

Charter School Facilities Finance: How CDFIs Created the Market, and How to Stimulate Future Growth

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Working Paper 2008-02

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Paying For School: An Overview of Charter School Finance

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Charter School Facilities Finance: How CDFIs Created the Market, and How to Stimulate Future Growth¹

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Executive Summary

This working paper examines the role that Community Development Financial Institutions (CDFIs) play in supporting the successful growth of public charter schools. CDFIs are financial institutions whose primary mission is to provide capital and development services to financially underserved markets. Charter schools are publicly funded schools that are permitted to operate independently in exchange for a high degree of accountability for academic performance.

Charter schools receive public funding for operations, but usually they must find and finance a facility on their own. Charters rely largely on nongovernmental resources and their own ingenuity to solve facilities problems. Because conventional financing was not accessible in the start-up years of the movement, CDFIs were the first to respond to the needs of charter schools by providing facilities loans and real estate development assistance. Their work is a case study of how CDFIs can “make the market,” that is, how their investment activity can establish the viability of an emerging market and nurture its development to the point of market acceptance.

CDFIs have been assisted in their work by the federal government through the U.S. Department of Education’s Credit Enhancement for Charter School Facilities Program. The program provides grants to non-profits and government agencies to leverage private-sector capital for financing charter school facilities. Although CDFIs have successfully used these grants and other tools to help open up the credit markets to charter schools, the demand for capital still far outstrips the supply.

This paper recommends the creation of Charter Academy Bonds (CABs). CABs would offer investors tax credits in lieu of collecting interest payments on the bonds from the schools, thus making debt more accessible and affordable. CABs would provide public incentives to leverage private investment, which would allow a greater number of charter schools to access the capital they need to operate in quality facilities.

Introduction

Community Development Financial Institutions (CDFIs) play an important role in supporting the successful growth of public charter schools.² As charter schools are one of the most significant education reform movements to surface in the United States in decades, the capacity to fully finance them is an important issue in public education. CDFIs are financial institutions whose primary mission is to provide capital and development services to meet the needs of low-income people and communities. CDFIs fill market niches underserved by traditional banks and investors. Because charter schools primarily help families in low-income neighborhoods, there is a natural connection for CDFIs.

There are currently more than 4,300 charter schools in existence, with many more in the planning stages. This paper recommends a new national policy solution that will open up the capital markets to charter schools and address one of the movement's most persistent obstacles: access to adequate facilities and facilities financing.

All charter schools struggle to secure a space to call home. Unlike school districts, charter schools cannot issue bonds that are backed by taxpayers. The problem is made worse because charter schools often take in less per-pupil revenue than their public school counterparts. Data from the National Alliance for Public Charter Schools show that charter schools, on average, lack funding parity with district schools, collecting about 78 percent of what traditional schools are allocated on a per pupil basis.³ Addressing the facilities problem is important because:

- Facilities issues absorb the time and energy of school administrators, whose expertise is education, not real estate development.
- Facilities costs can deplete resources that should be spent on instruction rather than on bricks and mortar.
- Facilities problems prevent some schools from expanding to meet demand and, in some cases, block new charter schools from opening.

Despite the lack of proper facilities, the number of charter schools has grown rapidly (see Figure 4), creating a demand for facilities financing in the tens of billions of dollars. Annual demand is estimated to be approximately \$1.3 billion.⁴ Banks and other financial institutions have been reluctant to lend to all but the most credit-worthy charter schools. Chief among these reasons are the experimental nature of the charter movement and the attendant risks inherent in start-up ventures. With expertise in high-risk lending and innovative problem solving, CDFIs have stepped in to provide needed capital and technical assistance. In responding to the considerable demand for facilities financing, CDFIs have propelled their own growth and are finding a path to reach investors in the capital markets. Their work is a case study of how CDFIs can “make the market.”

The Credit Enhancement for Charter School Facilities Program (CECSF) has been central to the success of CDFIs' charter facilities financing efforts. Enacted first as a demonstration in 2001 and later authorized under the No Child Left Behind Act, the program makes funding available to induce private-sector investment in charter school facilities. To date, the U.S. Department of Education (ED), through the Office of Innovation and Improvement, has awarded \$205 million under the program, 84 percent of which has gone to CDFIs.⁵ While the program was not intended specifically for CDFIs, they have proven to be the most effective vehicles for organizing and delivering capital to this nascent market. Data compiled by The Charter Coalition shows that for every \$1 of federal funding, program grantees have raised \$8 of private capital.⁶ Program awards to date will cumulatively infuse more than \$1.6 billion into the market.

This credit enhancement has unquestionably created greater access to capital.⁷ In a 2008 ED report on CECSF implementation, investigators found that “many of the assisted schools . . . would not have received facility loans *at any price* before the Program, because lenders believed that these schools reflected a prohibitively high level of risk.”⁸ As beneficial as it has been, however, the CECSF program as a policy measure is not broad enough to meet the capital requirements of all charter schools.

Through fiscal year 2007, CECSF grantees have provided 207 charter schools with \$739 million in financing. This is a laudable achievement for sure, but it still falls short. The tax-exempt bond market has rated and financed fewer than 150 schools, or less than 3.5 percent of the market. Taken together, both the CECSF and the bond market have financed fewer than 400 of the 4,300 charter schools operating today, or approximately 8.5 percent.

Charter schools cope with facilities obstacles in creative ways such as co-locating with others, using modular structures, or foregoing options such as athletic facilities and cafeterias. They also direct operating dollars to capital costs, thus reducing the funds available for instruction.

Figure 1

Possible Sources of Funds for Charter Schools

Source of Funds	Key Issues	
CDFIs	Lack of balance sheet capacity Serving multiple markets Lack of funds for Charter Schools	
Commercial Banks	Shorter term loans (10-15 years) Higher monthly debt payment	Individual underwriting standards Individual documentation Individual portfolio requirements
Bond Market	Longer term loans (30-40 years) Lower monthly debt payment More attractive pricing	Efficiently organized Standardized products Standardized documentation Consistent underwriting

Because charters are public schools, it makes sense for the public sector to create incentives and level the playing field, enabling charters to more easily obtain access to quality facilities. But charter schools remain shortchanged. To serve more charter schools equitably, greater federal intervention is needed because the majority of charter schools cannot afford to pay the risk-adjusted rate of return for capital. Absent such capacity, the market will not respond to charter schools on its own. A stimulant will be necessary from a source that is publicly or socially motivated to help grow this market, however, socially motivated capital, such as foundation grants and program related investments (PRIs), is an extremely scarce resource. In addition, charters already look to foundations for funding to support their educational programs and organizational infrastructure. It may be possible and highly desirable to mobilize socially motivated capital to work in tandem with public resources to leverage private investment, but it is not currently available in the form or at the scale required to solve the facilities problem.

With the right tools, CDFIs can help deliver a scalable solution to the charter school market. CDFIs have the appetite for charter school risk, but they do not have the balance-sheet capacity to meet the demand for capital. The five largest CDFIs serving the charter market have collective balance-sheet assets of less than \$1 billion, and all of these CDFIs lend in multiple markets, including affordable housing, health care, child care, small business, commercial real estate, and long-term care. Total balance-sheet assets available for charter school lending per year is probably no more than \$150 million. To extend their lending capacity, CDFIs rely on leveraging off-balance-sheet resources such as creating lending pools enhanced by CECSF, selling senior loans and holding junior positions in those loans, and using New Markets Tax Credits (NMTC).

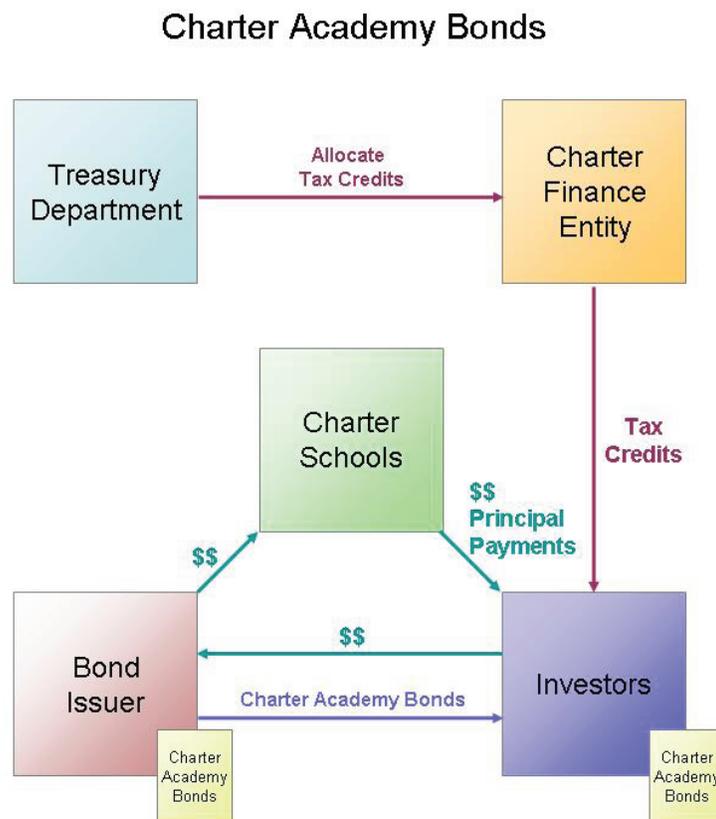
CDFIs are skilled in the practice of leveraging private investments with multiple sources of capital, and the federal government can put that experience to work to solve the charter facilities problem.

