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## Revolving Loan Funds for Small Business Development

*By Ian Pulsipher*

*Revolving loan fund programs can be particularly important to inner-city and rural areas..*

*Entrepreneurs who seek loans may face stringent income, asset and collateral requirements.*

*RLF programs provide financing of \$35,000 or less for small companies.*

*RLFs are supported by both federal and state governments.*

Revolving loan fund (RLF) programs are designed to contribute to the economic development of communities and states by supporting the start-up and expansion of small businesses that are not served by traditional lending sources. These funds provide loans to small business owners—often low- to middle-income entrepreneurs located in distressed urban or rural communities—at fixed rates and terms more favorable to businesses than those offered in commercial lending markets. Once the program is under way, the original capital base is designed to be replenished by the principal payments, interest and fee payments of previous loan recipients. This money is then to be lent back for further investment into entrepreneurial activity. Programs can be particularly important to inner-city and rural areas that may be underserved by commercial lending institutions.

**Gap Financing.** RLF programs are often described as providing “gap financing” for small businesses. Entrepreneurs served by these loans may be unable to secure capital from banks or commercial lenders because of stringent income, asset and collateral requirements. The programs allow greater weight to be given to the potential success of small businesses and their ability to repay in the future rather than to current financial conditions. RLFs are not meant to be permanent substitutes for commercial lenders but, rather, to serve as an alternative source of financing for small businesses until they are able to fund their capital needs from traditional sources.

RLF programs are also described as the middle section of the “lending continuum” because they provide financing between microenterprise borrowing—designed for companies of five or fewer employees with financing needs of less than \$35,000—and purely commercial borrowing that they cannot yet receive. Before small businesses have matured to the point of full commercial borrowing, RLF financing often is used as a supplement to funds that can be obtained from traditional lenders.

**Census of Federally Funded RLF Activity.** RLFs receive support from both federal and state governments. The Corporation for Enterprise Development conducted a survey of federal involvement in the industry in 1997 that provides insights into both the role of federal government support for the program and the effects of these programs in the development of small businesses.

The study examined financial support provided to 603 RLFs from six different federal agencies. Major findings from the study include the verification of a general occurrence of growth in the overall number of these loan funds in the industry and expansion in the scope of the programs’ missions and focus. The study also produces important findings regarding performance. On average, it took a loan of only \$5,338 to save or create one job, and default rates were only slightly higher than those from private sector banks.

## State Action

At least 19 states operate RLF financing programs for small business development, in some cases supported by federal community development block grant funds. Of these states, nine directly operate RLF programs, and 10 provide funds to such programs operated by organizations other than state governments.

Nevada and North Dakota directly fund and operate state RLF programs, both of which target rural entrepreneurs. Both also maintain a strong focus on job creation. The loan amount in North Dakota's program—up to \$300,000—is directly proportional to the number of jobs to be created. Nevada's program focuses on employment for low- to middle-income residents. Participating firms are required to document that they have provided opportunities to obtain newly created jobs first to applicants from this group.

Other state programs—such as those in Maine and Ohio—involve funding RLFs operated by other organizations. In Maine, funding from the state allows regional development organizations to provide up to \$200,000 to businesses of up to 50 employees. The program, designed to create good jobs in the state with RLF capital subordinate to that from other lending sources, is for small business creation in either urban or rural areas. Ohio's Economic Development Program, run by the Office of Housing and Community Partnership, provides funding to local governments to provide gap financing for small businesses in their communities. With the exception of loans for public infrastructure projects, loan repayments go back to the local RLF to be redistributed as small business loans.

**Benefits and Challenges.** The U.S. Small Business Administration reports that small businesses provide approximately 75 percent of the net new jobs added to the economy and employ 50.1 percent of the private workforce. Thus, the anticipated contribution that RLFs can make to the overall economic development of communities and states is visible in the role that small businesses play in the U.S. economy, especially in employment. RLF programs are designed to increase the positive effects of small business activity by helping to create and expand more small businesses.

Challenges to RLF success, however, are inherent in their design. The conciliatory terms of loans—especially repayment—may not allow sufficient operational income compared to operational costs. Easier access to credit also might shelter firms from appropriate competition or allow them to undertake growth strategies that will be unsustainable under future commercial borrowing.

## Selected References

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