

The Struggle to Establish a Vibrant Secondary Market for Community Development Loans

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Securitization of loans and their sale to long-term investors has revolutionized many areas of finance: real estate, autos, consumer credit. But despite many efforts, it has not taken hold in community development financing. The obstacles to creating a secondary market for community development loans are similar to obstacles other markets faced: lack of data, standardization of documents and loan process, and loan volume. Other markets have managed to overcome these obstacles. Yet despite recent advances, such as the Community Reinvestment Fund's issuance of rated securities in November 2004 and May 2006, the goal of a vibrant secondary market for community development loans seems as tantalizingly close today as it did nearly a decade ago, when a community development consultant wrote in *Community Investments* that "piece by piece, a secondary market is taking shape." This development was in the "not-too-distant future. And, with the trend toward reduced public support, the sooner the better."¹

The benefits of a secondary market were put this way by the National Task Force on Financing Affordable Housing in its 1992 report, "From Neighborhoods to the Capital Markets":

The lack of a fully functioning secondary market for multifamily loans also works indirectly to raise the costs of borrowing. Having to keep the loans in portfolio contributes to a mismatch between the terms on which lenders are willing to lend (shorter terms, variable rate) and those which are sustainable for this type of borrower (longer term, fixed rate). The resulting exposure of projects to interest-rate risk and refinancing uncertainties means that fewer affordable housing projects are developed, and more run into trouble than would be the case if lenders were encouraged to lend on terms more appropriate to this type of project and borrower.

The need for more capital for community lending seems urgent. CFED researchers, in a late 1990s survey of revolving loan funds in Ohio, found that eighty-five of the fund managers believed that they needed more funding to pursue their mission.² And the need for liquidity is particularly a problem for the larger and more successful Community Development Financial Institutions (CDFIs). (For a more detailed discussion of how CDFIs access the secondary market in various ways, see the several articles that follow this article in this issue.)

¹ Kathleen Kenny and Frank Altman, "The Emerging Secondary Market for Community Development Loans," *Community Investments*, 9:2 (Spring 1997).

² Andrea Levere, Daphne Clones, and Kent Marcoux, *Counting on Local Capital: A Research Project On Revolving Loan Funds* (Washington, DC: Corporation for Enterprise Development, 1997).

The CDFI Fund commissioned a report to assess the feasibility of fostering a secondary market for community development loans. Although the Fund never released the report, a Government Accountability Office (GAO) study cited an early version that indicated that very few CDFIs had actually tried to securitize their loans. The study argued that while “about one-third of the respondents have sold at least some loans they originated, CDFI participation in the secondary market for loans remains quite small.”³

The GAO study, entitled “Community and Economic Development Loans: Securitization Faces Significant Barriers,” also found that very few small business loans were securitized. From 1994 to 2001, only \$6.2 billion of nonfederally guaranteed small business loans and \$22 billion of SBA-guaranteed small business loans were securitized. This was a small percentage of the estimated \$450 billion in outstanding small business loans held by commercial banks in June 2001.⁴

This article attempts to understand this puzzle, where there seems to be great need, much talk, and many efforts, and yet still no fully functioning secondary market for community development loans. To wrestle with that question, this article provides an overview of community development loan securitization (how it works and who the players are), looks at the early innovators in this field, and then traces more recent developments.

How It Works

While many of the articles in this issue deal with the selling of loans into a secondary market, a truly vibrant secondary market involves a process of securitization. Securitization turns loans into actual securities by taking existing loans on affordable housing, community facilities, or small businesses, or assets backed by their cash flows, and separating them into tranches that can be sold to investors. In this way, the lender, as the originator of the loan, gets a lump sum rather than the interest and principal payments over the loan’s term. This allows the lender to re-lend the capital to new projects. When this market is working efficiently, it connects the lowest-cost capital to community projects, increases liquidity for lenders, and helps lenders and investors better manage their financial risk.

Most transactions are not large enough to be securitized on their own (although for an interesting example of a large single-transaction securitization, see the David Bowie’s royalties deal discussed in Robert Van Order’s article in this issue). Smaller transactions require an aggregator that pools the loans that can be sold to investors. The most widely known aggregators are the government-sponsored enterprises (GSEs) for mortgages, Fannie Mae, Freddie Mac, and Ginnie Mae. There are other aggregators, including Sallie Mae for educational loans, and many private aggregators, such as Bank of America or GE Capital. One of the leading aggregators for community development loans is the Minneapolis-based Community Reinvestment Fund, which specializes in buying existing community development loans and selling them to investors (see Frank Altman’s article in this issue).

³ GAO, “Community and Economic Development Loans: Securitization Faces Significant Barriers,” October 2003, 36.

⁴ *Ibid.*, 8–9.

When assets are securitized by an aggregator, the assets are transferred to another legal entity that divides the cash flow into senior and junior tranches. The financial institutions that transferred the assets to the new legal entity often retain the subordinate interest in the security. The senior interest is structured in a way that gives it first claim to cash flow and the underlying collateral in case of default. Investors are more comfortable with purchasing the senior interest as a security because the protections provided ensure that the risk of default is lower.⁵ (For more detail on the mechanics of how an originator prepares loans for a sale, see the articles by Judd Levy and Kenya Purnell and George Vine in this issue.) In significant ways, this technique has transformed banks and finance companies from being portfolio lenders into loan brokers, managing the relationships between borrowers and long-term capital investors.