Any federal incentive should enable charter schools to access the financial products available on the bond market since these instruments are best suited for charter schools. Compared to commercial bank loans, bonds tend to be longer in term and more attractively priced. The terms of commercial bank loans normally extend to ten or fifteen years, while bond terms can extend to thirty or even forty years, thus easing the monthly debt service burden. The bond market, more efficiently organized than banks, each of which has its own underwriting standards, loan documentation, and portfolio management requirements, can offer a standard product, standard documentation, and consistent underwriting criteria.

Most charter schools are tax-exempt and therefore qualify for 501(c) (3) bonds, which could be an alternative financing option. Under normal market circumstances, tax-exempt bonds trade at a discount compared to taxable bonds, usually around 70 percent of the coupon price. Unfortunately few charter schools can clear the financial hurdles of the tax-exempt bond market.

This paper recommends the creation of a new class of bonds called Charter Academy Bonds (CABs). Figure 2 shows a proposed design that draws from two existing federal programs. The subsidy mechanism of offering tax credits in lieu of interest is modeled after the Qualified Zone Academy Bond (QZAB) Program. The distribution of tax credits through the Treasury Department to certified entities is borrowed from the New Markets Tax Credit (NMTC) program, which has proven to be a highly efficient deployment channel.

Figure 2



CABs would be sold to investors in the capital markets in the same manner as other bonds. However, instead of collecting interest payments on the bonds from the schools, investors would receive federal tax credits equal to the risk-adjusted rate of return on the debt. The tax credits would be allocated by the Treasury Department to qualified Charter Finance Entities (CFEs), which in turn would allocate tax credits

to schools. The Treasury Department would qualify CFEs based on their experience underwriting charter schools and their ability to efficiently deploy assets. CFEs would receive tax credit allocations, analyze transaction risk, structure deals, allocate tax credits to charter schools, work with investment bankers to place the bonds, and maintain an ongoing monitoring role. (Section 6 will describe the CABs in more detail.)

CABs would require little by way of new complex mechanisms for implementation. QZABs and NMTCs are understood and accepted by investors and would provide a launching pad for CABs. Moreover, investors have accepted CDFIs as effective intermediaries for tax credits. With deep knowledge of the charter market and NMTCs, CDFIs are well positioned to deliver on the promise of CABs as a solution to the facilities problem for charter schools.

Section 1: Public Charter Schools Defined

Charter schools are permitted by state law to operate outside the rules and regulations that govern traditional public schools. Charter schools are not permitted to practice selective enrollment or to charge tuition. In exchange for greater autonomy, schools agree to be held accountable for the academic achievement of their students. In addition, they are expected to meet the terms of their charter or face closure by their authorizing bodies. Funding for charter schools is determined by state law. Typically schools receive funding based on their enrollment, commonly referred to as “per pupil” allocations, with additional funding for special education and for special-needs students.

Charter schools were created as an experiment in the state of Minnesota in 1991 to address the decline in public school performance. Since the publication of the landmark study, *A Nation at Risk* in 1983, education reformers have struggled to address what the report cites as “disturbing inadequacies” in our public school system that threaten to erode the foundations of American society.⁹ Further, despite the promise of school desegregation since *Brown v. the Board of Education*, the “achievement gap” between white and minority students has remained an intractable problem. According to the National Assessment of Education Progress (NAEP), in 2000, 70 percent of African American students scored below “*basic*,” the lowest level of proficiency in math compared to 58 percent of Hispanic students, 29 percent of white students, and 26 percent of Asian American students. In reading, 48 percent of African American students scored below *basic* compared to 41 percent of Hispanic students, 28 percent of Asian American students, and 22 percent of white students (NAEP 2006).

While many worthy experiments have been devised to spark changes in public school performance, no other innovation has been as widespread as the creation of charter schools. As of September 2007, forty states and the District of Columbia have charter laws. Figures 3, 4, and 5 illustrate the growth of charter schools since 1991. Today, approximately 4,300 schools operate across the United States, with enrollment of more than 1.3 million students.¹⁰ This represents 3 percent of all public school students nationally. In some cities, such as New Orleans and Washington, D.C., charter enrollment has climbed to more than 25 percent of total public school enrollment.

