

# Creating a Marketplace: Information Exchange and the Secondary Market for Community Development Loans<sup>1</sup>

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The lack of information exchange between community development lenders and capital investors limits the growth of a secondary market for community development assets. This obstacle also limits the ability of community development lenders to tap into the virtually endless capital resources of the secondary market, thereby limiting the valuable services these organizations provide to underserved communities. Participants from the Federal Reserve's Conference on the Secondary Market for Community Development Loans in 2006 suggested solutions modeled after popular social networks, such as MySpace, speed dating, and Match.com. The area of social networking may initially appear to be an unexpected source of inspiration for a community development finance model, but the underlying benefits of economic efficiency, widespread visibility, and reduced search cost make these models viable solutions.

Central to the academic discussion on information exchange is the theory of asymmetric information, which George Akerlof introduced in his seminal study on the market for used cars.<sup>2</sup> Another important article in the academic literature of information theory is George Stigler's "The Economics of Information."<sup>3</sup> The article analyzes one of the most important economic considerations of information—ascertaining market price. For buyers and sellers seeking to uncover the appropriate market price for a good, the cost of searching is the time associated with finding a willing counterparty. This is especially pertinent for "unique" goods, or those that exhibit a high degree of heterogeneity, such as community development loan portfolios. A Congressional Budget Office study on the securitization of small business loans finds that "where secondary markets have been slow to develop, the high cost of transactions seems to be a major inhibitor."<sup>4</sup> By reducing the search time associated with identifying buyers and sellers, and by improving the flow of information between parties, finding the optimal market price for a product becomes less costly and more efficient.

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1 This article is a summary of findings from a longer working paper prepared for the Federal Reserve Bank of San Francisco's Center for Community Development Investments. For more in-depth discussion on this topic, see <http://www.frbsf.org/publications/community/wpapers/2007/wp07-01.pdf>.

2 G. Akerlof, "The Market for 'Lemons': Quality Uncertainty and the Market Mechanism," *Quarterly Journal of Economics* 84, no. 3 (1970).

3 G. Stigler, "The Economics of Information," *Journal of Political Economy* 69, no. 3 (1961).

4 Congressional Budget Office, "Developing a Secondary Market for Small Business Loans." Inter-Agency Report, 1994, available online at <http://www.cbo.gov/showdoc.cfm?index=5013&sequence=0>

Modern applications of information technology make the social-networking models relevant solutions for addressing the information problem. Information systems linking different organizations, also known as interorganizational information systems (IOS), can make use of information technology to increase economic efficiency. The “electronic marketplace” is an IOS that allows participating buyers and sellers to exchange information about market prices and product offerings with a goal to establish buyer-seller relationships.<sup>5</sup> Markets serve a number of functions in an economy, and the increasing role of information technology in these markets facilitates their operation. The introduction of an electronic market system reduces search costs and increases efficiency by reducing the cost of unproductive searches, and it allows buyers to locate products that better match their needs.<sup>6</sup> In the absence of an efficient IOS, high search costs lead to efficiency losses and eventually cause the market to break down or prevent an efficient market from being established at all.

The implication for current research is that while data remain central to the growth of investor activity in community development, a mechanism must be developed that allows lenders and investors to easily share and access these data. Mary Tingerthal, president of the Capital Market Companies, Housing Partnership Network, stated that “any investment is possible only if the investor has the necessary information—the data—to decide whether to make an investment or purchase an asset.”<sup>7</sup> It is vital that CD lenders improve their data-collection processes, and it is equally important that they have an efficient mechanism for finding a willing investor with whom to share this data.

A reputable institution could significantly advance the development of such a mechanism by establishing an online information-exchange platform that would allow buyers and sellers of community development loans to: (1) efficiently identify suitable counterparties, and (2) effectively share the appropriate type and amount of data to facilitate a sale.

Most community development lenders borrow the majority of their available capital from mainstream banks through a term loan or line of credit, shown as “lending to the lender” in the diagram below.<sup>8</sup> In contrast, the secondary markets financing model, shown as “purchasing from the lender,” allows lenders to replenish their capital supply through the sale of receivables. The characteristics of these two models differ greatly, and the industry needs to change the way it communicates with investors in order to transition from the present model to the secondary market structure.

