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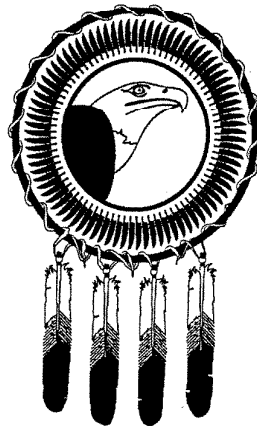
*Financing American Indian Economic Development
An Analysis and Organizational Structure for S. 721
The Indian Development Finance Corporation Act*

by

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EXECUTIVE SUMMARY

In this paper, we recommend financial, marketing, and operating strategies for the proposed Indian Development Finance Corporation. These recommendations are based upon our review of reservation economies, capital markets, and the experiences of similar development finance institutions.

The Indian Development Finance Corporation (IDFC) will lend in a very difficult economic setting. Indian Country does not have a singular set of economic problems or business resources. First, each reservation possesses a unique geographic location and asset base. Second, the IDFC must begin its work in communities with few skilled laborers or experienced managers. The problems caused by decades of high unemployment have not been reversed by education or training programs. Third, lenders must recognize that reservation lending falls within a unique area of U.S. law. Issues of jurisdiction, tribal sovereignty and land status create investment climates different from the rest of the United States. The Corporation will enter a mass of communities, each with dramatically different needs and resources.

Off-reservation organizations provide most of the funds for Indian Country's business development. The three sources of internal investment -- trust assets; tribal savings; and individual savings -- are either inaccessible or relatively small. Assistance from Federal agencies has not fared well, either. Budget cuts have limited the role of Federal agencies like the

Office for Economic Opportunity (OEO), the Economic Development Administration (EDA), and the Labor Department through its Comprehensive Education and Training Act (CETA) program. Despite increased programming by the Bureau of Indian Affairs (BIA), overall government investment in Indian Country has gone down.

Economic development, increasing the resource base of a community, requires more than a supply of money. It also requires the participation of community members who are willing and able to manage investment. In Indian Country, there are cases where interested borrowers cannot overcome barriers to capital acquisition. For many Indian businesspeople, these barriers include: lender risk aversion; high information costs; lack of collateral; transaction costs; and managerial inexperience.

In this paper, we highlight four development finance programs which illustrate different approaches to business lending. In each case, management attempts to resolve the conflicts between organizational objectives, methods of financing, return on investment, relationships with governments and clients, customers, and choice of personnel. The four institutions we discuss are:

Commercial Banks. Commercial banks may be located close to reservations but seldom participate in their economies. One organization, the American Indian National Bank (AINB), specifically tried to lend in Indian Country. Nevertheless, the AINB ran into many of the problems that other lenders habitually avoid. The Bank could not service different groups of customers, meet high loan administration costs, as well as receive limited returns on business lending and still meet its financial goals.

Lakota Fund. The Lakota Fund is a small business development program located on the Pine Ridge Reservation in South Dakota. The Fund, a not for profit corporation, states that its primary goal is to meet community needs. To achieve this goal, the Fund makes small loans (usually under \$1,000) and

operates an active outreach program to encourage informal businesses to utilize its services. The Fund is capitalized and managed independently of the tribal government despite its strong ties to the reservation community.

Hoopa Valley Revolving Loan Fund. The Hoopa Valley Revolving Loan Fund (RLF) was founded by the Hoopa Valley Tribal Council and the Economic Development Administration (EDA). The tribe established the RLF to help create and retain reservation jobs. Most of the RLF's loans are "unbankable," because the borrowers lack collateral or sufficient amounts of equity. Despite the Fund's financial success, it faces several long-term problems. Low demand for loans is one of its greatest concerns. The RLF's failure to target specific types of businesses and its omission of outreach and borrower assistance programs are possible contributors to this problem.

International Finance Corporation. A subsidiary of the World Bank, the International Finance Corporation (IFC) lends to businesses in member countries, primarily less developed countries (LDCs). To assist business development and ensure that its funds are well managed, the IFC extensively analyzes the project's financial, economic, and technical requirements. This thorough analysis and the IFC's good track record enable it to attract other world lenders in cofinancing or resale of IFC loans. The IFC encourages host nation participation in the decision process by requiring the approval of the government before it makes a loan.

The goal of Senate Bill 721, the Indian Development Finance Corporation Act, is to create a development bank appropriate for Indian Country. We believe that the International Finance Corporation's ability to operate profitably; bridge local economies with external capital markets; develop management skills; and cooperate with host nations make it an attractive model for the IDFC.

Like the International Finance Corporation, the Indian Development Finance Corporation cannot expect to replace existing capital markets. Its limited resources and potentially large customer base demand that it serve as a bridge between existing

markets and Indian businesses. To help attract the participation of other investors, as well as recognize the limitations of its resources, lessen portfolio risk, and hedge against increasing capital costs, we recommend that the IDFC:

- 1). Lend to many types of Indian Country businesses;
- 2). Cap the level of IDFC participation in any one project;
and,
- 3). Price all loans at a market rate reflecting project risk.

Choosing a target market for a new Indian development bank requires that its Directors accept trade-offs --- the Corporation cannot be all things to all people. Since the IDFC's goal is to create sustainable development, we recommend that the Corporation target its services to the needs of small to medium sized enterprises. While this is admittedly a difficult lending market and the glamour of the "big" deals is tempting, small and medium businesses are more likely to encourage the managerial and technical expertise of Indian businesspeople, use local resources, and compliment tribal development plans. In particular, we recommend that the IDFC:

- 1). Lend to any financially, managerially, and technically feasible reservation business, regardless of ownership;
- 2). Lend only to IDFC member tribes;
- 3). Lend or invest funds in amounts from \$25,000 to \$1 million.

After all is said and done, the IDFC must successfully deliver loans, equity investments, and business assistance. The Corporation's success hinges upon its ability to actually fulfill a reservation's business needs. Our final recommendations for the IDFC include:

- 1). Establish one central office for all lenders;
- 2). Assign the lenders to projects according to their area of business expertise;
- 3). Assist potential and current borrowers with loan applications and business operations; and,
- 4). Create a separate approval process for small and large business loans.

INTRODUCTION

There is an economic problem in Indian Country. Human, financial, and physical resources are under utilized while most American Indians live in poverty. The sub-optimal education, job training, and prospects offered to most young American Indians creates a self-perpetuating cycle of poverty. The American Indian Nations, always geographically segregated, have become economically isolated, too.

It is difficult to envision an economic development path appropriate for American Indians. Certainly, there are many actions which may marginally improve reservation economies. Unfortunately, none of these programs create a clear path for Indian self-sufficiency or self-determination. Moreover, many tribal leaders, tired of outside meddling that historically served to weaken tribal communities, hesitate to rearrange current institutions. In many respects, these leaders have hit upon the key issue in economic development. How can a community develop its economy without violence to traditional society? Can these two forces work together?

In the past year, a bill, entitled S.721: The Indian Development Finance Corporation Act, has been brought to Congress. The bill's proponents suggest that business investment and self-determination can work side by side. [see Appendix I: Analysis of S.721]. The development finance strategy, which has its origins 19th century France and the Credit Moblier, allows

governments to channel funds to low income individuals or groups in the form of business loans. Lenders hope that borrowers can increase personal and social wealth, if given a chance to participate in business ventures.

In this paper, we compare and contrast plans for an investment program in Indian Country. To do this, we start with an examination of reservation economies. Hardly a singular condition, the Indian Country economy is actually a combination of hundreds of local economies. General areas of interest include natural and human resources, human capital, political and legal standards, and the financial wealth of these communities.

With the conditions of reservation economies in mind, we briefly explore some issues of American Indian economic development finance. Can investment accomplish it all? If not, what other factors are required? Development finance is not a new idea. In our third chapter, we look at the operations of four existing business development lenders. Of particular interest is each group's goal in offering loans, procedures followed to reach its market, and the inter-relationship between these procedures. We chose commercial banks, the Lakota Fund, Hoopa Valley Revolving Loan Fund, and the International Finance Corporation to exemplify the variety of lending strategies followed in situations similar to Indian Country.

Drawing on the paths blazed by others, we conclude this paper with our own recommendations for an Indian Development

Finance Corporation. These recommendations concern the IDFC's financial policies, target borrowers, and operating procedures.

Managing the development process is like battling the multi-headed Hydra of Greek mythology. We hope that our discussion of issues lops off a few heads and hints at the location of others. However, the ultimate success of a development finance institution depends upon the diligence of the persons staffing it. Their agility, ability, and sharp swords are the ultimate challenge to that nasty Hydra.

CHAPTER 1

CHARACTERISTICS OF RESERVATION ECONOMIES

Although tempting, we cannot set forth a singular description of economic conditions in Indian Country. There are currently 283 federally recognized reservations located across the United States, from Maine to Oregon. Variation across reservations in wealth and economic activity is marked. The total 51.8 million acres held by tribes experience differences in access to population centers, availability of natural resources, and climate. Moreover, each reservation operates under a unique constitution and ownership structure. In addition, early twentieth century laws allowed for the sale of Indian land. Many choice parcels and valuable resource bases were lost. The result has been a checkerboard of land ownership on some reservations and consolidated ownership on others. Typical of a tribe which has lost control of its land is the Lac Courte Oreilles Band of Ojibwa who own only 22,062 acres of their 69,714 acre reservation in Northern Wisconsin. The result of these variations is tribes with different economic strengths and weaknesses.

A number of factors influence reservation business development. The following table identifies some of these factors and their conditions on the reservation as found by the GAO Business Investment Survey on Indian Reservations, 1976. We chose to expand on several of these factors in the following sections.

In particular, we detail the status of natural resources, human resources, political and legal conditions, and financial capital availability on the reservations.

TABLE 1: FACTORS INFLUENCING BUSINESS DEVELOPMENT POTENTIAL ON INDIAN RESERVATIONS (% response)

FACTORS	RESERVATION CONDITIONS		
	GOOD	FAIR	POOR
1. Labor force availability	59.5	27.4	13.1
2. Facility requirements	49.4	35.1	15.6
3. Transportation requirements	39.7	38.5	21.8
4. Raw materials and/or supplies	34.8	39.1	26.1
5. Site location and development requirements	64.9	17.6	17.6
6. Geographic location	60.2	25.3	14.5
7. Financial and other assistance	44.2	14.0	41.9
8. Employee housing availability	33.8	21.8	22.4
9. Tax advantages	55.0	15.0	30.0
10. Proximity to markets	38.5	35.4	26.2
11. Population (market potential)	43.9	21.2	34.8
12. Social, community amenities	38.8	32.8	22.4
13. Climate	51.3	36.8	11.8

Source: GAO Business Investment Survey on Indian Reservation, 1976
 Reprinted by the Council for Energy Resource Tribes (CERT), Tribal Self-Government: A Self-Sufficiency Analysis, p. 47.