Figure 3 – Growth of Charter Laws

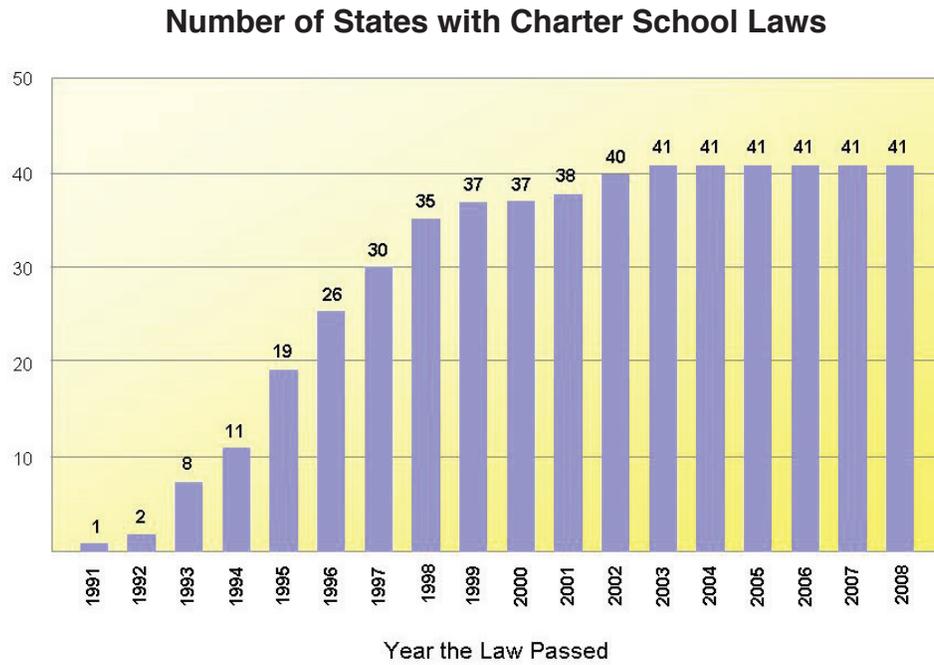


Figure 4 – Growth of Charter School Creation

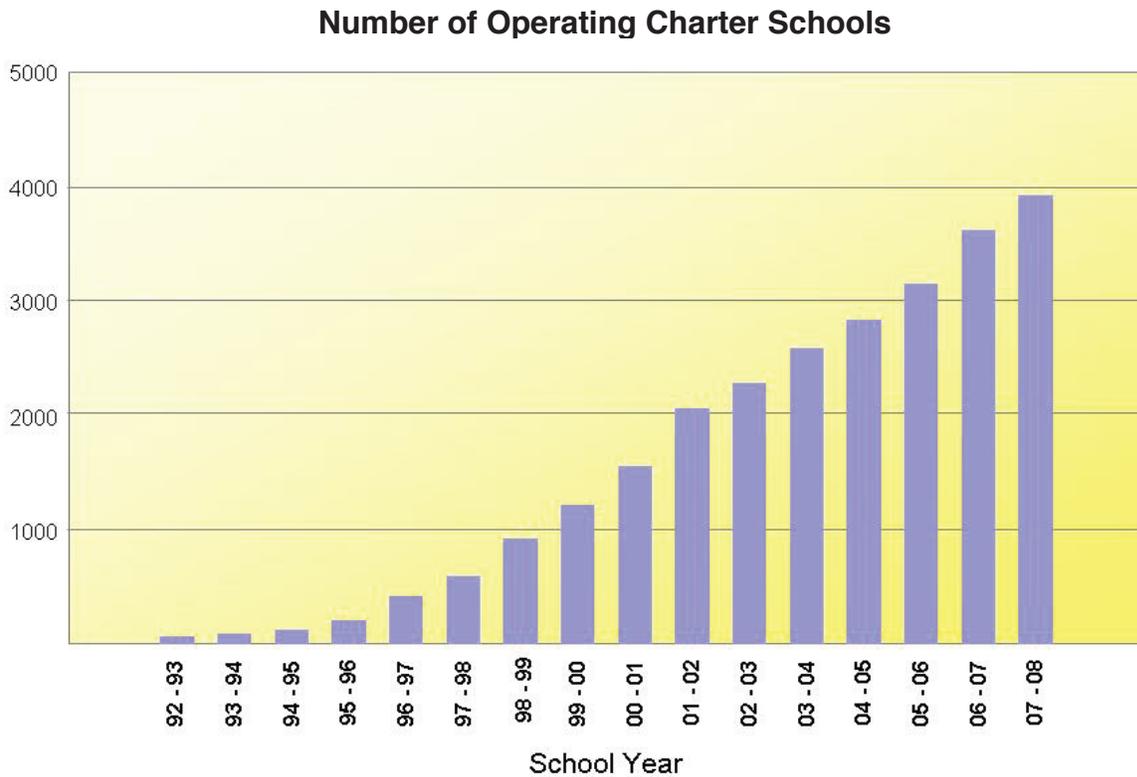
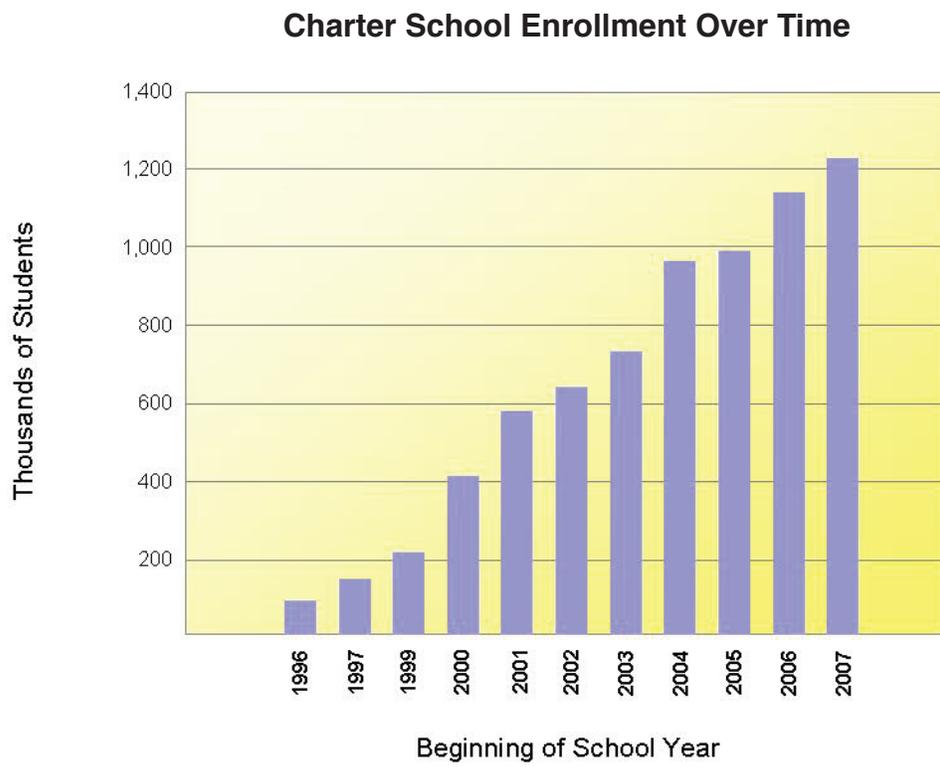


Figure 5 – Charter Enrollment



Section 2: What We Know About Charter School Achievement and Facilities Financing

Charter School Achievement

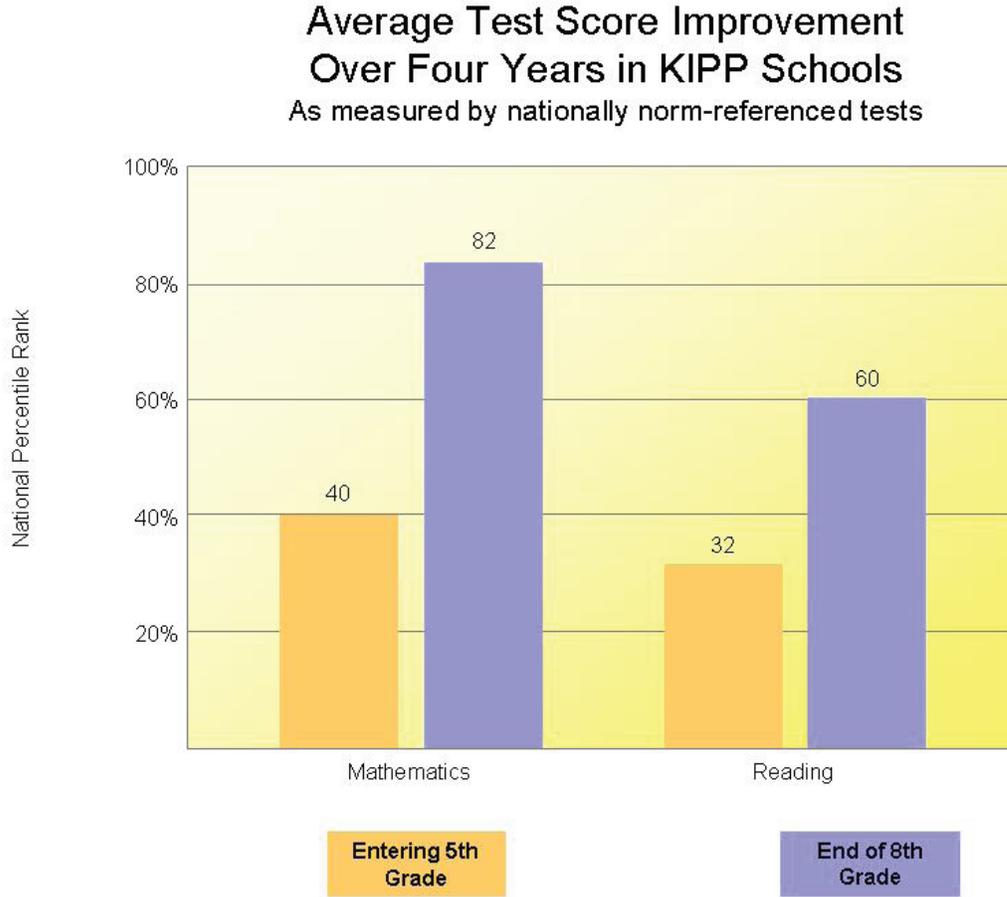
The charter school movement is relatively young and is still taking shape. However, there has been keen interest in finding out whether charter schools can in fact outperform district public schools. Of the many studies this question has spawned, contradictory findings proliferate. To make sense of the data, the obstacles associated with conducting charter school research and interpreting the findings must be understood. The most significant obstacles include the following:

Apples-to-apples: comparing charters to traditional public schools. Charter schools disproportionately serve low-income and minority students (see Figures 7 and 9).¹¹ This fact is not open to debate. The existence of an “achievement gap” between low-income and minority students and their higher-income counterparts is also well documented. The question is: If charter school students perform well below the average public school student at the time of enrollment, is it better to compare their performance to that of an average public school student, as many studies do, or to compare them to students with similar demographic characteristics? Another question: If students begin school performing significantly behind grade level and their performance is marginally better than traditional public school students, how should marginal improvement be judged? Many have called for “value-added analysis” to measure whether individual students are better off for having attended a charter school. The best way to measure this, these advocates argue, is to follow the progress of individual students over time. This research methodology is more costly and time-consuming to implement, so fewer of these higher-quality studies have been conducted.

Varied instructional approaches. “Charters” are a form of organization, not a pedagogical approach. Charter laws were meant to encourage educational innovation in the classroom. As a result, charter schools follow a plethora of instructional models, some of them standard but many of them unique. Further, many charters attract specific demographic groups with unique characteristics. The lack of uniformity in charter schools makes it difficult to isolate the causes of either achievement gains or poor performance.

Quantifying results in the aggregate. Results to date show that some charter schools outperform their peer public schools by large margins. For example, the well-known Knowledge Is Power Program (KIPP) has created sixty schools in low-income urban areas across the country. KIPP measured all of its middle schools in operation from 2001 to 2007 and compared the performance of its students to national norms. The data show that students on average entered KIPP in fifth-grade ranking in the fortieth percentile in math and the thirty-second percentile in reading. By the end of eighth grade, KIPP students were performing on average in the eighty-second percentile in math and the sixtieth percentile in reading. These comparisons are against all students in the United States, and not just against urban schools or other low-income, minority students. In the 2006–7 school year, 100 percent of KIPP schools outperformed their district averages in both reading and math (Fig. 6).

Figure 6 – Comparison of KIPP Schools to National Norms



While some schools are clearly high performing, others are not. Attempts to draw conclusions based on the average charter school may lead to inaccurate judgments.

Charter schools are controversial. One premise of the charter movement is that the bureaucratic structure that administers and delivers public education in the United States is part of the problem. Charter laws enable administrators to create a parallel system that does not have to abide by the rules or accountability mechanisms of traditional public school systems, including hiring unionized teachers. Teachers' unions have mounted formidable opposition to the charter school movement.

