

Community Development  
**INVESTMENT REVIEW**

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Proceedings of the  
**Conference on the Secondary Market for  
Community Development Loans**

Board of Governors of the Federal Reserve System  
Martin Building, Washington, DC  
September 6-7, 2006

Conference Keynote Address

***Governor Randall S. Kroszner,  
Board of Governors of the Federal Reserve System***

Proceedings / Themes from the Conference

***David J. Erickson***

Essays on Conference Themes

Turning Uncertainty Into Risk: Why Data Are the Key to Greater Investment

***Mary Tingertbal***

Growing Pains

***Doug Winn***

Bridging the Information Gap between Capital Markets Investors and CDFI's

***Ellen Seidman***

Strategies for Selling Smaller Pools of Loans

***John McCarthy***

Check Your Guns at the Door

***Catherine Dolan***

FEDERAL RESERVE BANK OF SAN FRANCISCO



## Community Development INVESTMENT REVIEW

The Community Affairs Department of the Federal Reserve Bank of San Francisco created the Center for Community Development Investments to research and disseminate best practices in providing capital to low- and moderate-income communities. Part of this mission is accomplished by publishing the *Community Development Investment Review* three times a year. The *Review* brings together experts to write about various community development investment topics including:

**Finance**—new tools, techniques, or approaches that increase the volume, lower the cost, lower the risk, or in any way make investments in low-income communities more attractive;

**Collaborations**—ways in which different groups can pool resources and expertise to address the capital needs of low-income communities;

**Public Policy**—analysis of how government and public policy influence community development finance options;

**Best Practices**—showcase innovative projects, people, or institutions that are improving the investment opportunities in low-income areas.

The goal of the *Review* is to bridge the gap between theory and practice and to enlist as many viewpoints as possible—government, nonprofits, financial institutions, and beneficiaries. As a leading economist in the community development field describes it, the *Review* provides “ideas for people who get things done.” For submission guidelines and themes of upcoming issues, visit our website: [www.frbsf.org/cdinvestments](http://www.frbsf.org/cdinvestments). You may also contact David Erickson, Federal Reserve Bank of San Francisco, 101 Market Street, Mailstop 620, San Francisco, California, 94105-1530.

Center for Community Development Investments  
Federal Reserve Bank of San Francisco  
[www.frbsf.org/cdinvestments](http://www.frbsf.org/cdinvestments)

### Advisory Committee

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**Bob Taylor**, Wells Fargo

**Kerwin Tesdell**, Community Development Venture Capital Alliance

### Center for Community Development Investments Staff

**Joy Hoffmann**, FRBSF Vice President

(415) 974-2228

[Joy.K.Hoffmann@sf.frb.org](mailto:Joy.K.Hoffmann@sf.frb.org)

**Jack Richards**, Community Development Director

(415) 974-3314

[Jack.Richards@sf.frb.org](mailto:Jack.Richards@sf.frb.org)

**Scott Turner**, Community Development Manager

(415) 974-2722

[Scott.Turner@sf.frb.org](mailto:Scott.Turner@sf.frb.org)

**John Olson**, Director, Center for Community

Development Investments

(415) 974-2989

[John.Olson@sf.frb.org](mailto:John.Olson@sf.frb.org)

**David Erickson**, *Review* Editor

(415) 974-3467

[David.Erickson@sf.frb.org](mailto:David.Erickson@sf.frb.org)

**Steve Baxter**, Layout & Design

[Steve.Baxter@sf.frb.org](mailto:Steve.Baxter@sf.frb.org)

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# Foreword

John Olson  
*Director, Center for Community Development Investments*

*November 2006*

The Federal Reserve Bank of San Francisco and the Board of Governors of the Federal Reserve System held a special, invitation-only conference in Washington, DC on September 6 and 7, 2006, on the secondary market for community development loans. The conference was organized largely because of the eager responses we heard from readers of our most recent issue of the *Review* on the subject. After publishing the *Review*, we reached out to lenders, investors, intermediaries, policymakers, and academics to collect as many reactions as we could. While there was a diversity of opinion on the precise programs or tools that are needed to create a more vibrant secondary market for community development loans, some interesting themes emerged: that the industry is on the cusp of a breakthrough, that the industry needs to do a better job of learning from the interesting ideas and innovations in the field, and that the industry needs new ways of coming together and collaborating with one another.

In response to this feedback, we invited a small group of community development thinkers and practitioners to engage in a highly interactive series of discussions over the course of a day and a half, and you'll be reading about the fruits of those discussions in these pages. My colleague David Erickson provides a comprehensive summary of the multi-faceted discussions at the conference, and the balance of this *Review* consists of more detailed explorations of specific themes that emerged. Each essay approaches its theme with an eye towards what the future might hold by suggesting next steps and ideas for new directions. Our goal with this *Review* is to capture the best ideas from the conference and lay them out as a possible road map for the industry.

The Center for Community Development Investments remains committed to creating a forum for the discussion of these ideas and a platform for their implementation. We'd be delighted to hear about other ideas to add to the discussion, but we're especially interested in hearing from those of you who are working towards making the ideas discussed in this *Review* come to life. We invite you to join us in making real progress.