1.1 NATURAL RESOURCES

Physical assets found in Indian Country are impressive. The United Indian Development Association reports that Indian tribes possess 5.3 million acres of commercial forest land, 2.5 million acres of arable land, and 44 million acres of grazing land. Roughly 4% of all U.S. oil and gas reserves, 40% of all uranium deposits, and 30% of all western coal reserves are also located in

Indian Country. [1] Past sales of reserves have contributed to the \$1.5 billion in royalty payments which are currently held in trust by the U.S. Government. [2]

Income from the use of these physical resources are not divided equally among tribes. In 1983, reservations in the Southwest received \$89.4 million (57%) of the \$156.1 million total Indian mineral revenues. In comparison, the Rocky Mountain region reservations received \$32.4 million, and the Southern Great Plains region received \$32 million of these mineral revenues. In 1981, timber revenues went primarily to tribes in the Northwest; they received 82% (\$59.1 million) of all timber revenues. [3] Only nine (9) tribes received revenues of more than \$2,500/reservation resident in 1981, and thirteen (13) received more than \$1,000/resident. All together only fourteen percent (14%) of the tribes received natural resource revenues equal to more than \$500/resident. [4]

1.2 HUMAN RESOURCES

In 1987, the U.S. Indian population was estimated to be over 1.7 million people. First Nations Financial Project, based in Falmouth, Virginia, recently calculated that 49.6% of the approximately 600,000 reservation Indians live in poverty. In comparison, only 16% of all U.S. citizens live in poverty. [5] Nine of the nation's 25 poorest counties are in South Dakota, and eight of those are on or near Indian reservations. [6] Census figures show that reservation unemployment was 43.5% in 1958,

37.3% in 1967, and 58% in 1980. In 1980, it was estimated that roughly one-half the Indian population was under 20 years old. According to First Nations, these new generations are living in places where the alcoholism rate is 499% greater than the national average and homicides occur at 51% greater frequency than the norm. A recent New York Times article cited the following statistics: 50% of all young Indians have serious alcohol or drug problems, [7] and, nationwide, young Indian men commit suicide at a rate more than twice the average for their age group. [8]

To date, reservation education and training programs have not made a dent on the overall economic malaise. A report entitled "The American Indian Experience in Linking Vocational Education and Economic Development," written by the National Center for Research in Vocational Education, cites continuing problems in communication between educators and community planners, low commitment by tribal councils to secondary and undergraduate education, and a reluctance by all parties to appraise and fund Indian Country's long-term needs. [9] Bureau of Indian Affairs (BIA) human resource programs have done no better. The President's Commission on Indian Reservation Economies (1984) did not fault the basic programs offered by the BIA, but rather their means of administration. [10] As of 1984, only 27% of employment and training funds was spent on direct services -- the other 73% was spent on administrative overhead.

1.3 POLITICAL AND LEGAL STATUS

Indian Country resides in a unique area of United States law. Tribal governments' power on reservation lands differ from state or local governments in the areas of jurisdiction, tribal sovereign immunity, and land status. These differences are described below.

Jurisdiction. Indian tribes' "powers of 'internal' sovereignty are only limited by express acts of Congress and tribes own actions." [11] Powers within tribal jurisdiction include "the power to determine the tribe's form of government, eligibility for membership, police power over the activities of members, charter business enterprises, regulate commercial activity and to tax members and non-members." [12]

Tribal Sovereign Immunity. Like the Federal, state, and local governments, tribal governments are immune from suit. This immunity includes tribally controlled businesses but does not protect individual members of the tribe.

Land Status. Tribal lands and resources are held in perpetual trust by the Federal Government. While privately held land may be sold, Federal regulations require that Tribal leases be limited to 25 years, or up to 99 years with Congressional approval.

Critics of tribal legal status commonly cite links between slow economic development and reservation governance. Issues like business ownership/legal recourse, control of resources, and taxation do change the tenor of Indian Country economics.

However, as discussed below, none of these issues create insurmountable barriers to development.

Business ownership in Indian Country often includes the tribal government as manager or shareholder. This choice of mixed enterprise can create management and liability questions for the government, investors, and other businesses. For instance, can political leaders lead the government and manage commercial subsidiaries? Steve Stallings of the United Indian Development Association reported to the Indian Business Leaders' Networking Exchange Meeting (January 1985) that, "Frequent Tribal leadership turnover often results in the lack of responsibility for prior decisions that have been made. New leaders frequently insist on new management resulting in more and continued delays." [13]

In terms of liability, tribally owned and operated businesses are also immune from suit. The result is a "business climate" where non-reservation investors appear to have little legal recourse. Yet, both tribal management and immunity are negotiable items. Tribes willing to contractually waive their sovereign immunity in a business venture and separate political and commercial management can do so. Charles Peone, President of Integrated Native Resources and a member of the Colville Tribe, commented on his Tribe's sawmill acquisition: "Within the structure of the holding company board there is not a Tribal Council member, in order to insure the separation of business and government ... We wanted to set up an organization where the Tribe

could evaluate us on a share basis." Tribal economies are not bound to any one form of public or private governance.

As set forth by the law, tribal governments hold the power to tax all reservation residents. While in practice, tribal taxation is no different from state or local taxation, reservation outsiders may fear double taxation (reservation and state) or selective application of the law. The first fear, double taxation, was expressly prohibited in *White Mountain Apache v. Bracker* (1980). Selective taxation does not appear to be a real impediment to business development. We found no instances of punitive taxation in any of our conversations or documents.

The President's Commission on Indian Reservation Economies (1984), concludes that Federal control of tribal land and resources has made reservation lending and borrowing very difficult. [14] Typically, lenders want to secure loans with property. In the trust relationship, tribes and reservation businesspeople cannot use land as loan collateral. They can offer future income streams or lease rights. However, private lenders often view this collateral as insufficient and risky and are reluctant or unable to lend money for reservation projects. The practical result for reservation residents has been poor access to mortgage, personal, and business loans.

1.4 FINANCIAL CAPITAL

1.4.1 Internal Financial Capital

There are three potential sources of internal investment

capital in Indian Country: trust funds; tribal savings; and individual savings. Indian trust funds total over \$1.8 billion.

[15] However, these funds and the return earned on their investment are held in trust and controlled by the Federal Government. Therefore, this source of capital is, for the most part, unavailable for investment purposes by the tribes.

Two other sources of investment capital, internally generated savings by tribal governments and individuals, are not easily found in Indian Country. According to the Council of Energy Resource Tribes in its report, "Tribal Self-Government: A Self-Sufficiency Analysis," tribal economies invest 4 1/2 cents out of every dollar of reservation income to generate more income. The United States economy invests nearly 18 cents out of every dollar. [16] One factor that contributes to the low savings rates for both tribes and individual members is the almost complete absence of credit or savings institutions on the reservations. There are almost no savings and loans, finance companies, real estate investment trusts, or insurance companies on reservations. Deposits generated from tribal enterprises are usually handled off the reservation, and tribal trust funds are deposited in money markets across America. Some tribal governments' habit of making per capita payments from natural resource or business income is another factor that has contributed to the low savings investment rates of tribes. However, many tribal governments now make a conscious effort to invest a portion of this income.

1.4.2 Federal Economic Development Programs

Historically, the three major sources of financial capital for economic development activities in Indian Country were the Office of Economic Opportunity (OEO), the Economic Development Administration (EDA), and the Labor Department's Comprehensive Employment and Training Act (CETA) programs. These three programs increased spending on Indian programs from \$42.3 million in 1969 to \$264.6 million in 1980. However, with the 1980 budget cuts, expenditures fell to \$116.7 million in 1984. An example of the sharp cutbacks is CETA programs, which spent \$197.8 million in 1980. By 1984, CETA's successor, the Jobs Training Partnership Act (JPTA), spent only \$75.4 million on similar programs. EDA cut back expenditures on its Indian programs 78% between 1981 and 1983. [17]

Because of the declining commitment of these organizations in the early 1980s and its designation as the administrator of the Indian Financing Act of 1974, the Bureau of Indian Affairs (BIA) became and continues to be the major source of financial capital for Indian economic development. BIA economic development programs include programs for employment development, direct loan programs, loan guarantees, grant support, and natural resource development. In the mid 1970s, employment development programs were the largest single item in the BIA budget. Funding reached a peak of \$50 million in 1977. In 1982, however, funding fell to \$27 million, where it has remained. Under the Indian Financing

Act of 1974, a total of \$137.9 million in guaranteed loans were provided, but no new appropriations have been made since 1976. In 1975, \$33.2 million in grant support for new enterprises was authorized for 1975 - 1984 under the Indian Self-Determination Act. While all other BIA development programs experience budget cuts since 1980, the budget for natural resource development has increased during that period. Its funding rose from \$27 million in 1973 to \$120 million in 1985. [18]

While the BIA and EDA have been the primary players in the Indian economic development process, the General Accounting Office has repeatedly found serious inadequacies in these agencies' performance. Two GAO reports, one issued in June 1975 and one in February 1978, highlighted these major deficiencies: inadequate project review and monitoring; administrative deficiencies; and inadequate technical assistance. [19]

CHAPTER 2

ISSUES IN ECONOMIC DEVELOPMENT FINANCE

Economic development activities consist of two components: the utilization of existing resources, like natural and human resources; and, investment designed to increase the resource base. In this section, we concentrate on the use of investment in the development process.

2.1 THE IMPORTANCE OF CAPITAL IN THE ECONOMIC DEVELOPMENT PROCESS

Capital investment comes in two forms: equity and debt. Equity, or common stock, involves long payback periods and usually allows suppliers to participate in the management process of the firm. Returns on investment are not guaranteed, but the higher potential return on the investment compensates for the increased risk. Businesses use debt to improve cash flows (lines of credit) or for capital investments. Debt repayments are usually scheduled for intermediate- (one to five years) or long-term periods.

A puzzling question concerns the role investment plays in the development process. How important is capital in the economic development process? Current literature indicates that capital is often an overstated component to economic development. In a study on Louisiana development finance, the Counsel for Community Development, Inc. found that, "(s)uccessful development hinges on a number of conditions: a favorable market; access to the key

factors of production -- land, labor and capital; and managerial and organizational capacity to produce for that market." [20] William Diamond in his book, Development Banks, a World Bank publication, also states that, "Attention is usually concentrated on the shortage of capital, for that shortage is often considered the main obstacle to development. This is, of course, neither always nor everywhere the case..... The process of investment ... implies that the persons or institutions concerned will have the managerial, administrative and technical experience necessary to use effectively the capital they risk.... (S)hortage of capital is closely linked in underdeveloped countries with shortages of entrepreneurship, of technical skills in planning and operating an enterprise and of managerial talent." [21] These people emphasize that financial capital will not solve all the problems encountered in the economic development process. However, they do indicate that capital and its availability are essential ingredients to successful development.

2.2 SUPPLY AND DEMAND IN THE CAPITAL MARKET

Like all markets, capital markets operate as a function of the supply and demand for capital. Members of tribes and of Congress frequently mention "capital gaps," the lack of available capital, as a supply concern. Others define the supply issue as a problem of barriers to capital acquisition. Eric Natwig, in his article, "Institutional Barriers to Financing Development Projects

in Indian Country," identifies four barriers Indian borrowers face. These barriers are: collateral; servicing costs; perceived high risk; and lack of information. [22] A "capital gap" is an availability problem; a barrier is an access problem. Given the sophisticated and, for the most part, efficient capital market in the United States today, we feel that a lack of capital is not the problem faced by the majority of the potential clients of the Indian Development Finance Corporation. Although we found no empirical studies to support either position, our observations have led us to conclude that the conditions faced by potential Indian businesspeople are the result of barriers to capital acquisition, an access problem.

