

SB 238

() USE COMMITTEE REPORT

(11)

Date Referred: May 17, 1991

FURTHER REFERRALS:

Date of Committee Action: 5/19/91

The FINANCE Committee considered:

CSSB 238(FIN)

CS FOR SENATE BILL NO. 238 (FINANCE)

RURAL DEVELOPMENT INITIATIVE FUND

"An Act relating to the rural development initiative program."

RECOMMENDATIONS:

be replaced with _____ the same title

a new title

have attached amendments(s)

do pass

do not pass

no recommendations

individual recommendations

additional referral to the _____ Committee

ADOPTS: _____ letter of Intent

ATTACHES NEW FISCAL NOTE(S): (Dept)

APPROVES PREVIOUS: (Dept/Date)

fiscal impact _____

fiscal note(s) DEPT 5/19/91

zero fiscal note _____

zero fiscal note(s) _____

| SIGNING DO PASS | DP | OTHER RECOMMENDATIONS | DNP | NR | AM |
|-------------------------------------|-------------------------------------|-----------------------|-----|----|----|
| Eileen P. Maclean <i>Maclean</i> | <input checked="" type="checkbox"/> | | | | |
| Boyer | | | | | |
| Tau Brown <i>Brown</i> | <input checked="" type="checkbox"/> | | | | |
| Koponen | | | | | |
| JACKO | <input checked="" type="checkbox"/> | | | | |
| Barnes | <input checked="" type="checkbox"/> | | | | |
| Sharp | <input checked="" type="checkbox"/> | | | | |
| Phillips | <input checked="" type="checkbox"/> | | | | |
| Wasson | <input checked="" type="checkbox"/> | | | | |
| Wm | <input checked="" type="checkbox"/> | | | | |
| NAVAVE | <input checked="" type="checkbox"/> | | | | |

Mike Navarre *E P Maclean*
CHAIRMAN'S SIGNATURE

FISCAL NOTE

STATE OF ALASKA
1991 LEGISLATIVE SESSION

BILL NO. SB 238

Revision Date: 5/13/91 Department Affected: Dept. Community & Regional Aff
 Title: RURAL DEVELOPMENT INITIATIVE PROGRAM BRU: EMPLOYMENT/TRAINING/RURAL DEVELOPMENT
 Component: COMMUNITY DEVELOPMENT ASSISTANCE
 Sponsor: SENATORS ADAMS & HOFFMAN
 Requestor: _____ COMPONENT SERIAL NO.

| | | | |
|---|---|---|---|
| 1 | 1 | 7 | 9 |
|---|---|---|---|

Expenditures/Revenues: (Thousands of Dollars)

| OPERATING | FY 92 | FY 93 | FY 94 | FY 95 | FY 96 | FY 97 |
|-------------------|-------|-------|-------|-------|-------|-------|
| PERSONAL SERVICES | | | | | | |
| TRAVEL | | | | | | |
| CONTRACTUAL | | | | | | |
| SUPPLIES | | | | | | |
| EQUIPMENT | | | | | | |
| LAND & STRUCTURES | | | | | | |
| GRANTS, CLAIMS | | | | | | |
| MISCELLANEOUS | | | | | | |
| TOTAL OPERATING | -0- | -0- | -0- | -0- | -0- | -0- |

| | | | | | | |
|---------|--|--|--|--|--|--|
| CAPITAL | | | | | | |
|---------|--|--|--|--|--|--|

| | | | | | | |
|---------|--|--|--|--|--|--|
| REVENUE | | | | | | |
|---------|--|--|--|--|--|--|

FUNDING: (Thousands of Dollars)

| | | | | | | |
|---------------|---------|-----|------|-------|-------|-------|
| GENERAL FUND | 1,000.0 | -0- | -0- | -0- | -0- | -0- |
| FEDERAL FUNDS | | | | | | |
| OTHER | | | 47.3 | 236.2 | 236.2 | 283.5 |
| TOTAL | 1,000.0 | -0- | 47.3 | 236.2 | 236.2 | 283.5 |

POSITIONS:

| | | | | | | |
|-----------|--|--|--|--|--|--|
| FULL-TIME | | | | | | |
| PART-TIME | | | | | | |
| TEMPORARY | | | | | | |

Estimate of current year impact:

ANALYSIS: (Attach a separate page if necessary.) See attached.