Securitization is an old technique, dating back hundreds of years, but its widespread application is a relatively recent phenomenon. Fannie Mae, which is synonymous with securitization, has been around since 1938, but its participation in the secondary market for mortgage-backed securities (MBS) did not start in earnest until 1970. Loans other than real estate were not securitized until the 1980s (e.g., auto loans in 1985 and credit-card debt in 1986). Securitization of MBS, and other asset-backed securities, or ABS, “has grown from a non-existent industry in 1970 to \$6.6 trillion [in outstanding assets] as of the second quarter of 2003,” according to Cameron Cowan, partner in the law firm Orrick, Herrington, and Sutcliffe.⁶

A vibrant and efficient secondary market has many advantages for all the participants in the transaction—borrower, lender, loan aggregator, and investor. For borrowers, it lowers their cost and can allow for more favorable loan terms. Lenders benefit greatly when their loans are more liquid. First and foremost, they get a capital infusion by selling old loans off their books. It also allows lenders to increase cash reserves, change lending terms, or diversify their portfolio by adjusting their concentration on certain geographies or types of borrowers. Finally, investors are attracted to MBS and ABS (compared to similar investments) through a combination of competitive yields, known risk parameters, flexibility of payment streams, and the desire to diversify their investment portfolios.⁷

Even though there is not a deep, well-used secondary market for community development loans, there have been many successful efforts of smaller securitizations for particular types of loans or assets, almost all of which were made possible by government guarantees (see Table 1).

5 Karl F. Seidman, *Economic Development Finance* (Thousand Oaks, CA: Sage Publications, 2005), 425.

6 Statement of Cameron L. Cowan, Partner Orrick, Herrington, and Sutcliffe, LLP, on behalf of the American Securitization Forum Before the Subcommittee on Housing and Community Opportunity Subcommittee on Financial Institutions and Consumer Credit United States House of Representatives Hearing on Protecting Homeowners: Preventing Abusive Lending While Preserving Access to Credit, November 5, 2003. <http://financialservices.house.gov/media/pdf/110503cc.pdf>.

7 Comptroller of the Currency, “Asset Securitization,” November 1997, 4. www.fdic.gov/news/news/financial/1999/FIL99109.pdf.

Securitization Models and Lenders and Borrowers Involved⁸

Model	Lenders	Borrowers
SBA 504 Program guaranteed	Certified Development Companies	For-profit businesses that have qualified for conventional loans.
SBA 7(a) guaranteed	Commercial banks, credit unions, small business lending companies and other nonbank lenders	For-profit small businesses that have demonstrated they could not obtain financing without the 7(a) program
SBA 7(a) unguaranteed	Commercial banks, credit unions, small business lending companies and other nonbank lenders	For-profit small businesses that have demonstrated they could not obtain financing without the 7(a) program
HUD Section 108 guaranteed	CDBG grantees and their designated lenders	For-profit or nonprofit borrower
Community Reinvestment Fund	Nonprofit, for-profit, and government community economic development lenders	Local business, affordable housing, and community facilities borrowers

Obstacles to Creating a Secondary Market

Although the concept is relatively straightforward, in practice there are many obstacles to creating a secondary market—some inherent in developing any secondary market and others that might be unique to community development loan pools. To some degree, all pioneers of existing secondary markets had to find ways to standardize their lending practices and loan documents, collect and report consistent data, and overcome initial skepticism from the investor community. In the case of single-family mortgages, for example, many specific factors bear on an individual home’s value (location, quality, design, etc.). It took years to establish a successful track record and create confidence in the investor community to believe pools of single-family mortgages could be turned into a commodity investment. This evolution would not have taken place without the careful management and credit enhancements from the federal government and GSEs. As important as building investor confidence was the work Fannie Mae and Freddie Mac played in establishing uniformity for applications and loan documents. The GSEs introduced the standard mortgage application in 1973 and followed with standard mortgage documents for all states in 1975.⁹

The creation of a secondary market for community development loans faces all the chal-

⁸ GAO, “Community and Economic Development Loans,” 27.

⁹ Denise DiPasquale and Jean L. Cummings, “Financing Multifamily Rental Housing: The Changing Role of Lenders and Investors,” *Housing Policy Debate*, 3: 1, 22.

lenges that the single-family mortgage market did (data, standardization, and interest from investors), but it has the added complications of low volume, thin spreads that make pricing difficult, and a business model that puts an emphasis on boutique loans with high levels of customer service that require intensive loan servicing. Furthermore, community development loans are complicated and “may include public and private-sector involvement on a number of different levels,” according to former Federal Reserve Board Governor John P. LaWare in testimony on Capitol Hill. He explained that “a single loan to a program for the revitalization of a number of properties within a particular neighborhood could involve several borrowers having varying degrees of experience and financial capacity, and be supported by numerous state, federal, and private assistance programs.”¹⁰ With so many moving parts, it may be too difficult to make investors comfortable with community development investments.

Overcoming Obstacles

One response to such a complicated underlying asset would be to provide investors with a credit enhancement that ensures the investor against losses stemming from the underperformance of the underlying assets the way Ginnie Mae, Fannie Mae and Freddie Mac did for single-family mortgages. “External credit enhancements rely on third parties to provide additional assurance of timely payment of principal and interest to investors,” according to the GAO report. “These enhancements can be governmentally provided (e.g., loan guarantees) or privately provided (e.g., loan guarantee insurance or letters of credit).”¹¹ In any case, the credit quality of the asset is based on the credit standing of the institution providing the guarantee. For example, pension fund investors do not need to understand the intricacies of the single-family mortgage market; they need to understand the credit quality of Fannie Mae or Freddie Mac.