## Conference Keynote Address

*Remarks by*

***Governor Randall S. Kroszner***

*Board of Governors of the Federal Reserve System*

**E**nhancing the community development finance field's access to the capital markets is an important topic and one that I care about quite a bit. Facilitating capital flows to address the economic needs of people in distressed areas is an element of overall economic growth, and so the Federal Reserve System's Community Affairs function plays an important role in helping the System address important growth imperatives. I saw the importance of these activities firsthand when I was at the University of Chicago. The enormous progress that has been made on the south side of Chicago from 1990 to today is a testament to the importance of community revitalization efforts and the ability of community development finance to transform neighborhoods.

Public funding for community development faces budgetary challenges. Private charitable sources, though often very generous, can be somewhat unpredictable. It is important, therefore, that community developers are able to tap the power of markets to ensure sustainable funding for these activities. Of course, there's a real challenge in building a bridge between the two very different worlds of capital markets and community development. The world of Wall Street practices strict market discipline, emphasizing the need for standardized products, tough underwriting requirements, and careful management and evaluation of risks. The world of community development, on the other hand, has a commitment to people in neighborhoods that have been left out of the economic mainstream and have unique characteristics and needs.

It is important to think about bridging these two worlds because there is so much work to be done, and the tremendous growth in this area suggests that the field is reaching a new level of maturity. In 1991, for example, around 2,000 community development corporations (CDCs) had built about 300,000 units of housing and 17 million square feet of commercial space. By the end of this year, it is expected that 4,600 CDCs will build more than a million units and 126 million square feet of commercial space. Community development financial institutions (CDFIs) have become more sophisticated and more innovative, and the field is growing. There are now more than 600 CDFIs, with \$19 billion dollars of assets and \$20 billion of finance activities, and they report relatively low charge-off rates of only about 1 percent. Marrying these two disparate worlds by using the capital markets to leverage community development resources could lead potentially to revolutionary change in the funding of community revitalization.

There are significant challenges to bringing these two worlds together, but there already have been demonstrations of success. The Community Reinvestment Fund in Minneapolis, for example, issued two rated securities in 2004 and 2006 totaling \$130 million. For the first time, the senior tranches were privately rated by a major rating agency as AAA, opening the

door to new institutional investors. Community Development Trust, one of the nation's only community development REITs, has recently securitized about \$45 million in mostly Low Income Housing Tax Credit loans, representing 2,000 affordable units. These are just a couple of examples that show the feasibility of tapping the capital markets to finance community development activities.

The history of the Chicago Mercantile Exchange and Chicago Board of Trade may shed some light on the current problem in community development of creating liquidity in a market of heterogeneous assets. In the 1870s, the market for grain did not enjoy the very deep liquidity we see in today's market. At the time, Chicago was facing competition from exchanges in Minneapolis, St. Louis, and from some in Europe that had created innovative structures to make markets more liquid. In order to create a liquid market for grain trading, buyers and sellers of grain needed a way of systematically analyzing the different kinds of grain that came into the exchange from different sources. In other words, the market needed a way of grading the grain. The market created special silos that combined grain from a number of sources. Buyers no longer bought a silo of grain from one source, but a silo of, for example, "Winter Wheat Number 2" that would be graded in a way that allowed buyers to know exactly what they were getting.

To facilitate the creation of a futures market, the exchange then established minimum quality standards, which might be analogous to a lender's underwriting standards, based on the need for market participants to evaluate the reliability of promises of future deliveries of grain to the buyer. Buyers and sellers of grain ultimately became members of the exchange, supported by an underpinning of standardized measures of grain quality and minimum standards for exchange members. Eventually, the exchange itself became counterparty to all of the transactions. All of the market participants were members of the exchange, and so if something went awry, the members were liable to make good on it. They mutualized the risk, so, for example, a buyer of a standardized contract for "Winter Wheat Number 2" didn't necessarily care from a financial standpoint who the seller was because of the presence of the central counterparty—the clearing house—that stood as a guarantor to both sides of the transaction.

These innovations were developed by, and for, market participants. There was no government involvement or regulation. These durable constructions survived World War I and the Great Depression without any government guarantees, without any government insurance, and, until only relatively recently, without any government oversight.

This example of the development of the Chicago grain market raises some poignant questions for the community development industry. Can a similarly durable structure be developed for community development? Is it possible to do so without government intervention or subsidy? How can the industry certify the quality of its assets? How can the industry make data provision systematic? How can more informed and uniform underwriting standards be developed that adequately address the unique and inherent risks associated with certain asset classes? How can community development make its risk factors more known, more systematic, and easier to price?

None of these questions is easy, but the answers may lead community development to a transformative change in how it finances its work, and there are already examples of this kind of thinking in the marketplace. I was pleased recently to join the Board of Directors of NeighborWorks America. One of the subsidiaries of NeighborWorks, Neighborhood Housing Services of America (NHSA), works in a way that has some of the characteristics of the Chicago grain market. It certifies the quality of particular lenders so that outsiders don't have to do the due diligence on each individual group. Rather, they can give the NHSA "Good Housekeeping Seal of Approval," based on systematic criteria that provide comfort to investors, and that's an important first step.