Prepared By: Remond Henderson, Director Phone: 465-4708
 Division: Administrative Services Date: May 13, 1991
 Approved by Commissioner: Edgar Blatchford
 Agency: Department of Community and Regional Affairs Date: 5/13/91

Distribution (by preparer): Legislative Finance, Legislative Sponsor, Requestor, OMB, & Impacted Agency(ies).

This fiscal note supercedes a prior note - provided for HB 256, and SB 238. HB 256 was a companion measure introduced in the House. HB 256 was linked, fiscally, to HB 222 insofar as the bill appropriated \$10 million to capitalize the REDIF. With the demise of HB 222 the prior fiscal note for HB 256 and SB 238 is moot. The funding source and level for SB 238 is unknown at this time and, therefore, the fiscal note is reduced. (see position paper).

The one million dollars is included as a contribution to the REDIF as a funding source. The one million dollars is identified in the Governor's FY92 capital budget for rural development grants and is one of the Hickel Administration's priorities. but currently it is not reflected in the Senate's Capital budget. Therefore, we have requested that level of funding for this bill.

The zero operating budget for the REDIF is justified by the capacity of our existing RDF operations system to absorb this small amount of funds.

Finally, the "other" sources of revenue reflect an estimate of income from loans made with the one million dollars.

CS FOR SENATE BILL NO. 238 (FINANCE)
IN THE LEGISLATURE OF THE STATE OF ALASKA
SEVENTEENTH LEGISLATURE - FIRST SESSION

BY THE SENATE FINANCE COMMITTEE

Offered: 5/15/91
Referred: Finance

Sponsor(s): SENATORS ADAMS, Hoffman

A BILL

FOR AN ACT ENTITLED

1 "An Act relating to the rural development initiative program."

2 BE IT ENACTED BY THE LEGISLATURE OF THE STATE OF ALASKA:

3 * Section 1. AS 44.47 is amended by adding new sections to read:

4 ARTICLE 11A. RURAL DEVELOPMENT INITIATIVE PROGRAM.

5 Sec. 44.47.300. RURAL DEVELOPMENT INITIATIVE FUND. (a) The rural
6 development initiative fund is created in the department. Unless provided otherwise in the
7 appropriation act, an appropriation to the fund is retained in the fund for use under
8 AS 44.47.800 - 44.47.820 and does not lapse at the end of a fiscal year. Each year the
9 commissioner shall request an appropriation to the fund of interest and other income earned on
10 loans or investments of the fund. Money in the fund may be appropriated for costs of
11 administering AS 44.47.800 - 44.47.820.

12 (b) The commissioner may place money from the fund into a special reserve account as
13 necessary. The commissioner may use money in the account to protect the state's security
14 interest in collateral on loans made from the fund, to protect the state's interests in investments

1 made from the fund, or to defray expenses incurred during foreclosure or other legal proceedings
2 involving loans or investments made from the fund.

3 (c) The commissioner may use money from the fund to provide for loan information
4 officers under AS 44.47.155.

5 Sec. 44.47.810. RURAL DEVELOPMENT LOANS. (a) The department may use
6 money from the rural development initiative fund to make a loan of up to \$100,000 to a person,
7 or a loan of up to \$200,000 to two or more persons, to be used for working capital, equipment,
8 construction, or other commercial purposes by a business located in a community with a
9 population of 5,000 or less. A person who has received a loan under this subsection may not be
10 granted another loan until after the original loan is entirely repaid.

11 (b) The department shall require collateral for each loan made under this section and
12 shall require that a reasonable amount of money from other nonstate sources be committed for
13 use on any project or enterprise for which money from a loan will be used. The department by
14 regulation may establish other conditions for loans. The department shall by regulation establish
15 rates of interest that are not less than six percent per year and terms of repayment for loans made
16 under this section.

17 Sec. 44.47.820. DISPOSAL OF PROPERTY ACQUIRED BY DEFAULT OR
18 FORECLOSURE. The department shall dispose of property acquired through default or
19 foreclosure of a loan made from the rural development initiative fund. Disposal shall be made
20 in a manner that serves the best interests of the state, and may include the amortization of
21 payments over a period of years. The commissioner shall request an appropriation to the fund
22 of proceeds from disposal of property under this section.