Some internal credit enhancements are often arranged by the lender. One such structure is to have a senior and subordinate position where the senior securities have first claim on cash flow. Another is overcollateralization, where the value of the assets in the pool exceeds the value of the securities issued. And there are various ways to funnel cash flow into reserves as a way to give investors confidence of timely payments. Finally, lenders may be required to make a loan pool whole by substituting nonperforming loans with financially healthy ones.¹²

The Buy Side

Even under the best circumstances, however, there may be restrictions generated within the investor community that make securities backed by community development loans unat-

¹⁰ John P. LaWare, member, Board of Governors of the Federal Reserve System, Before the Subcommittee on Economic Growth and Credit Formation of the Committee on Banking, Finance and Urban Affairs, October 7, 1993.

¹¹ GAO, “Community and Economic Development Loans,” 31.

¹² Ibid.

tractive. “Pension funds,” according to Denise DiPasquale and Jean L. Cummings, “have a fiduciary responsibility, which results in a bias against investments that are perceived as risky relative to alternative investments.”¹³ Public pensions are regulated by the Employee Retirement Income Security Act of 1974 (ERISA) and private pension funds have similar guidelines. In addition to a regulatory environment that is hostile to community investments, DiPasquale and Cummings also find that pension funds and other institutional investors such as life insurance companies do not have the expertise to properly evaluate community development loan pools. If there is technical knowledge, it is often housed in the social-investments branch of the organization, which does not have the same access to investment capital as the mainstream investment side of the organization.

Investors also favor large investments; they have tremendous pressure to keep transaction costs low because they are getting a relatively low rate of return for their investment. This fact creates problems for community development lenders because they are not set up to do a high-volume of business. Their clients, almost by definition, have been passed over by the high-volume traditional lending community.

One answer to this problem is for loan aggregators to warehouse loans until they reach a threshold where they can pool and sell the loan securities. Warehousing, however, requires capital reserves. Loan aggregators, such as CRF, rely on socially motivated investors, program-related investments (PRIs), and other capital reserves such as Equity Equivalent Investments (EQ2s) to generate sufficient capital reserves to warehouse loan pools. Because there are so many fixed costs with assembling a loan pool and making it attractive to investors (e.g., getting the pool rated by one of the credit-rating agencies), the loan pools have to be relatively large. Frank Altman, president and CEO of CRF, estimates that the optimal pool size is above \$100 million.

The Sale Side

There are also disincentives from the sell side of this market. The Economic Development Administration conducted a pilot project with revolving loan funds to sell loans to the secondary market and found that “many RLFs [revolving loan funds] indicated they were not interested in securitization because they had no need to make new loans,” according to the study’s author, Kelly Robinson. Although this seems to fly in the face of the comments by many practitioners, it does speak to the possibility that there is a dearth of high-quality projects to securitize, particularly in specific rural or small markets. It also might be true that the RLFs have insufficient staff resources and expertise to maintain a high volume of loan underwriting.¹⁴ Put differently, it does not make sense to invest in the internal capacity to deliver loans to a pool, with all the added work that brings, if you are only completing a few loans per year.

Another issue is that many community lenders rely on keeping their loans on the books

¹³ DiPasquale and Cummings, “Financing Multifamily Rental Housing,” 96.

¹⁴ Kelly Robinson, “Expanding Capital Resources for Economic Development: An RLF Demonstration,” Economic Development Administration, 2001. http://www.eda.gov/ImageCache/EDAPublic/documents/pdfdocs/lg3_5f17_5fcapresources_2epdf/v1/lg3_5f17_5fcapresources.pdf.

so they can collect ongoing servicing fees as a way to finance their organizations. This can be particularly important when the lender is trying to show strong cash flow as a way to establish its financial credibility. In the EAD study, however, “the RLF managers we interviewed that had experience with securitization did not describe origination and servicing fees as an important source of revenue for their organizations,” according to Robinson.¹⁵

Finally, many lenders or originators may not be motivated to securitize because the price is too high to attract investors to their largely low-interest loans. In other words, the discount—the difference between what is due on the loan portfolio and the market price that investors will pay—is too deep. There are at least two reasons why investors might demand a discount on community development securities: (1) the underlying loans may be below market rate (and therefore below their other investment options such as Treasury notes); and (2) the underlying assets (e.g., small businesses in low-income neighborhoods) are risky. Robinson estimated that the gross discount was around 10 percent on the 115 loans he examined in the EAD demonstration project.¹⁶

Early Securitization Innovators

There never has been national leadership from one of the GSEs, HUD, or some other agency on community development securitization. In this absence, a number of smaller securitization experiments around the country were focused on a region or asset type. Early efforts by community development lenders to access institutional capital got their start in the 1980s and early 1990s. The efforts were led by lender consortia such as Community Preservation Corporation (CPC) in New York City, Savings Associations Mortgage Company (SAMCO) and the California Community Reinvestment Corporation (CCRC) in California, and Community Investment Corporation (CIC) in Chicago.¹⁷ These isolated regional efforts grew up alongside more national efforts to actually securitize specific types of loans, such as co-op loans securitized by a subsidiary of the National Cooperative Bank (NCB), or small business loans that were securitized with help from the Small Business Administration (SBA).

CPC was an early leader in establishing a secondary market for mortgages through private placements to the New York City Employees Retirement System. The State of New York Mortgage Agency (SONYMA) provided credit enhancement for CPC loans. “Each CPC loan has a 100-percent mortgage guarantee backed by SONYMA’s extensive reserves (not the full faith and credit of the state of New York),” according to the GAO report “Expanding Capital.” “These reserves accrue annually through a special surtax on all commercial mortgage loans.” (For more on CPC’s secondary market activities, see John McCarthy’s article in this issue.) CPC has also partnered with the New York City Teachers Retirement

15 Ibid., 23.

16 Ibid., 25.

17 GAO, “Housing Finance: Expanding Housing Finance: Expanding Capital for Affordable Multifamily Housing,” October 28, 1993, 57. <http://www.gao.gov/cgi-bin/getrpt?RCED-94-3>

System, the New York State Common Retirement Fund, the United Methodist Church, and Fannie Mae.¹⁸

The creation of the Community Reinvestment Fund in 1989 and its growth through the 1990s represented a major advancement in the effort to create a vibrant secondary market for community development loans. CRF has purchased more than \$300 million in community development loans from over one hundred lending organizations located in almost half the states in the country, and, as described later in this article, has more recently issued rated securities backed by some of these loans.