To address these concerns and to make greater headway in our collective understanding of charter schools, the National Alliance for Public Charter Schools has published *Charter School Achievement: What We Know* (2007).¹² Though the source is a pro-charter advocacy organization, the report is nonetheless comprehensive and attempts to be balanced. It includes seventy comparative analyses of charter school and traditional public school performance, including a study-by-study look at the strengths and weaknesses of the methods of study. (None of the studies was conducted earlier than 2001.) The report draws the follow summary conclusions:

Methodological quality. Many studies have one or more of the following methodological problems: measuring how much value charter schools are contributing to their students; studying an adequate number of students and schools to be statistically significant; and/or using sound comparisons with disaggregate analysis to show how well different kinds of students and schools are doing.

Mixed results of limited use. Of the seventy studies, thirty look only at a snapshot of performance at one or more points. Twelve show charter schools generally underperforming traditional public schools, while eighteen show comparable, mixed, or generally positive results.

Improvement. Twenty-one studies find that overall gains in charter schools were larger than other public schools. Fourteen examine whether individual charter schools improve their performance with age (e.g., after overcoming start-up challenges). Of these, ten find that as charter schools mature, their performance improves. Three find no significant differences between older and younger charter schools. One finds that older charter schools perform less well than district schools.

It is safe to say that the research findings are unclear and for the most part inconclusive, though the “change over time” data are generally encouraging regarding the performance of charter schools. Many have suggested that in order to extract the best ideas that this experiment in educational innovation has encouraged, research efforts should pay more attention to why some charter schools perform so much better than other schools.

Charter School Facilities

State charter laws make no provisions for public facilities or, in most cases, adequate public funding for school buildings. Currently only eleven jurisdictions provide supplemental revenues for facilities costs on a per pupil basis, and most are insufficient to cover the total capital costs associated with school facilities. In addition to a lack of funds, there is a lack of information on *how* to finance facilities. The publications concerning the financing of charter school facilities are either aimed at describing the market or helping charter schools manage the process of developing and financing their campuses.

The most comprehensive publication is the Local Initiatives Support Corporation’s *Charter School Facility Finance Landscape* (2007), which catalogs public and nonprofit facilities programs across the United States. It is a resource for both individual charter schools searching for sources of financing and policymakers seeking an understanding of facilities issues. According to this study:

- Eleven states offer per pupil funding for facilities costs,
- Ten jurisdictions have authorized some other form of grant funding for facilities,
- Five states have publicly funded loan programs,
- Six jurisdictions offer some form of credit enhancement for charter facilities,
- Thirty-four of the forty-one jurisdictions allow charters to access tax-exempt debt through conduit issuers, and
- Twenty-nine jurisdictions allow charter schools to participate in their QZAB program, though many have prioritization criteria or other obstacles that effectively block charters from accessing the program.

The predecessor to the landscape study, *Paying for the Charter Schoolhouse: Policy Options for Charter School Facilities Financing* by Bryan Hassel (1999), documented the facilities challenge and discussed funding programs as well as approaches to solving facilities problems. A widely used technical assistance manual published by NCB Capital Impact, *The Answer Key* (2005), offers a step-by-step guide to the process of developing and financing a school building.

Interestingly, the written body of knowledge available to help gain an understanding of charter facilities has been produced by CDFIs, a fact that further demonstrates the importance of CDFI participation in the charter movement.

Section 3: Why Charters?

Most CDFIs do not think of themselves as education reformers. So what motivates them to be players in the charter school market? There are three major influencing factors. The first is simply the *demand for development capital*. Because charter schools lack public resources and must look to the private market for capital to support facilities, from the outset they discovered that finding, developing, and paying for a facility were among the most formidable obstacles to starting and expanding their schools (U.S. Department of Education 1998). Initially the reception of the capital market investors to the financing needs of charter schools was stone cold. CDFIs moved in to fill the void. But even after more than ten years of operations, the facilities issue is still a major concern to charter schools.

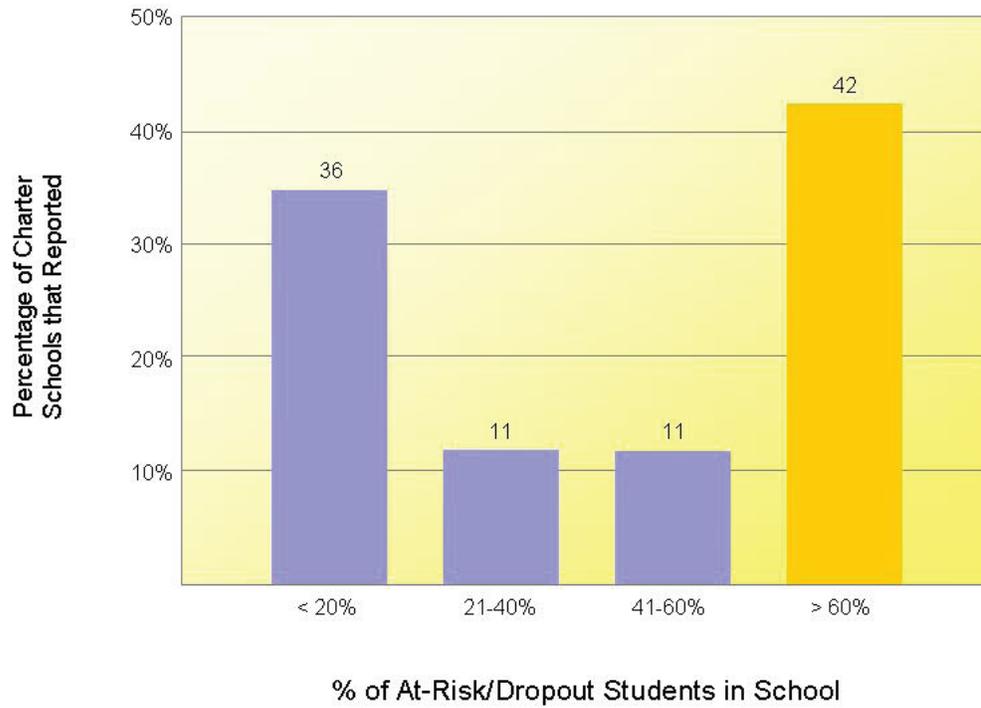
The reasons traditional financial institutions were reluctant to lend to charter schools are not surprising. Charter schools in need of financing, especially in the early years of the movement, were likely to be start-up or early-stage ventures with an unproven financial track record. The terms of their charters are usually three to five years, yet they may require twenty-year amortization schedules or more to make debt service affordable. Charter schools initially encounter three risk factors. First, the charter contract stipulates the closure of the school if it fails to reach its academic goals. Second, the risk of not meeting the conditions of the charter is further increased because charters tend to enroll low-performing students. And third, charter school buildings are often single-purpose assets with limited reuse potential located in low-income communities where real estate values may not support the cost of redevelopment. In addition, charters usually face opposition at the state and local levels from stakeholders within the traditional public school system. Objections are most passionate around the autonomy and resources granted to charter schools. For all these reasons, traditional investors have been reluctant to take the time to understand the market. If there is such a thing as a “classic” development finance market, charter schools qualify. CDFIs stepped in because they saw an opportunity to add value.

A second factor that drew CDFIs to the market is that, although created to improve the quality of public education, charter schools are proving to be an *effective tool for community development and revitalization*. Because they tend to serve low-income, minority students, charter schools are disproportionately located in urban areas that are financially underserved—a prime market for CDFIs. Charter schools often redevelop underused or dilapidated properties and convert them into attractive spaces. The adaptive reuse of existing facilities helps to preserve land and reduce sprawl. These smart growth principles contribute to community and neighborhood sustainability. The schools create jobs and attract ancillary businesses and services to the immediate neighborhood, helping to anchor community development efforts.

A third factor, and perhaps the most compelling, is that charter schools are *improving the quality of education for low-income students* in many communities. Most charters are founded by parents, teachers, educational entrepreneurs, and other community leaders seeking better educational outcomes for poor and low-income children who have no other choice than to participate in an educational system that almost everyone agrees is failing them. Depicted in Figure 7 are data from the Center for Education Reform showing that 42 percent of charter schools serve populations where 60 percent or more of the students are considered “at-risk.” In communities where children have less than a 50 percent chance of completing high school, some charters are preparing and sending them to college. This is a significant poverty alleviation strategy.

Figure 7 – Charter School Demographics

Charter School Demographics At-Risk/Dropout



Section 4: What CDFIs Have Accomplished

CDFIs began addressing the needs of charter schools shortly after the first charter law was enacted. In 1993, NCB Capital Impact made a small pre-development investment of \$25,000 in EdVisions, a teacher-owned cooperative that opened Minnesota New Country School (NMCS), one of a small group of charters operating in 1994. According to *Charter School Facility Finance Landscape* (Local Initiatives Support Corporation, April 2007), there are now twenty-five private nonprofit organizations offering facilities financing. Collectively these organizations provided more than \$600 million in direct financial support through 2006. All of the twenty-five organizations surveyed in the report are either certified as CDFIs by the Treasury Department's Community Development Financial Institutions Fund or are nonprofit organizations with common missions of providing development finance to one or more underserved markets.

