4	11.3	45.2	1.6	1.6	19.4
7. USDA Farm Service Agency (formerly FmHA) (n=25)	60.0	56.0	48.0	0	0	20.0
8. Small Business Administration (7(a) guaranteed loans)(n=41)	22.0	24.4	63.4	12.2	4.9	7.3
9. Small Business Administration (LowDoc)(n=39)	23.1	15.4	61.5	5.1	0	10.3
10. Small Business Administration (504 certified development companies)(n=54)	16.7	29.6	61.1	1.9	11.1	14.8
11. Beginning farmer programs (agriculture bonds)(n=43)	46.5	11.6	32.6	2.3	2.3	27.9
12. Revolving loan funds (n=69)	60.9	4.3	31.9	0	0	20.3
13. Other federal programs (please specify)						
14. Other state programs (please specify)						
15. Other private programs (please specify)						

7. If you checked ***other*** to represent a reason or reasons not listed in the previous matrix, please identify those reasons in the space below.

8. How adequate or inadequate are these institutions/programs in providing needs for ***"Business"?***

Financial Institution/Program	Check One For Each			
	Inadequate (1)	Marginal (2)	Adequate (3)	# of Responses (4)
Business (not production agriculture)				
1. Commercial banks	8.9	50.0	41.1	326
2. Credit unions	40.2	42.2	17.6	204
3. Bank community development corporations (for credit)	38.4	43.1	18.5	211
4. Bank community development corporations (for equity)	49.5	38.8	11.7	196
5. Captive financing arrangements (e.g., vendor financing)	11.2	54.5	34.3	178
6. Revolving loan funds	27.3	44.5	28.2	319
7. Community development corporations	33.3	43.7	23.0	261
8. Farm Credit System (e.g., agribusiness)	15.2	44.1	40.7	145
9. Foundations	61.8	29.8	8.4	178
10. Small Business Administration (7(a) guaranteed loans)	11.1	38.1	50.8	307
11. Small Business Administration (LowDoc)	9.2	39.2	51.6	283
12. Small Business Administration (504 certified development companies)	15.3	39.1	45.6	294
13. Small Business Investment Companies	45.6	38.5	16.0	169
14. USDA Rural Development (e.g., business & industry, intermediary re-lending programs)	27.3	43.9	28.7	289
15. Venture capital firms (e.g., equity)	61.9	29.2	8.8	226
16. Microloans	45.7	38.4	15.9	245
17. Other federal programs (please specify)				
18. Other state programs (please specify)				
19. Other private programs (please specify)				

9. If you checked ***inadequate*** for any of the institutions/programs for business, of the reasons listed below, which reason(s) best describes why you believe a program is inadequate?

Financial Institution/Program	Check All That Apply					
	Not enough funds (1)	Too much paperwork (2)	Restrictive eligibility criteria (3)	High interest rates (4)	High minimum loan amount (5)	Other (specify below) (6)
Business (not production agriculture)						
1. Commercial banks (n=29)	27.6	6.9	65.5	34.5	13.8	17.2
2. Credit unions (n=82)	28.0	2.4	47.6	7.3	1.2	29.3
3. Bank community development corporations (for credit)(n=81)	35.8	7.4	16.0	3.7	1.2	55.6
4. Bank community development corporations (for equity)(n=97)	35.1	4.1	19.6	4.1	1.0	54.6
5. Captive financing arrangements (e.g., vendor financing)(n=20)	45.0	5.0	10.0	25.0	0	15.0
6. Revolving loan funds (n=87)	79.3	13.8	18.4	1.1	2.3	14.9
7. Community development corporations (n=87)	54.0	4.6	5.7	1.1	0	43.7
8. Farm Credit System (e.g., agribusiness)(n=22)	36.4	13.6	36.4	4.5	0	18.2
9. Foundations (n=110)	48.2	8.2	34.5	0	.9	28.2
10. Small Business Administration (7(a) guaranteed loans)(n=34)	23.5	50.0	41.2	11.8	2.9	11.8
11. Small Business Administration (LowDoc)(n=26)	23.1	30.8	57.7	15.4	0	15.4
12. Small Business Administration (504 certified development companies)(n=45)	24.4	53.3	44.4	6.7	11.1	22.2
13. Small Business Investment Companies(n=77)	36.4	10.4	19.5	7.8	5.2	46.8
14. USDA Rural Development (e.g., business & industry, intermediary re-lending programs)(n=79)	60.8	41.8	35.4	1.3	2.5	19.0
15. Venture capital firms (e.g., equity)(n=140)	50.0	5.7	20.0	13.6	8.6	30.0
16. Microloans (n=112)	63.4	11.6	18.8	4.5	1.8	24.1
17. Other federal programs (please specify)						
18. Other state programs (please specify)						
19. Other private programs (please specify)		11				

10. If you checked ***other*** to represent a reason or reasons not listed in the previous matrix, please identify those reasons in the space below.