“CRF has begun to harness the power of markets to organize disparate development lenders,” according to CRF president and CEO, Frank Altman. “The secondary market structure not only enables development lenders to tap the institutional capital markets, but it also fundamentally changes the ways in which these lenders view themselves. The participants in CRF’s secondary market no longer view government grants as the sole source of capital in their development loans. They will be able to sell them to private investors and thereby diversify the sources of capital on which they rely to fund new economic development loans.” Altman stressed that “we must increasingly regard federal assistance as a catalyst or incentive for private-sector investment.” These efforts translate into finding “ways to improve the productivity of each dollar,” he said.¹⁹

NeighborWorks, a national network of affordable community development organizations, also has been a significant player in the inchoate efforts to securitize community development loans. Its subsidiary, Neighborhood Housing Services of America (NHS), started securitizing CDBG loans in 1974. NHS has operated “a specialized secondary market created to replenish the revolving loan funds and capital pools of local NeighborWorks organizations.” By 2004, NHS had purchased more than \$650 million in loans from local NeighborWorks organizations and their local lending partners.²⁰

NCB transacted the first securitization of co-op loans in 1986. Testifying before the Senate Committee on Banking, Bradford T. Nordholm, president of the Cooperative Funding Corporation, a subsidiary of the NCB, said his organization had continued to innovate with securitization by completing the first securitization of cooperatively owned mobile home park mortgages in 1992. In 1993, it “successfully completed the first-ever securitization of affordable housing mortgages, the Mortgage Investment in Low-Income Communities Security (MILC), a pioneering effort to increase the flow of capital into affordable housing nationwide applauded by HUD Secretary [Henry] Cisneros.”²¹

Nordholm was also successful in securitizing small co-op business loans. Testifying to Congress in the early 1990s, he observed that “most types of small business credit are beginning to be securitized—revolving lines backed by receivables and inventory, intermediate-

18 <http://www.communityp.com/index.php?sec=history&page=mortgageinsurance>.

19 Frank Altman, president of CRF, testimony before the Subcommittee on Public Buildings and Economic Development—Committee on Transportation and Infrastructure, February 22, 1995.

20 NeighborWorks Annual Report 2004, 26–28.

21 Hearings Before the Senate Committee on Banking, Housing and Urban Affairs, September 9, 1993.

term loans and leases backed by equipment and longer-term real estate loans.” Nordholm went on to point out that “efficient conduits must develop in order to facilitate securitization, conduits that can deliver a minimum of \$10 million to \$25 million, preferably \$100 million of homogeneous financial assets, with good performance statistics on both the ultimate borrowers, conduit and servicer.”²²

Yet more than a decade later, very few small business loans have been securitized, and the ones that are usually have the financial backing of the SBA. SBA began securitizing small-business loans in 1985, “when it first allowed depository institutions to pool and sell the guaranteed portion of their SBA loans,” according to the EAD report. “This was similar to the original ‘pass through’ on Fannie Mae guaranteed mortgages.”²³ In the end, however, SBA may not be especially helpful in setting precedents for securitizing community development loans for the following reasons: (1) SBA underwriting is highly standardized, which provides high volume; (2) the loans are made by private banks at near-market interest rates, which are higher than most community development businesses could afford; and (3) most of the loans carry SBA’s guarantee.

Early Efforts to Bring in the GSEs

In the 1990s, both the Local Initiatives Support Corporation (LISC) and the Enterprise Foundation made efforts to partner with the housing GSEs to securitize affordable housing mortgages. LISC’s subsidiary, the Local Initiatives Managed Assets Corporation (LIMAC), partnered with Freddie Mac in 1991, but the program was suspended after two years with only one transaction completed (eight existing mortgages totaling \$4.6 million). A subsidiary of Enterprise, Enterprise Mortgage Investments (EMI), partnered with Fannie Mae in 1994. Both partnerships received funding from the National Community Development Initiative (NCDI), which enlisted Jean Cummings and Denise DiPasquale to do an analysis of the programs, which were published in HUD’s *Cityscape* in 1998.²⁴

The stated goal of the LIMAC/Freddie partnership was to provide “a missing piece in the housing puzzle.” The partnership planned to “target community development corporations (CDCs) and small banks that would not normally work with Freddie Mac.” LIMAC would buy loans from approved Freddie Mac multifamily seller/servicers. They would pool the mortgages and swap the pools for Freddie Mac MBSs, which could be sold to institutional investors. There was a risk-sharing arrangement where LIMAC and the originating lender had the top 20 percent of losses and Freddie Mac would share the remaining 80 percent with the lender. LIMAC had to assemble the loans, which may have required warehousing. And lenders could retain servicing and earn a fee.²⁵

The EMI/Fannie Mae program was different in that EMI was the originator, under-

22 October 7, 1993, Bradford T. Nordholm, president, Cooperative Funding Corporation. Before the U.S. House of Representatives Committee on Banking, Housing and Urban Affairs.

23 Robinson, “Expanding Capital Resources,” 9.

24 “Developing a Secondary Market for Affordable Rental Housing: Lessons from the LIMAC/Freddie Mac and EMI/Fannie Mae Programs,” *Cityscape* 4: (1998).