The community development finance field faces some fundamental questions about how the value of market discipline can be tapped to strengthen community lending transactions. The most critical way to harness market discipline is to think about how data can be systematically provided. The markets are very good at dealing with systematic data. They have a lot of difficulty dealing with unique situations. The gap between Wall Street and community development can be bridged by knowing the kind of systematic disclosure that investors want and knowing the unique features of communities that the community development field works with.

In conclusion, I'm very confident that the expertise and dedication found in the community development industry can move the industry in the right directions to address the obstacles as well as expand the opportunities of facilitating a more active secondary market for community development. There will no doubt be challenges associated with this work, but the future looks bright, and I offer my encouragement to everyone who is diligently working toward a financing system that works efficiently at scale for community development.

## *The Secondary Market for Community Development Loans* Conference Proceedings

**David J. Erickson**

*Federal Reserve Bank of San Francisco*

At the Federal Reserve’s September conference in Washington, D.C., one participant remarked, “There are lakes of capital and lakes of need.” How to channel one to the other was the central question we wrestled with at the two-day conference. This article attempts to capture the major themes and ideas from those discussions. It starts with an overview, then explores why community development finance needs to evolve, and concludes with strategies to achieve next steps.

Although the conference did not uncover any “silver bullets,” the conferees explored a multi-faceted framework for connecting community development to the capital markets: community development lenders need to better understand different investors and their different appetites for risk; investors need more, and better, data on community development assets; and lenders and investors need a new platform for exchanging this information.

Many conferees agreed that data was the key to progress. Going forward, we need to mine existing data, generate new programs to gather it, and find proxies and other stand-ins for the data we do not have in the ongoing effort to transform community development investing from an uncertain proposition to one with known risk parameters for investors. Robert Van Order made one of the most important observations during the two-day event: “Risk is where you know the probabilities, like roulette. It may be very risky, the chances of winning may be very small and the payoff is very big, but you can evaluate that.” Uncertainty, on the other hand, is when “you don’t know the probabilities.” When you know the risk, you can realistically price the asset, but under conditions of uncertainty, investors assume the worst and will either forgo an investment or demand exorbitant insurance.

Other important themes from the conference—problems with the portfolio lending model, a desire to expand, and the need to leverage existing subsidies and other resources—are summarized in this article and expounded upon in other essays in this *Review*. Many of the observations help us better understand the current state of affairs, but there were also many ideas on new financial technology, new approaches to public policy, and new ways to organize this market in order to “connect the lakes.”

### **I. Overview**

Robert Van Order, the former chief economist at Freddie Mac and a University of Michigan economics professor, kicked off the conference with a presentation based on his article in the last issue of the *Community Development Investment Review* (summarized below). The presentation proposed three questions: (1) what are the basic ways to raise capital? (2) what



advantages are there to one over another? and (3) what special burdens do community development lenders face in this framework? On the first issue, Van Order, borrowing from the work of the economist John Hicks, said: “There are two typical ways of thinking about raising money; one is the bank route and the other is the capital markets or bond route.”

## **Bank vs Bond Model**

In the traditional sense, banks “originate and hold loans and raise money in the deposit market.” All aspects of the lending process are centered in the bank—“originating the loans, collecting the money, managing the credit risk.”

The second model is securitization, “which is really the bond market or the financial markets.” In an effort to clarify the terminology, Van Order explained that “secondary market” is a term that means “the second place that the pieces of paper go.” He said, “It’s a little bit similar to how Aristotle talked about metaphysics, but that just meant it was the chapter of the book that came after the book on physics.” He continued, “It’s the securitization that is interesting, the turning of these instruments, these loans of various sorts, into securities that can go to the bond market.”

A significant difference between the bank model and the bond model is the latter’s division of labor. Van Order used single-family mortgages as an example.

Right now in the mortgage business, about half of the loans go through mortgage brokers who have no stake in [the entire process] other than getting the deal done. Servicing is done by separate people. Raising the money may be entirely in the bond market, and taking the risk might be assumed by an insurer or a third party. The problem is, of course, that when you do this and you have something like a food chain, you’re at risk if the people ahead of you in line don’t do a good job. So this division of labor is a neat thing. It’s in securitization, but it involves some costs.

The division of labor provides opportunities for specialization, but it also creates principal-agent problems and transaction costs. In addition, this approach creates problems around information, as John Quigley, an economist from UC Berkeley, commented, “You probably have a lemons problem,” referring to the economist George Akerlof’s concept of making decisions under conditions of asymmetry of information.

The most attractive aspect of the bond model, however, is that lenders can access tremendous amounts of capital: “You have a neat machine for raising money in the bond market,” according to Van Order. However, “you have a problem with getting bond market investors to be interested in things they don’t know much about. So the question is, how do you balance those two things?”

## The Example of the Mortgage Market

An illustrative example of an asset class that was once funded through the bank model but evolved to the bond model is the case of single-family home mortgages.

Van Order observed that the evolution to the bond model for mortgages also triggered a division of labor and created an information problem. “When you buy things second, you’re buying them from someone who knew them first and probably knows more than you do. An awful lot of what went on in the evolution of the mortgage market and the development of the secondary market had to do with trying to overcome that problem.”

