Virginia's
Rural Economic Analysis Program

HORIZONS

March/ April 1996 Volume 8, Number 2

The Search for Credit in Rural Virginia

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Entrepreneurs with creative ideas for new business ventures need start-up money. Small businesses having established niches and now looking for ways to expand can be thwarted by lack of capital. Individuals wanting to own and operate a farm or current farmers wanting to change what they do face similar credit barriers. Around the country, and certainly Virginia is no exception, access to capital is crucial in economic development and growth. Rural communities are often hit the hardest by lack of access to capital.

Tobacco provides a significant part of the income for many families in south central and southwest Virginia. In some counties, tobacco makes up 60 to 70 percent of farm sales. And adjustments appear imminent in the tobacco sector. As farm families making their living producing tobacco are forced to look for alternative income sources, the need for new investments and entrepreneurial activity in Virginia's rural communities becomes an immediate issue. If a member of the farm family needs to find an off-farm job, economic development that generates high quality jobs is essential. With new jobs often created only by new investments, the lack of access to capital stifles opportunities. Frequently, those firms most in need of capital do not have the equity that private sector financial institutions require to allow them to make loans.

In 1994-95, a broad-based group involving REAP staff, leaders in the tobacco sector, Virginia Farm Bureau, Virginia Agribusiness Council, Virginia Department of Agriculture and Consumer Services, Virginia Cooperative Extension, the Institute for Environmental Negotiation and the Cooper Center for Public Policy at the University of Virginia, the Virginia Community College System, and IQ Health was involved in a number of statewide and regional meetings. The coalition prepared a set of recommendations for a special legislative committee charged with looking at ways to assist tobacco farmers. Recognizing the importance of access to capital, one recommendation to the legislative group was to find ways to make credit more accessible. The legislative committee, agreeing that a need for access to capital exists, passed a resolution in the General Assembly in early 1996 asking the Small Business Commission to examine:

> new initiatives and existing state programs which may increase the accessibility to public and private capital; programs implemented in other states; . . . and the appropriate role of the state in providing the agricultural community with greater access to capital. (Resolution No. 34)

Several other states have already addressed the issue of the need for access to credit. In 1986, Michigan instituted a program which has become a model for other states. The Michigan Strategic Fund implemented the Capital Access Program (CAP). The goal of the program is to provide credit so that a business can get started and become eligible for commercial credit. CAP is based on a concept of pooling risk. Instead of the typical equity requirements or guarantees provided by other programs, CAP has a special reserve fund for each participating bank. The bank makes the loan. The borrower pays a one-time "risk premium," plus any normally required bank fees. The premium is matched by the bank and the cost is passed on to the borrower. The Michigan Strategic Fund then matches the sum of the premiums. These premiums provide the "pool" of reserves for any losses by

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Horizons is a publication of the Rural Economic Analysis Program (REAP) in the Department of Agricultural and Applied Economics and College of Agriculture and Life Sciences at Virginia Polytechnic Institute and State University.

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loan default. The existence of this pool does not allow the bank to be less prudent when making these loans than it would normally be. If the losses from CAP loans exceed the pooled reserves, the bank is at risk for any losses above the CAP reserve.

These loans will usually be more expensive to the borrower than conventional loans because of up-front fees associated with CAP. But total costs to the borrower will still be less than is often required for "venture capital" funds in the financial markets. And, more importantly, access to capital is being provided to firms that otherwise might not be able to obtain it.

There are few eligibility limitations for Michigan's CAP loans. They must be used for business purposes. They cannot be used for the construction, renovation, or purchase of residential housing. They cannot be used by a bank to refinance an existing high risk loan. There is no limit on the amount of the loans, although the average loan, to date, is $52,000. As long as the business is located in Michigan and satisfies the bank's criteria, it is eligible.

Many states have programs geared to making capital available to beginning farmers. The state programs have some differences, but basically provide tax-exempt bonds to fund the loans. Typical requirements for these loans are:

- never having owned an interest in a substantial amount of land,
- not purchasing assets from a close relative,
- not refinancing existing debt,
- having access to sufficient working capital,
- having a net worth less than $200,000, and
- having experience or education in the type of farming for which the loan is being made.