25 *Ibid.*, 25.

writer, and servicer of the loans. Fannie was the investor, funding the mortgages. The EMI/Fannie program also differed in that it allowed for other investors. For example, the United Methodist Church bought \$10 million in Fannie Mae MBSs through the program. Initially, according to Cummings and DiPasquale, “the program was to focus on long-term, permanent mortgages for smaller, central city, multifamily LIHTC [Low-Income Housing Tax Credit] projects being developed by CDCs and other nonprofit organizations—a market segment that program participants felt was underserved.”

There was also a risk-sharing arrangement where EMI took the first 5 percent of loss and shared the remaining loss with Fannie Mae, although EMI’s share of losses was not to exceed 20 percent overall. The EMI/Fannie Mae program got a late start because of lengthy negotiations over underwriting and what some saw as overly burdensome Fannie Mae documentation.²⁶

In the end, these two programs did not accomplish their goals, but they did provide important insight into how the GSEs could be incorporated into a community development secondary market. And although the programs were different, they had some common themes of what did and did not work. For example, both were delayed in their rollout because the aggregators (EMI and LIMAC) had substantial differences with their GSE partners over what constituted a risk in the loan and how to underwrite and price the transaction. These divergent views created substantial back-and-forth negotiations that drained time and resources.²⁷ The transactions also required a considerable amount of extra work for borrowers, and according to Cummings and DiPasquale, “More than one potential lender dropped out of the program because of the amount of documentation required.”²⁸

It was possible to set the fees for part of the process up front, so the borrowers knew how much they would pay in points and rate to participate in the program. But Freddie Mac’s guarantee was not priced until the end of the transaction in what was termed Freddie Mac’s “black box.” “This uncertainty overshadowed every step of the negotiations,” according to Cummings and DiPasquale. “When the final price was set, both LIMAC and the lender felt that the price was too high, and the investor subsequently took a cut in its return to make the transaction feasible.”²⁹

A Changing Political Environment for Community Development

An important change occurred in the political climate in Washington over community development policies in the late 1980s and early 1990s. There seemed to be a growing consensus across the political spectrum that low-income communities were better off when a network of community groups, local and state governments, and elements of the private sector worked together to build housing and provide credit and social services.

Unlike previous antipoverty programs that produced such rancorous debates, the legislative deliberations for the new system redrew the battle lines in often unpredictable ways.

26 *Ibid.*, 26.

27 *Ibid.*

28 *Ibid.*, 29.

29 *Ibid.*, 31.

Consider how the conservative Republican HUD Secretary, Jack Kemp, lobbied his liberal colleagues strenuously to reauthorize the LIHTC program. He urged liberals on the House Ways and Means Committee to “rise above the left-right debate and find consensus as to what our Nation can do to fight poverty.”³⁰ The consensus he referred to was use of public-private partnerships to deliver social services. Kemp went on to praise both liberals and conservatives on the committee for their “willingness to walk away from ideology.”³¹ Some of this same rhetoric was present in the early 1990s debates over creating a secondary market for community development loans. A significant difference, however, was that community development finance advocates were not as successful as affordable housing advocates in securing federal funds to help create a secondary market of community development loans.

1992–1995: A Burst of Creativity at the Federal Level

In terms of building a secondary market, the developments leading up to 1993 tended to be small efforts, but starting that year there was a flurry of proposals at the national level. They included: (1) an effort by HUD to create a national credit enhancer on the foundation of FHA, the Federal Housing Corporation (FHC); (2) the FHA/State Housing Finance Agency Risk Share program; (3) new guidelines for Fannie Mae and Freddie Mac that directed them to buy more affordable housing mortgages; and (4) the Riegle Act of 1994, which helped foster community development finance and, at one point, contained a provision to create a new GSE for small business loans. Many of the proposals were generated by staff in the Clinton administration, and many of the same proposals were killed by the Republican majority in Congress after 1994.

1. FHC

In 1994–95, HUD put forth a proposal to “reinvent” FHA to be an organization that continued its traditional work but expanded into new areas of community development finance. This new organization, to be called the Federal Housing Corporation (FHC), would have combined an “entrepreneurial, market-driven mode of operation with a public-purpose mission and mind-set,” according to Nicolas Retsinas, the HUD Undersecretary in charge of the proposed change.³² The FHC “would continue to run the FHA single-family product mix,” but it might also “experiment with pioneering mortgage products.”³³

Retsinas observed that many lenders “would like to increase their community reinvestment lending but cannot afford to tie up their capital in multiyear loans.” Perhaps even more important, however, FHC credit enhancement might impose standardization on the documents and due diligence processes in community lending that “could help lenders attract secondary market capital and spur dramatic increases in community lending.”³⁴

30 U.S. Congress, House of Representatives, Committee on Ways and Means. *Low-Income Housing Tax Credit*, Hearing Before the Subcommittee on Select Revenue Measures of the Committee on Ways and Means, House of Representatives, 101 Cong., 2d sess., May 23, 1989.

31 House of Representatives, *Low-Income Housing Tax Credit*, 6.

32 Nicolas P. Retsinas, “Comment on Kerry D. Vanell’s ‘FHA Restructuring Proposal,’” *Housing Policy Debate*, 6: 2 (1995), 397.

33 *Ibid.*, 405.

34 *Ibid.*, 406.

