FEDERAL RESERVE BANK OF SAN FRANCISCO

Community Investments Vol. 9, Issue 2
The Emerging Secondary Market for Community Development Loans

Author(s): Kathleen Kenny, Community Investment Consultant and
Frank Altman, President and CEO, Community Reinvestment Fund
Summer 1997

Over the past decade, a handful of pioneering organizations have gradually built a small secondary market for community development loans. Although the potential for growth in this market is tremendous, serious impediments must be overcome before significant growth can occur. In the context of today's shrinking supply of public funds for community and economic development, the need for recycling scarce capital is greater than ever.

What is a Community Development Loan?

Community development loans differ from more traditional loans, in that, in addition to seeking financial returns, they also seek social returns. Most community development loans are used for multi-family affordable housing, economic development or other public purposes that fall outside the scope of the mainstream financing system served by Fannie Mae and Freddie Mac. Recent amendments of Community Reinvestment Act (CRA) regulations clearly state that in order to be considered a community development loan, a loan must have as its primary purpose "the revitalization or stabilization of low-or moderate income areas." The regulation also provides examples of qualified community development loans that would receive credit under the CRA. These examples include (but are not limited to) loans to: nonprofits serving low- and moderate- income housing or other community needs; loans to financial intermediaries including CDFIs and CDCs that serve low-and moderate- income communities; loans to local, state, and tribal governments for community development activities; and loans to finance environmental clean-up as part of an effort to revitalize the low- or moderate- income community in which a property is located.[1]

Community development loans are originated by a wide range of lenders including financial institutions, nonprofit development organizations, city and state revolving loan funds, public and quasi-public development agencies, community development financial institutions, lending consortia, and special programs sponsored by the private sector.

Public funding comes from many sources--Community Development Block Grants (CDBG), the HOME Program, rural development grants through the U.S. Department of Agriculture, Economic Development Administration (EDA) grants, local tax increment financing, special purpose or municipal bond issues, and other state or local funds reserved for housing and economic development projects. Foundation grants and private capital also serve as important sources of development finance.

Unfortunately, drastic cutbacks in federal and state budgets combined with the scarcity of new capital severely threaten the longevity of many of these programs. To survive, community development lenders must look to an emerging secondary market to replenish their capital. Without this source of "recycled capital," some lenders may find it difficult to continue fulfilling their community development missions into the future.

The Importance of a Secondary Market for Community Development Loans

The credit system for single family mortgages demonstrates the tremendous possibilities offered by an organized secondary market. Today, more than two-thirds of new single-family mortgages originated in the United States are sold on the secondary market. By mid-1996, the outstanding balance of residential mortgages pledged to instruments such as mortgage-backed securities (MBS) was $1.6 trillion, or 43 percent of total residential mortgage debt outstanding.[2] By now, these securities are widely understood and accepted by individual and institutional investors alike. The maturation of this financing system over the past two decades has meant that borrowers can readily find mortgage loan funds at a reasonable cost, lenders can replenish and recycle their funds, and investors can enjoy healthy returns with relatively low risk.

Likewise, the development of an efficient financing system for community development loans would serve the needs of community-based borrowers, lenders, investors, and the public by:

1. Providing a renewable, ongoing source of capital for community-based lenders, and
2. Supporting the efforts of federal, state and local government and the philanthropic community to sustain affordable housing and economic development programs by leveraging existing assets over time.

The Pioneering Organizations

Over the past decade, a few national nonprofit organizations have helped pave the way for an emerging secondary market by serving as a bridge between community development lenders and institutional investors. What distinguishes these nonprofits as a group is their flexibility and ability to adapt to the needs of their constituents in order to fill gaps in the marketplace. Unlike the traditional secondary market intermediaries such as Fannie Mae and Freddie Mac who deal in large volumes and standardized products, these nonprofit pioneers are serving the needs of community-based borrowers and lenders whose products are anything but conventional.

An example of a pioneering nonprofit is the Community Reinvestment Fund (CRF), an organization based in Minnesota and incorporated in 1988 to create a secondary market for community development loans — particularly loans to small businesses that create jobs and build wealth in rural and urban communities across the country. With ongoing support from foundations and corporations, CRF has developed a flexible yet disciplined approach by throwing out the "cookie cutter" mentality and responding to the unique needs of its market. That approach has enabled the Fund to purchase more than 700 economic development and housing loans from 47 organizations as diverse as the City of Red Lake Falls (MN), the California Integrated Waste Management Board and Homes for South Florida. To date, CRF has privately placed ten series of its Community Reinvestment Bonds totaling $34 million to 31 investors, including a host of banks, life insurance companies and pension funds.