Access to capital is difficult for potential borrowers who have little or no available collateral and a lack of experience in management. Given the limited number of existing businesses in Indian Country, most business loans go to start-ups. However, start-up and minority businesses traditionally have another capital demand problem - they require equity investment. Equity is usually obtained from the savings of family, friends, and business associates; banks cannot make equity investments. Native Americans, like other minority businesspeople, have a smaller equity base to call on because of lower than average savings rates.

In addition, access to capital in Indian Country can be inhibited by a number of factors, including risk-aversion and information or transaction costs. Lenders' risk-aversion dictates

that borrowers whose products, management forms, and operating environments are familiar to the lender will be preferred over less familiar borrowers. Lenders rely heavily on information about the borrower's professional and social position in the community. Conscious and unconscious prejudice can increase the perception of risk. Risk-aversion makes it difficult for small, start-up, and minority-owned businesses to borrow.

Information and transaction costs, the costs associated with evaluating loans and performing projections or analysis, incurred in lending to small, start-up and minority-owned businesses are also higher than those incurred in lending to conventional, larger, and established businesses. Information about reservation economies is often difficult, or impossible, to obtain because of poor tribal accounting systems. Easy credit checks used by lenders - business performance and credit history - are not available for new or small businesses. In addition, borrowers may be unable to project sales or analyze operations in the way banks commonly require. In these cases, information costs become an obstacle to even completing a loan application.

Potential borrowers must also demand capital for a capital market to be effective. "... (W)hen productive investment is inhibited by genuine shortages of long-term finance, those shortages may ... also reflect a lack of appreciation of new opportunities or a shortage of persons willing and able to grasp them.... The fact that there are unexploited opportunities for

investment ... suggests that the lack of demand for capital may be as serious a bottleneck as the inadequate supply of capital." [23] The Department of Interior, in a letter to Sen. Daniel Inouye dated September 4, 1987, voiced concern about the lack of demand for capital in Indian Country. "We believe that Indian tribes do not need a new source of investment capital; instead, they need more good business projects. For the past several years we have been unable to allocate all of the Bureau of Indian Affairs (BIA) funds available for the tribal business projects...." [24]

While demand is a legitimate concern, it is important to consider the performance of the BIA as a source of development capital. In addition to the serious inadequacies found by the GAO in its investigation of the BIA, other factors could affect demand. The ability to make timely decisions, an important factor in the fast-paced business world, appears to be lacking in BIA programs. One respondent to the GAO Business Investment Survey on Indian Reservations said he waited a year for a financial decision and then decided to locate his business elsewhere. Six months later, he was contacted and told that the assistance was available. [25] Red tape, or the bureaucracy, can also make business development frustrating. "Over the years Navajo entrepreneurs have complained about the 47 steps of approval needed from both the tribe and Bureau of Indian Affairs to open the doors of even a small business." [26]

Table 2 illustrates the difficulty in interpreting the interaction of supply and demand for capital in Indian Country.

TABLE 2: NAVAJO NATION SHOPPING CENTER SITE
DEVELOPMENT AND CONSTRUCTION INVESTMENT
(in thousands of dollars)

Project	EDA	HUD	CSA	Private	Tribe	other	Total
Window Rock	1.558				.20		\$1.738
Chinle		.952	2.048				3.0
Tuba City	1.464	.904			.623		2.991
Kayenta	1.2			1.2a	.418	.042	2.860
Shiprock					.20b		.20
Crownpoint	na	na	na	na	na	na	na
TOTAL	\$4.202	1.856	2.048	1.200	1.44	.042	\$10.789

SOURCE: Division of Economic Development, Navajo Tribe, 1983
Reprinted by AINB

a: capital acquisition from private source in progress
b: site development completed February 1983

As the table indicates, only one of six projects in the Navajo Nation Shopping Center Site Development and Construction Project obtained private financing. The question is -- does this chart demonstrate: (1) a lack of private funds or barriers to access of these funds; (2) the presence and obvious advantages of federal money (it's a cheaper source of borrowing); or (3) the strength of the tribe's organization in overcoming bureaucratic obstacles?

CHAPTER 3

MODELS FOR FINANCING ECONOMIC DEVELOPMENT

In this chapter, we delve into the operations of four existing development finance programs. Our reasons for choosing these programs are threefold. First, they illustrate a variety of development schemes, spanning a range of services, sources of capital, and lending capacity. The four programs we studied are: commercial banks, with particular attention on the American Indian National Bank; the Lakota Fund, a privately funded microenterprise and small business loan fund; the Hoopa Valley Revolving Loan Fund (RLF), a government sponsored loan fund for small and medium business development; and, the World Bank's International Finance Corporation (IFC), a source of capital for large businesses operating in less developed countries. (see Table 3: Models for Financing Economic Development: A Summary.) One example of these institutions' differences is a comparison of lending capacities. The Lakota Fund's largest loans are less than \$1,000. This style of development looks strikingly different than the International Finance Corporation whose loans average \$10,000,000.

The second reason for choosing these programs is their experience in lending in areas with economic conditions similar to those found in Indian Country. These programs, with the exception of the commercial banks, tailor their activities to overcome barriers to accessing capital markets or capital gaps, a

TABLE 3: MODELS FOR FINANCING ECONOMIC DEVELOPMENT:
A SUMMARY

	Commercial Bank	Lakota Fund	Hoopa Valley RLF	World Bank - IFC
Type of Borrower	community residents, businesspeople	members of the Oglala Sioux tribe	tribal members & non-tribal members whose businesses are on the Hoopa Reservation or provide employment to Reservation residents	private businesspeople or cooperative ventures in member developing countries
Type of Business Funded	all types	micro and small start-up & operating businesses	business start-ups, expansions, & retentions	all types, mostly expansions
Loan Size	\$300,000 - 1,000,000	under \$1,000 and \$1,001 to \$10,000	\$1,000 - \$600,000	Average = \$10 million
Funding Source	investors, accountholders	private, mostly foundations	federal govt.	international subscriptions, loans from World Bank
Membership of Review Board	bank officers & lending officers	all tribal members, except one	people from local area	Bank management
Borrower Assistance	none	loan application and business planning assistance	none	third party & in-house loan application, planning, and technical assistance (may be a loan requirement)
Outreach Efforts	business calls, advertising	small business workshops, advertising, & word of mouth	none	little - staff identifies potential projects
Payment & Follow-up Schedule	monthly payments, automated project review, periodic calls	weekly or monthly payments and personal contact	monthly payments	monthly payments, one post loan audit

lack of available capital. For example, the Hoopa Valley RLF and the World Bank's IFC address the issue of barriers to capital acquisition. They lend to projects that are "unbankable" in the private market because of risk, collateral, or equity finance problems. On the other hand, the Lakota Fund addresses a capital gap problem. There are currently no other sources of microenterprise capital on or off the reservation.

The third reason we chose these programs is to offer you, the reader, a chance to envision your own recommendations for the proposed Indian Development Finance Corporation. There are a number of options available to a new Indian Country lender. For example, status quo or loan guarantee programs have been implemented using commercial banks. Could local lending models taken from the Lakota Fund or the Hoopa Valley operations be used nationally in Indian Country? Or is a centralized lending program, like the IFC, an option? We hope that these case studies, along with our description of the characteristics of Indian economies, help you to weigh the options available to a new Indian Country lender.

One interesting aspect to the organizational studies is the linkage between strategic issues such as organizational objectives; methods of financing; rates of return; relationship to the government and to clients; range of activities; and choice of personnel. An organization's objective determines the institution's range of activities, a range of activities

determines methods of financing, financing determines rates of return, and so on. While it may be tempting to design an institution that attempts to address all development problems, these models help to illustrate that no such easy solution exists. A program must make internal financial and managerial sense before it can even hope to work with others and achieve its goals.

3.1 COMMERCIAL BANKS

American capital markets are reputed to be the largest and deepest in the world. Small and medium sized commercial banks are an important component to this market's effectiveness. With offices in most every town or city, banks are natural lenders to business of all types.

Motives of a typical commercial bank are simple - earn at least enough money to pay back investors and depositors. All of a bank's funds come from individuals expecting some return. Depositors, like other firms' bondholders, give banks money for the promise of safe return of principle and a particular level of interest. Hence, to ensure that cash deposited resembles cash invested, bankers agonize over the level of portfolio diversification, timing of repayments, and the probability that debt will be paid in full. Unexpectedly low returns from a loan portfolio could create a crisis, because the costs to obtain money then exceed the income from lending money.

A typical lending process centers on one individual, the

commercial banker. This banker has the flexibility to seek out new clients, arrange financing, and follow-up the loan until it is repaid. During this process, the banker collects detailed information on the borrower to help assess whether a new loan will "perform." Items commonly requested to help assess a loan's riskiness include: credit bureau ratings on owners and managers; principal's managerial history; personal and business financial statements; tax returns; business references; business plan including marketing details and projected cash flow; and loan collateral. Ultimately, the lender must make a decision -- should the bank lend money to this business?

The freedom of a commercial banker to lend is tempered only by review of their peers. Typically, bank and lending officers examine loan applications in regular meetings. In this meeting, the lender must explain why the loan should be approved, what amount of risk is inherent in the deal, and what the appropriate price should be for lending services.

As an illustration of a commercial bank's lending procedures, we chose to examine the American Indian National Bank (AINB). Since 1973, the American Indian National Bank has been an active lender in Indian Country. "The American Indian National Bank was founded on the conviction that a national Indian financial structure, wholly owned and controlled by American Indian and Alaskan native Tribes, organizations, and individuals, could assist Indian communities to establish and

develop a strong economic base." [27] The Bank implemented this plan with a full service branch in Washington, D.C. and a lending office in Albuquerque, New Mexico. By 1986, the AINB had accumulated \$22 million in assets, roughly half of which was in their loan portfolio. [28] The following year, reeling from a declining deposit base and low income, the AINB was sold to outside investors. [29]

The AINB had difficulties common to commercial bank lending in Indian Country. First, the AINB tried to serve multiple markets. Not only did it gear its lending towards Indian Country (17% of total), but it tried to serve a non-Indian community too. [30] This lack of focus made the difficult task of managing a new bank even more difficult. Second, the bank faced high transaction costs in Indian Country. Its bases in Washington and Albuquerque only exaggerated the costs of working with American Indian businesses. Third, the Bank's income could not increase to meet higher costs. Federal banking regulations and rules of the BIA Guaranteed Loan Program limited the fees and interest rates charged by the Bank.

3.2 LAKOTA FUND

The Lakota Fund is a non-profit small business development loan program located on the Pine Ridge Reservation in southwestern South Dakota. The Fund is a partnership between members of the Oglala Sioux Tribe and First Nations Financial Project (FNFP) and operates without interference from the tribal

government. The Lakota Fund is funded by FNFP and offers a loan pool of \$635,000. First Nations Financial Project receives its funding from organizations such as the Ford Foundation, the MacArthur Foundation, the Needmor Fund, and the Northwest Area Foundation. It obtains its funding at interest rates of 0 - 5%. FNFP also receives equity grants and monies for operations such as institutional development, policy, and marketing. No government money is used by FNFP or the Lakota Fund.