The FHC, even though it hit many of the themes that made other community development programs successful, never was authorized. According to Retsinas, he could not get the idea past the “partisan gates of Congress.”³⁵ A critical Price Waterhouse audit of FHA’s multifamily loan insurance programs probably also contributed to the resistance in Congress to expand a loan insurance strategy at FHA.³⁶

2. FHA Risk Share

In some ways, this flurry of activity at the national level was a continuation of exploring new ways to fund community development efforts that was an outgrowth of the political debates in the 1980s. The Cranston-Gonzalez National Affordable Housing Act of 1990, for example, charged the GAO to examine federal credit enhancements. Two years later, the GAO outlined four credit-enhancement options and Congress chose to pursue one, the FHA risk-sharing demonstration project. The proposed Risk Share program was an effort to find ways in which the federal government could put its credit capability behind the efforts of state housing finance agencies (HFAs) to bring down the financing cost of affordable housing.³⁷

The FHA Risk Share program allowed experienced housing finance agencies to use their own underwriting standards and documents. The program, which still exists, “provides full FHA mortgage insurance to enhance HFA bonds to investment grade. HFAs may elect to share from 10 to 90 percent of the loss on a loan with HUD” depending on how much they share underwriting responsibility and risk of loss.³⁸ “Compared with 100 percent credit enhancement, a partial federal credit enhancement reduces the government’s risks and potential costs, but generally subjects the loans to be securitized to an evaluation by the credit rating agencies or investors (for unrated securities)” according to the GAO.³⁹

3. New GSE Guidelines

The Federal Housing Enterprises Financial Safety and Soundness Act of 1992 revised the regulations governing Fannie Mae and Freddie Mac. One section, entitled “Special Affordable Housing Goal,” for the first time specifically required Fannie Mae and Freddie Mac to purchase affordable multifamily rental housing loans.⁴⁰

35 Email from Nicolas Retsinas, June 10, 2006.

36 “Community and Economic Development Loans,” 54.

37 GAO, “Housing Finance: Expanding Capital for Affordable Multifamily Housing,” October 1993, 3.

38 <http://www.hud.gov/offices/hsg/mfh/progdsc/riskshare542c.cfm>.

39 GAO, “Community and Economic Development Loans,” 51.

40 *Ibid.*, 53.

4. Riegle Act

The Riegle Community Development and Regulatory Improvement Act of 1994 did many positive things for community development finance, including the creation of the CDFI Fund. But the proposal to create a GSE for small business loans did not make the final cut.

The debate over what became the Riegle Act echoed familiar themes: government-subsidized financing would help the community development network (including banks and other for-profit businesses) use the market to improve low-income communities. “[Senator Alfonse] D’Amato’s [R-NY] approach favors a market oriented solution and avoids creating a massive bureaucracy,” according to William Acworth, a finance reporter for the *American Banker*. He also wrote that the small business loan securitization bill had the backing of the Treasury and the Federal Reserve, but that its prospects were in doubt. Some bankers, according to Acworth, said that “small business loans are so different that pooling them into a viable security is extremely complex and often impossible. In their own view, the bill is simply a political gesture to small business, an important constituency on Capitol Hill.”⁴¹

The Clinton administration and community development advocates were early and aggressive supporters of this bill, as were the real estate and banking industries. Donald Susswein told the House Committee on Banking, Finance and Urban Affairs, that “the Mortgage Bankers Association of America, the National Associations of Realtors, and the National Realty Committee would strongly support a bill that would lead to a broad-based commercial secondary mortgage market.”⁴²

An important part of the early legislation was the Venture Enhancement and Loan Development Administration for Small Undercapitalized Enterprises, or Velda Sue. This agency, similar to Fannie Mae in the mortgage market, would buy, securitize, and resell business loans to investors.” This proposal, pushed by Rep. John LaFalce (D-NY), did not make it into the final bill.⁴³

Marilyn Rovira, vice president of LIMAC, testifying in support of the Riegle Act to the House Banking Committee, acknowledged that there was an inherent tension with community development small business loans. “Many, if not most, of these loans are small, involve substantial technical assistance to borrowers, and have customized structures,” she said. However, she continued, in an effort to “expand these kinds of lending efforts and promote the revival of healthy market dynamics in distressed communities, nonprofit lenders need to move beyond the portfolio lending that is now the norm in the industry and tap into broader sources of private funds.”

Rovira went on to point out that one way to solve the problem of connecting low-volume,

41 William Acworth, “Top Bank Regulators Back Loan Securitization Bill,” *American Banker* 3:35 (September 20, 1993), 1.

42 Written statement of Donald B. Susswein, Esq. on behalf of the Mortgage Bankers Association of America, National Association of Realtors, National Realty Committee, Before the Subcommittee on Economic Growth and Credit Formation for the U.S. House of Representatives Committee on Banking, Finance and Urban Affairs, September 23, 1993.

43 James C. Allen, “Asset Securitization: Borrower’s Market Crimps Business-Loan Securitization Series: 15,” *American Banker*, 160: 12, (January 19, 1995), 24.

boutique loans to a commodified institutional capital market was to rely on intermediaries such as LIMAC. “LIMAC’s purpose is to show, with our small but growing track record, that these nontraditional community development loans, when properly underwritten, are not inherently risky and that they can be securitized,” Rovira said. “The only way to document that risks can be taken is to take them.”⁴⁴

The Conference Report on the Riegle Act showed that not everyone got what they wanted.⁴⁵ The final version of the bill dropped the idea of Velda Sue, the community development GSE. As Paul Kanjorski (D-PA) said:

Ironically, one of the other sectors of the economy left without effective access to a secondary market under this legislation is community development loans. Testimony given during my subcommittee’s hearings clearly outlines the very real need for a secondary market for community development loans.⁴⁶

The bill did create the CDFI Fund and other community development incentives, such as the Bank Enterprise Award.⁴⁷

Tom Ridge (R-PA) did not agree with the Act’s plan to promote CDFIs; he wanted to see more incentives for community lending at existing banks. “I have always believed that people left behind want to become part of the mainstream again.” He argued, “Do not separate us with separate institutions.”⁴⁸ Nevertheless, he was supportive of the bill, as were other well-known conservatives such as Toby Roth (R-WI), who said, “I will vote for the bill even though I have grave reservations about the bill’s provisions that create a new Federal bureaucracy to create new subsidized nonbank lending institutions in urban inner-cities,” referring to the creation of the CDFI Fund.⁴⁹

By the end of the years’-long process, there was overwhelming support for the Riegle Act and it passed 410–12 in the House. It emerged from the conference committee in 1994 to become law.