The map below indicates the locations of loans purchased by CRF throughout the United States over the last eight years. Though the map reflects the Fund's largely regional emphasis during its formative years, CRF is gearing up for expansion nationally over the next three years. In addition to offices in Minnesota, Oregon and Colorado, CRF plans to establish a permanent presence in the state of California.

Locations of CRF-purchased loans from 1989-1997

Another pioneering nonprofit, Local Initiatives Managed Assets Corporation (LIMAC), focuses primarily on housing loans with an emphasis on tax credit equity bridge loans. Based in New York, LIMAC opened its doors in 1987 with an investment from The Ford Foundation, which also established the Local Initiatives Support Corporation (LISC). LIMAC initially purchased its housing loans exclusively from LISC, but now purchases from a wide variety of originators such as the Low Income Housing Fund, Mercy Housing, state housing finance agencies, and other community development financial institutions. LIMAC's investors have also changed over time and are now predominately banks and pension funds which make advance commitments to purchase products that meet agreed-upon underwriting and term criteria. LIMAC's volume has increased steadily in recent years, and now totals $125 million in loans purchased or committed.

A third pioneer, Neighborhood Housing Services of America (NHSA), purchases single family affordable housing loans in support of its network of over 170 affiliated NeighborWorks® organizations throughout the country. Under its two primary programs, NHSA buys rehabilitation loans originated by local NeighborWorks® programs. It also buys home mortgage loans originated by local lenders on behalf of nonprofits. NHSA now purchases about $35 million in loans annually, with a cumulative total of over $200 million in loans in its 23 year history. The majority of NHSA's investors are insurance companies and financial institutions.

More progress has been made in creating a secondary market for single-family affordable housing than for community development loans. This is in large part due to a more developed infrastructure of originators and investors. However, the promise of a secondary market for community development loans which include affordable multifamily and economic development loans remains largely unfulfilled.

The need for a financing system for multifamily housing loans was the subject of a landmark report issued by the National Task Force of Financing Affordable Housing in 1992.[3] Sponsored by an impressive list of corporations, foundations and national nonprofits, the task force proposed a series of recommendations designed to promote a more efficient, less fragmented system. The effort resulted in creation of the Multi-Family

Housing Institute, based in Washington, D.C., which has been charged with the task of implementing the recommendations of the task force. The Institute, which is now affiliated with the Urban Land Institute, is creating a national database to track the performance of affordable and market rate multi-family properties. The database, which tracks over 200 specific data elements, includes information on the loan performance, management, and fiscal health of each property tracked. A web site is planned for early 1998 which will make these data available to the public. From there, industry benchmarks could be established for property and loan performance, helping capital markets better assess the risks of such multi-family financings.

None of the advances made to date have come easily. For example, the first sale in 1992 of $14 million in loans by the California Community Reinvestment Corporation (CCRC) to Fannie Mae was a lengthy and difficult process. Since then, CCRC and several other consortia have sold relatively small portions of their portfolios to private investors and in some cases to their own member banks. Selling loans in this piecemeal fashion is expensive without the help of a conduit mechanism for aggregating and securitizing large pools of loans.

In spite of the challenges, intermediaries such as CRF, LIMAC and NHSA are proving that community development loans are a good investment. Neither CRF, LIMAC nor NHSA has ever been delinquent on a bond or other scheduled payment, and there have been few defaults. Investment returns have been attractive as well. In the case of CRF, for example, investors have obtained returns ranging between 160 and 200 basis points above comparable Treasury rates. Underwriting criteria are high by any standard, and risk is mitigated by excess collateral, excess cash flow, credit enhancements and other structural safeguards.

Who Invests?

Investing in the diverse array of loans and products offered by these intermediary organizations is an equally varied set of investors, including the following:

- *Philanthropic contributors* who provide operating support to these intermediary organizations as well as contributions/grants to credit reserve funds.

- *Socially motivated investors* which include foundations, religious organizations, banks and insurance companies. Though rate of return varies widely, each of these investors is generally willing to take a less-than-market rate return in exchange for other benefits, such as fulfillment of community reinvestment goals.

- *Standard institutional investors* seeking market rates of return. In the long run, these are the investors who will take community development loans into the mainstream secondary marketplace.

The Size of the Potential Market

Nationally, the U.S. Department of Commerce and others have identified more than $4 billion in loan assets held by cities, nonprofits, and revolving loan funds. In California alone, the California Association for Local Economic Development (CALED) estimates that more than $200 million in economic development loans are held in the portfolios of its membership.

The potential market for multi-family affordable housing loans is also estimated to be large. However, while the potential may be enormous, there are no reliable data on the size or quality of multi-family loans held in portfolios across the country. An informal survey conducted by the Federal Reserve Bank of San Francisco of nine nonprofit lending organizations identified more than $420 million in permanent multi-family loans held in portfolio. Still, complete and accurate data would further the argument that there is great profit potential in creating a secondary market for community development loans.