11. How adequate or inadequate are these institutions/programs in providing needs for ***"Community Infrastructure"?***

Financial Institution/Program	Inadequate (1)	Marginal (2)	Adequate (3)	# of Responses (4)
	Check One For Each			
Community Infrastructure				
1. Bonds	8.6	31.1	60.3	302
2. Commercial banks	29.0	41.0	30.0	293
3. Community development corporations	47.9	37.9	14.2	219
4. Foundations	63.6	28.1	8.5	199
5. Bank community development corporations	51.1	38.5	10.4	182
6. HUD block grants (e.g., CDBG)	28.8	42.4	28.8	330
7. USDA Rural Development (e.g., water & waste disposal)	25.6	41.6	32.8	308
8. Economic Development Administration	35.3	39.7	25.0	320
9. Farm Credit System	30.7	43.6	25.7	101
10. State revolving funds (e.g., water & waste disposal)	26.9	44.8	28.3	290
11. Other federal programs (please specify)				
12. Other state programs (please specify)				
13. Other private programs (please specify)				

12. If you checked ***inadequate*** for any of the institutions/programs for community infrastructure, of the reasons listed below, which reason(s) best describes why you believe a program is inadequate?

Financial Institution/Program	Check All That Apply					
	Not enough funds (1)	Too much paperwork (2)	Restrictive eligibility criteria (3)	High interest rates (4)	Low maximum loan amount (5)	Other (specify below) (6)
Community Infrastructure						
1. Bonds (n=26)	34.6	34.6	46.2	15.4	7.7	34.6
2. Commercial banks (n=85)	23.5	14.1	52.9	49.4	9.4	16.5
3. Community development corporations (n=105)	47.6	4.8	14.3	0	0	41.9
4. Foundations (n=126)	53.2	8.7	40.5	0	.8	27.8
5. Bank community development corporations (n=93)	44.1	5.4	17.2	5.4	2.2	46.2
6. HUD block grants (e.g., CDBG)(n=95)	84.2	34.7	41.1	0	0	14.7
7. USDA Rural Development (e.g., water & waste disposal)(n=79)	83.5	35.4	30.4	1.3	1.3	7.6
8. Economic Development Administration (n=113)	85.8	23.9	32.7	0	.9	8.8
9. Farm Credit System (n=31)	32.3	6.5	48.4	6.5	0	19.4
10. State revolving funds (e.g., water & waste disposal)(n=78)	80.8	21.8	25.6	2.6	2.6	7.7
11. Other federal programs (please specify)						
12. Other state programs (please specify)						
13. Other private programs (please specify)						

13. If you checked ***other*** to represent a reason or reasons not listed in the previous matrix, please identify those reasons in the space below.

14. Some states or local organizations have developed programs to help finance rural development. How long, if at all, have the following programs for production agriculture, business, and community infrastructure been in existence in your state or area?

Program	Check One For Each: Do not have this program (1)	Less than 1 year (2)	1 to 5 years (3)	Greater than 5 years (4)	Don't know (5)
Production Agriculture					
1. Beginning farmer loan programs (agriculture bonds)	14.6	0	7.1	11.7	62.6
2. Revolving loan funds	16.6	.3	8.3	21.7	48.9
3. Venture capital funds	22.0	1.1	3.4	11.1	57.4
4. Microloan funds	18.9	1.7	13.7	4.3	56.6
5. Guaranteed loan programs	7.7	.3	3.4	32.6	50.3
6. Other (please specify)					
Business					
7. Revolving loan funds	8.0	2.3	17.1	64.3	6.9
8. Venture capital funds	28.3	1.4	12.9	27.4	27.4
9. Microloan funds	19.7	5.4	36.6	13.4	22.3
10. Guaranteed loan programs	10.0	1.1	11.7	63.1	11.4
11. Other (please specify)					
Community Infrastructure					
12. Bonds	2.9	0	2.3	81.7	9.7
13. Revolving loan funds	12.6	2.9	15.4	53.1	12.0
14. Other (please specify)					

SECTION 5: POTENTIAL BORROWERS

In some cases, potential borrowers package their loan applications to draw on multiple sources of funds, thus spreading the risk and possibly increasing the amount of funds ultimately available to the borrower.