Recent Developments

Since the mid-1990s, many advances have been made in all aspects of this secondary market story: early innovators have continued to innovate; certain advances are beginning to overcome securitization obstacles (e.g., lack of data); and new programs have been proposed at the federal level, some of which involve a greater role for the GSEs. That said, there still has not been a breakthrough that allows community development lenders to tap the massive pools of capital available from investors. The following is a discussion of these recent developments.

44 Testimony by Marilyn Rovira, vice president, Local Initiatives Managed Asset Corporation, House Banking, Economic Growth and Credit Secondary Market Development Act, October 7, 1993.

45 Conference Report on H.R. 3474, Riegle Community Development and Regulatory Improvement Act of 1994 (House of Representatives—August 4, 1994).

46 *Congressional Record*, H6786.

47 Riegle Community Development and Regulatory Improvement Act of 1994 (P.L. 103-325, 108 STAT. 2160).

48 *Congressional Record*, H6790.

49 *Congressional Record*, H6788.

Federal Efforts and GSEs

In recent years, there have been rumblings about new programs to create a secondary market, but they have not achieved any significant scale. In 1999, for example, HUD Secretary Andrew Cuomo proposed the creation of an expanded market for CDBG loans. Lauding the efficiencies in the single-family finance market, the Secretary said, “We don’t have that in economic development (loans). If we did, it would be a fundamentally different system, and that’s where we’re trying to go.” HUD already had experience with selling Section 108 economic development loans into the secondary market. “The thin edge of the wedge in the crack in the wall is there,” Cuomo said. “It’s a daunting undertaking, but there is some precedent.” That program never got off the ground, however.⁵⁰

A potentially more promising program from the federal government is one where the U.S. Department of Education is providing grants for credit-enhancing charter school loans. The Charter Schools Facilities Financing Demonstration Program has already scored some successful securitizations through groups such as The Reinvestment Fund (TRF), NCB, and the Low-Income Investment Fund. LIIF received a \$3 million grant in the first round of this program and is using it “as loan loss reserve funds to leverage \$64 million in private capital that LIIF and its partners are actively raising for further financing of charter school facilities.”⁵¹ Nancy Andrews, president and CEO of the Low Income Investment Fund, said, “With this grant capitalizing a loan loss reserve, we are now leveraging investments . . . from Citibank, Wells Fargo, Prudential, and other mainstream investment houses.”⁵²

There is also some interest in making a greater commitment to affordable housing part of the GSE reform legislation, which is currently being debated in Congress. One such proposal last year, the Reed Amendment, proposed that Fannie Mae and Freddie Mac set aside 5 percent of their profit to provide production grants in addition to credit enhancements for securitizing affordable housing mortgages. Nancy Andrews explained to the Senate Banking, Housing and Urban Affairs committee how this program might work. “The GSE would agree in advance to buy, say, \$100 million of these loans and would establish a special loss reserve pool or ‘credit enhancement’ from the GSE Underserved Market Fund,” she said. The “GSE would then pool these funds into a mortgage-backed security and provide credit enhancement that would confer its AAA bond rating on the pooled security. This security could then be sold in the capital markets.”

The final pieces in this evolving story include innovation in solving some of the continuing problems of generating enough data to make adequate risk/reward pricing decisions, along with exciting breakthroughs by CRF in creating a rated community development security. Both of these developments are described below, followed by a description of recent secondary market innovations by the insurance industry and credit unions.

50 Ed Staples, “HUD Plans CDBG Secondary Market,” *Mortgage-Backed Securities Letter* 14:6 (February 8, 1999), 1.

51 Susan Harper, “Funding Our Future: Charter School Finance 101,” Low-Income Investment Fund, 3.

52 Congressional Quarterly, Capitol Hill Hearings Testimony, April 19, 2005, Senate Banking, Housing, and Urban Affairs, “Regulation of Government Sponsored Housing.” Testimony by Nancy O. Andrews, president and CEO of LIIF.

Overcoming Obstacles to Securitization and Further Proving the Concept

As Alan Greenspan noted at the 2005 National Community Reinvestment Coalition Conference, the lack of reliable data is one of the industry's major handicaps, particularly as it migrates to using "new sources of equity—community development venture capital funds and secondary markets that securitize community development loan pools." Greenspan praised a number of efforts currently under way, including: (1) CDFI Fund's Community Investment Impact System, which collects standardized data on customers, transactions, and markets that use the New Markets Tax Credit program; (2) the Neighborhood Reinvestment Corporation's new data system that defines and measures the impact of community development programs; and (3) the Opportunity Finance Network's (OFN) "CDFI Assessment and Rating System" or CARS. "By consistently and reliably measuring outcomes, and thus helping current and prospective investors better assess their risks and predict their returns, community development organizations can attract more funding. Such accountability is crucial for any organization, regardless of size," he said.⁵³

CARS is an important effort to try to standardize how CDFIs collect and report data. "Some CDFIs are actively trying to access the capital markets and have explored the possibility of obtaining a rating from a Wall Street firm," according to OFN. "While a CARS rating is not a Wall Street rating, the CARS process, over the long run, can help the rating agencies understand CDFIs and help CDFIs prepare for an eventual Wall Street rating or other transaction with the financial markets."⁵⁴

Another recent breakthrough that might help clear the fog for investors interested in community development loans is a new small business portfolio model from Standard and Poor's. The model uses "a Monte Carlo-based algorithm that assesses loan portfolio default outcomes under various stress scenarios," according to a press release.⁵⁵ Using data from the SBA 7(a) program, and "after accounting for business sector and geographic correlation, one can generate statistically stable simulations of loan portfolio default outcomes." The model is designed for portfolios and not individual loans. The database has twenty years of history on 10,000 lenders with 650,000 small business loans.