Impediments to Creating a Secondary Market for Community Development Loans

Significant barriers must be overcome before the market for community development loans is able to achieve its full potential as a fully-functioning, high-volume secondary market. Lack of shared practices and policies among originators will likely continue to be obstacles in this diverse marketplace. Consistent loan documentation, common approaches to underwriting, and risk-weighting systems to standardize credit quality could all help in reducing these obstacles.

Another major constraint is the lack of a financial infrastructure for community and economic development loans. A successful secondary market requires a "string" of relationships along the financing pipeline from loan originators to investors. These relationships are well developed in the single-family mortgage market, but are incomplete or nonexistent for multi-family affordable housing and community and economic development loans. Until the market catches up, organizations such as CRF and LIMAC will continue to play multiple roles, such as providing credit enhancement for their own portfolios or warehousing loans.

Originators of community development loans often price their loans substantially below market rates. Yet, at the same time, some potential loan sellers are reluctant to "mark their loans to market" (discount the face value of the asset). In addition, sellers accustomed to a continuing stream of capital sometimes hesitate to use the secondary market, especially if there is a discount involved, when new funds are freely available. CRF and others stress the need for an educational process with potential sellers to help them understand how to value these assets in a mainstream marketplace.

Even if underwriting, documentation, and pricing issues are resolved, community development loans may always require some form of credit enhancement to attract large numbers of investors. Since many community development loans are subordinated to other creditors with respect to either collateral or cash flow, credit enhancements reduce investor credit risk. Moreover, because there is currently incomplete information on the overall performance of community development loans, credit enhancements compensate for the risks, real or perceived, that accompany incomplete information. In time, when a track record is established, it is hoped that even credit enhancements can be priced and sold to investors seeking higher returns for higher risk.

Other impediments exist since these investments are not liquid, not rated (though this may change over time), and not publicly traded. Each of these factors limits the field to institutional investors alone--at least for the time-being.

Promising Signs and a Hopeful Future

The experience of these pioneering organizations over the past decade has demonstrated that properly structured financial instruments make it possible for private institutions to invest in the community development financing system while decreasing reliance on public sector incentives, guarantees or tax dollars.

But in order for these programs to be meaningful, they must achieve greater scale. The costs of organizing a budding national market are enormous. The philanthropic community, including the Ford Foundation, has played a critical role in providing venture capital for some of these early efforts. Other key stakeholders--foundations, corporations, and the public sector, are beginning to recognize the enormous untapped resources that a viable secondary market for community development loans could unleash.

Most industry leaders would agree that there has been progress on all fronts. Piece by piece, a secondary market is taking shape. All of the organizations described above share a common vision--that of a fully-functioning, private capital market for community development loans in the not-too-distant future. And, with the trend toward reduced public support, the sooner the better.

Resources

Community Reinvestment Fund
2400 Foshay Tower
821 Marquette Avenue, Minneapolis, MN 44412
Ph: (612) 338-3050, website: www.crfusa.com,
E-mail: Info@CRFUSA.com

Local Initiatives Managed Asset Corporation
733 Third Avenue, New York, NY 10017
Ph: (212) 455-9882, E-mail: mrovira@liscnet.org

Neighborhood Housing Services of America
1970 Broadway, Suite 470, Oakland, CA 94612
Ph: (510) 832-5542

Multi-Family Housing Institute
1025 Thomas Jefferson Street, NW, Suite 500
Washington, DC 20007
Ph : (202) 624-7165

[1] For further detail on the regulatory definition of a community development loan, please refer to Regulation BB, "definitions."

[2] Vandall, Kerry D. Improving Secondary Markets in Rural America, paper prepared for the Federal Reserve Bank of Kansas City, December, 1996.

[3] From the Neighborhoods to the Capital Markets, The National Housing Task Force on Financing Affordable Housing.

About the Authors:

 **Kathleen Kenny** is an independent consultant, based in San Francisco, who specializes in programs that promote community investment. Her clients include banks, foundations, nonprofit community development organizations, cities, and the Federal Reserve Bank of San Francisco. She is the former Deputy Director of the Development Fund in San Francisco, where she helped establish eight bank lending consortia for affordable housing in seven states. She can be contacted at KathKenn@aol.com.

 **Frank Altman** is President and Chief Executive Officer of the Community Reinvestment Fund. Prior to co-founding CRF, he held senior positions in several state agencies in Minnesota, including the Minnesota Housing Finance Agency. In addition to his responsibilities at CRF, he serves on numerous national boards and commissions. In 1993, he was named Financial Services Advocate of the Year for Minnesota and Region V by the U.S. Small Business Administration.