The Lakota Fund "is structured to be responsive to the cultural needs of the people." [31] To accomplish this objective, the Fund assists microenterprises in the informal sector of the reservation economy, as well as small local businesses established by tribal members. The Fund focused its energies on informal businesses after it found only forty-seven (47) existing businesses on the Pine Ridge Reservation. However, the Fund identified ninety-seven (97) other income generating activities not classified as businesses. Examples of these microenterprises include traditional family collectives (known as "tiospaye"), food vendors, artisans, and locksmiths. There were, at that time, no existing sources of capital for these microenterprises. The Fund made the decision to fill this micro-loan gap by emphasizing loans to the "non-classified," income enhancing microenterprises. The average size of a micro-loan at the Lakota Fund is under \$1,000; its small business loans are offered between \$1,001 and \$10,000. For loans exceeding

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this range, the staff provides business planning and loan packaging assistance for borrowers so that they may apply for loans at local banks. In these cases, the Lakota Fund may lend a portion of the total amount, to be complimented by another loan from the bank.

The Lakota Fund includes outreach to borrowers as part of its program. First Nations Financial Project staff determined that there were clear barriers to capital even within the reservation boundaries. The Pine Ridge Reservation is larger in area than the state of Connecticut, but it is populated by only 20,000 people. The Project staff observed that people who were far away from the center of commerce, Pine Ridge, had difficulties accessing public monies, much less private. These people became the "poorest of the poor." To reach out to these people, the staff located the Fund's office in Kyle, South Dakota, a town more centrally located than Pine Ridge. Other outreach efforts include small business workshops in the various towns on the reservation, local news announcements, and word of mouth.

The loan application and approval process differs slightly between micro and small business loans. Similarities include a strong emphasis on borrower assistance and close work between the client, the Technical Assistance Specialist, and the Executive Director in structuring the loan application. For both types of loans, the Technical Assistance Specialist collects information regarding: the borrower's experience and character; the plan for

the business and use of loan proceeds (an informal plan for micro-loans and a formal plan for small business loans); loan collateral; and, financial projections indicating payback ability.

Loan volume at the Lakota Fund is high. In the first six months of operation, over thirty (30) loans were made and over fifty (50) loans were made in the first nine months. Most of the loans made in the first six months were micro-loans (\$1,000 or under); two were in the \$1,001 to \$10,000 range. Because of the large loan volume, the Executive Director has the authority to review and approve all micro-loans. For small business loans, the local Board of Managers and FNFP's President and Vice-President must also approve the loan. Full lending authority will be granted to the local Board in two years provided it maintains a satisfactory loan repayment. While the small business loan review process is more extensive than the micro-loan process, Lakota Fund and FNFP personnel are constantly aware of the need for timely decisions in the fast paced business world.

The Lakota Fund operates independently of the tribal government despite its strong ties to the reservation community. At the Fund's inception, the tribal government agreed to a "waiver of sovereign immunity." The Lakota Fund maintains strong community ties through its local Board of Managers. Eight tribal members are members of the local Board. Only one

representative from the tribal government is allowed on the local Board at any time. The ninth member of the Board is not a tribal member; he is a bank president from Nebraska.

The Lakota Fund achieves rapid turnover of funds by requiring a maximum one year pay-back for all micro-loans. Interest rates on these loans average 2% above prime. Payments are made monthly and, sometimes, weekly. Since payments on micro-loans are made frequently, prompt follow-up on delinquent payments is easy. Small business loans operate in much the same way except that payments and financial statements are submitted monthly. Again, prompt action is taken on delinquent payments, and there is thorough monitoring and frequent contact with borrowers.

Currently the Lakota Fund is researching the applicability of "peer group lending" on the reservation as one way to reduce its micro-loan administration costs. Peer group lending is a concept used by a number of microenterprise lending programs in Third World countries. The South Shore Bank of Chicago is also testing this concept in cooperation with a program in rural Arkansas. These programs only lend to self-selected groups, from which one loan is made and guaranteed by the group. After the initial loan is repaid, additional members of the group are eligible for loans. In this process, group members serve as co-sponsors and loan monitors, replacing the need for collateral and reducing administrative costs. In addition, they serve as a support system for each other for the duration of their

borrowing. (See Appendix II: Group Lending in Microenterprise Economic Development.)

3.3 HOOPA VALLEY REVOLVING LOAN FUND

The Hoopa Valley Revolving Loan Fund (RLF) operates on the Hoopa Valley Reservation, located in the remote timber country of Northern California. The tribe established the revolving loan fund in 1977 as a part of the U.S. Economic Development Administration's (EDA) Revolving Loan Fund project. In this project, the EDA has provided \$200 million to over 200 revolving loan funds across the country. [32] The EDA supplies grant funds for technical assistance and planning, as well as works with local communities to establish RLFs. Once established, the RLFs operate independently, funding themselves from loan repayments. Hoopa Valley's RLF only makes direct loans at an interest rate of 8-1/2%. It is supervised by a Loan Committee, which includes local residents with experience in banking, real estate, and business.

The Hoopa Valley tribe started their RLF to help create and retain jobs. In most years, reservation unemployment rates exceed 80%. The RLF considers itself successful if it is able to create or retain work for under \$15,000 per job. In 1985, the RLF's Semi-Annual Report to the EDA indicated that the loan fund succeeded, creating work at a cost of \$13,370/job for total loans and \$11,695/job for active loans. Table 4 shows the number of

jobs created and retained for total and active loans. [33]

TABLE 4: JOB CREATION AND RETENTION FOR THE
HOOPA VALLEY RLF (1985)

<u>Private Sector Jobs</u>	<u>Created</u>	<u>Retained</u>	<u>Total</u>
For Total Loans:	50	123	173
For Active Loans:	42	123	165

Most of the loans given by the RLF are "unbankable," because the borrowers lack the appropriate types of collateral or sufficient amounts of equity. Even with RLF participation in the loan process, the private sector leveraging ratio (private dollars per RLF dollar) for the Hoopa Valley RLF is much lower than the national average for RLF leveraging. Hoopa Valley's leverage ratio is \$1.43 for total loans and \$1.28 for active loans [34], compared to a RLF national average of about \$4.00. [35]

Despite Hoopa Valley's apparent success in meeting efficiency goals, the RLF must battle several long term problems. Of greatest concern to the loan fund is the area's low demand for loans. The Loan Fund Administrator reports that although funds and several projects are available, no one seems to be interested in pursuing the ideas. This lack of demand for development capital is difficult to explain. One simple answer might be that the area residents don't want to start businesses. However, other explanations are also quite plausible. First, the Hoopa Valley RLF does not provide any loan or business assistance. Loan applications are completed by the borrowers, and there is no

formal network in place for providing loan packaging assistance. With the exception of its Board, the RLF also has no ties with outside technical assistance providers. Second, the RLF does not publicize the services it offers. Because the loan fund has been operating since 1976, the RLF staff assumes that people knew of it and its services. Third, the loan fund never developed a broad base of potential borrowers. In its first six years, three of the RLF's four largest loans were made to the same timber corporation. Between 1978 and 1981, this corporation received loans totalling over one million dollars. The corporation has deferred payments on two of these loans. The fourth large loan went to another logging operation and is in default. [36]

It is almost ironic that the RLF has problems finding borrowers since its lending policy covers most business sizes. A look at the 17 loans the RLF made in its first eight years of operation reveals a wide range of loan amounts. This range may be a natural result of the limited lending area of the RLF (it lends only to reservation businesses), or it may simply reflect an unfocused lending policy. Our analysis of RLF loans indicates that different size loans yielded very different results. Large loans (\$150,000 to \$600,000) accounted for 27 of the reported jobs created and 12 of the jobs retained. Although exact numbers are difficult to discern, it appears that medium-sized loans (\$10,000 to \$70,000) accounted for most of the reported jobs retained. Small loans (\$1,000 to \$10,000) appeared to create more jobs than they retained. [37]

A final problem facing the Hoopa Valley RLF are delinquent payments. Besides the large loans mentioned above, the RLF has ten medium-sized loans; six of these were current and four were delinquent up to 270 days according the Annual Report. Of the RLF's three small loans, two were repaid and one was delinquent 30 days. [38] Given the RLF's loan portfolio, it seems unlikely that it will maintain a strong financial position if it continues its past lending practices.

3.4 WORLD BANK: INTERNATIONAL FINANCE CORPORATION (IFC)

The International Finance Corporation (IFC) is the business lending affiliate of the World Bank. (See Appendix III: World Bank Lending Programs.) Founded in 1956, the IFC works primarily from a central office in Washington, D.C. to help connect world capital markets with those of developing nations. These nations may be isolated due to a risky business environment, lack of accumulated wealth, or poor balance of trade payments. The Corporation's By-Laws require that the organization not "undertake any financing for which in its opinion sufficient private capital could be obtained on reasonable terms." [39] Although the Corporation loans only to projects considered "unbankable" by the private capital markets, the IFC earned \$25 million in 1986 and \$53 million in 1987 (return on equity assets of roughly 7%). [40]

The International Finance Corporation's private sector

lending does not take place at the expense of national sovereignty. The IFC, a government sponsored corporation, is fully capitalized by stock purchased by member nations (these investments do not receive any dividends). Although 50% percent of the funds come from the U.S., Japan, Germany, France, and Great Britain, every country must purchase stock before it can be eligible for an IFC loan. If a government, even after paying for membership, decides that a particular project is against the nation's best interest, it can block an IFC deal. The Corporation's Articles of Agreement state that the IFC "shall not finance an enterprise in the territories of any member if the member objects to such financing." [41] Hence, the IFC does not require explicit investment or participation from member nations in business loans, yet can be assured of their approval.

IFC loans, which average over \$10 million per loan, require a staff skilled in many areas. To assist local managers, every project involves an engineer who examines a business' technical requirements, financiers who strike up the "deal," and economists who examine macro effects and the viability of a new business. Before a project is considered for approval, the staff prepares a brief that includes: the business' objectives; a timetable for operations; its anticipated technical requirements; its current management/institutional capacity; the state of the national economy; cash flow statements; and a cost vs. benefit analysis for alternative technology and institutional designs. While the clients may prepare many of these documents for their own

purposes, the IFC habitually prepares its own analysis. The IFC also regularly follows up on borrowers. The cost of this exhaustive loan administration amounts to 3-4% of gross disbursements - a relatively low number only because the loan amounts are so large. [42] Even with this skilled staff and conservative lending practices, the IFC's lending market is risky enough to warrant a loss reserve equal to 10.5% of the loan portfolio. [43]

Using William Diamond's definition of financial institutions, the International Finance Corporation is a classic development bank. [44] Rather than subsidize business, the IFC attempts to bridge the gap between borrower's cash needs and external capital markets. By their own account, "The World Bank can provide only a small part of the external resources needed to stimulate the economic growth of its member developing countries." [45] The IFC will not accept all lending risk and limits its lenders to 25% equity plus debt participation in any one project. The IFC prices investments according to business risk so that all borrowers also bear their appropriate cost of debt or equity capital. Cost plus pricing allows the Corporation to recapture its costs and make loan packages attractive to other lenders. The IFC regularly syndicates its loans (sells off portions of existing loans) or arranges for co-financing (brings in third party investors). The IFC estimates that 50% of all loans are either co-financed or syndicated. [46] In 1984, the

World Bank claimed that every \$1 of IFC funds attracted another \$5 of private investment. [47] By ushering in the world capital market, the IFC is able to assist member countries far more than its own resources could allow.