15. To what extent, if at all, has this packaging of fund sources been successful for potential borrowers in your state or area?

	Check One					
	To little or no extent (1)	To some extent (2)	To a moderate extent (3)	To a great extent (4)	To a very great extent (5)	# of Responses (6)
1. Production Agriculture	38.8	33.6	19.0	7.8	.9	116
2. Business	5.8	18.0	34.7	25.4	16.1	311
3. Community Infrastructure	6.4	20.7	34.1	27.1	11.7	299

16. In your opinion, are potential rural borrowers in need of credit and/or equity capital ***aware of,*** and ***knowledgeable on how to apply*** for various financial resources available to them?

	Check One For Each									
	Aware of sources					Knowledgeable on applying				
	Definitely Yes (1)	Probably yes (2)	Probably no (3)	Definitely No (4)	# of Responses (5)	Definitely Yes (1)	Probably yes (2)	Probably no (3)	Definitely No (4)	# of Responses (5)
1. Production Agriculture	9.8	42.8	41.6	5.8	173	5.4	30.5	51.5	12.6	167
2. Business	3.6	40.5	48.8	7.1	338	4.9	25.0	51.2	18.9	328
3. Community Infrastructure	17.5	51.5	26.7	4.3	326	13.3	37.0	37.7	12.0	316

17. In general, how adequate, if at all, is the technical assistance (e.g., writing business plans, analyzing cash-flows, preparing loan applications, developing marketing plans, etc.) that is provided to potential borrowers?

	Check One For Each			
Borrowers for:	Inadequate (1)	Marginal (2)	Adequate (3)	Don't know (4)
1. Production agriculture	11.1	16.3	13.1	58.0
2. Business	8.3	44.6	42.6	3.7
3. Community infrastructure	7.4	28.9	52.6	8.9

SECTION 6: THE FUTURE

If you need additional space to answer the following two questions, please use separate sheets of paper and attach to the end of this questionnaire.

18. In general, what, if any, federal or state legislative action should be taken to address any credit and/or equity capital problems or "gaps" that exist for rural development in production agriculture, business, or community infrastructure?

Production Agriculture

Business

Community Infrastructure

19. What are the key changes that are occurring in rural credit markets that are affecting or could affect the availability of credit and/or equity capital?

Production Agriculture

Business

Community Infrastructure

Thank you for your cooperation and assistance. This concludes the questionnaire!

Comments From the U.S. Department of Agriculture

Note: GAO comments supplementing those in the report text appear at the end of this appendix.

DEPARTMENT OF AGRICULTURE
OFFICE OF THE SECRETARY
WASHINGTON, D.C. 20250

APR 25 1997

SUBJECT: GAO Draft Report (GAO/RCED-97-109) "Rural Development: Availability of Capital for Agriculture, Business, and Infrastructure"

TO: Robert A. Robinson
Director
Food and Agriculture Issues
U.S. General Accounting Office

We have reviewed the subject report and have the following comments for your consideration.

See comment 1.

Rural Development, specifically the Rural Business-Cooperative Service (RBS) has several loan and grant programs that provide financial assistance to rural communities for business and economic development purposes. These programs include:

- Business and Industry (B&I) Guaranteed Loan Program
- Business and Industry Direct Loan Program
- Intermediary Relending Program (IRP)
- Rural Business Enterprise Grant (RBEG) Program
- Rural Economic Development Loan (REDL) Program
- Rural Economic Development Grant (REDG)Program
- Rural Business Opportunity Grant (RBOG) Program
- Rural Venture Capital Demonstration Program

While these programs may be relatively small when compared to the Small Business Administration (SBA) programs, in some instances they are the only available Federal funding sources for some rural areas. It is our understanding that only approximately 20 percent of SBA funding goes to rural communities; whereas, our programs are specifically designed to provide assistance to rural communities.