The first efforts to overcome principal-agent problems involved contracts and down payments. But in time, what gave investors comfort was that they could know the risks by using abundant and good data. “Without [good data], you’re at risk of people who make the loans keeping the good ones and selling you the bad ones.” Van Order notes that “understanding credit history and having a big database” gives investors some comfort that they are making good risk-return estimates.

Another advantage was the quality of the collateral. “The great thing about the American system is that you can bounce people out of their houses if they don’t make the payments,” according to Van Order. “Now that may sound cruel, and sometimes when I do this presentation in international groups, I’ll put something up on the board that says if you want people to have good housing, you have to be able to take it away from them.” Foreclosure is rare, he notes, “between one and two percent over the life of the loan.” Because foreclosure is an option, homeowners can borrow at very low rates over a long term.

## The Mortgage Market: Lessons for Community Development?

Can community development loans be compared to the mortgage model? It may be a stretch, according to Van Order. Consider the following characterization of community development loans:

They’re very different. They’re very heterogeneous. You don’t always have good information about the characteristics of the business or the borrower. They tend to be small in scale, so that some of the advantages of getting to the bond market are missing. They’re servicing-intensive. By that I mean, you have to keep track of the borrowers. And the loans may have to be sold at a discount. The latter, I don’t think is all that interesting. The fact you sold at a discount means they’re worth less than market. They’re worth less whether or not you hold them. But particularly the first four [characteristics listed above] are things that make securitization less likely to happen, and they’re all things that make it hard for bond market investors.

## Two Securitization Models

The bond model has two basic types: (1) the standard model, where the transaction is set up like a mutual fund; and (2) the David Bowie model, which operates more like corporate bonds (with credit enhancement built into the transaction). “In terms of securitization models, I want to think again of two polar cases. One is the pass-through, the mortgage-backed security model, which is basically a pool of loans,” according to Van Order.

In the case of secondary mortgage markets, Fannie, Freddie, or Ginnie, those are credit enhancements, but much of the risk—in particular, payment risk—is passed straight through to the investors. Maybe it’s carved up, which is one of the interesting things.

The advantage of the straight pass-through in the way that Fannie and Freddie do it is that it is relatively homogeneous. You can call up a broker and say you want to buy a Fannie Mae thirty-year fixed rate and the broker will deliver one. You don’t have to worry too much about whether they’re giving you a really bad one because they’re pretty homogeneous, and you don’t have to worry about the credit risk.

The second example is the David Bowie model, where the British rock star sold his future revenue stream from his music royalties to investors.

[David Bowie] sold ten-year debt secured by the royalty stream and it was a securitization. They sold the bonds. They were ten-year bonds. They had a rating. The bonds actually got downgraded a few years after because of Napster, right? But they were there, and while it was a securitization, it wasn’t quite the same as the pass-throughs because it was set up as a corporation, where the assets and the cash flows that came in were from these receipts, and there was a liability, the ten-year bonds, and Bowie kept a residual. You can think of it as two classes, but he was essentially the shareholder. He had limited liability. The idea was at the end of ten years he’d refinance. He raised \$55 million.

It appears that the David Bowie royalties securitization model had similarities with the community development loan market.

He had an asset that was very heterogeneous that the market didn’t much know about, but he had an equity cushion, which you can think of as taking a subordinated position. The market would handle the debt because of the equity cushion. So, this structure could get a bond-market rating, AA, AAA, something like that, and the institutional and traditional bond market investors could handle this. You could sell everything off. The deal was self-contained.

### **Which One Is Better? Does It Matter?**

“Does rearranging those cash flows in some fancy way add value? And the answer is that in this particular situation with perfect markets, people understanding the risks, it doesn’t.” Drawing on the Modigliani-Miller theorem, Van Order said that the financing structure should be irrelevant. He illustrated this idea with a simple metaphor about someone ordering a pizza. The person behind the counter says, “You want this in six slices or eight slices?” The response is: “Why don’t you cut it into eight slices. I feel hungry tonight.”

But markets are not perfect and information is incomplete. “What is it, if you’re proposing a structure—a securitization structure, a bank structure, Bowie bonds, messy CMOs—what is it about carving up the cash flows in this particular way that gives you an advantage over some other way?” In other words, how does the structure of the transaction add value? John Quigley suggested that a Bowie-style securitization might have several advantages:

First, there may be external benefits to certain kinds of lending. The benefits might arise from geographical concentrations, providing external effects in particular areas, or there might be benefits from risk pooling, for example, in providing loans to similarly situated mobile home owners across geographical areas.

In addition to helping to manage risk, securitization also allows lenders to carve up the asset into risk tranches and sell off each layer to the most appropriate and motivated buyer. Lenders can create discrete investment products that might match the appetite for specific investors. Van Order compared this to cutting up chickens; you can sell the whole chicken, but you might get a better price if you sell breasts to the people who want to buy only breasts and thighs to those who only want to buy thighs.

## **II. Why Evolve?**

The for-profit marketplace for certain loan products has changed dramatically. John Quigley said, “The success of mortgage lenders in basically changing from a bunch of unrelated institutions that make loans, service loans, and then put them in the basement somewhere, to a set of institutions that originate loans that are then serviced by specialists and sold in world capital markets is really a spectacular change.”