CHAPTER 4

RECOMMENDATIONS FOR THE INDIAN DEVELOPMENT FINANCE CORPORATION

Senate Bill 721 charges that the Indian Development Finance Corporation (IDFC) shall "provide for and promote the economic development of Indian tribes by furnishing the necessary capital, financial services, and technical assistance to Indian owned business enterprises and ... stimulate the development of the private sector of Indian tribal economies." [48] As exemplified by the four development finance programs, a new lender in Indian Country faces a number of decisions about organizational focus and design. However, as the description of reservation economies and the four programs also indicate, a new lender can use this freedom to address many different economic issues.

In this chapter, we give our recommendations for an IDFC organizational plan. In many respects, the IDFC we propose resembles the World Bank's International Finance Corporation. A word of caution - not all features of the IFC are applicable in Indian Country. (see Appendix V: Comparison of the IFC and IDFC.) However, besides the fact that it seems to work, there are four specific features of the IFC that we hope to simulate in the IDFC. These features are:

- (1) Its ability to maintain its financial position;
- (2) Its focus on being a bridge to private capital markets - not a replacement;

- (3) Its emphasis on keeping politics out of the project evaluation process, while at the same time allowing for government participation before beginning the project; and,
- (4) Its policy of lending to any member nation business, government or privately owned, which proves itself to be financially, managerially, and technically feasible.

We organize our recommendations for the IDFC around three main topics: the financial position of the IDFC; its potential customers; and its operating procedures. In a nutshell, we propose that the IDFC should protect its financial position by:

- * lending to many types of Indian Country businesses;
- * setting a ceiling for its participation in any given project; and,
- * making all loans at market rates plus cost.

Additionally, we suggest that the IDFC identify and serve its borrowers by:

- * lending to all reservation businesses, including loan funds or other finance projects, which can prove themselves to be financially, managerially, and technically feasible;
- * lending only on member tribes' reservations; and,
- * supplying equity and debt to projects in the range of \$25,000 to \$1,000,000.

Finally, we recommend that management operate its programs by:

- * establishing one central office, somewhere west of the Mississippi;
- * organizing its office according to industry expertise;
- * assisting potential and actual borrowers with loan applications and business operations; and,

- * creating a separate approval process for small and large business loans.

4.1 FINANCIAL POSITION

The IDFC cannot expect to meet all the capital needs found in Indian Country. The current Bill calls for paid in capital of only \$25 million over a two year period. [49] It is simply too small to create a substitute Indian capital market. The combination of limited funds, wide dispersion of the Indian population across the United States, and large variations in financial demands and social needs outline a customer base far larger than any single institution can serve. Presently, existing capital markets seem to stop at the edge of the reservation. Therefore, the IDFC must focus on bridging the barriers between private capital markets and reservation businesses.

In this section, we address the financial problems that a development bank will face over time. Two major concerns - risk and increasing capital costs - lead to our recommendations to:

- 1). Lend to many types of businesses within Indian Country.
- 2). Cap the level of IDFC participation in any one project.
- 3). Price all loans at a market rate reflecting project risk.

4.1.1 Risk

Our first recommendation is that the IDFC diversify its loan portfolio so that it includes many different types of

reservation businesses. According to the Capital Asset Pricing Model, risk can be divided between that which is diversifiable (unsystematic or firm specific risk) and that which an investor must bear (systematic or economy wide risk). A good investor diversifies away all unsystematic risks. The Lakota Fund successfully avoids some firm specific risk by targeting all of the Pine Ridge Reservation's ninety-seven informal business activities, ranging from locksmiths to food vendors. For the IDFC, diversification requires a conscious effort to stay off the latest economic development bandwagon and constantly lend to a variety of industries. The Corporation cannot afford to place all its eggs in one basket.

Our second recommendation, that the IDFC cap its level of investment in any one project, is also designed to protect the Corporation from unnecessary risk. Common logic dictates that if the IDFC is a business' sole investor, the individual entrepreneur has lots to gain and little to lose. The IDFC would bear all the costs of business failure. By limiting the Corporation's investment, we can place some of the cost of failure back onto the principals. They would either have to put together some money of their own or obtain additional funds from a lender. From the point of view of the IDFC, it would be nice to know that the entrepreneur could convince others of the viability of their business plans. The World Bank's IFC follows a similar policy - it will not invest more than 25% of a

project's cost. A positive result from this policy has been the near mandatory inclusion of other investors in IFC projects and a stronger relationship between financial institutions.

4.1.2 Increasing Cost of Capital

The initial Balance Sheet for the IDFC will contain roughly \$20 million in cash from the sale of capital stock to the Federal Government. For awhile, this investment provides an automatic corporate income. Invest it in a savings account, and the IDFC is profitable! However, this income will disappear rather quickly once the IDFC begins lending. As shown in Appendix V, cash flows of the Corporation will be negative for many years. Loans will leave the IDFC's treasury and will be replaced by partial payments. Although our numbers are very rough, after ten years we expect the IDFC will need to begin leveraging its operations. That is, the Corporation will have to borrow money before it can lend money. Although ten years may seem far in the future now, present lending practices must prepare the IDFC for the future.

The IDFC will only be able to leverage its operations if it prices its loans at market rate plus some allowance for risk. Like any other business, this development bank will only be able to maintain its financial position if income exceeds expenses. As the IDFC begins to leverage its assets, expenses will include interest payments to another institution on the money it has borrowed. As seen in Table 5, the more the IDFC leverages

itself, the more important it is for all IDFC loans to make market returns.

TABLE 5

Leveraging	None	1:1	3:1	10:1
Weighted Average Cost of Capital	2%	6%	8%	9.3%
IDFC Margin (market interest at 10%)	8%	4%	2%	.7%

Assumptions: market interest at 10%; Federal Government receives no returns on its investment; and, tribal governments earn market rate on their investments.

The bottom row, IDFC margin, indicates the margin from which technical assistance, administration, and loan defaults must be paid. To those who claim that IDFC investments should earn less than market rate, we can only note that \$25 million is a lot of money, but it's not limitless.

Most development banks leverage their equity on a two to one or three to one ratio, according to William Diamond. [50]. If the IDFC accepts that ratio, Appendix V indicates that its operations will have to be managed skillfully. Surprises, such as increased interest paid to savings accounts, cost the American Indian National Bank hundreds of thousands of dollars in the mid 1970s. [51] The IDFC is susceptible to similar losses stemming from changes in interest rates, administrative costs, and payback timing of equity investments.

4.2 BORROWERS

Choosing a target market for a new Indian development bank requires answers to a number of questions. What kinds of ownership structure are the most appropriate in Indian Country - tribal, private, or some combination? How much control should host governments have in the economic development process? For the most part, we find the World Bank's International Finance Corporation's (IFC) example helpful. The IFC lends to viable business ventures which are both privately and publicly held, but it understands that development is a community process. Therefore, after the project has been evaluated, it seeks host nation approval for implementation. If the host nation does not approve, the project is dropped. We feel that the following recommendations define the appropriate borrower market for the IDFC:

- 1). Any financially, managerially, and technically feasible reservation business, owned by either a tribe, an Indian entrepreneur, or a joint venture of the two and located on a reservation, should be eligible for IDFC assistance.
- 2). The IDFC should restrict lending to member tribes.
- 3). The IDFC should make loans and take equity positions in amounts between \$25,000 to \$1 million.

4.2.1 Ownership Structure

The IDFC should lend to any financially, managerially, and technically feasible reservation business, regardless of the

ownership structure. [See Appendix VI, for a discussion of on- vs. off-reservation lending]. The current version of U.S. Senate Bill 721 states that the IDFC may only lend to tribally owned or controlled businesses. We find this provision unnecessarily restrictive. We are in a period of time when many tribes want to separate their business management from political leadership. Recent business purchases by the Passequadey, Lummi, Laguna, Colville, and White Mountain Apache tribes all limit the government's role to that of a shareholder - capable of voicing complaints only on a returns per share basis.

Lending to private businesses does not imply that tribal governments should be eliminated from the economic development process. To ensure that the IDFC's decisions are not detrimental to community planning goals, we recommend that the IDFC only lend to businesses on member reservations and that governments be allowed to veto IDFC loans on their reservations. This arrangement gives tribal governments two opportunities for input on privately held projects. First, if a reservation doesn't want to develop any tribal or private businesses, it will not become a member of the IDFC. Second, if a particular project would hurt the community, the project will not be done. If a Tribal Council thought that any privately held business could adversely affect the community, that loan could be vetoed. Thus, the IDFC's work with individuals will not preempt tribal control over the reservation's general economy.

4.2.2 Type of Lending and Amounts

Finally, we recommend that the IDFC take equity positions in business ventures and lend in amounts between \$25,000 and \$1,000,000. We believe that loans in this range are appropriate for long term business development since: 1) there is little equity available for small reservation businesses; 2) small scale development is most adaptable to reservation economies and society -- management and worker skills can be improved as the businesses grows; and, 3) the IDFC has a relatively small capitalization that cannot support numerous multi-million dollar projects.

In this paper, we consistently refer to the IDFC's investments as loans and equity investments. We believe that an effective development bank in Indian Country needs the flexibility to provide debt and equity capital. Most businesses cannot survive carrying debt without equity -- revenues vary but loan payments do not. Since neither type of investment is easily obtained Indian Country, we find the flexibility to offer either debt or equity, as the situation warrants, an important ingredient for successful economic development.

We recommend that the IDFC forego any large (greater than \$1,000,000) loans or credits, unlike IFC practices, for a number of reasons. First, managerial incentives of IDFC personnel can become badly misconstrued when one project can make or break the Corporation. Also, we do not want to create false short-cuts to

asset growth that increase IDFC risk and distract management from broad based investment practices.

4.3 IDFC OPERATIONS

After all is said and done, the IDFC must successfully deliver loans, equity investments, and assistance. It must also attract external participation in its loans. The experiences of the IFC, the Lakota Fund, the Hoopa Valley RLF, and the American Indian National Bank emphasize the importance of financial control, skilled staff, and loan operations designed to fit the borrower's needs. Our recommendations for meeting these requirements are:

- 1). Locate lending operations from one central office;
- 2). Assign lenders to projects according to areas of business expertise;
- 3). Assist potential and current borrowers with basic financial, managerial, and strategic questions; and,
- 4). Create separate approval requirements for small business and large business loans.

4.3.1 Centralization of Operations

To best serve the needs of reservation businesses, we recommend that the IDFC locate its lending operations in one national office. We offer two reasons why a central office is needed. First, loan volume from any given area is likely to be small, and administrative costs for operating offices on many

reservations would swamp the resulting revenues. Second, the experience of the Graameen Bank and Lakota Fund indicates that direct customer contact is key to a loan's success. Regional offices would not settle this situation. As seen in the EDA's experience with the Hoopa RLF, a regional office does not assure intimate contact with the reservation community. Neither do "middlemen" such as loan guarantees or third party contractors. "Middlemen" can help bring services to the regional or local level, but these parties do not share the IDFC's incentives to do a good job. The IDFC can manage its own corporate culture but cannot do the same for all affiliated institutions who neither share in the capital risk or rewards.

While we recommend that the IDFC establish only one office, this plan could be disastrous if the site is not located west of the Mississippi. Though chartered in Washington D.C., the IDFC must try to divorce itself from the image of a "Beltway" insider for a number of reasons. First, if borrowers identify the IDFC as a government program, they could blur its use and purposes with that of the BIA loan programs, EDA grants, and Administration for Native Americans (ANA) grants. Second, management located in Washington may be tempted to manage their legislative agenda more than their lending operations. Physically removing offices from Washington can ensure management's attention to their real clients -- American Indian businesses. Outreach and assistance activities will also be aided by an office located closer to Indian Country.