Numerous issues were raised concerning the access to capital in rural areas for agricultural business and community infrastructure purposes. One proposal suggested that Federal financial and technical assistance programs be targeted to borrowers having difficulty accessing capital.

There are several rural Business Programs and initiatives that have been targeted to provide resources to borrowers having difficulty accessing capital:

1. **The President's Initiative on Empowerment Zones/Enterprise Communities (EZ/EC) and Champion Communities (CC)**

   Three rural EZs and 30 ECs have been designated by the President to not only receive Health and Human Services Social Services Block Grant assistance but are recipients of earmarked funding for the B&I, IRP, and RBEG programs. These communities were selected based on economic opportunity, sustainable community development, community-based partnerships, and their strategic vision for change.

   Of the 227 applicants for EZ/EC status, 194 were designated as Champion Communities, identified to receive assistance as a response to specific requests for funding and technical assistance. The State Directors are encouraged to consider priority points when scoring projects in CCs for funding consideration.

   See comment 2.

   Attached is a copy of the list of EZ/EC/CCs and a factsheet.

2. Other initiatives that have targeted resources include:

   A. The President's Pacific Northwest Economic Adjustment Initiative
   Due to Federal actions to limit the harvesting of old-growth timber in the Pacific Northwest area (Oregon, Washington, and northern California) an economic crisis resulted due to the area's heavy dependence on the timber industry. The Secretary of Agriculture, along with 10 other Departmental/ Agency heads, entered into an interagency Memorandum of Understanding (MOU) for economic adjustment and community assistance to the timber-impacted PNW area. This MOU was developed to provide financial assistance to assist the communities and residents impacted by this economic crisis. As a part of this MOU, certain dollar amounts of financial assistance were identified and made available to fund economic relief projects during Fiscal Years 1994, 1995, 1996, and, by amended MOU, 1997 and 1998, from the B&I, IRP, and RBEG programs, in addition to other Rural Development mission area programs (Water and Waste Disposal and Community Facilities).

   B. Presidential Rural Economic Area Partnership (REAP Zones)
   REAP is a Presidential national demonstration project, implemented in two multi-county regions within North Dakota, to curb out-migration and job

GAO Draft Report (GAO/RCED-97-109) 3

losses while increasing economic opportunities by detailing necessary strategies, assistance, and funding needed to stop the out-migration, increase jobs and create more economic opportunities. REAP partners are working to involve local persons and businesses, private and public sectors, foundations, State agencies, and other Federal agencies to become partners working to fund economic development projects. (Attached is a copy of the REAP Zone map.)

C. Business and Industry Direct Loan Program

The B&I Direct Loan program is being funded for the first time in 15 years. The program level will provide financial assistance to communities and businesses that cannot get credit elsewhere and which need financial assistance at lower interest rates than a guaranteed loan program. The B&I Direct Loan Program provides needed financial assistance to communities and businesses that are not being served because the associated risks may not attract existing lending sources even with a guarantee.

It can be focused on those parts of rural America in greatest need, such as areas of high poverty (Mississippi Delta Empowerment Zone/Enterprise Communities), Dorgan Zones (REAP), PNW Relief, Colonias, Native American Reservations, Appalachia); areas undergoing significant and rapid economic transformations, such as areas impacted by military base closings; and areas undergoing fundamental declines in traditional industries, such as agricultural and mining areas.

The program will also be used to focus on population groups whose persistent poverty and potential for economic advancement have high priority, including African-American, Hispanic-American, and Native American population groups.

D. Rural Development Technical Assistance in Target Areas

In addition to the financial assistance available, Rural Development has designated field staff to work with communities located in the mission area targeted areas to assisting them in accessing available Federal resources to meet identified business, economic, and community infrastructure needs. Those areas include the:

1. Non-Metropolitan Counties with Greatest Declining Population, 1980-1990
2. Non-Metropolitan Persistent Poverty Counties
3. Areas impacted by Federal actions or natural disasters (PNW and REAP are examples)

E. **Streamlined B&I Guaranteed Loan Program Regulation**
Recently the B&I Guaranteed Loan Program regulation was rewritten and published in the Federal Register (on December 23, 1996). Major enhancements were made to the regulation along with the automation of the application forms (see attached information sheet). This revised regulation provides for eligibility to a broader clientele and provides flexibility in delivering the program in targeted areas.