When CDFIs entered the charter market, banks were absent from the scene, the option of tax-exempt bond financing was unthinkable, there were no public resources to address the facilities problem, and school founders were struggling to find solutions. Not only were financial resources scarce, but most charter school operators were educators who had little or no knowledge of how to develop and finance a school facility. Against this backdrop, CDFIs got to work.

Figure 8 – CDFI Loans to Charter Schools

Charter School Loans

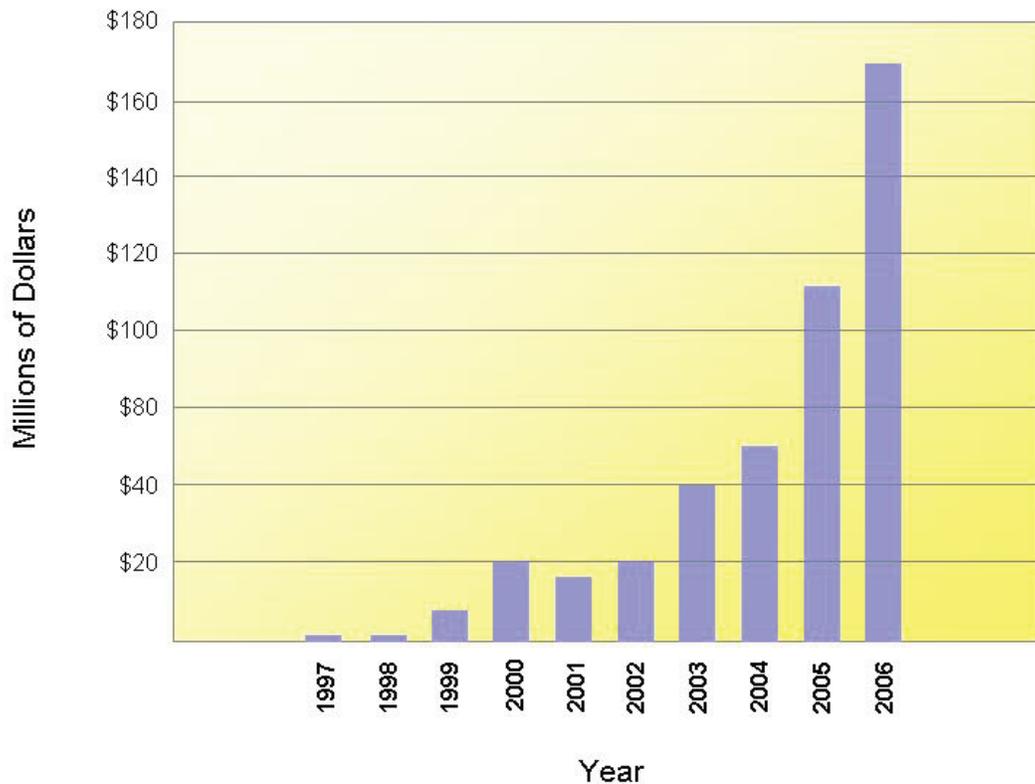


Figure 8 shows the aggregate growth of charter lending volume among the nine most active CDFIs, including CL Fund, IFF (formerly known as the Illinois Facilities Fund), Local Initiatives Support Corporation, Low Income Investment Fund, NCB Capital Impact, Raza Development Fund, Nonprofit Facilities Fund, Self-Help, and The Reinvestment Fund. From 1997 to 2006, CDFI disbursements grew from \$275,000 to nearly \$170 million per year. Cumulative disbursements over this ten-year period exceeded \$460 million, a volume that approaches sufficient scale to affect the industry and attract the attention of capital market investors. Over this same period, 436 loans were made, financing more than 200,000 school seats. Over 80 percent of the schools financed serve a majority of low-income children. CDFIs provided a range of products, including loans for mortgages, leasehold improvements, and working capital.

In the earliest days of the charter movement, schools had to open using their own funds. By 1994, however, the Clinton administration established a role for the federal government by creating a program to provide start-up seed funding under Title X of the Elementary and Secondary Education Act. This act alleviated the need for high-risk start-up working capital loans.

The problem of finding, leasing or buying, and renovating space rose to the top of the list as the biggest barrier to opening schools. The first studies of charter schools commissioned by the U.S. Department of Education in the late 1990s showed that charters tended to be smaller than the average public school, with seven out of ten leasing space. This remains true today; average charter school enrollment is 40 percent less than conventional public schools, and only 30 percent of charter schools own their buildings (Center for Education Reform 2007). When it came to space, many schools had to improvise, occupying temporary spaces, church basements, vacant storefronts, or unused public school buildings. Accordingly, CDFIs made leasehold improvement loans as well as first-mortgage loans available to those schools capable of owning their facilities. Loan amounts tended to be in the \$250,000 to \$2 million range.

Charter school loans held by CDFIs perform well, despite the perceived risks in the market. Most CDFIs experience default rates of less than one percent, with no history of loan losses. Borrowers were beginning to establish creditworthiness; banks, however, were still reluctant to get involved, and not more than a handful of bond deals had been executed. In 1999, Moody's Investment Services published its first analysis of the charter school market. Standard and Poor's and Fitch soon followed. While the bond market was beginning to pay attention, there was still a healthy dose of skepticism. Most bond deals were rated below investment-grade, which meant that charter schools were still paying relatively high rates for capital. In a 2002 report, Fitch asserted that despite strong demand, "schools without three to ten years of successful operating history or substantial credit enhancing features will remain hard pressed to earn investment-grade ratings. Most proposed bonds in the sector possess credit features consistent with the 'BB' or 'B' rating categories" (Fitch Ratings 2002). The continued growth in charter school demand put more pressure on those already willing to make charter loans.

When CDFIs first entered the market in the mid-1990s, for the most part they were making loans from their own balance sheets. However, as the movement matured and the demand for charter school seats continued unabated, whether by increased enrollment at existing schools or by new schools opening, CDFIs were quickly running out of capacity to provide financing. As shown in Figure 5, enrollment was growing at double-digit rates. Charter operators needed room to grow, and also wanted to upgrade their space to reflect their changing status as long-term institutions. Occupying permanent space was a way to achieve both. Transaction sizes began to climb as a result, requiring CDFIs to find even more creative solutions to serve the market. Fortunately, the federal government devised a useful way to help.

Section 5: The Role of the Public Sector

To encourage traditional financial market investors to respond to the needs of charter schools, Congress appropriated \$25 million in 2001 to create a credit enhancement demonstration program. After a successful first year, the Credit Enhancement for Charter School Facilities (CECSF) program was authorized under the No Child Left Behind Act and funded at approximately \$36 million per year through 2007. In 2008, funding dropped to \$12 million. To date, over \$205 million in grants have been awarded to nineteen organizations; fourteen CDFIs have received a total of \$172 million.¹³

The original purpose of the demonstration program was to find innovative, market-based solutions to the facilities financing problem. The program has in fact been an effective impetus for promoting innovation and attracting traditional capital to charter schools. It is an important platform from which to build a more comprehensive approach to funding charter school facilities.

Accomplishments of the Credit Enhancement for Charter School Facilities Program

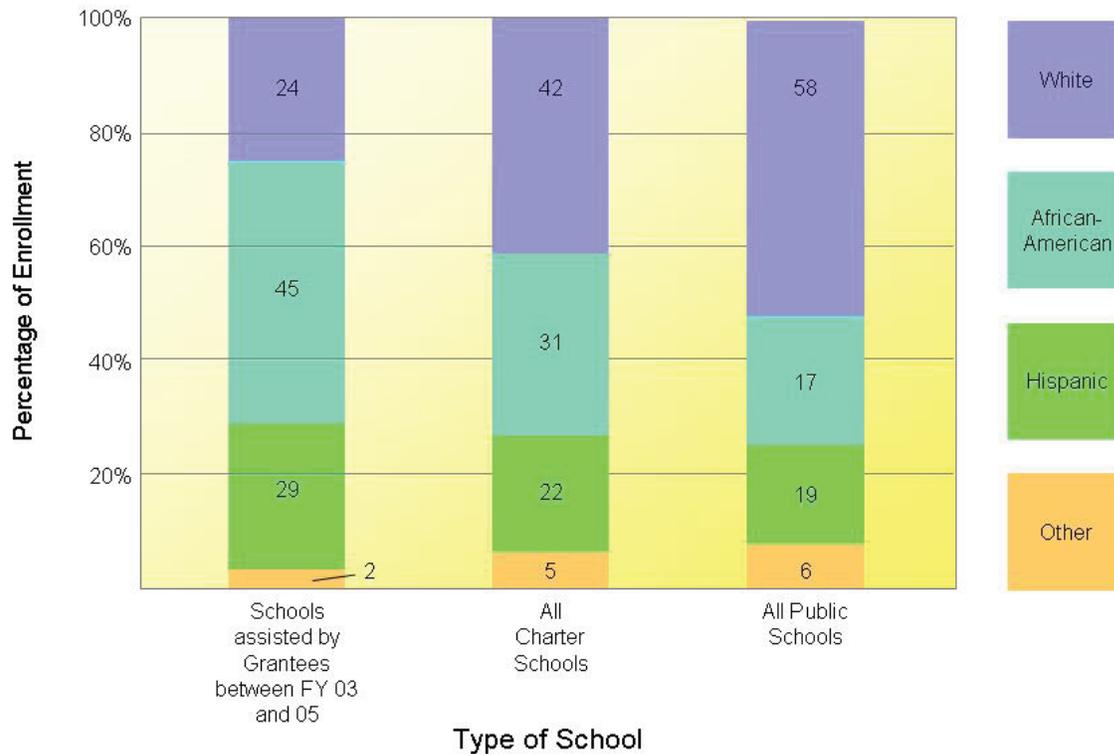
The Department of Education issued a report on the CECSF program in April 2008. While the study period extends only from 2003 to 2005, its findings are still useful for assessing the effectiveness of the program. The report draws the following conclusions:

- Many charter schools are unable to qualify for loans that could be used for facilities-related purposes because lenders perceive them to be too great a risk. The credit enhancements funded by the program reduce lenders' exposure to losses in the event that a charter school defaults on its loan. As a result, the program has improved charter schools' access to capital markets, resulting in more lending than would have occurred without the program.
- Many of the assisted schools, according to representatives of grantees, commercial lenders, investment banks, and rating agencies, would not have received facility loans at any price before the program, because lenders believed that these schools reflected a prohibitively high level of risk. With the addition of credit enhancements, assisted schools received loans with rates and terms that were better than would otherwise be available.
- Based on a review of loan-level data and information provided by grantees and assisted schools, there is evidence that grantees are using innovative methods, especially related to helping charter schools borrow directly from private lenders.
- Grantees disproportionately made loans to charter schools in which lower-income and minority students comprised a larger share of enrollment as compared to all charter schools and all U.S. public schools.
- Finally, the assisted charter schools themselves were located in census tracts with lower median household incomes and a larger share of minority residents than the counties in which the schools were located.

Figure 9 shows that 59 percent of the 23,162 students enrolled in assisted charter schools were eligible for free or reduced-price lunches, compared to 39 percent of all students in public schools and 44 percent of all charter school students. Minority students accounted for a larger share of students in schools assisted by grantees between FY 2003 and FY 2005 compared to students enrolled in all charter schools and all public schools. The proportion of white students in schools assisted by grantees between FY 2003 and FY 2005 was 24 percent, the proportion of such students in all charter schools was 42 percent, and in all public schools it was 58 percent.

Figure 9 – Comparison of Racial/Ethnic Composition FY 2003–FY 2005

Racial and ethnic composition of students enrolled in schools assisted under the Program



Source: Report on Implementation of Credit Enhancement for Charter School Facilities Program, Department of Education, 2008

The latest data from the Department of Education, which extends through September 30, 2007, shows that grantees provided a total of 207 charter schools with \$739 million in financing. Of this amount, 65 charter schools obtained \$332 million in financing during Federal Fiscal Year 2007.

To understand further the benefits of the program, it is useful to describe some of the initiatives and products that have been created with CECSF support. They tell the story of how CDFIs have used innovation and collaboration to shape a market response to charter school facilities financing.

With first-round funding, The Reinvestment Fund (TRF) and NCB Capital Impact collaborated to create the Charter School Capital Access Program (CCAP) Fund. TRF and NCB Capital Impact used a \$6.4 million grant as a first-loss reserve to create a \$45 million lending pool capitalized by leading banks and thrifts such as Citibank, JPMorgan Chase, Washington Mutual, and Bank of America. For many of the participants in the fund, CCAP was their first foray into charter school lending. Part of the goal for TRF and NCB Capital Impact was to demonstrate that charter loans could be prudent investments.

The request to participate in CCAP was a much easier proposition for financial institutions to consider than a direct loan to a charter school in part because the banks did not actually have to make the loans themselves and therefore did not have to have an in-depth understanding of the industry. At the time of creation, TRF and NCB Capital Impact each had at least five years of experience in the market, a collective portfolio of nearly \$40 million, and no loan losses to date. The two organizations had underwriting criteria

that was consistent and time tested. Another attractive feature was the first-loss reserve, which protected investors fully for the first \$6.4 million of loan loss. Additionally, TRF and NCB Capital Impact each invested \$5 million into CCAP in a subordinate position to further protect the senior lenders. Under such a scenario, it became highly unlikely that investors would suffer losses.

To date, credit quality in the CCAP Fund has been exceptional. There have been very few delinquencies and no defaults or losses. Since the creation of CCAP, banks in the program have continued to lend to charter schools, mostly through CDFIs. The *Charter School Facility Finance Landscape* (Local Initiatives Support Corporation, April 2007) reports that Bank of America and Citigroup each have invested between \$100 million and \$150 million by 2007.

In 2005, NCB Capital Impact created The Enhancement Fund with \$60 million from a single pension fund investor, the first such institutional investor to enter the charter market. Because the pension fund is a “buy and hold” investor, NCB Capital Impact was able to create twenty-five-year fully amortizing loans. On an “all-in” basis, pricing is competitive with tax-exempt bonds and provides a long-term financing option for schools that cannot reach the bond market. The positive initial experience of the investor made way for investments with other CDFIs lending to charter schools.

Another grantee, IFF, used the program to enhance tax-exempt bonds for charter schools in Chicago. Most charter bond transactions have some kind of credit enhancement, usually in the form of bond insurance or letters of credit from banks. IFF’s Illinois Charter Capital Program (ICCP), created with an \$8 million grant from the CECSF, facilitated bond issuances in 2006 for two charter operators by funding loss reserves that reduced the cost of bond insurance. The transactions, totaling \$18.7 million, created four new campuses serving 1,873 students, approximately 90 percent of whom are low income. The bonds are twenty-five-year fully amortizing notes and are attractively priced.

In the most recent round of funding, the CECSF program enabled CDFIs to stretch the boundaries of collaboration to a new level in order to achieve both product innovation for charter schools and industry innovation for CDFIs. In March 2006, a group of leading CDFIs facilitated by the Housing Partnership Network (HPN) gathered in Chicago at the MacArthur Foundation to discuss ways of working together to gain greater access to the capital markets. A variety of strategies were discussed, ranging from creating a CDFI-owned bank to aggregating and securitizing pools of loans. The conversation was initially not specific to charter schools but included all asset types originated by CDFIs. To find common ground and move an idea forward after the meeting concluded, participants submitted data on lending activities segregated by asset type. The data revealed what is evident in Figure 8, but had not yet been quantified by participants: CDFIs were building enough scale in the charter sector to be taken seriously by the capital markets. To pursue further the concept of securitizing charter school loans, a subgroup was created that included the Low Income Investment Fund, NCB Capital Impact, the Raza Development Fund, Self-Help, The Reinvestment Fund, HPN, and the Community Reinvestment Fund, a national nonprofit financial intermediary that securitizes economic development loans.

In 2007, the group created the Charter School Financing Partnership (CSFP). CSFP is a cooperatively-owned nonprofit LLC originally designed as a conduit to accumulate charter school debt and sell securities backed by the debt into the capital markets. It received a \$15 million grant from CECSF to implement its strategy. Unfortunately, shortly after incorporation, the secondary market virtually disappeared in a matter of weeks. Like IFF and other CECSF grantees, CSFP has had to respond nimbly by crafting a new approach. As of summer 2008, CSFP is going forward with a tax-exempt bond product designed to reach charter schools that are either too small or too risky to access the tax-exempt market on their own. It will likely be beneficial to schools that would receive ratings just below investment-grade. The CSFP product will allow them to reach investment grade and enjoy the benefits of better pricing and terms. The program is sized at \$100 million and is designed such that if the secondary market for commercial debt returns anytime soon, it can be retooled to create the first-ever charter school securitization.

The depth of collaboration required by CSFP exceeds any prior experience of its members. To accomplish its goals, CSFP participants will create common underwriting criteria, standard documents, and agree to take shared risk in transactions. Further, the financial model of CSFP will not follow the old rules. CDFIs will not hold originated assets in portfolio, except for small residuals. This will have an impact on both the income statements and the balance sheets of the CDFIs who participate. Fees will replace earning assets and liquidity will improve. To make the model work for both the market and CSFP, a high volume of product origination will be essential. Customized loan structuring as a way of doing business, a hallmark of CDFIs, will be challenged under this model.

Not only is the market ripe for CDFIs to experiment with this new form of product development and industry innovation, but time is of the essence. For their own long-term success, CDFIs must demonstrate that they can offer scalable solutions to some seemingly intractable problems. All indications are that CDFIs are prepared to do just that. In the charter school market, however, a new tool is needed to achieve further progress. Even though \$100 million will be beneficial to the market, it is still only another drop in the bucket.