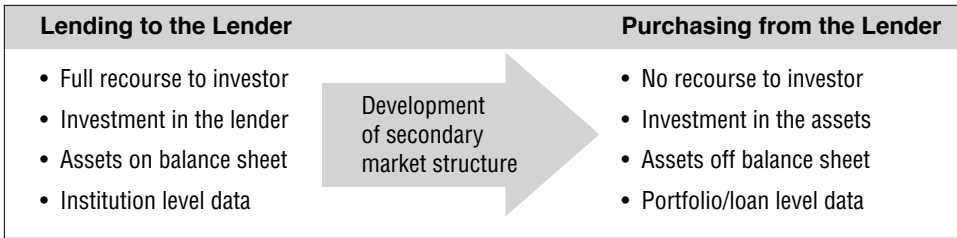
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5 J. Bakos, “Information Links and Electronic Marketplaces: The Role of Interorganizational Information Systems in Vertical Markets,” *Journal of Management Information Systems* 8, no. 2 (1991).

6 Ibid.

7 Mary Tingerthal, “Turning Uncertainty into Risk: Why Data Are the Key to Greater Investment,” *Community Development Investment Review* (Federal Reserve Bank of San Francisco) 2, no. 2 (2006).

8 An interview with Dan Letendre of Merrill Lynch on January 29, 2007, informed this section on capital financing models.



The creation of an online platform would facilitate this transition by allowing parties to share the specific types of data most relevant to the sale of community development loans. Lenders would share organizational data and provide data points related to their individual portfolios available for sale. For example:

- Loan-to-value ratio
- Debt service coverage ratio
- Interest rates
- Expected investor pass-through yield
- Portfolio size (amounts and number of loans)
- Types of loans in the portfolio (for diversification)
- Geography (to meet CRA objectives by reaching certain markets)

This list is only a preliminary estimation of the specific data investors are seeking. The development of an online platform requires a collaborative process that actively engages the investor community, in order to discern what these specific data needs are. The online platform would facilitate only the introductory phase of information sharing, where buyers and sellers identify the potential for transactions. Any actual legal sale of assets would occur through subsequent one-on-one conversations outside the sphere of the platform.

Another consideration for the development of an information-sharing mechanism is the type of secondary market activities that will occur. Whole loan sales and securitization are two distinct types of secondary market transactions. Securitization is better suited for large-volume loan pools (typically in the range of \$100 million) because of the significant transaction costs associated with the complicated legal and financial structure.<sup>9</sup> In contrast, the sale of whole loans allows each loan to be sold as a separate investment with buyers often purchasing more than one loan at a time. Whole loan sales are often used when the volume of loans to be sold is relatively small or the sales of loans are infrequent.<sup>10</sup> The community development field at present does not originate loans at a sufficient volume to support widespread securitization, but the development of an online platform can facilitate whole loan sales as a precursor to larger-volume transactions.

The platform host can play a significant role in implementing this online information-sharing tool. Some important considerations for implementation include:

<sup>9</sup> Interview with Frank Wilary and Doug Winn, February 5, 2007.

<sup>10</sup> HUD (1995), Notice: CPD 95-05.

- The platform host should be a highly credible and neutral third party.
- Access to the online tool should be limited, requiring that participants be involved in the financing of community development activities.
- The online platform should have a strong educational component.
- The beginning focus should be on whole loan sales as opposed to securitization.
- A mix of strategies should be used to attract participants and encourage continued involvement.
- Enforceable policies must be introduced to keep the data current.

The community development industry can benefit from increased secondary-market activities, but the present landscape of information sharing between lenders and investors remains a significant barrier. The lack of understanding of what investors want in relation to loan purchases is compounded by the lack of an information infrastructure.

Although the limited scale of the industry is a concern, it is valuable to develop the infrastructure to support the ongoing growth of the industry into the future. If the industry waits for lenders to increase their originations to a scale large enough to address the lack of information-sharing infrastructure, a lag will occur between the need for a mechanism and the implementation of that mechanism. The community development industry should seek early-stage solutions that can be modified and adapted as it grows in its lending capacity and becomes comfortable with the capital markets. The other benefit of taking proactive steps to improve market infrastructure is the likelihood that the information-sharing mechanism will act as a catalyst for secondary market growth. Just as eBay created a secondary market for heterogeneous goods (where people were suddenly able to find buyers for their old lamps and used books), the introduction of an efficient electronic marketplace may similarly spur the growth of purchases of community development assets.

The prospective platform host has the opportunity to take a leadership role in supporting community development lenders in their capital financing strategies. The creation and operation of an online information-sharing platform will allow lenders and investors to connect efficiently with one another in order to build trust and professional relationships. The formal implementation of a new platform also signals to the industry that the growth of the secondary markets requires a transition from the status quo—moving from the lending to the lender model to the purchasing from the lender model.

Both community development lenders and capital investors have opportunities for mutual gain in the growth of secondary markets. The ultimate beneficiaries are those communities that depend on this market for scarce financial resources. Strong, healthy communities are the surest sign of this industry's success. Improving information exchange will ensure that a solid infrastructure will be in place to support the community development industry in the future.

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