3. The attached chart provides the impact on rural America that Business Programs had for Fiscal Year (FY) 1996.

4. Attached is a chart showing, for FY 1997, the following funding levels available to provide business and economic assistance in rural areas.

The 1996 FAIR Act ("Federal Agriculture Improvement and Reform"), Public Law 104-127 (known as the 1996 Farm Bill), authorized the Rural Business Opportunity Grant and Rural Venture Capital Demonstration Programs be administered by RBS to provide technical assistance, planning, development, and assistance for rural venture capital needs in rural communities. These programs support the financial needs of rural communities identified in the GAO report. Please see the attached factsheet for more information on these programs.

See comment 3.

In your report, reference is made to allowing the sale of Federally-subsidized community development loans. In support of this concept, another way RBS is looking at providing additional capital in rural areas in through a demonstration project to allow the sale of third-party recipient loans by IRP lenders. An MOA is currently being developed to finalize this demonstration project

Another agency within USDA that assists entrepreneurs and businesses that are attempting to commercialize bio-based industrial products (non-food, non-feed) from agricultural and forestry materials and animal by-products is the Alternative Agricultural Research and Commercialization Corporation (AARC). AARC is a wholly-owned government corporation of USDA (see attached factsheet)

Jill Long Thompson
JILL LONG THOMPSON
Under Secretary
Rural Development

Attachments

See comment 4.

DEPARTMENT OF AGRICULTURE
OFFICE OF THE SECRETARY
WASHINGTON, D.C. 20250

APR 21 1997

SUBJECT: GAO/RCED-97-109, "Rural Development: Availability of Capital for Agriculture, Business, and Infrastructure

TO: Robert A. Robinson
Director
Food and Agriculture Issues
U. S. General Accounting Office

The subject draft report was reviewed in the Rural Housing Service, including Single Family Housing, Multiple Family Housing, and Community Programs.

The Community Programs Staff has the following comments which are directed to the section on "Alternatives Proposed for Improving Availability of Capital in Rural Areas."

OMB Circular A-129 prohibits Federal agencies from issuing loan guarantees for tax-exempt bond issues of local government and from financially participating with a loan guarantee in a local project financed with the proceeds from a tax-exempt bond issue.

However, with Federal program resources continuing to decrease, permitting a Federal guarantee of tax-exempt issues, in certain situations, may prove to be an acceptable option in providing financing for critical infrastructure needs. Many communities do not qualify for the programs administered by Rural Development and, yet, are not financially able to establish a credit rating with the bond market and needed improvements are not being made. It may be time to re-evaluate the restrictive nature of Federal policy in financing local improvements.

JILL LONG THOMPSON
Under Secretary
Rural Development

United States Department of Agriculture

Farm Service Agency

Stop 0573
1400 Independence Ave SW
Washington DC 20250-0573

April 22, 1997

TO: Robert A. Robinson, Director
Food and Agriculture Issues
United States General Accounting Office

FROM: Carol Wagner, Director
Audits and Investigations Group

Karren L. Deen

SUBJECT: Rural Development: Availability of Capital for Agriculture, Business, and Infrastructure (GAO Code 150423) Review Draft

Enclosed is a copy of a memorandum dated April 16 from the Farm Service Agency's (FSA's) Deputy Administrator for Farm Loan Programs, which responds to your April 4 request for comments on the subject draft review.

Please address any questions to Karren Deen, FSA, Audits and Investigations Group, at 720-6152.

Enclosure

United States Department of Agriculture

Farm Service Agency

Stop 0521
1400 Independence Ave SW
Washington DC 20250-0521

APR 16 1997

TO: Carol Wagner, Director
Audits and Investigations Group

FROM: Carolyn B. Cooksie
Deputy Administrator for
Farm Loan Programs

Carolyn B. Cooksie

SUBJECT: Responding to U.S. General Accounting Office (GAO) Draft Report on Rural Development: Availability of Capital for Agriculture, Business, and Infrastructure

We have reviewed the April 8, 1997, Draft of the GAO report. It does appear to us that the private lending officials surveyed believe that certain borrowers in rural areas have difficulty in obtaining capital. The survey results reflect that production agriculture borrowers having difficulty in obtaining capital include beginning farmers, minority farmers and expanding farmers. The survey findings should help justify the administration of the United States Department of Agriculture, Farm Service Agency, Farm Loan Programs (formerly FmHA).