Generally, these loans are for a maximum of $250,000, of which not more than half may be used for other than land acquisition and improvements such as conservation compliance and buildings. Up to $125,000 can be used for purchases of new, depreciable agricultural machinery and equipment and young breeding livestock. There may be provisions for used equipment, machinery, and older breeding stock. Some states will only lend to proprietorships or partnerships, not to corporations.

These loans to beginning farmers are made through local banks using federal tax exempt private activity bonds. The bonds are purchased by the lender and then issued to the borrower for the amount of the loan. A public hearing is required before loan approval is complete. Terms and conditions, such as interest rate and repayment date, are agreed upon and stated in the loan agreement.

There are advantages to using these bonds. Banks, the entities with expertise in lending, evaluate the loans. The bonds give banks greater flexibility in risk-taking. The biggest advantage, of course, is the borrower obtains access to bank financing which might not be available otherwise.

In Virginia at this time, there is no separate beginning farmer program. The source of funds for beginning farmers who are not eligible for commercial bank or Farm Credit System loans is the Farm Services Agency, which resulted from combining the Farmers' Home Administration (FmHA) and the Agricultural Stabilization and Conservation Service (ASCS). With the passage of the Farm Bill on April 4, 1996, changes took place in the requirements for, and restrictions on, the Beginning Farmer Program. Funds have been set aside specifically for the Beginning Farmer Program. Priority will be given to beginning farmers who are purchasing real property that has been acquired by the Farm Services Agency as the result of foreclosures or voluntary deed transfer in lieu of payment. This program can provide working capital for a beginning farmer. Some of the problems facing beginning farmers will be alleviated by this program, but existing farmers will find it harder to obtain money. The problems facing the entrepreneur in rural communities will not be solved by the latest Farm Bill.

The Rural Credit and Development Act of 1994 made changes in the role that the Farm Credit System (FCS) can play in rural areas. The Act changed the provisions for rural housing loans, making the requirements less stringent. It expanded the eligibility of rural and agricultural businesses that provide goods and related services to farms by eliminating the requirement that the services be performed on the farm. The Act authorized FCS to purchase loans that would be eligible for FCS lending from local commercial banks, thereby making more capital available for lending through the local banks. Rural communities can now borrow from FCS to finance community facility projects. A provision was added to lend to local businesses that provide goods and services to eligible cooperatives if the loan would provide a direct benefit to the cooperative. Finally, rural water systems, as well as power generation byproducts, or related services or benefits, were made eligible for Farm Credit lending. These changes will help some businesses and rural communities.

Horizons (ISSN 1075-9255) is published bimonthly by the Rural Economics Analysis Program (REAP). REAP is administered in the Department of Agricultural and Applied Economics in Virginia Tech's College of Agriculture and Life Sciences. Please address all correspondence to REAP, Department of Ag. and Applied Economics, Virginia Tech, Blacksburg, VA 24061-0401; phone (540) 231-9443.

The Alternative Agricultural Research Commercialization (AARC) Center, created by the 1990 Farm Bill and funded in 1993, relies on appropriations from Congress and a revolving fund which reinvests proceeds from repayments in other projects to provide funds. The purpose of AARC is

> to expedite development and market penetration of industrial (nonfood, nonfeed) products from agricultural and forestry materials and animal by-products. It assists the private sector in bridging the gap between research results and commercialization of that research . . . Preference is given to projects that benefit rural communities and are environmentally friendly. (Brochure)

More information is available from The Alternative Agricultural Research Commercialization Center, USDA, 14th Street, NW, Room 0156, South Building, Washington, DC 20250-0401, fax (202) 690-1655.

The U.S. Department of Agriculture's Rural Development Administration administers a loan guarantee program, which is primarily aimed at agricultural processing operations rather than production agriculture. The program's purpose is to increase the non-agricultural jobs in rural areas and assist local lenders in providing credit for expansion and preservation of jobs. It has a wide range of uses. But it cannot be used for any project that will result in the transfer of business or employment from one area to another or transfer of ownership, unless the transfer prevents the business from closing, prevents loss of jobs, or provides increased employment.