Section 6: Charter Academy Bonds

A fundamental premise of the argument in favor of the creation of Charter Academy Bonds is that as a matter of parity, charter schools, as public schools, should be able to access the bond market under the same or nearly the same conditions as traditional public schools. Public school facilities are financed with general obligation bonds issued with the full faith and credit of a local municipality. Because they are backed by agencies with taxing authority, local school districts are considered low-risk investments and enjoy easy access to bond financing at low interest rates. By contrast, charter schools are stand-alone organizations without the advantages of taxing authority.

Even though district-run public schools have easier access to the capital markets, many school district facilities, especially in urban areas, are in poor condition from chronic underinvestment. A June 2000 report from the National Center for Education Statistics estimated that \$127 billion is needed to fix America's school buildings. This figure is consistent with the findings of an earlier U.S. Government Accountability Office (GAO) study that estimated the cost of bringing schools into good overall condition to be \$112 billion. Other studies estimate that the cost to construct new schools and classrooms and to modernize existing schools is more than \$300 billion nationwide.¹⁴ The main contributor to underinvestment in public schools is the reality faced by public officials whose citizens do not want to pay higher taxes to support investment in public infrastructure. The argument that charter schools should have access to general obligation bonds is an idea that is likely to end up dead on arrival.

Short of offering a full faith and credit guarantee, municipalities can extend "moral obligations" to back a tax-exempt revenue bond issuance. The state of Colorado has used more obligations most aggressively. However, only 19 percent of charter schools in Colorado have gained access to bonds as a result. In Indianapolis, the mayor's office has extended the moral obligation of the city to charter schools seeking bonds. Moral obligations do not bind a municipality to repay a defaulted bond, however, so their impact as a risk-mitigating factor has limitations. Only one Indianapolis charter school has used the moral obligation so far, which makes it difficult to draw reliable conclusions about the benefits of the tool. While moral obligations should be encouraged, they are not the catalyst needed for large-scale financing programs.

A new mechanism is required that is both effective and politically feasible. CABs can meet both tests, assuming a commitment is made to leveling that playing field for charter schools. The recommended incentive mechanism for CABs is modeled after the Qualified Zone Academy Bond (QZAB) program.

QZABs were created by Congress in 1997 to address a growing need for modernization of school facilities in low-income areas. QZABs provide bondholders with federal tax credits in lieu of cash interest payments. Some have called for the broader use of QZABs for charter schools as a solution to the facilities conundrum, but significant design obstacles make the existing QZAB program too fundamentally flawed to be effective for charter schools.

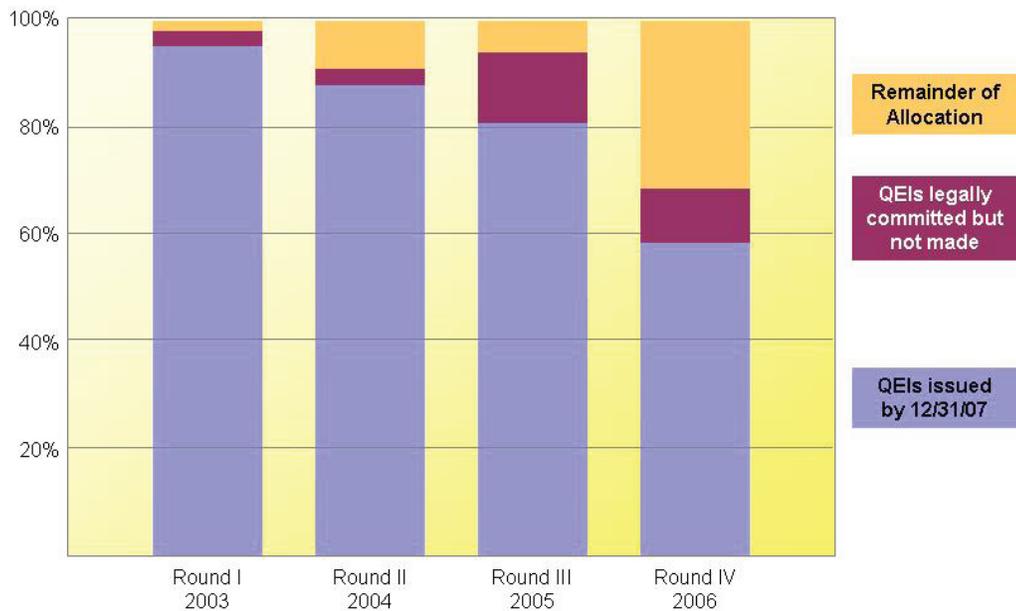
The first and most significant problem is the *distribution mechanism* for the tax credits. QZAB allocations are made by the Treasury Department to State Education Agencies (SEAs), which can choose to distribute the credits or sub-allocate them to Local Education Agencies (LEAs). To access QZABs, charter schools often need the cooperation of their local school districts or state agencies, but these entities may not have an interest in helping them, and inasmuch as they are competing organizations, they may have the motivation to impede charter schools. In fact, because charter schools can operate outside the regulations that govern local school districts, it is not uncommon for charters to be treated with resistance at the local level.

Even when hostilities do not exist, QZABs get bogged down in bureaucracy and as a result have been undersubscribed. From 1998 to 2007, \$4 billion was authorized under the QZAB program, but only \$1.6 billion in bonds were issued, a cumulative deployment rate of only 40 percent. Other limitations of the QZAB program include the prohibition from financing new construction and the threshold requirement that applicant schools enroll at least 35 percent low-income children.

A CAB program would provide the clean slate charters need to design a mechanism that is scalable and efficient. To address the problem of deploying CABs effectively, it is recommended that CABs mimic the distribution system of the New Markets Tax Credit (NMTC) program.¹⁵ The NMTC program was enacted in 2000 to create incentives for investors to provide capital to financially underserved, low-income markets. The program was the first tax credit to bypass the protocol of allocating tax credit authority to projects from the federal level through state and local government. In programs such as QZAB and the Low Income Housing Tax Credit (LIHTC), tax credit allocations are made to states based on population and poverty statistics. State governments then choose to allocate directly to projects or sub-allocate to local jurisdictions, which then make allocations to projects. In the NMTC program, by contrast, the Treasury Department certifies allocatees called Community Development Entities (CDEs). CDEs then allocate tax credits directly to projects. This approach has proven to be effective and efficient. As of 2006, the CDFI Fund reported that 70 percent of tax credit allocations made in the first three years of the program (2003–5), or \$5.5 billion of the \$8 billion allocated, had been converted into cash investments. A more recent survey released by the New Markets Tax Credit Coalition in May 2008 shows that by December 2007, CDEs who completed the survey had deployed 80 percent of their allocations from the first four years of the program (2003–6), a rapid rate of deployment.

Figure 10 – NMTC Deployment

Percent of QEIs Issued & Committed



Source: New Markets Tax Credit Coalition, Progress Report, May 2008.

Since its inception, the NMTC program has been oversubscribed by ten times in each allocation round. CDEs compete for allocations based on their knowledge of the industry, the merits of their strategy, and their effectiveness in deploying assets. CDEs can be either nonprofit or for-profit. Much like the role of certified CDEs in the NMTC program, CFEs would structure transactions and allocate CAB tax credits to investors.

The question might reasonably be asked: Why not just model a program for charter schools entirely after the New Markets Tax Credit program, or expand the existing program with special “carve-outs” for charter schools? In fact, experience shows that charter schools that have been able to access NMTCs report high degrees of satisfaction with the program. There are two reasons such a solution would be suboptimal: (1) advocacy groups who see themselves as the protectors of the NMTC program have worked diligently to prevent “carve-outs,” fearing that once permitted, there would be an avalanche of worthy causes seeking the same treatment, and (2) tax credits in the NMTC program are available only for seven years, while credits in the QZAB program extend to fifteen years. The NMTC credit is a shallower subsidy, so while NMTC loan products beat out conventional financing for charter schools, they are not as favorable as the all-in subsidy of a QZAB.

To design the specific product features of CABs, a good starting place would be to follow the methodology established in the QZAB program for setting the rate and term of the product. On a regular basis, the Treasury Department posts the rates and terms for QZABs based on a formula outlined in the program’s regulations.¹⁶ As of June 2008, the QZAB rate was 5.79 percent and the term was fifteen years. In essence, the calculation is intended to price QZABs so that the issuer (in this case the charter school acting through a conduit) will save 50 percent of the par value of the bond. For example, suppose “College Prep,” a fictitious charter school, wanted to finance the acquisition and rehabilitation of a school building that will cost \$5 million. Assume for the moment that the investor is willing to price the CAB bonds at 5.79 percent and to offer a thirty-year amortization period. For the first fifteen years of the bond term, the investor would receive its interest payment in the form of tax credits. The charter school would make principal payments to the investor as if the interest rate were 0 percent. Annual debt service without the CAB credits would be \$352,000; with the CAB credits, it would be \$167,000, a saving of \$185,000 per year. Over the fifteen-year period, the school saves \$2.7 million in interest expense, or approximately 50 percent of the face value of the bond on a present-value basis. At the end of the tax credit period, the school would be responsible for assuming full payment of principal and interest if the term of the bond is thirty years. If the investor has offered only a fifteen-year term, the school would have to refinance the bonds.