The following are GAO comments on the U.S. Department of Agriculture's (USDA) letters dated April 21-25, 1997.

GAO Comments

1. We have added more detail on USDA's financial and technical assistance programs that are targeted to rural areas for business and economic development.

2. USDA included some attachments that provided additional detailed information about specific agency programs. We have not included these attachments in the report.

3. We have revised the report to recognize that USDA plans to conduct a demonstration project allowing the sale of loans to third-party recipients.

4. We recognize that certain restrictions exist with respect to the sale of tax-exempt bonds to finance community infrastructure needs. However, a complete discussion of this issue is beyond the scope of this report.

Comments From the Small Business Administration

Note: GAO comments supplementing those in the report text appear at the end of this appendix.

U.S. SMALL BUSINESS ADMINISTRATION
WASHINGTON, D.C. 20416

April 18, 1997

Mr. Robert A. Robinson, Director
Food and Agriculture Issues
U.S. General Accounting Office
441 G Street, N.W.
Washington, D.C. 20548

Re: GAO Draft Report entitled Rural Development: Availability of Capital for Agriculture, Business, and Infrastructure (GAO code 150423)

Dear Mr. Robinson:

In response to your letter of April 4, 1997, we are pleased to provide the Agency comments on the above referenced report.

We agree that certain borrowers in rural areas, such as start-up, expanding, and minority-owned businesses have difficulty in obtaining capital. We concur with the findings that these difficulties are frequently caused by factors such as: (1) a lack of equity or collateral; (2) a lack of business or management skills; (3) a lack of knowledge about available resources; and (4) entrepreneurs, such as software developers, seeking to establish businesses in primarily agricultural areas.

The report acknowledges several current initiatives to help increase the availability of capital. These include federal, state, and private programs developed to provide technical assistance to prospective borrowers. A majority of those surveyed by GAO believe this assistance is marginal and inadequate, although GAO interviews with rural development officials indicate this negative response might be due in part to insufficient resources to meet the demand.

SBA's Small Business Development (SBDC) program is one of the technical assistance providers mentioned. The Congress created the SBDC program in 1980 to provide a free resource to small business owners seeking management and technical to aid in the start-up, expansion and successful operation his/her small business. The program is a unique partnership between SBA and states that permits each of the 57 SBDCs to be tailored to the economic development needs of its particular region. The SBDC program meets the counseling and training needs of about 570,000 clients annually through a network of approximately 1000 service delivery locations. Over 50% of the service delivery location serve rural counties. Approximately 65-70% of those counseled were

Robert A. Robinson
Page Two

interested in business start-up or acquisition. More than one quarter of those counseled get information on sources of capital. Forty percent of all clients are women. Nineteen percent of all clients are minorities.

While this represents a significant effort, we do not disagree with those officials who believe that insufficient resources are available to meet rural America's small business needs. Two factors inhibit SBA's ability to deliver additional services to small business located in rural communities: the program's authorized level is $77.5 million but it is currently funded at $73.2 million; and, by statute the funds are distributed among the states on a pro rate bases based upon the population of the state as compared to the total population of the United States, with minimum funding set at $200,000.

The report also discusses possible changes in SBA's lending programs to target groups having difficulties meeting current SBA credit criteria. Recognizing the higher risk associated with such small businesses, it suggests loan approvals be contingent upon the borrower agreeing to work closely with SBDCs.

See comment 1.

We agree that technical assistance can be beneficial to many borrowers. SBA currently notifies all SBA guaranteed loans recipients of the services and location of our nearby technical assistance partners. This assures that borrowers in need of technical assistance are aware of our partners services and location. This approach acknowledges that many factors besides a business owners skill and knowledge impact a small business access to capital. Given the limited funding currently available to the SBDC program we believe our approach is significantly more cost effective than requiring all borrowers work closely with their local SBDCs as a condition of obtaining the loan.

Additionally, we would like to mention that the Office of Advocacy has produced research that is relevant to the subject matter of the report and can be obtained upon your request.

1. Advocacy's 3 banking studies (1995, 1996 and 1997) ranks the small business lending patterns of the nation's commercial banks on a state-by-state basis. Further on the banking studies, there is listing specifically ranking loans to small business and farms of less than $250,000.