We also recommend that the IDFC create specialized divisions

within the IDFC lending operations. These specialized divisions will be staffed by individuals with relevant industry experience. The IDFC could develop lending divisions such as mineral and natural resources, tourism and recreation, light manufacturing, and financial services. This arrangement would benefit borrowers by providing access to an industry expert who understands a business' common difficulties. The Corporation would benefit from its improved ability to evaluate loan requests. These specialized lenders would be well acquainted with the comparative business advantages of each project. Moreover, by creating distinct areas of lending operations, the IDFC creates incentives for staff that lead to a diverse loan portfolio. Staffers specializing in minority contractor businesses (SBA Section 8a), are unlikely to succumb to temptations of resource development loans.

4.3.2 Loan Procedures

The most important decision the IDFC will make concerns its loan application requirements and evaluation procedures. If its staff is unable to make good decisions, the IDFC faces a very bleak future. Although based in a central office, we expect loan officers to assist borrowers with basic financial and business problems. More explicitly, we expect the loan officer to be responsible for all facets of the loan process, including:

1. organizing small business meetings on reservations;
2. meeting individual entrepreneurs to discuss business

- plans and study financial needs;
3. evaluating loan requests;
 4. matching businesses to needed technical expertise, either within the IDFC or third party consultants;
 5. visiting borrowers and monitoring on-going business operations and loan repayments; and,
 6. working with clients to consider future financial needs.

This is an extensive list, and the loan officers will face a number of obstacles in fulfilling their responsibilities. First, lenders will be physically and socially isolated as reservation outsiders. As such, they face huge barriers to assessing the credit-worthiness of potential borrowers and providing personal business assistance. We have identified several ways that could prevent the distance from becoming a fatal flaw. First, the IDFC may wish to modify its lending agreements to allow for multiple co-signers. This would be a variation of the "peer group lending" concept discussed previously. Although this may not be a perfect source of information, co-signers will strengthen the lenders' understanding of the borrower's reputation and standing in the community. Second, the Corporation should strive to make its lending officers valuable to the reservations as sources of assistance. Though the IDFC should not take upon itself the responsibility for managing a business, it can market its staffs' experience with similar ventures, develop contacts with experts in relevant areas, and answer pertinent financial and technical questions. The IDFC should also serve as a bridge between the

reservation communities and outside private markets and industry experts.

As stated earlier, the IDFC must ensure the financial viability of its borrowers. In addition to informal signals, the IDFC should routinely collect and analyze traditional sources of information such as individual tax returns and statements of a business plan. Although the primary responsibility of fulfilling the application requirements will remain with the borrower, the IDFC lending officers will assist the borrower in preparing such information.

We recommend that the IDFC create separate approval requirements for small business and large business loans. For loans between \$10,000 and \$250,000, a lending committee made up of loan officers and senior management should be authorized to approve a loan and set its terms. Information and presentation of a loan prospect to the committee will be done by the loan officer in charge of the account. Advantages of this commercial bank-like process are its simple and quick decision path, the personal incentives for loan officers to put forth well documented and thought out loan requests, and its ability to utilize the Corporation's management expertise. However, we believe that loan approval should also be required from the Board of Directors for loans in excess of \$250,000 but less than \$1,000,000, the organization's funding limit. This additional step will provide shareholders with direct financial control and force loans with

political ramifications to be addressed by members of the Board, not just management. Moreover, the IDFC will only have the resources to make a limited number of large loans. The Board should be intimately aware of the financial implications of large project assistance.

4.4 THE IDFC OF THE FUTURE

Five years after the prospective Indian Development Finance Corporation's birth, we cannot expect the institution will have followed all the suggestions made in this paper. Like the businesses that it will lend to, the IDFC must phase in its services and grow with the market. Below, we discuss the Corporation's roll-out and factors that may alter its operations.

During the first several years of the IDFC's life, the Corporation will reach a limited number of people and provide limited services. The IDFC organizational structure, as we described it, automatically expands at a slow rate. There are several reasons for this. First, the organization's common and capital stock will take years to sell. Without this money, the organization must remain small. Possible causes of delayed capitalization are a slowdown of appropriations from the Federal Government, or a small number of outside investors if tribes choose to wait and watch the IDFC operations before investing. After ten years of work, the American Indian National Bank had only four major tribal investors. [52] Second, if tribes are slow to buy stock, the IDFC will not have many customers. The

bill now states that only businesses belonging to member tribes can utilize IDFC services. Third, cofinancing and resale of loans will be difficult until the IDFC obtains the trust of other banks or investors. The Corporation's staff must build relationships with other bankers, a timely process.

Should the assumptions made in this paper be incorrect, the IDFC will have to make changes in its operations. For example, we assume that a small but identifiable group of people in Indian Country want to develop businesses. These potential entrepreneurs may not be fully trained in management or accounting, but they will be willing to learn. We have no empirical evidence to justify this assumption - the IDFC will simply have to find out how much demand for capital really is in Indian Country. Another assumption we made is that IDFC managers and directors can operate essentially free from government influence. Such an arrangement is rare - the National Cooperative Bank is one of the only government lending institutions without an active public managerial role. Finally, the organization will only be as good as its staff. No amount of strategic planning can replace the work of individual lenders. Their diligence and skill are absolute necessities for the Indian Development Finance Corporation.

FOOTNOTES

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APPENDIX I: SECTION-BY-SECTION ANALYSIS OF S.721: THE INDIAN
DEVELOPMENT FINANCE CORPORATION ACT

Note: The following material is directly quoted from two sources:

1. Quotes marked "BILL" are from: Report 100-306, Calendar No. 596, Senate, Report to Accompany S.721: Indian Development Finance Corporation Act, March 22 (legislative day, March 21), 1988.
2. Quotes marked "ADMINISTRATION" are from: Letter from Ralph Reeser, Acting Assistant Secretary, United States Department of the Interior, to Sen. Daniel K. Inouye, Chairman, Select Committee on Indian Affairs, responding to request for views on a proposed amendment in the nature of a substitute for S.721, March 2, 1988.

Definitions

BILL: Section 3 - Contains the definitions for use in this Act... Eligible Indian business enterprises means any commercial, industrial or business activity -

At least 51 percent of which is owned by an Indian tribe, including subsidiary entities, which produces or furnished goods, services, or facilities on a for-profit basis, whose -

- (1) Principal place of business is located within, or adjacent to, the boundaries of an Indian reservation, or
- (2) Principal business activities, in addition to the production of a stream of income, are determined by the Corporation to be directed at contributing to the economy of any Indian tribe.

ADMINISTRATION: ... (W)e object to limiting economic development financing eligibility to enterprises mostly or entirely owned by tribal governments. The development of sound Indian private sector enterprises, insulated from tribal government politics, should be encouraged.... Limiting the term "Indian business enterprise" to any commercial, industrial or business entity which is operated for profit is unnecessarily restrictive. Some non-profit organizations could make a significant contribution to Indian economic development and have an even greater ability to pay back a loan than some profit organizations.... Ownership by more than one tribe appears to be unnecessarily precluded.

BILL: An amendment was adopted during markup to the definition of "eligible Alaska native village or regional or village corporation" to clarify that the bill does not imply that these entities possess sovereign governmental powers but are recognized by the United States as eligible for the programs created by this Act.

TITLE I - ESTABLISHMENT OF CORPORATION

Section 102 - Functions

BILL:The Corporation is specifically authorized to make loans or commitments for loans to any Indian business enterprise which has a sound organizational structure, income in excess of its operating costs, assets in excess of its liabilities and a demand for its goods and services.

ADMINISTRATION: The provisions of this paragraph appear to be ineffective. This section is weakened by the absence of any requirement of collateral. Increasing the revenue and asset requirements would also strengthen this section.

BILL:In setting such terms rates and charges for loans made under this subsection, the objective of the Corporation will be to provide credit to Indian business enterprises at the lowest reasonable costs taking into account the cost of money to the Corporation, the necessary reserve of the Corporation and the technical and other assistance available to the borrower.

The Corporation may:

make loans or loan commitments to any Indian business enterprise or purchase, insure or discount any obligations of an Indian business enterprise;

guarantee all or any part of the principal and interest of any loan made by any State or federally chartered lending institutions;

purchase or make commitments to purchase, all or any portion of equity or ownership interest.

ADMINISTRATION: ...S.721 approaches the continuing problems of Indian economic development with previously tried solutions: loan authority, loan guarantees, and grants. The establishment of a new financial corporation would create another bureaucracy, would duplicate what is already available, and would not address the underlying problems of economic development in Indian country...(It) creates a new Indian economic development program that largely duplicates -- at a high cost -- existing Bureau of Indian Affairs direct loan and loan guaranty programs authorized by the Indian Financing Act.

Section 103 - General Powers

BILL: This section defines the general powers of the Corporation to include:

1. Lease, purchase, accept gifts or donations, own, hold, improve, use, sell, convey, mortgage, pledge, lease, exchange, or otherwise dispose of any property, real, personal or mixed or any interest therein:

2. Sue and be sued and go to court;

3. Represent itself, or to contract for representation in all judicial, legal, and other proceedings;

4. Make use and pay for services, facilities, and property of any board, commission, independent establishment, or executive agency or department of the executive branch in carrying out the provisions of this act;

5. Use the United States mails on the same terms as the executive departments of the U.S. Government;

6. Participate with other financial institutions, agencies, instrumentalities, trusts or foundations in loans or guarantees under this Act;

7. Accept guarantees from other agencies for which loans made by the Corporation may be eligible;

8. Establish regional offices as needed;

9. Buy and sell

A. Obligations of, or instruments insured by the United States or any agency or instrumentalities thereof, or

B. Securities backed by the full faith credit of any such agency or instrumentality;

10. Make investments;

11. Establish offices within the Corporation as may be necessary including offices for: Project Development, Project Evaluation and Auditing, Fiscal Management and Research and Development;

12. Exercise all other lawful powers necessarily related to the establishment of the Corporation in order to carry out the provisions of this Act.

Section 104 - Board of Directors

BILL: The powers of the Corporations are vested in a twenty-one member board of Directors. The twenty-one members will represent:

A. 1 officer of the United States Government designated by the Secretary of the Interior;

B. 19 individuals who represent the shareholders in the corporation;

C. The President of the Corporation.

....The Board of Directors will be responsible for establishing the policies of the Corporation and supervising the management of the Corporation.

The federal representative would:

1. Have 20 percent of the share of votes cast at annual shareholder meetings;

2. Be overruled only by a two-thirds majority vote at regular board meetings in matters involving calling of callable capital; borrowing by the Corporation of amounts in excess of \$10 million; loans or investments made by the Corporation in excess of \$1 million; the adoption of changes to investment and credit policies.

ADMINISTRATION: Although these provisions appear to provide for some Federal oversight, we do not believe that this level of Federal participation is commensurate with the level of Federal

financial contribution and risk of liability...Since the Federal Government is incurring most of the risks, the configuration contained in the bill unduly favors the beneficiaries. The Federal Government should be provided a greater proportion of the representation on the Board of Directors...The United States should have a share of votes cast at all shareholders meetings which is proportional to the risk which it is incurring. Under that arrangement, its greater representation on the board would eliminate the need for a veto and override provision.
(Sections 105 - 110 not included)

TITLE II - CAPITALIZATION

Section 201 - Issuance of Stock

BILL: The Corporation is authorized:

1. To issue shares of stock in the Corporation in an amount determined by the Board of Directors;
2. To redeem or repurchase any share of stock issued by the Corporation at a price determined by the Board of Directors.