Perhaps the most exciting recent development proving the viability of securitizing community development loans is the issuance of rated securities by CRF in 2004 and 2006. Previously CRF had been able to place privately hundreds of millions of dollars in community development loans, but by having its security rated by Standard and Poor's, it was able to attract new investors. For example, in CRF 17, issued in November 2004, the "first three tranches were rated AAA, which enabled eight new institutional investors with strict investing guidelines, including Northwest Mutual Life, to buy into the deal," as reported in an article in *Investment Dealers Digest*.⁵⁶

53 "Remarks by Chairman Alan Greenspan at the 2005 National Community Reinvestment Coalition Conference, Washington, D.C., March 18, 2005. "Empowering Communities, Attracting Development Capital, and Creating Opportunities." www.federalreserve.gov/boardDocs/speeches/2005/20050318/default.htm

54 *CARS on the Road*—Edition 2. National Community Capital Association, 2005, 6.

55 Press release, "Standard & Poor's Introduces U.S. Small-Business Portfolio Model," February 5, 2005.

56 Elizabeth Wine, "Helping the Poor Via the Capital Markets," *Investment Dealers Digest*, February 28, 2005.

CRF is still working on improving the process. For example, many investors want to see a pool where no one loan is much bigger than the others; they prefer a pool of similarly sized loans (sometimes referred to as granularity). And there is a push to make sure that the pools are diversified geographically (though many bank investors are more interested in buying into pools with projects in their CRA assessment areas).

In May 2006, CRF rolled out its second rated security, CRF 18. According to Standard and Poor's Pre-Sale document

The ratings assigned to CRF-18 LLC's \$47.59 million CRF USA community reinvestment revenue notes series 18 reflect the credit enhancement consisting of overcollateralization, subordination, an interest reserve account, and excess spread. The ratings are also based on CRF's demonstrated servicing ability. This securitization is a pool of small business development loans that are not insured or guaranteed by any governmental agency.⁵⁷

The Center for Community Self Help in North Carolina also has been generating a track record of performance with community development loans with Fannie Mae through its Community Advantage Secondary Market Loan Program. Self Help buys affordable mortgages and sells them to Fannie Mae, but with full recourse. A grant from the Ford Foundation helps underwrite a considerable amount of the financial risk for Self Help.

The Center for Community Capitalism at the University of North Carolina at Chapel Hill has been studying the performance of these loans, which "could not otherwise be readily sold in the secondary market because of their perceived higher risks." These loans have:

flexible underwriting and typically include one or more of the following features: low or no down payment, higher debt-to-income ratios, approval of borrowers with spotty credit records or no established credit, and waivers of private mortgage insurance and the usual requirement that a borrower have at least two months of loan payments available as a cash reserve at the time of closing.⁵⁸

There also have been developments in the secondary market by both the insurance industry and credit unions, which seem to be driven by the desire to show that they are doing innovative work around community development without the stick of CRA-like legislation for their industries. The insurance industry launched Impact Community Capital (Impact), which has been providing capital to community development lenders (for a more complete discussion of a transaction with Impact as purchaser, see George Vine's article in this issue).

The National Federation of Community Development Credit Unions launched its secondary market program with a purchase of single-family mortgages that were originated by Self Help for recent immigrants at the end of 2005. The loans use Individual Taxpayer Identification Numbers (ITINs) rather than social security numbers. Federation Executive Director Cliff Rosenthal said the Federation plans to purchase other loans, including co-op loans and manufactured housing mortgages. "The goal of the CDCU Secondary Market is

57 http://www2.standardandpoors.com/servlet/Satellite?pagename=sp/sp_article/ArticleTemplate&c=sp_article&cid=1145743573642&s=&ig=&b=2&dct=19.

58 Michael A. Stegman, Roberto G. Quercia, and Walter R. Davis, "Sharing the Wealth Through Homeownership: A Preliminary Exploration of the Price Appreciation Experiences of Low- and Moderate-Income Families Who Bought Homes Under the Community Advantage Secondary Market Loan Program," July 21, 2004 (revised July 8, 2005). Center for Community Capitalism, University of North Carolina at Chapel Hill.

to purchase nonconforming loans at a fair price from credit unions, season them, aggregate them, and then resell them when and where appropriate,” according to Terri J. Fowlkes, the recently appointed director of the CDCU Mortgage Center.⁵⁹

Conclusion

The possibility of a fully functioning secondary market for community development loans holds the promise of dramatically increasing the flow of cheaper capital to struggling low-income communities. Over the last twenty-five years, that promise has been realized at points in time and in fits and starts. But the overall goal remains elusive. It is not clear what program, policy, or product might break the bottleneck and help bring about this market. In the meantime, however, creative and talented community development financial practitioners will continue to lay the groundwork—collect the data, prove the concept, build new models—in order to find ways to more fully engage the capital markets in community development.

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59 Rafael Morales, “New Secondary Market Launched: Federation Begins Purchase of Affordable Mortgages,” NFCDCU Press Release. <http://www.natfed.org/i4a/pages/index.cfm?pageid=994>.