

The MATURING Secondary Market for Community Development LOANS

by Michael Blumfield, Director of Marketing, Community Reinvestment Fund



Some 20 years ago, the engineers at Sony figured out how to make a battery-powered cassette player small enough to carry around in your hand. It was made of metal, had no radio and cost more than \$200. Those who bought the initial models got quizzical looks from strangers, not sure what to make of people who walked around with headphones on, listening to music privately in public places.

Now the Walkman and its equivalents are ubiquitous. Commuters tune in news shows on city buses, homeowners play tapes while cleaning their yards, kids nod their heads in sync to MP3 tunes as they trod off to school. What was once a product at the margins has become so commonplace that no one thinks twice about them.

The secondary market for community development loans isn't quite as mature, but it's getting there. What was once a novelty has become a widely accepted method of bringing fresh money in the doors of community development lenders nationwide.

Community Reinvestment Fund, Inc. (CRF) has been striving to make the secondary market for community development loans a well-established financial option since 1989. Through a lot of effort, plus as much imagination and flexibility as we could muster, we've moved the ball a good way down the field. That means not just more options for lenders and investors, but more dollars for the nation's disadvantaged communities.

Consider:

- In 1989, CRF bought just over a million dollars worth of economic development loans—all confined to CRF's home state of Minnesota. In the most recent fiscal year, CRF bought more than \$60 million in loans from lenders across the country
- Initial deals for CRF resembled a space docking, timed just right to link lenders with loans to sell and institutional investors (banks, insur

ance companies, pension funds) ready to buy. Now, with resources of its own, CRF can buy millions of dollars worth of loans and warehouse them until aggregating them into a debt security, issued at least once a year

- Previously, government agencies looked apprehensively on sales of loans that were made with money from government programs. Recently, the Economic Development Administration, the CDFI Fund, and two Federal Home Loan Banks have commissioned studies and pilot projects to review how the secondary market can help stretch scarce funding dollars

This article reviews some of the history of the secondary market for community development lending, as well as examples of how the products for serving such a market have developed. We specifically look at transactions that have occurred within the Federal Reserve Bank of San Francisco's District.

INITIAL WORK

CRF was formed at the end of the 1980s, as funds for government programs intended to promote community development lending began to dry up. A quick definition: community development lending is intended to provide not just financial returns, but social returns as well. It includes loans for job creation, economic development and community facilities, such as daycare centers and healthcare facilities. (Affordable housing is also part of the mix, although a better-established market because of the uniformity of its products.)

These loans are typically executed by government groups such as city, county or statewide lending agencies, community development nonprofits and increasingly tribal entities (box 1), all of whom have an express mission of stimulating economic development in their target areas.

Box 1: Overcoming Sovereign Immunity Issues

The need for new capital for economic development lending is felt most acutely by tribal governments, who face dauntingly high unemployment rates and scarce resources. Financial markets have had trouble reaching Indian Country in part because of sovereign immunity issues that limit an outside agency's ability to take action should a loan default.

CRF found a way to overcome those issues through a loan participation with the Hoopa Valley Tribe in Northern California. The tribe was trying to complete a \$1.55 million fire fighting station, which would employ more than 50 people to battle blazes in forests throughout the country. The tribe was short on cash—to the tune of more than \$400,000. CRF agreed to an advance. Getting there took tremendous dedication on the part of both parties, as well as significant legal work. In addition to the transaction itself, the tribe needed to waive tribal immunity and agree on which courts should settle any disputes. Then, the proposed transaction had to be reviewed by two federal agencies—the Bureau of Indian Affairs and the Economic Development Administration, which had provided key funding.

The hard work paid off, not only in helping the Hoopa Valley Tribe get its fire station, but also in paving the way for other tribal governments to take advantage of the secondary market for economic development lending.

Frank Altman, CRF's founder and president, saw an opportunity to use the securitization instrument that has worked so well in mortgage banking. By selling loans instead of holding them until maturity, lenders would have more cash to make more deals. Essentially, what Mr. Altman wanted to do was use private capital sources—institutional investors—to fund public needs.