The Corporation shall offer a total of 500,000 shares of common stock of the Corporation for sale at \$50 per share to Indian Tribes. The number of shares of stock available for purchase by each Indian tribe shall be established by a formula established by the Board of Directors, which will take into account economic conditions and other appropriate indicators. Funds held in trust for an Indian tribe may not be used to purchase shares of stock in the Corporation.

ADMINISTRATION: Limiting the purchase of common stock to Indian tribes is an unnecessary restriction. In order to encourage Indian entrepreneurs and a stronger private sector on reservations, individual Indians should also be allowed to own voting common stock.

BILL: The Secretary of the Interior, acting on behalf of the United States, is authorized to subscribe 2,000,000 shares of capital stock in the Corporation. Subject to the availability of amounts provided in advance by appropriate Acts, the Secretary shall pay:

1. \$20,000,000 representing 20 percent of the shares of capital stock in the Corporation within the 2 year period beginning on the date of enactment of this Act
2. Up to \$80,000,000, representing 80 percent of the value of the shares of capital stock in the Corporation upon call of the Board of Directors of the Corporation. The request will be in the form of callable capital and will be based on an assessment of need, taking into account a risk analysis of the investment and credit policies of the Corporation.

The capital stock subscribed by the Secretary on behalf of the United States:

1. Shall be valued at \$50 per share;

2. Shall be nonvoting stock; and,
3. May not be transferred to any person or entity other than the Corporation.

The stock or other securities issued by the Corporation shall be "exempted securities."

ADMINISTRATION: If the Federal Government is to purchase stock, it should purchase voting stock. In this way, the Indian Development Finance Corporation's degree of independence from the Federal Government would be directly related to the financial contribution made by the United States...The \$100 million price tag to the Federal Government is excessive.

TITLE III - AUTHORIZATION OF APPROPRIATIONS

Section 301 - General operational expenses

BILL: \$2,000,000 is authorized to be appropriated for fiscal year 1989 and such sums as may be necessary for fiscal years 1990 and 1991. \$2,500,000 is authorized for fiscal years 1989, 1990, 1991, 1992 and 1993 for project development activities.

ADMINISTRATION: We oppose these authorizations.

Section 302 - Authorizations for paid-in-stock

BILL: There is authorized to be appropriated for fiscal years 1989 and 1990, \$10,000,000 for the purpose of carrying out the capitalization provisions in this Act.

Beginning in fiscal year 1991, an amount not to exceed \$80,000,000 is authorized to carry out the capitalization provisions in this Act.

ADMINISTRATION: We oppose this authorization.

Concluding Remarks by the Administration

...(W)e would not oppose S. 721 if it were modified to:

-- deauthorize, concurrent with establishment of the Indian Development Finance Corporation, the Indian direct and guaranteed loan programs now operated by the Bureau under the Indian Financing Act and the current portfolio of BIA loans and guarantees assigned to the new corporation;

-- remove the restriction that limits the corporation to loans and guarantees for enterprises which are mostly or entirely owned by tribes;

-- provide that stock in the corporation purchased by the Federal Government would be voting stock, to ensure the corporation's degree of independence from Federal control would be directly proportional to the relative level of financial participation by tribes;

-- provide that Federal and tribal equity in the corporation must be pooled for purposes of investment, to ensure all

shareholders incur the risks of those investments in proportion to their contribution;

-- provide for appropriate oversight and control of the spending, borrowing, investment, and other activities of the corporation and to prevent disruptive impacts on the market of Federal and federally related securities;

-- make various other technical and substantive changes outlined in the attachment to this report.

APPENDIX II: GROUP LENDING IN MICROENTERPRISE DEVELOPMENT

Microenterprise development has traditionally been a concern of international development organizations, not U.S. domestic development organizations. Microenterprises are typically small, family owned and operated businesses which employ one to four persons and whose owners have little or no access to credit, education, insurance and legal advice. In developing countries these businesses include street vendors, artisans, mini-manufacturers, seamstresses, shoe repairmen, small time distributors and shop owners in cities and villages. Although these businesses have been around for a long time, they have gained recognition by development agencies because they employ many of the people who migrate from the rural to the urban areas.

[1]

The Grameen Bank in Bangladesh first used the group lending technique, a peer pressure incentive system, to further microenterprise development. Other organizations, like ACCION, a private development organization which operates primarily in Latin America, and the Good Faith Fund, a nonprofit affiliate of an Arkansas bank-holding company, adopted the technique as well. Group lending is based on five basic principles, which all of these organizations employ in minor variations. The principles are:

1. Lend only to groups of people (usually five persons per group).
2. Require borrowing groups to form by themselves.
3. Teach borrowers to use existing resources. Force ideas to be developed using existing cash flows.
4. Avoid paperwork. Keep lending as simple and informal as possible.
5. Allow the borrowers to help themselves. Do not provide technical assistance.

The Grameen Bank and ACCION both get credit directly to poor individuals through a number of holding company programs. The Grameen Bank has made over \$30 million in loans through a decentralized system of 226 branches and has reached over 180,000 borrowers. It reports a default rate under two percent. ACCION works through affiliates in 13 Latin American and Caribbean nations. Through its affiliates, it has reached 16,000 small firms and more than 100,000 people in some of the poorest communities in Latin America. ACCION reports a payback rate that is over 98 percent. It has determined that it can create a new, permanent, full time job for as little as \$375, because of the labor intensive nature of these microenterprises.

The Good Faith Fund is a microenterprise development organization established in Arkansas to serve the rural poor. It loans small amounts of cash to groups of five. The Fund is capitalized by \$500,000 in equity investment and is operated by the Southern Development Bancorporation, a partnership between the Winthrop Rockefeller Foundation in Arkansas and the South Shore Bank of Chicago, a subsidiary of the Shorebank Corp., a

bank-holding company. It is described as "the most radical experiment in rural economic development since the Tennessee Valley Authority." [2] It deviates from the traditional U.S. rural economic development model in two major ways. First, it works to develop new and homegrown businesses rather than try to attract large firms from outside. Second, there is virtually no government involvement in the program.

Although it is an affiliate of a bank-holding company, the Fund makes loans in an area geographically distinct from its corporate cousin. This separation is intentional and is designed so that borrowers will not know of larger lending opportunities and will be forced to manage small amounts of money first. The loan application process relies heavily upon the borrowing groups' own decisions. Each group must organize without help from the bank. The group is eligible for a loan when they have exactly five, non-related persons. Once the group is formed, the Good Faith Fund lends to one person in the group. If this loan is repaid as agreed, two more people in the group are eligible for loans. Finally, if the first three loans are handled properly, the bank will lend to all five persons in the group. Throughout this process, the bank expects the group to regulate itself through self-selection and expectations of future loans.

When asked if the government could mimic a private lending program, Ronald Grzywinski, Shorebank Corp. chairman and a primary architect of both the Grameen Bank and the Good Faith Fund programs, mentioned four barriers that it would have overcome. First, a private bank has great flexibility in its operations and lending requirements. If a program used public funds, greater accountability would be required. The rules that would be needed to protect the public interest and use of funds would not allow the informal trust that a micro lending program intends to build. Second, public fund managers have greater difficulty changing lending rules and markets. Small lending programs tend to be highly entrepreneurial and successful in as much as they follow their market. A public fund would require a broad legislative mandate that could be adapted by management with a minimum of political interference. Third, the program has to run free of parochial meddling. This could be difficult if the Board of Directors is significantly controlled by one or two parties. Finally, government programs tend to presume care giving. Moreover, its employees tend to be attentive to service and developing human resources. However, a micro lending program contains very little assistance for borrowers. Its success is dependent upon the efforts of the impoverished. Assistance may debilitate as much as it aids - the theory behind micro lending hints that only borrowers can work themselves up the economic ladder.

Footnotes:

[1] p. 12, Pacific Business Newsletter, June 1987.

[2] "Bootstrap Banking," Osborne, David, INC., August 1987.

APPENDIX III: WORLD BANK LENDING PROGRAMS

The World Bank is an international financial institution devoted to raising the standards of living in developing nations. Operationally, the Bank channels funds and expertise found in the wealthier nations to the less developed ones. The World Bank has a total capitalization in excess of \$40 billion and controls three separate entities: the International Bank of Reconstruction and Development (IBRD); the International Development Association (IDA); and the International Finance Corporation (IFC). All of the World Bank programs limit lending to member countries.

In this paper, we only consider the operations of one World Bank subsidiary, the International Finance Corporation (IFC). Though a sub-unit of IBRD, the IFC and each of the other branches of the World Bank maintain separate offices, loan criteria, and funding. Although the IFC works with businesses to take advantage of IBRD or IDA projects, the Corporation chooses its projects independent of other World Bank commitments.

The differences between the IFC, IBRD, and IDA are quite striking. The customers of the IBRD and IDA are always governments. The scale of these loans dwarf any other bank's operations (see Table 1). Funds are utilized for increasing a nation's infrastructure, payment of debts, or more recently, restructuring the nation's macro economy. Interest rates offered by both corporations are significantly below market prices. None of these loans have ever defaulted, primarily because such an action would foreclose future borrowing opportunities of the country. The IFC, on the other hand, lends only to businesses. Government participation in the venture is not required. Moreover, there is no recourse to the government for defaults of their nation's businesses. Hence, the IFC's loan portfolio is far riskier and has been more effected by defaults than its sister lenders.

TABLE 1
SUMMARY OF SELECTED BALANCE SHEET ITEMS FOR IFC AND IBRD (1987)
(All numbers in thousands of U.S. dollars)

	IFC	IBRD
Loan and Equity Investments	2,755,677	18,774,241
Total Assets	2,814,121	108,224,901
Owners Equity	721,850	7,272,383
Accumulated Earnings	337,640	1,112,930

APPENDIX IV: COMPARISON OF THE INTERNATIONAL FINANCE CORPORATION
AND THE INDIAN DEVELOPMENT FINANCE CORPORATION

While we found the International Finance Corporation's (IFC) approach to business lending helpful, we do not suggest that the IDFC can use all its policies. Clearly, the two development banks are intended to serve different customers, utilize different resources. They are also creatures of different authorizing environments. At best, the IDFC can replicate the set of incentives that the World Bank has created for its borrowers, lenders, and shareholders. Below, we list a few of the differences in the organizations' capabilities.

Size of Loan. The raw financial assets of the IFC dwarf those of the IDFC. At the end of 1987, the International Finance Corporation held \$2.8 billion in total assets, with paid in equity of \$700 million. The IDFC's planned paid in capitalization is \$25 million. At an average of \$10 million per loan, the IFC could create the equivalent of the IDFC with two or three disbursements.

Cooperation with Banking System. The IFC derives numerous benefits from being part of the World Bank and the world banking community. The IFC has a number of partners in making loans to Developing Nations. The U.S. Agency for International Development, Commonwealth Development Corporation, and Caisse Central de Cooperation Economique gear their portfolios toward the IFC's non-traditional borrowers. The IDFC has no such financial partners.