Betsy Zeidman, of the Milken Institute, however, reminded the conferees that the community development finance industry may not be prepared for such a radical transformation. Many CDFIs and other community lenders are not experiencing a liquidity crisis, or feeling an urgent need to access the capital markets. She mentioned that her group had completed a research project in the San Francisco Bay Area on CDFIs and banks lending to the Latino community. Her finding was that many of the groups did not want to securitize any of their loans. Many respondents to her study said, “We don’t need the capital. We don’t have a liquidity problem.” She pushed many of them, asking why they were not more

aggressive and lending more and the responses were, “We don’t see enough deal flow” and “It’s too expensive.”

While there were some discussions at the conference about how feasible and reasonable it would be to aggressively pursue new capital market strategies for community development, most conferees felt strongly that there was a need to evolve, based in part by the drive to expand their community development mission and to use subsidies more efficiently—to get the maximum bang for the buck.

Bob Schall, president of Self-Help Ventures Fund, said, “We’ve been portfolio lenders for many years, but we’re facing barriers on how to keep financing”:

- On the portfolio model, we’re constrained by a lack of equity and can borrow only so much debt with restricted equity, so that’s a good reason to sell.
- Another reason is that the source of debt is primarily from banks and is generally more expensive than the bond or repo market, so it’s the shortest route to better-priced debt.
- Also, [community development] assets are often long-term and we’re trying to match it on the liability side. Bank debt is often not the best source for this match.

“In reality,” Schall continued, “we’re being pushed into securitization because of a lack of success on the portfolio side.”

It was surprising to hear that even some of the world’s largest financial institutions were feeling “pushed into securitization.” Dan Letendre of Merrill Lynch suggested that he was also concerned with constraints.

And so, while \$70 billion is a relatively large balance sheet, when we operate as a \$1 trillion institution with only 5 percent on the balance sheet, I have to tell you, we feel every day—and I feel every day—capital constrained and the balance sheet is a high priority.

Letendre said that deciding to move into the capital markets is not easy; hard and painful decisions must be made about how to change the way a community lender does business before it can sell loans into the secondary market. [See Doug Winn’s article on this topic later in the *Review*.]

Before you have to do it, it’s only a demonstration, and you don’t make the hard choices until you’re required to do it. But the best and the brightest and the biggest CDFIs, and the fastest growing, are getting to that place.

In large measure, the drive to evolve is the ambition to do more. CDFIs and community lenders are aggressive in their efforts to serve their communities, and the growth of some of the leading CDFIs has been staggering. Consider the example of the Low Income Investment Fund (LIIF). Nancy Andrews, president and CEO of LIIF, said, “The year that I joined

[1998], we thought that we were doing a fairly high volume of business and we made a total of \$7 million of loans in three markets. And I remember my staff was complaining about being overworked. My Southern California office made a sum total of \$2 million in loans that year and had two loan officers to do that. The year 2006 for us just concluded on June 30, and for the second year in a row, we've done close to \$100 million of loans. We are planning on \$120 million of loans next year." The rapid change made Andrews remark that the industry is now on a cusp, "some say, an inflection point."

Frank Altman, president of CRF, echoed the sentiment that community development had made dramatic progress. Twenty-five years ago the industry did not exist and only 10 to 15 years ago did community development financial institutions start to build up their lending and investment efforts: "Only over time have organizations kind of working in isolation at a very small scale in communities been able to tap the depository market by getting banks to come into their efforts, or the philanthropic marketplace by developing a mechanism to use program related investments from foundations or the quasi equity using something called equity equivalent investments that a number of banks have pioneered."

Many conferees agreed that the next step for many organizations in community development finance was to employ both bank and bond models. Playing off Van Order's comparison of bank and bond models, Bob Schall suggested that the group think of that comparison not as an either/or proposition, but as using both approaches; in other words, touting the bank *and* bond model. "I don't think we should just look at securitization but rather look at improving the portfolio model because it is best for CDFIs to have both options." Securitization could help both for selling assets and for managing a CDFI's portfolio. For example, the "MBSs [mortgage-backed securities] that have been created have been very helpful in attracting debt. By holding MBS on balance sheet, they also are a great source of collateral for the repo market." He concluded, "We're able to attract credit from the repo market at much better rates."

Others agreed that the bank and bond models are fruitful ways to think about strategies for how securitization could help community lenders expand their work. Dan Letendre, for example, supported this approach, saying that Merrill Lynch had to employ bank and bond models as well:

I think just to reiterate what you've heard before, it's not about just being a portfolio lender or just being someone who originates and sells, but rather you're going to be both, like banks are today. In my view, large banks, trillion-dollar institutions, are beginning to say, "I cannot book and hold all the mortgage volume that I have, my balance sheet isn't big enough, but I'll originate stuff that I can sell and I'll originate some things that I hold." If that's true for a trillion-dollar institution, I'm sure it's going to be true for community development loan funds as well.

## Leverage

An important aspect of strategies to grow is using equity to leverage debt. Andrews said that going forward “we will leverage our balance sheets much more than we will grow our balance sheets. We will use the balance sheet as a tool, not as an end in itself, but as a tool to accomplish the larger goal of our mission”:

So, while I don’t know what the future will really look like, what I can easily imagine is taking the Low Income Investment Fund’s \$100 million balance sheet and leveraging that into a billion-dollar book of business or a billion-dollar company that is servicing a very, very large portfolio.