Alaska State Legislature

Al Adams
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Official Business

May 16, 1991

TO: Representative Navarre, Co-Chair
Representative MacLean, Co-Chair
House Finance Committee

FROM: Sen. Adams *APA*

RE: Hearing for SB 238

Please schedule SB 238: An Act relating to the rural development initiative program, at your earliest convenience.

Attached is a "white paper" from the Department of Community and Regional Affairs on how they envision this loan program working.

As you know, a major roadblock to rural economic development is access to capital. This bill would allow the department to make loans to be used for working capital, equipment, construction, or other commercial purposes for businesses in communities with populations of 5000 or less.

This bill addresses a missing link in our rural economic development program. I believe we need to take action on this proposal this session.

I appreciate your attention to this matter.

STATE OF ALASKA

DEPT. OF COMMUNITY & REGIONAL AFFAIRS

OFFICE OF THE COMMISSIONER

WALTER J. HICKEL, GOVERNOR

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May 13, 1991

POSITION PAPER

RE: SB 238

Sponsor: Adams, Hoffman

Program Effects on Bill:

Under current law, the Department is directed to promote development of rural areas of the state and is authorized to "... formulate a coordinated program to broaden and diversify the economic base of rural areas;" (Ch. 47, Article 3)

The Department currently administers a Revolving Development Fund (RDF) under the Rural Economic Development Initiative (REDI) program.

The RDF is capitalized with Federal Community Development Block Grant (CDBG) receipts. A pilot program, the RDF has proven the utility of a rural financing program, but has also highlighted the need for additional, more-flexible monies to be directed towards this program. The federal monies only allow the Department to address certain limited types of opportunities.

The impact of SB 238 shall be to structure and implement a state-funded development program.

If SB 238 is passed, DCRA staff shall expend a minimum of six months to prepare regulations for public review. These regulations are expected to be extensive, requiring the review and input from numerous agencies, rural business persons, banks, and the general public. Once developed, the regulations will be subject to a public hearing process and possible revision.

A one million dollar fiscal note is appended which will provide some initial capitalization of the fund once the regulations are adopted. This one million dollars is reflected within the Governor's FY92 Capital Budget request and is one of the Hickel Administration's priorities, but currently is not reflected in the Senate Capital Budget plan.

This fiscal note assumes that existing staff can manage the development, design, and initial implementation of the regulations.

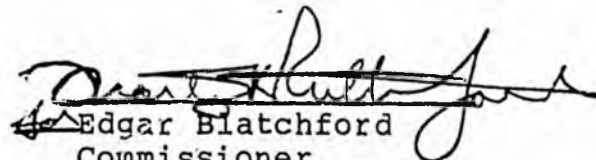
May 13, 1991
Position Paper
SB 238
Page Two

The existing staff structure utilized for the CDBG RDF program may be used initially to support the program.

Comments:

The Department strongly supports passage of the bill. Our experience has shown that there is considerable interest in and need for rural loans. However, the current funding source (CDBG) contains many restrictions and is highly bureaucratic.

The presence of state dollars can eliminate two important restrictions. Namely, the current requirement that the RDF loan must go through a municipality; and second, that the RDF loan is limited to second class cities or municipalities.


Edgar Blatchford
Commissioner

SB 238: AN INITIATIVE OF HOPE
A perspective provided by the
Department of Community and Regional Affairs
Rural Development Division

BACKGROUND: *SB 238 proposes to establish a Rural Development Initiative Fund (REDIF) within the Department of Community and Regional Affairs. This document constitutes a "White Paper" by DCRA staff to explain various sections contained in the legislation well as synopsise a proposed structure for the REDIF.*

In the early 1980's, the Alaskan banking system was awash with cash, and in an expansionist mode. Competition among banks led to increases in services in rural Alaska. Alaska National Bank of the North, United Bank of Alaska, and National Bank of Alaska expanded into rural Alaska. The economic contraction in the mid-80's led to the failure of the most aggressive banks due primarily to the collapsed value of their urban portfolios. Former bank officials for both UBA and ANB contend that the rural portfolios of the two banks were among their most reliable performers. The strength of rural investment is reflected in the relative performances of the housing loan portfolios of AHFC compared with those of the primarily rural DCRA HAD program. When AHFC was faced with huge defaults in the late 1980's, mostly from urban and suburban markets -- into the low double digits -- the HAD portfolio, primarily rural, performed with a default rate under 5%.