Name Recognition. The IFC, though independent, can use the World Bank's name for professional credibility and respect. The affiliation at least opens a few doors. The IDFC, on the other hand, is likely to obscure its relations to the Federal Government. In addition, possible association with BIA or EDA loan/grant programs are generally unwanted.

APPENDIX V: CASH FLOW ANALYSIS

As noted in the text, the IDFC's financial position probably will be riskier than the average bank's. In this Appendix, we use a simple cashflow analysis to explore the prospects of a lender such as the IDFC. Please note, these estimates are not intended to predict financial values as much as to illustrate financial trends.

This model demonstrates several problems facing the Indian Development Financial Corporation. These quandries are:

- * The IDFC will have a steady outflow of cash over the first eight to fifteen years. Unless additional equity is added during this period, the Corporation will have to borrow funds to meet obligations. With borrowing, however, the IDFC will introduce an additional expense to be paid by loan revenues;
- * Most of the IDFC's early income will come from interest on paid in capital. Short run profitability turns on the rate at which capital is contributed by common and capital shareholders. If either government delays its contribution, lost income will go directly to IDFC's "bottom line";
- * If the Corporation uses moderate levels of real interest, such as 5%, even low repayment rates can be sustained for a period. However, we suspect as the cost of capital rises, this will no longer hold true.

Below we explain the sources for some of our estimates:

1. Equity investment, loan/assistance, and start up costs (columns 2 and 7) are derived from the plans of the Senate Select Committee on Indian Affairs. As drafted, the IDFC will receive \$20 million paid in capital from the government and \$5 million from participating tribes. These amounts are paid in over two years. The Committee also expects technical assistance and loan support to total \$2.5 million per year.

2. Loan payments (column 3) received are simply repayments on loans already disbursed. This repayment schedule's cashflow is a very optimistic estimate. First, it assumes that all technical assistance will be cross-subsidized by superior returns on investments. Second, it assumes that returns on all three investments are earned in similar time frames. Equity investment will certainly require a longer time for repayment. Default rates were chosen as a middle ground between estimates of the World Bank (10%) and AINB (41%) experiences. The latter estimate is derived from pro rated loss provisions on its Indian Country loan portfolio.

3. The Select Committee allows for \$2.0 million in administration fees (column 5) in the first year of operations. After that, we allow for fixed office costs of \$200,000 annually and employee salaries of \$300,000 annually. Our estimate of "Adminrate", the percentage of loan volume net of overhead, comes from case studies rates ranging from 3% with the IFC to 26% with the AINB. Although our fixed and variable administrative costs

well exceed some midpoint, the unique combination of smaller loans and greater technical assistance should place the IDFC at the extreme end of the spectrum.

IDFC CASH FLOW PROJECTIONS

INPUT ASSUMPTIONS

quarterly loan volume	625	administration cost per loan	7
annual overhead	50	#staff paid by admin allowance	3
ave. loan amount	60	number of loans each quarter	10.4
yrly interest rate	0.13	average quarterly loan pymt	2535
loan repay rate	0.90	annual government stock purchase (\$20mil total)....	2,500
admin per loan	0.12	annual tribal stock purchases (\$5mil total).....	625
ave. yrs to repay	12		
annual inflation	0.08		

NOTE: All numbers in thousands of dollars.

QUARTER YEAR	NEW EQUITY	LOAN PAYMENTS RECEIVED	INTEREST ON UNLOANED CAPITAL	ON ADMIN COSTS	COMMON DIVI- DENDS	CASH OUT IN LOANS OR ASST.	NET CASH FLOW	PERIOD END CASH BALANCE	VALUE OF ASSETS	CHNG IN ASSETS VALUE
89 1	3125.0	0		500		625	2,000	2,000	2,563	2,406
2	3125.0	24	40	500		625	2,064	4,064	5,189	2,626
3	3125.0	48	81	500		625	2,129	6,193	7,880	2,691
4	3125.0	71	124	500		625	2,195	8,388	10,638	2,758
90 1	3125.0	95	168	97	0	625	2,666	11,054	13,866	3,229
2	3125.0	119	221	99		625	2,741	13,795	17,170	3,304
3	3125.0	143	276	101		625	2,818	16,613	20,551	3,380
4	3125.0	166	332	103		625	2,896	19,509	24,009	3,459
91 1		190	390	105	0	625	(149)	19,360	24,423	413
2		214	387	107		625	(131)	19,229	24,854	432
3		238	385	109		625	(112)	19,118	25,305	451
4		261	382	111		625	(92)	19,026	25,776	470
92 1		295	381	113	0	625	(73)	18,953	26,266	490
2		309	379	115		625	(52)	18,901	26,776	510
3		333	378	118		625	(32)	18,869	27,306	530
4		356	377	120		625	(11)	18,857	27,857	551
93 1		380	377	123	0	625	10	18,867	28,430	572
2		404	377	125		625	31	18,899	29,024	594
3		428	378	127		625	53	18,952	29,639	616
4		452	379	130		625	76	19,027	30,277	638
94 1		475	381	133	0	625	98	19,126	30,938	661
2		499	383	135		625	121	19,247	31,622	684
3		523	385	138		625	145	19,392	32,329	707
4		547	388	141		625	169	19,560	33,060	731
95 1		570	391	144	0	625	193	19,753	33,816	755
2		594	395	146		625	218	19,971	34,596	780
3		618	399	149		625	243	20,214	35,401	805
4		642	404	152		625	269	20,482	36,232	831
96 1		665	410	155	0	625	295	20,777	37,090	857
2		689	416	158		625	321	21,098	37,973	884
3		713	422	162		625	348	21,446	38,884	911
4		737	429	165		625	376	21,822	39,822	938
97 1		760	436	168	0	625	404	22,226	40,788	966
2		784	445	172		625	432	22,658	41,783	995
3		808	453	175		625	461	23,119	42,807	1,024
4		832	462	178		625	491	23,610	43,860	1,053
98 1		855	472	182	0	625	521	24,130	44,943	1,083
2		879	483	186		625	551	24,682	46,057	1,114

3	903	494	189		625	582	25,264	47,201	1,145
4	927	505	193		625	614	25,878	48,378	1,176
99 1	951	518	197	0	625	646	26,524	49,586	1,209
2	974	530	201		625	679	27,202	50,827	1,241
3	998	544	205		625	712	27,915	52,102	1,275
4	1022	558	209		625	746	28,661	53,411	1,308
00 1	1046	573	213	0	625	781	29,441	54,754	1,343
2	1069	589	218		625	816	30,257	56,132	1,378
3	1093	605	222		625	851	31,108	57,545	1,414
4	1117	622	226		625	888	31,996	58,996	1,450
01 1	1141	640	231	0	625	925	32,920	60,483	1,487
2	1164	658	236		625	962	33,883	62,008	1,525
3	1188	678	240		625	1,001	34,883	63,571	1,563
4	1212	698	245		625	1,040	35,923	65,173	1,602

1. A large assumption implicit in this model is that administration costs vary that administration decreases with larger loan values, I do not believe that this skews the results shown above. Administration costs are a relatively small factor in the cashflow - interest rates, repayments, and loan volume effect profitability far more dramatically.
2. Unless otherwise stated, this model assumes that the Federal Government and Tribal Councils contribute capital in a very timely fashion.
3. Interest rate was set at a 5% real return. We would expect this rate to be adjusted as management learns the true lending costs.
4. All equity numbers assume that future conversions of callable capital will be made after the time frame of this analysis.

SENSITIVITY OF ASSETS TO
REPAYMENT RATE & LOAN VOLUME

	REPAYMENT RATE	LOAN VOLUME (in thousands)		
		353	500	625
	0.50	25,563	29,094	32,097
	0.80	43,817	50,890	56,904
	0.90	49,902	58,155	65,173

SENSITIVITY OF IDFC TO SLOW EQUITY PAYMENT

	LAST QUARTER'S INCOME	LAST QUARTER'S ASSET VALUE	CASHFLOW
GOVT. AND TRIBES PAY IN 8 YRS	400	27,213	(6)
GOVT. IN 4 YRS. TRIBES PAY IN 8 YRS.	527	33,666	121
BOTH PAY IN 2 YR	651	39,992	245

SENSITIVITY OF INCOME TO
REPAYMENT RATE & LOAN VOLUME

	REPAYMENT RATE	LOAN VOLUME (in thousands)		
		353	500	625
	0.50	105	281	430
	0.80	683	1,021	1,309
	0.90	875	1,268	1,602

APPENDIX VI: RESERVATION VS. OFF-RESERVATION LENDING

The choice between universal IDFC service and selected service resembles a constant tension between the IDFC's goals and its capacity. On the one hand, we recognize that social and racial barriers can limit all American Indian businesspeoples' access to capital. Moreover, a over half of American Indians do not live on a reservation. Hence, any decision to exclude non-reservation businesses from IDFC lending is difficult. However, the IDFC is by definition a lender which selects only a few of the requests put to it. The Corporation's problem is setting up a list of priorities which will maximize the effect of its lending program. In our opinion, IDFC lending can be most useful if targetted toward on-reservation businesses, with possible inclusion of firms within a few miles of reservation boundaries and off-reservation retail firms that are extensions or outlets of on-reservation production facilities. Below, we discuss four issues that brought us to this conclusion.

1. The IDFC is a public/private entity whose loans must meet social and financial standards. The social standards cannot be readily identified -- how is a social benefit easily estimated? We believe that the IDFC can make the most dramatic effect by targetting the neediest economies -- reservations. Native Americans living on reservations face extremely high unemployment rates and low incomes compared to the rest of the nation. To improve the economic status of American Indians, the IDFC should begin with reservation lending.

2. Exclusive lending to reservation businesses is a reasonable way to promote jobs for American Indians. Jobs are likely to be held by persons living close to the business. If the IDFC's goal is to create jobs for American Indians, the best place to foster business is in an American Indian community. While there are non-reservation Indian communities, we would prefer to keep IDFC management out of jurisdictional questions and allow them to concentrate solely on lending questions.

Moreover, spillover effects from Indian owned business are far from automatic. The recent recipient of the United Indian Development Association "Owner of the Year" award operates a business in Stockton, California. This business deserves the award for its growth and strong management. However, given that only three of its twenty employees are American Indians, it's difficult to connect it with large spillover benefits to the American Indian community.

3. There should be no incentive for IDFC managers to avoid reservation lending. IDFC managers will want the Corporation to be as financially sound as possible. Current capital market behavior indicates that reservation businesses are riskier or at least more difficult to work with than off-reservation businesses. If these two assumptions hold, the IDFC staff may be tempted to

make a large number of off-reservation loans. The IDFC is a venture with social goals and no perverse incentives should exist for management to escape these requirements.

4. The IDFC is not a private bank and should only finance businesses that face significant capital shortages. The primary barrier to off-reservation business capital acquisition is racial/cultural prejudice. While we do not take this barrier lightly, there are far better ways to address the problem than starting a new finance corporation. Information networks, education programs, or legal counsels could all address this problem effectively.

Certainly, the issue of off-reservation lending is a difficult one. One could easily state that off-reservation businesses do help others by setting examples and providing accessible expertise. It might also be argued that the IDFC should start by lending to the strongest American Indian business opportunities for financial reasons. We believe that the IDFC is a financial institution created to "...provide for and promote the economic development of Indian tribes," and its most direct route to this goal is by lending to reservation businesses.