Thomas Bledsoe, president of the Housing Partnership Network (HPN), has been pioneering new ways to leverage funds by coordinating his many members’ capital, expertise, and influence. “I think smart use of subsidy is a key for our industry, to figure out how to do that, and it means leveraging the different types of social investors who are around this room and elsewhere.”

For example, building on a \$2 million earmark in the federal budget, HPN started its own insurance company:

We put \$2 million of federal dollars into creating a \$30 million fund, which has, in turn, done about \$500 million worth of leverage. So, you know, it’s a high-leverage model, but we will use some core equity that typically comes from earmarks from the federal government.

So we have basically taken some public dollars, put on top of that foundation dollars, put on top of that CRA-type investments, and that becomes equity, effectively, to leverage senior debt.

Leverage is not always easy to come by, however, particularly when deal participants insist on a high amount of reserves or other padding such as overcollateralization in the deal. Annie Donovan from NCB Capital Impact said, “We have been active in the community facilities market, and in charter schools and in health care in particular. We have put together funds where we have taken in—mostly from government sources—first-loss capital and we use that as a reserve, a first-loss reserve. We use our own balance sheet, and we have a partnership with TRF [The Reinvestment Fund]. The first fund we did was in partnership with them where the first loss sits in a bank. We put in our own subordinate capital in front of the senior capital, and that’s been very successful in leveraging senior capital.” The problem, she said, was that sometimes the investors do not understand the asset class and require inordinate amounts of reserves.

According to Frank Altman, leveraging is a necessary strategy for using scarce public subsidy in the most efficient ways possible. But it is important to remember that leverage is usually possible only when there is subsidy in the transaction. “It’s not whether you choose

the portfolio model or the securitization model; we're indifferent," he said. "It's about how we attract market-rate capital to a nonmarket system. And it's a system that's been highly dependent on federal appropriations and subsidy."

Smart use of subsidy helps in lobbying efforts to make the case to legislators that scarce government resources are used wisely. An important part of using subsidy is to make sure that the industry as a whole is using each subsidy dollar where it can most benefit low-income communities. On this point, Altman said:

Maybe as a group we need to think about this "X" dollars of subsidy that's going to be available. If we're going to go with the GSE route, or if we're trying to get federal appropriations, we need to figure out where we want to try to get the biggest bang for the buck for the subsidy because everyone's trying to get two million for child care and three million for something else. I don't know if that's necessarily efficient and if that helps everyone.

This is bigger than any one of us, and we're trying to think about the industry.

### III. Strategies for Getting There

Nancy Andrews of LIIF started a brainstorming session with a pep talk:

[People say] this stuff is just so new and it's heterogeneous, and it's small, and it's got all of these obstacles, and there's really no way to pull this off because the obstacles are so great, and if you could pull it off somebody already would've pulled it off because there are plenty of smart capitalists that could do this. But the truth is that if you look at the history, you look at the last 25 years of the community development movement and you see what we've done, what I'm here to say is that you all who have really put this all together, you're strong enough, you're smart enough, you're definitely good-looking enough to make it all happen.

Many at the conference agreed that a first step in accessing capital markets is to better understand who investors are and what types of investments they want. Dan Letendre started educating the group on how different investors are motivated by different goals. A particularly helpful insight was his typology of community development investors. [See an article on this theme by Ellen Seidman later in this issue of the *Review*.] "Every investor has a different set of preferences that they are trying to reach when they're interested in either lending to you or buying pools of loans, and while every single investor is unique, I like to think of them, if there's a segmentation, in at least three classes of investors: there are CRA volume shoppers, there are innovators, and there are yield shoppers."



### *1. CRA Volume Shoppers*

Under the Community Reinvestment Act, banks are evaluated based on community development loans and community development investments, and those institutions that have less than what they're looking for are interested in quickly increasing the volume of CRA qualifying loans. CRA volume shoppers are looking for short-term instruments, preferably one-year loans, loans that we either pay off or renew next year, because, as you know, under the CRA test it's about loan originations, not how much we hold.

CRA volume shoppers want to have new product on an annual basis. They look for low-risk investments that are relatively easy to understand. They are not as yield-sensitive as other investors. David Leopold of Bank of America echoed this sentiment—that any conversation about how to pull this market along should focus to some degree on Community Reinvestment Act considerations. “So my point is that as we discuss this,” Leopold said, “it is important to keep in mind how to maximize the regulatory benefit for investors who have regulatory goals and to minimize the regulatory constraints for investors who are likely to have those regulatory constraints.”

### *2. Innovators*

Innovators are generally interested in showing the regulators, the press, and other organizations that they are extremely innovative. Usually, they have satisfied their volume concerns and are interested more in showing that they're not only innovative but also are complex and creative. Usually these investors are interested in smaller dollar volume, nonstandard transactions, and they're also not high-yield demanders. But you can't count on them for a lot of volume. Sometimes they take more risk, but you can't count on them for volume.