If the CAB rate is lower than the investor’s risk-adjusted rate-of-return hurdle, then the bonds could be sold at a discount, meaning that the investor would pay less than \$5 million, but the charter school would still have to repay the full face amount of \$5 million. If the credit risk was lower than the risk-adjusted rate-of-return hurdle, the bonds could be sold at a premium, meaning the investor would pay more than \$5 million for the bonds.

If the risk-adjusted rate of return is too low for the investor, and the charter school is located in a distressed census tract, or serves more than 35 percent low-income students, the CAB rate would be adjustable by up to 100 additional basis points. The justification for granting greater subsidies to low-income charters is similar to the justification for creating NMTCs or QZABs in the first place. Developing schools in low-income areas is just as costly as in other places, yet the value of real estate in distressed communities is lower, which serves to constrain the flow of capital. The CAB program should allow for the use of other credit enhancements such as the CECSF and state and local enhancements so that schools that are still too risky for market investors have additional tools at hand to make a deal feasible.

Any investor with a federal tax obligation would be eligible to use CAB credits. To access a CAB, a charter school would apply to a certified Charter Financing Entity (CFE), who would evaluate the risks of the transaction and structure a CAB to meet the needs of the school. Much like CDEs in the NMTC program, CFEs would work with investors or investment banks to place the bonds appropriately and would be compensated through the proceeds of the transaction.

CABs present a better structure than any other financing option currently available to charter schools, including commercial loans, taxable or tax-exempt bonds, or NMTC deals. CABs will create access to greater pools of capital because both the incentives and the distribution system of CAB are designed to match the needs of investors and charter schools. The best deal on the market for charter school facilities is currently

New Markets Tax Credits. CABs will outperform NMTCs because the credits are longer and the subsidy level is deeper in present-value terms.

The scale of the CAB program could initially match that of the QZAB program, currently sized at \$400 million per year in allocation authority. Once the concept is proven in the marketplace, the CAB pool should be determined based on a rigorous assessment of the annual demand for facilities financing by charter schools.

A CAB program designed as described would require little by way of complex new mechanisms for implementation. The bond market has accepted QZABs. Both the CDFI Fund and its CDEs, many of whom would qualify as CFEs, have demonstrated a capacity to allocate tax credits efficiently. Moreover, investors have accepted the role of CDFIs and CDEs as effective and efficient intermediaries. It would be relatively easy for investors to make the leap to CABs, which share many of the characteristics of QZABs and NMTCs.

Summary

Charter schools are making their mark on the education reform landscape. They are not without controversy, or immune to legitimate criticism in some cases, but they are a worthwhile endeavor in a field that is traditionally one of the most resistant to change. There is nothing more inspiring than seeing a young person at risk of ending up a teenage mother, becoming a ward of the prison system, or just stuck in a low-wage job head off to college.

CDFIs have helped make this important innovation happen by responding to the critical need charter schools have for facilities development and financing. As a result, CDFIs have fueled their own growth and have produced important innovations for the community development finance field.

The role of the federal government in providing credit-enhancement funding to organizations such as CDFIs cannot be understated. Without these incentives, and without CDFIs to structure and administer them effectively, the growth of the charter movement would proceed at a slower pace. The CECSF program provides a model for using public policy to promote growth of charter schools. However, a bigger solution is needed that addresses the scale of the facilities problem in the charter school market. CDFIs can be the fulcrum for the solution, but additional help will be needed from the public sector. It is therefore recommended that the next federal administration advocate for the creation of Charter Academy Bonds. CABs will provide incentives at scale that will finally level the playing field for charter schools by allowing far more of them to access the capital they need to operate in quality facilities.

Annie Donovan is Chief Operating Officer of NCB Capital Impact. She is responsible for leading the company's efforts in innovative community lending, expert technical assistance, strategy formation, product innovation, and policy development. NCB Capital Impact provides solutions, based on cooperative principles, to solve the problems poverty creates in America.

Endnotes

- 1 This article is adapted from a chapter in *Community Development for the 21st Century*, edited by the National Academy for Public Administration and published by M.E. Sharpe, July 2008.
- 2 For the purposes of this article, the term Community Development Financial Institution (CDFIs) refers to organizations whose primary mission is to use financial and development services to create access to capital for underserved markets and communities. The Community Development Financial Institutions Fund (CDFI Fund) certifies CDFIs as part of its Financial Assistance and other programs. Not all of the CDFIs referenced in the text are certified by the CDFI Fund. However, all have either a primary community development mission or a more targeted mission to develop and finance charter schools.
- 3 National Alliance for Public Charter Schools. <http://www.publiccharters.org/>
- 4 There are no formal estimates of charter school demand for facilities financing. The author estimated the demand based on several sets of assumptions. The first calculation assumed that each student requires 100 square feet of space, and that each square foot of space costs on average \$200 to develop (this includes both the cost of construction or “hard costs” and the fees associated with development or “soft costs”). This means that for every student enrolled in a charter school, \$20,000 is required to cover capital costs. Total demand assuming a static state would be \$26 billion. Assuming an average life of the space of 20 years, and equal spacing of construction over 20 years, demand per annum at today’s enrollment would be \$1.3 billion. It’s probably unlikely that only 5% of schools need to finance new or upgraded facilities. If we assume that 25% of schools need facilities development, the number rises to \$4.3 billion.

Another calculation was made using the estimated demand for facilities investment by all public schools and multiplying it by the charter school market share of 3%. A June 2000 report from the National Center for Education Statistics estimated that \$127 billion is needed to fix America’s school buildings. This figure is consistent with the findings of an earlier GAO study that estimated the cost of bringing schools into good overall condition to be \$112 billion. Other studies estimate that the cost to construct new schools and classrooms and to modernize existing schools is more than \$300 billion nationwide. If we take the lowest estimate of \$112 billion and multiply by 3%, this would result in a demand calculation of \$3.4 billion.
- 5 See the Department of Education Web site for a list of awardees by year, <http://www.ed.gov/programs/charterfacilities/grant-eelist.doc>
- 6 The Charter Coalitions is an unincorporated group of 15 community development practitioners working together to preserve and enhance federal support for charter school facilities funding. For further information and the list of members, see <http://www.thechartercoalition.org/>.
- 7 The term “credit enhancement” in this context is defined as any mechanism that reduces the credit risk of investors in a financial transaction, or shields investors from losses. Loan guarantees and reserves for loan losses are commonly used credit enhancements.
- 8 Temkin, Kenneth, Hong, Grace, Davis, Laurel, Optimal Solutions Group, LLC and Bavin, William, Education Capital Group, Implementation of the Credit Enhancement for Charter School Facilities Program, U.S. Department of Education, Office of Planning Evaluation and Policy, 2008, p. xi. <http://www.ed.gov/rschstat/eval/choice/charter-school-facilities/final-report.doc>
- 9 National Commission on Excellence in Education, 1983, *A Nation at Risk*.
- 10 National Alliance for Public Charter Schools, Growth and Quality in the Charter School Movement: Charter Dashboard, May 2008. <http://www.uscharterschools.org>
- 11 In the charter school market, “low-income” status is measured by a child’s eligibility for subsidized meals through the U.S. Department of Agriculture’s School Lunch Program.
- 12 National Alliance for Public Charter Schools, *Charter School Achievement: What We Know*, October 2007.
- 13 Office of Innovation and Improvement, U.S. Department of Education, April 2008.
- 14 See note 4.
- 15 The Treasury Department’s New Markets Tax Credit (NMTC) Program has been named today as one of the Top 50 programs that will advance to the final stages of competition for the prestigious 2008 Innovations in American Government Award. The NMTC Program was chosen from approximately 1,000 programs representing all levels of government across the nation that applied for this award.

The Innovations in American Government Program is a significant force in recognizing and promoting excellence and creativity in the public sector. Through its annual awards competition, the program provides concrete evidence that government can work to improve the quality of life for citizens. By highlighting exemplary models of governments’ innovative performance, the program serves as a catalyst for continued progress in addressing the nation’s most pressing public concerns. It is administered by the Ash Institute for Democratic Governance and Innovation at the John F. Kennedy School of Government at Harvard University. www.innovationsaward.harvard.edu.
- 16 QZAB regulations provide that the amount of the QZAB credit equals the product of the “credit rate” and the face amount of the bond held by the taxpayer. The credit rate is determined by the Treasury Department and is based on its estimate of the yield on outstanding AA rated corporate bonds. The term that the department estimates will result in the present value of the obligation to repay the principal on the bond being equal to 50 percent of the face amount of the bond.

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