Virginia has several programs for economic development that are available only to Virginia residents. These programs include: Private Activity Tax Exempt Bond Program, Virginia Small Business Financing Authority (VSBFA) Industrial Development Bond Program, VSBFA Umbrella Bond Program, VSBFA Taxable Bond Program, Virginia Defense Conversion Revolving Loan Fund, Virginia Economic Development Revolving Loan Fund, Loan Guarantee Programs, and the Export Financing Assistance Program. The purposes, uses, and restrictions for these programs are summarized in Table 1.

Most of these sources of credit are aimed at manufacturing industries and construction of facilities. None seem to be available for business expansion or for research and development to support new ideas. Some loan guarantee programs provide working capital through lines of credit, but most programs require that adequate working capital be available through other sources. The Virginia Defense Conversion Revolving Loan Fund and the Export Financing Assistance Program are available for working capital, but both programs are specifically targeted.

The need for access to capital for entrepreneurs with creative new ideas for business ventures and for existing businesses trying to expand is apparent. The marketplace will force adjustments in the tobacco sector, and the newly passed Farm Bill will force change and adjustment throughout much of rural Virginia. The 1996 General Assembly resolution calling for an examination of the proper role of the state in providing capital for worthy ideas and projects in rural Virginia is timely. As the appropriate agencies and/or commissions follow through on this resolution, anyone who shares REAP's interest in this area needs to become involved. The future viability of Virginia's rural communities and the quality of life in these communities could be at risk.

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NOTICES

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**New REAP Special Report: *The Economic Position of Virginia Agriculture: Mid-1990s* by Wayne Purcell. Contact the REAP office for copies.

**A SPECIAL ALERT by Wayne Purcell on how to manage the feed cost crisis facing livstock, dairy, and poultry producers is on the REAP Homepage.

Table 1. Virginia financing assistance programs.

Program	Purpose	Use	Restrictions
Private Activity Tax Exempt Bond Program	Provides bond allocation to VSBFA and local industrial development authorities for manufacturing and exempt facility projects	Manufacturing: acquisition, construction, and equipping of facilities; Exempt: same for sewage, solid waste, and qualified hazardous waste facilities	Cannot: refinance existing debt or be used for working capital Limited to $40 million nationally, $10 million within single political jurisdiction; some restrictions on purchase of existing facilities and used equipment
Virginia Small Business Financing Authority			
Industrial Development Bond Program	Issue tax exempt development bonds	Acquisition, construction, and equipping of manufacturing facilities	Cannot: refinance existing debt or be used for working capital All proceeds must comply with applicable federal tax code
Umbrella Bond Program	Provide cost-effective means to access tax exempt bond market through use of standard documentation and uniform credit enhancement to market bonds	Same as Industrial Development Bond Program	Not stated
Taxable Bond Program	Economic development financing using taxable bond market	Acquisition, construction, and equipping of commercial and industrial facilities	Cannot be used for speculative investment property acquisition or non-owner occupied facilities
Va. Defense Conversion Revolving Loan Fund	Assist defense dependent companies in expanding commercial markets and in diversification	Fixed assets and working capital	Not stated
Virginia Economic Development Revolving Loan Fund	Funds loaned through local industrial development authorities to bridge gap between private debt financing and private equity	Construct new facilities, acquire land and buildings, improve existing sites and buildings, purchase machinery and equipment	Cannot refinance existing debt; provide working capital; relocate company from one Va. jurisdiction to another; compensate for fundamental weakness in company; or provide funds obtainable from conventional sources
Loan Guarantee Programs	Support growth of small businesses and creation of new employment, and reduce risk to lending institution	Lines of credit for inventory or accounts receivable or loans up to 3 years to finance fixed asset purchases or permanent working capital	Cannot be used to refinance or restructure existing bank debt
Export Financing Assistance Program	VSBFA with Export-Import Bank of U.S. and U.S. SBA provides easier access to export financing and export credit insurance	Short term working capital for exporter; term loans for foreign buyers	Must be fully collateralized; be at least 51% U.S. content; shipped to a country Export-Import Bank of U.S./ SBA authorized to support

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VT/001/0496/3.4M/963498