### *3. Yield Shoppers*

Yield shoppers are more interested in making sure that they can use volume to build a profitable lending business. So they're most interested in rate, fees, and usage, because you don't want to have a \$20 million revolving credit facility with only \$5 million of it used because I'm only earning on the \$5 million. By the way, the CRA volume shoppers don't care about that. They get credit for the full amount of the revolving credit facility, used or unused. But the yield shoppers care about usage and are interested in a longer term. The yield shopper doesn't want to spend forever putting together a facility and then have it pay off in a year or two; they're interested in growing the volume of the business.

## **Creating Product that Investors Want**

The flip side of knowing investors better is that community development lenders are better able to provide them with the product they are looking for. In other words, community

development lenders need to understand the investing community better and to start creating investment vehicles and products that fit the needs of investors. Dan Letendre continued:

I raise those issues because I believe that the future is in converting—having CDFIs convert the loans that they are originating into securities or investments in the form that investors are looking for, and splitting up your loans into pieces that investors are looking for. You are lending on a fixed-rate basis and your investors are interested in floating rates, so it's important to convert that for them. And some investors are interested in senior or subordinated or very subordinated pieces, so convert your loans into what investors are looking for. I have investors interested in two-year pieces of paper, but my loans have prepayment or extension. You can combine a couple of investors that have different appetites to solve that type of a problem.

As much as lenders can rearrange cash flows and engage in all types of sophisticated financial engineering, Letendre reminded the audience that “there's no way you can financially engineer a low-rate asset into a high-yield investment if someone isn't giving you an awful lot of subsidy.”

Frank Altman agreed that carving up investments makes sense, but that doing so can be expensive and requires a lot of subsidy. Referring to CRF's two rated securities (CRF-17 and CRF-18), Altman said, “We're using a senior subordinated structure, but the issue becomes how much credit enhancement is necessary to get those senior pieces rated. So, credit enhancement ultimately in our case is raw credit enhancement. We don't have a federal guarantee. We don't have an insurance company that can wrap the security. We're working on those elements for the industry, but they're not there yet.”

## **Overcoming the Data Hurdle**

One of the repeated frustrations among community development lenders is that their assets perform well (loan losses are rare) but are priced as though they are risky. As Annie Donovan asked, how can we “get closer to true capital markets pricing for the credit enhancement that is being put in those deals? We believe we have something tantamount to a ‘AA’ risk and we're not necessarily getting ‘AA’ pricing right now.” Nancy Andrews also commented on this point: “We've done something on the order of half a billion dollars of lending in 20 years and we've lost \$190,000. So, you get some kind of sense of the underlying quality of the credits.”

The costs of getting investors comfortable in the absence of data are high. Donovan said, “We do a lot of community facilities lending, so in the educational field or in the health-care field, if we want to securitize, then we're going to have to be prepared to buy back initially very big pieces.” Buying back big pieces—in other words, holding on to a large portion of the security because nobody is willing to buy it—is very expensive. “But in community facilities

loans, if you look around, there's no comparable data anywhere," according to Donovan. "And the issue that Nancy brought up is that we have a track record, but somehow it doesn't seem to be enough volume to reach the hurdles, the kind of statistical hurdles we have to overcome. So, I wonder if anybody has any perspective on that and how to get over that hurdle?"

The key to better pricing is better data; that will enable the industry to turn uncertain investments into investments with known risks. [See the article by Mary Tingerthal on this theme later in the *Review*.]

Altman suggested that the process of securitization itself can be part of the solution. "When you securitize, what happens is that the obliqueness or the opaqueness of a process in a local community economic development organization suddenly becomes transparent because many pairs of eyes are looking at those loans."

Another by-product of securitization that might solve the data problem over time is the coordination of loan servicing. Such a coordination would create multiple benefits by saving money with good and efficient servicing systems that also collect data. David Sand from Access Capital focused the group's discussion on the need for servicing. "In my dream world there would be some industry-recognized master servicer who would have sub-servicing relationships."

If existing data are too limited to be useful, one alternative is to find proxy variables that can tell the story to investors how an asset will perform over time. Mary Tingerthal said, "We think that we're on the verge of that with some of the work that S&P [Standard and Poor's] has done in the small business lending category. I'd like to talk about where the other opportunities are, where there's been enough activity, where there's enough of a track record to be able to find proxies and put those together with the experience, and really begin to turn them into risk equations that can then be evaluated."

## **Making a Market**

It is hard to imagine an entity big enough to make the secondary market in community development loans happen. Even if investors could be brought on board and they could price the assets based on elegant models with sufficient data, it is still not clear how we could coordinate the infrastructure that is necessary to make this market work. Greg Stanton, of Wall Street Without Walls, emphasized this point when he said that you have to build the infrastructure: "It has everything to do with a systematic organization of originators working through defined aggregators that are able to sell to 'buy-and-hold' investors":

The major issue for these folks is putting the data collection on common ground required by grantors and foundations, one document, one law firm, one approach, and be able to set up the system devoid of egos with originators selling into the aggregators and selling off to the street. The street will then not be just an institutional investor, but will be an institutional investor that has a defined 10-, 20-, 25-year liability requirement that they need to match, and the CDFI industry can build a product for that.