CRF's core philosophy has remained consistent:

- **Investors need to earn a market rate for their money.** By asking investors to accept below-market rates, we would be curtailing the resources available for buying loans
- **Lenders need to have their individual situations understood.** Community development lending

varies tremendously in scope. CRF has bought everything from a beauty shop's micro-loan to a structured financing of multi-million dollar portfolios. We strive to create products that fit the varying needs of the lenders that come to us

- **Social purpose should always be at the forefront, but let the lender decide how to serve that purpose.**

As a nonprofit, CRF must be sure that at the end of the day our activities support a social purpose. So, we buy loans that clearly serve a greater good by creating new jobs and helping low-income borrowers enhance their economic status. Lenders need to show us how they will reuse the proceeds we give them, but the decision on how to best put the money to use is ultimately a local one, not one imposed by CRF

THE BASIC PRODUCT

In the beginning, there were simply loans that had been made and people who wanted to buy them. CRF calls this type of transaction an “existing purchase.” Initially, we worked exclusively in our home state of Minnesota, hitting the road to explain to community development lenders how they could raise more cash by selling the loans on their books.

Plenty of eyebrows and doubts were raised before the first loan was sold, but eventually the idea took. To be sure, those early customers were a group trying to find any method to get more money in the till—and in a hurry. One of those early adopters was Michael McPherson of the Oakland Business Development Corp. In 1992, McPherson’s fund was strapped for cash. McPherson had heard about CRF and gave us a call.

We looked over what he had in his portfolio and offered to buy three loans: an inner city printing company, a metal-castings concern and an arts and crafts cooperative. McPherson was handed a check for \$136,250 for the loans, then turned around and made more loans to a janitorial company, a computer company and another printing company. McPherson suddenly saw a new way of financing his operation. Since then, he’s returned to CRF repeatedly, selling a total of 23 loans worth \$867,000 in cash.

Sometimes, the transactions are more sweeping. For example, in 1999, the state of Arizona’s Department of Commerce sold CRF 15 loans for \$3 million. An assortment of commercial and manufacturing loans with face values ranging from \$70,000 to nearly \$500,000 and interest rates from 3% to 12%, the loans’ only commonality was in creating jobs for residents of the state of Arizona. By diligently reviewing each, CRF was able to buy them and provide the state the capital it needed to create more jobs.

GETTING FANCY

The chief advantage of selling existing loans is that it allows a lender to quickly raise money in a straightforward way, which may be all that is required for some lenders. Others see an ongoing need for tapping into the revenue that CRF can provide, such as for an ongoing program that will repeatedly make similar types of loans. We term these an “advance commitment.”

In Los Angeles, CRF has worked with the Los Angeles LDC on a program that complements the SBA 504 program¹ for deals that would not normally meet SBA requirements. CRF agrees to fund the 40% that would have been LALDC’s share in the transaction. Depending on the credit quality of the loan, CRF either takes a position on par with LALDC or senior to LALDC. LALDC typically adds a premium to the interest rate of between 0.5% and 1.0%, which adds operating dollars for LALDC.

Through this set-up, LALDC has been able to fund nearly \$5 million in loans due to CRF’s participation. The range of businesses supported has been vast including a community facility that provides drug counseling and rehabilitation assistance for inner-city residents, a silkscreen shop that employs ex-gang members and a chicken processing plant on Skid Row² that provides poultry to some of LA’s leading restaurants.

For some lenders, the major issue they need to work around is a discount on the loans they are selling. Because CRF prices loans relative to their market value (which is what our investors seek), those loans that carry a below-market interest rate earn less than their face value. The California Integrated Waste Management Board was look-

ing for such an approach—what we term “structured finance”—when it worked with CRF in 1996.