Generally it is the case that rural borrowers are lifelong Alaskans with extensive family ties within the state. Such clients are not likely to walk away from a debt. With proper underwriting and servicing of the deal, including the "hometown banker" approach to technical assistance to the client, a rural Alaskan investment can be as solid as any around.

Yet during the Governor's Conference on Small Business, particularly in the rural areas, one of the greatest needs identified was access to capital.

The Department of Community and Regional Affairs currently administers a gap financing program funded with federal Block Grant dollars called the "Rural Development Fund" (RDF) as part of its REDI menu of programs. In the first 9 months of start-up, the program has provided nearly \$400,000 in financing and leveraged over a million dollars for rural and small city entrepreneurs. The Department of Commerce has also been managing a loan program with federal dollars and while DCRA has been aggressively marketing its program, both agencies face the same fundamental constraints in the use of federal dollars.

Nevertheless, the RDF and the Small Business Development Loan program remain two of the few financing sources available to rural businesses.

There is no "equity investment" program currently available to rural Alaskan businesses. If debt capital is scarce in rural Alaska, "seed capital" is non-existent.

In other states, models have been developed for equity investment facilities from the Small Business Administration's SBIC/MSBIC (Small/Minority Business Investment Corporation) program to the Michigan Strategic Fund's BIDCO (Business and Industrial Development Corporation) to Arkansas' "Good Faith Fund".

HB 256 AND SB 238--Commentary
Page 2

PART I: COMMENTARY

A. SECTION 44.47.800 subsection (b) "...The commissioner may place money from the fund into a special reserve account as necessary..."

This part is included to permit the fund to operate in case of loss. This reserve account will be interest-bearing. The interest from the account should revolve back into the principal of the fund. An initial cap for reserves should probably be 30% of loans and investment outstanding. When a track record for the fund is established, the reserves will be reduced to match actual performance. By the end of the third year of operation, the fund manager should be able to make such an adjustment.

B. SECTION 44.47.800 subsection (c) "...The commissioner may use money from the fund to provide for loan information officers..."

The goal of the REDIF is to achieve self-sufficiency in operations. Past loan programs which failed, did so because they were not designed to be self-financing. The key to success of the REDIF shall be the presence of a strong and effective technical assistance team located in the field offices. The loan information officers will constitute the "front line" of a field operation which will ensure "Deal flow". The staff, together with the Economic Development Specialist, will operate to assist in "portfolio management". Both deal flow and portfolio management are major strategic thrusts within REDIF to help ensure success.

C. SECTION 44.47.810 subsection (a) "...Loan limitations and population cap for eligible communities..."

This section places a limitation of \$100,000 for an individual or \$200,000 for more than one individual per deal. No client who has received one loan is eligible to receive another until the current loan is "entirely repaid". The intent of this part is to ensure that there will be adequate distribution of the limited resources available through the REDIF. The population cap was placed at 5,000 to ensure that rural regional centers would have access to the funding as well as smaller villages. A village microeconomy is not a stand-alone unit. Even subsistence economic activities integrate regional rather than strictly local resources. The cash economic activities of rural Alaska fall together as a "trade area" and not just as a collection of local and statewide units.

The viability of a trade area is determined by the magnitude of "pull" which its regional centers exhibit (T. Nakazawa, et al, 1989). Consequently, it would not be adequate to address rural Alaskan Development in terms of the village microeconomy alone but it would be necessary to address expansion and development in the rural regional centers as well.

D. SECTION 44.47.820 "...Investment in Rural Business..."

This section extends the capacity of the REDIF to purchase equity in rural projects. The intent here is to purchase a preferred, non-voting class of stock. Purchase should be linked to securing other elements of REDIF funding or other financing.