2. Advocacy's Banking Holding company study and our 2 micro-loan studies.

3. On venture capital, Advocacy research has shown that there is an equity investment gap between investments of $250,000 and $5,000,000, a need that is not being met by existing equity markets - not even venture capitalists. The average venture capital investment is now approximately $6.5 million.

Robert A. Robinson
Page Three

Should you or your staff have any questions, please feel free to call Maria Moy of my staff at (202) 205-6104.

Sincerely,

John S Kushman

John Kushman, Director
Financial Administration Staff

The following are GAO comments on the Small Business Administration's (SBA) letter dated April 18, 1997.

GAO Comments

1. We have revised the report to recognize that SBA officials believe that, given the limited funding currently available, requiring that all borrowers receive technical assistance would not be as cost-effective as the practice of notifying guaranteed loan recipients of the services that are available.

Comments From the Department of Commerce

Note: GAO comments supplementing those in the report text appear at the end of this appendix.

THE SECRETARY OF COMMERCE
Washington, D.C. 20230
MAY - 6 1997

Mr. Robert A. Robinson, Director
Food and Agriculture Issues
U. S. General Accounting Office
Washington, D. C. 20548

Dear Mr. Robinson:

Thank you for your letter requesting the Department's comments on the draft General Accounting Office report entitled, "Rural Development: Availability of Capital for Agriculture, Business, and Infrastructure."

See comment 1.

Our comments address the section of the report that discusses the alternatives proposed by rural development officials for improving the availability of capital in rural areas. We believe the report does not provide a balanced assessment of economic development loan securitization, and its potential to tap additional sources of financing. The perspective of the Economic Development Administration is that the potential benefits of developing such secondary markets outweigh the possible shortcomings. We are providing the enclosed comments, therefore, for your consideration.

We appreciate your interest in the Department and its programs.

Sincerely,

William M. Daley

Enclosure

EDA COMMENTS
TO GAO REPORT ON RURAL DEVELOPMENT:
AVAILABILITY OF CAPITAL FOR AGRICULTURE, BUSINESS
AND INFRASTRUCTURE

The draft report on rural development (beginning on the bottom of page 22) neither fairly represents the perspective of EDA, nor provides a balanced assessment of the potential of securitization of economic development loans.

Over the past several years, EDA has been engaged in evaluating the feasibility of secondary marketing of economic development loans. Significant barriers, both technical in nature and non-technical have, to date, hindered the development of such a secondary market. Nonetheless, the increasing pressure on Federal and other public sector resources, will continue to drive the RLF community in the direction of secondary marketing as a potential source for new capital for lending.

EDA recognizes that, although not all RLF's are positioned to participate in securitization, it is appropriate to seek out and assist those organizations willing to lead the way in the development of standards, policies and procedures necessary for the development of a healthy secondary market. EDA, pursuant to discussions with U.S. Treasury officials and other Agencies that sponsor RLF programs, and in consultation with Congressional oversight staff, is poised to undertake a demonstration of actual securitization transactions.

In seeking to demonstrate securitization, EDA is taking the position of enabling the transactions to occur without influencing the pricing of the transactions -- that is, EDA is not permitting its funds to be used for credit enhancement or other schemes designed to influence the pricing of the transactions. In this way, it is hoped that the demonstration will reveal the true value of economic development loans and give a realistic picture of the investor community's interest in seeking out economic development loan-backed securities.

See comment 2.

In summary, while EDA is aware of the drawbacks and barriers associated with the development of a secondary market, the Agency is eager to further explore securitization by pursuing a demonstration program involving actual transactions. EDA believes the risks related to such a demonstration are more than offset by the potential to accelerate the development of a secondary market for economic development loans and the benefits of private investment in economic development lending programs.

The following are GAO comments on the Department of Commerce's Economic Development Administration's (EDA) letter dated May 6, 1997.

GAO Comments

1. The report recognizes both the potential benefits and limitations of the alternatives. We revised the report to recognize that EDA officials believe that the potential benefits of developing secondary markets for economic development loans outweigh the possible shortcomings.

2. We revised the report to recognize that EDA officials plan to explore secondary markets by pursuing a demonstration program involving the sale of loans into secondary markets.

Major Contributors to This Report

Robert C. Summers, Assistant Director
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