The Board, which encourages recycling in part by providing funds to businesses that work in recycled material, had a portfolio of loans all made significantly below market. CRF securitized 17 loans made to such borrowers as a manufacturer that converted recycled plastic milk cartons into toilet plungers and another that fashioned industrial buffing materials from recycled burlap coffee bags. The loans had a weighted average interest rate of 4.77%. CRF advanced \$4.7 million against a portfolio face value of \$6.1 million with California Integrated Waste Management Board holding a residual interest in the portfolio.

Finally, CRF can on occasion make a “loan to lender” by which CRF advances cash based on the strength of the lender itself, not the underlying loans. In 1996, the City of El Monte, CA was looking for a way to make more loans for rehabilitating affordable housing projects. The loans were made on a “due on sale” basis making the capital provided to borrowers essentially locked up and unavailable to lenders. CRF advanced the city \$1 million against the rehab loans, fully amortizing until 2003. With the deal, the city was able to make more loans for the same purpose—without waiting for the homes carrying the original loans to be sold.

WHAT’S AHEAD

The potential for selling community development loans is vast. Billions of dollars of loans have been made through programs intended to spur community and economic development. All signals suggest that the secondary market for such loans will grow dramatically over the next several years due to a number of reasons:

- Government cutbacks are forcing community development lenders to

1 *SBA Certified Development Company (504) Loan Program: www.sba.gov/financing/cert.html.*

2 *Skid Row borders Third Street on the North, Alameda Street on the East, Seventh Street on the South and Main Street in the West.*

look at alternative channels for recapitalization. Loans on their books are assets, which they can use in one form or another to bring more cash to their coffers

- Government agencies such as the Economic Development Agency are exploring how to best use the secondary market. The EDA conducted a pilot project recently that allowed lenders who had received EDA funding to sell the loans and CRF was able to buy more than \$5 million of such loans
- The New Markets Tax Credit—a brand-new federal incentive to target economically disadvantaged areas—potentially will provide a substantial injection of capital. Among the ways in which lenders can take advantage of the credit is through the secondary market (box 2)

Perhaps the most important rationale for the growth of the secondary market for community development loans is that lenders have gotten comfortable with the idea just as the public got comfortable with the people wearing headphones walking down the street. True, the secondary market for community development loans is unlikely to pique the interest of your average 16-year old the way the latest MP3 player might. But for an increasing number of community development lenders, having a ready source of capital is music to their ears.

ABOUT THE AUTHOR



MICHAEL BLUMFIELD is director of marketing for Community Reinvestment Fund, with responsibilities for creating awareness of the organization among community development lenders, investors and funders. His most recent work includes a series of teleconference educational seminars for lenders about how to take advantage of opportunities in the New Markets Tax Credit program.

Mr. Blumfield previously worked for American Express Financial Advisors in retirement plans marketing. He is a former journalist who worked for a variety of papers throughout the country. He received his B. A. from the University of Michigan and his M.B.A. from the University of Minnesota's Carlson School of Management.

Box 2: New Markets Tax Credit: “Going it alone” vs. “Teaming up”



For the first time, a tax credit is available to stimulate investment for economic development ventures that will benefit emerging markets. The New Markets Tax Credit provides investors seven years worth of tax credits and collectively could infuse \$15 billion in new capital during that timeframe. The credit goes into effect in early 2003.

The CDFI Fund, which is administering the program, has created several avenues through which the funds can get to the low-income businesses targeted for assistance. One way is for a lender that qualifies to participate in the program (called a “Community Development Entity” or CDE) to make direct loans or investments in businesses with the capital it receives from investors. To do this, that lender will need to receive his own tax-credit allocation. Think of this as the “go it alone” approach.

Alternatively, a lender can become a CDE and sell their loans to another CDE with a tax-credit allocation. Community Reinvestment Fund is currently a CDE and is applying for the tax-credit allocation. This is what CRF calls the “team up” approach.

CRF has lined up CDE-designated lenders from throughout the country to partner with in this “team up” style. We think it’s an effective way to leverage the expertise of both partners—CRF to handle the administration of the tax credit and local lenders to decide how to best put it to work.