HB 256 AND SB 238--Commentary
Page 3

For example, an EDS (or another financial consultant) might package a project which requires equity that is beyond the capacity of the rural business. A bank and, say, the Community Enterprise Development Corporation (CEDC) are participating in the package. The loans, however, cannot be made without equity (say, 20% in the deal). The business is able to come up with 5% equity leaving an equity gap of 15%. The entrepreneur agrees to form a stock corporation. The entrepreneur, with assistance from the Department of Commerce, forms a limited stock corporation and offers the REDIF investment fund an option on stock equal to the equity gap. An investment advisory board established by the commissioner of DCRA to advise staff (see "ADVISORY BOARD", below) approve the investment and the deal is made. Most investments will be small (called "micro-investments") in the magnitude of less than \$10,000. An equity position will only be considered when it secures some form of other financing and all other debt, equity, and grant options have been exhausted.

This section also allows the REDIF to induce private-sector investments in rural projects by underwriting them. For example, the commissioner may periodically issue an RFP requesting proposals from rural partnerships including, typically, a bank and a village corporation. Proposals are then received which identify projects which have merit but are deemed "too risky". The REDIF staff analyze the projects and recommend some to the investment advisory for underwriting. When the board agrees, a conditional guarantee will be written against loss. Funds from the REDIF will be set aside in an interest bearing account equal to the guarantee. As the project develops and the risk declines, REDIF will withdraw in favor of private underwriting. Fees will be charged for underwriting which will accrue to the REDIF.

Part II: SB 238 and 256 A Rural Economic Development Initiative Fund (REDIF)
for Alaska

Both the sponsors of the legislation and the DCRA/REDI staff feel that the REDIF should be structured both as a debt and as an investment (equity) facility. The program could be structured as follows. The major strategic thrust of this program may be summarized in a single word: "PARTICIPATION".

Participation refers to the act of joint financing of a project by two or more parties. "Bank participation" is a term used when one or more of those parties is a bank. "Participatory agreement" is a document which establishes the conditions for a party's participation. "Leveraging" refers to the use of equity to attract multiples of other funds into a deal. The objective of the REDIF is to make private investment possible by establishing incentives for participation. This is done in three ways:

- (1.) REDIF subordination of interest in collateral in a loan participation agreement with a bank (filling a collateral gap);
- (2.) REDIF financing equity to ensure the participation of other financing parties (filling an equity gap);
- (3.) the REDIF providing underwriting guarantees for investments in rural Alaska without which such investments cannot be made (filling a surety gap).

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Page 4

A. Low-Interest Loan Program

This program would complement the Federal funds used to capitalize both the DCRA and the CDBG loan programs. The State dollars will provide new flexibility to that program and allow a better "mix" of funds to generate more deals for Rural Alaskans. With interest and terms comparable to the REDIF/RDF program, this program would provide loans to rural businesses for working capital, Machinery and Equipment, construction, leasehold improvement, and site purchase. The program would be both direct and participatory. "Direct Loans" are those made directly by the REDIF to the client and not through an intermediary, such as a local government; "Participatory Loans" are those that involve other lenders and are sometimes made through them.

Loans for enterprises that *help diversify* the local economy will be a priority. For example, a loan made for an enterprise that promotes tourism, small fish processing, added-value timber and wood development, botanicals, or small manufacturing would constitute diversification initiatives and be of high priority. Loans that *provide for community multipliers* will be a priority. For example, a cafe where there is not one, a medical service which will pay for itself, a movie theater where none exists. Another priority for the program will be businesses that *provide for import substitution*. Examples include production of wood planks to supply boardwalks and other local construction, a commercial ammunition reloading business to supply local and regional hunters, a local repair business -- all might be examples of import substitution deals.

B. Good Faith Group Loans

Frequently, borrowers will not have collateral or tangible assets to contribute to the start-up costs of a new business. At times, there are compelling reasons to support the enterprise. For example, if the borrower has good character, necessary skills and is highly motivated; if the enterprise achieves the objectives of the program and there is a demonstrable market niche for a proposed product or service, then there is compelling interest in the EDS and the LIOs in pursuing financing for the business. Such opportunities will occasionally "group" together as they would, say, among middle-Yukon fishermen who know one another well and who may share financing objectives (in this example for small value-added processors).

This component of the REDIF will be patterned after similar programs developed by the Winthrop Rockefeller Foundation in Arkansas and the Shorebank Corporation in Chicago. The good faith fund concept is based upon individuals of good character coming together and, with business planning provided by consultants, securing a line of credit as a syndicate guaranteed by each individual. Although unsecured, the debt that is generated as the credit is "drawn down" becomes the responsibility of the syndicate. If the individual borrower within the syndicate fails to meet his or her obligation, the others in the syndicate lose their credit options until the debt is repaid.

This type of structure has been shown to do several things. First, it creates a solid support base for each business in the syndicate. Second, it tends to diversify resources available to each business as they share market information, equipment, etc. Third, there is a "counter-cycling of down periods" that balances good times and bad times. Fourth, the portfolio of shared liability spreads risk and recovery, which is good for the security of the fund.

HB 256 AND SB 238—A Description**Page 5****C. Entrepreneurship Loans**

These loans would be made in conjunction with the Entrepreneurship Training Program that has been operated for two years in both Bethel and Fairbanks. Approximately 50 rural entrepreneurs have been trained through the Entrepreneur Training Program conducted by both the Yukon Kuskokwim Campus of the University of Alaska in Bethel and the UAF SBDC in Fairbanks, the latter in conjunction with the Tanana Chiefs Conference Employment and Training Program. A six-week intensive course in business management results in certification and a fundable business plan. The candidates for the limited training slots are drawn from among rural entrepreneurs with new or expanding businesses.

The REDIF vision would be to add an actual loan committee review at the end of the training course with funding commitments from the REDIF Entrepreneurial Loan Program contingent upon committee recommendations.

D. Village Corporate Capital Pooling

The loss reserves will help to insure capital pooling agreements between village corporations and other investors. The capital pool would be structured to make private-sector reinvestment into rural communities possible. This program allows the REDIF to induce the private-sector to make investments in rural projects by underwriting those investments. For example, the commissioner may periodically issue an RFP requesting proposals for rural partnerships including, typically, a bank and a village corporation.

Proposals would then be received which identify projects which have merit but are deemed "too risky". The REDIF staff analyze the projects and recommend some to the investment advisory for underwriting. When the board agrees, a conditional guarantee will be written against loss. Funds from the REDIF will be set aside in an interest-bearing account equal to the guarantee. As the project develops and the risk declines, REDIF will withdraw in favor of private underwriting. Fees will be charged for underwriting which will accrue to the REDIF.

E. REDIF Venture Fund

An equity investment component of the REDIF would provide "seed" capital for promising projects. The REDIF venture fund would be based upon the model of the much VenCap Alberta Corporation, a venture capital corporation created with endowments from Alberta's oil royalties. VenCap provides investments that are secured by capital stock in the venture. Owners of the venture will retain first right of refusal on any stock liquidation by REDIF. The REDIF may subordinate its interest in favor of that of a leveraged participant if it is determined by the REDIF Board that there is a "reasonable expectation" that the leveraged capital will enhance the value of REDIF's holdings. Obviously the REDIF venture fund will be looking at "micro" and "mini" projects rather than the larger projects.

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Page 6

A major, but not the only, target here is "technology transfer and application" in the rural marketplace. ALASKA SCIENCE AND TECHNOLOGY - funded research, for instance, has demonstrated some practical technologies that may be applicable in the rural marketplace. Examples are the low-head hydro demonstration project and the aerobic humus toilet that have been shown to be practical for rural areas.

Each investment will seek to achieve a medium-yield present value Rate of Return (IRR) at the end of a specified term.

F. Fund Reserves

A principal reserve will be maintained by a contract fund manager in a secure, liquidable portfolio. This reserve will function both as a loss-reserve and contingency fund. The target return on these reserves should be a medium market rate for securities.

G. REDIF Operating Costs

AS 44.47.155 authorizes the Department to establish rural Loan Information Officers (LIOs). The LIOs would be placed within the Community Development Assistance component of the Community Development BRU to be supervised by the Statewide Economic Development Specialist. Also, these operating funds would be used for costs associated with an investment advisory Board.