Getting agreement on industry standards from a group of unrelated and often competitive organizations is no mean feat. In what some have called the “check your guns at the door” school of thought, Catherine Dolan of Wachovia Bank suggested, “Why don’t we get a core group of us that represents the funding side, the origination side, the credit enhancement side, and we all play various roles in each of the sectors, and just focus on two or three ways of going about this. And let’s agree to put the competitive issues and the egos, as best we can, aside and all agree to create some scale.” [See Catherine Dolan’s article on this idea later in this *Review*.]

There are many examples where borrowers who traditionally went to banks and other depository institutions for capital got fed up with that approach and went around them. Van Order suggested that the junk bond market might be a good analogy. “It doesn’t have a good name, but the junk bond market developed in the 1980s because Michael Milken and others discovered that low-credit borrowers were stuck going to banks. He also discovered that a diversified portfolio of these high-risk loans looked better than you might think, and it was an alternative market.”

## **Public Policy**

Public policy solutions might help the industry evolve toward a model that relies more on capital markets than depository institutions and foundations. As the institutions grow, they may develop a louder voice on Capitol Hill. As Andrews suggested, “I can imagine the policy clout that we could have if we leverage not only the vision of our organizations but also our track record and our scale, and we market this or describe this in the halls of Congress in an organized fashion.”

On specific policy solutions, such as technical assistance for CDFIs that would like to enhance their technical skills and capacity, Linda Davenport of the CDFI Fund said, “We do have a limited amount of funds, but it seems that with both technical-assistance and financial-assistance programs, there ought to be a way for people to competitively apply to the Fund for some amount of funding that would help bring together that strategic partnership that Nancy was talking about or standardized documentation.”

## **Networks**

Another theme that wove its way through many of the conversations at the conference was about how an organization might increase its capacity. There was discussion, too, about how multiple organizations, playing specialized roles in a transaction, could grow their capacity together. Many conferees referred to this as a network approach to achieving scale for the community development industry. As Altman said, “Our biggest problem, in my view, is getting the whole industry to scale to achieve specialization or differentiation so that we view ourselves as a network that works together with highly specialized organizations that can originate, can service, can securitize. Then we build on that network and on the

specialization that these different entities have to create something that is bigger and better than what we have if we're each operating individually." Growing as a network confers many benefits, according to Altman:

In other words, the more people who play in the game, the better it is for everybody. And the secondary market effort is still incredibly small compared to the marketplace of community development, financial institutions, and others that originate and create loans in low-income communities. So the more who can play, the better, and we need to find ways of doing that.

Getting to scale is related to that because the more who can play means that they need to be doing that at some scale so that efficiencies are created in the marketplace. We are just ecstatic about doing a \$55 million securitization of business loans, but that is way too small to be efficient.

To a large extent, that means finding out how we can scale up in a networked fashion rather than building vertical organizations because I don't think that's ever going to happen in our industry. So I want to play on what others brought up about finding areas of specialized expertise that we have already in the network, in the system, and then finding ways of organizing or enhancing those so that they can be a resource for the industry, whether it be LIIF in its capacity with child-care loans or New Hampshire's ability to make mobile-home loans. We don't have to keep replicating the wheel because right now we work in an industry that is highly fractionated and has very high transaction costs. Some of them are necessary because of the nature of our borrowers, but many of them are there because of the low scale of our operations. We need to find ways of applying technology and systems across the industry that will allow the industry to become more efficient because then we'll need less subsidy.

Thomas Bledsoe's Housing Partnership Network is already experimenting with network approaches to solving the scale and efficiency problems. "The strength that our organizations have is that they are local, so they're connected to their markets. They know risk very well and they have excellent information":

The key part of the model is being able to go to capital markets with enough scale and having the performance data to be able to back that up, and then create a structure that allows you to control the economics. If the organizations are managing the risk—and in the case of insurance it's our members who are doing property management, they're doing residence services, all of the things that mitigate risk—they are controlling the hot buttons on these deals, and so we're aligning their kind of risk management with financial returns based on how well the company does. So that company, the Housing Partnership

Insurance, is in its third year; it's done very well, it's been quite profitable. We've had funding from a lot of organizations around this table, including, actually, the U.S. Congress, and from that we realize that we can play a role in helping our larger members collaborate in accessing capital markets based on demonstrated performance.

We're looking at the possibility of using that structure and maybe using some of the same capabilities for single-family sub-prime loans, charter schools, and small rental properties.

Creating further specialization might fundamentally alter the roles of CDFIs. As Nancy Andrews explains:

We will begin selling our intellectual capital much more than we're selling our subsidized capital. It's our know-how that's important, not our money.

We'll very likely use other people's money much, much more than our own, whether it's a secondary market approach, securitization, asset sales, whatever, but we will very much be in the partnership business of trying to figure out a way of using the money that others have.

In addition to the advantages of specialization, larger networks can hook up into the massive structures of the capital markets. Working in isolation, no one CDFI could integrate into that system; working as a network, however, might bring the scale that is necessary to work toe to toe with world capital markets. Altman said:

The scale at which the [capital markets] have to operate is such that to get down to the retail level is impossible. So, the only way we can tap that capital to the extent that that capital is something we think is appropriate is to build an institutional framework or an institutional system with the scale that can actually talk to that institution. And a secondary market can do that. So, I think a large part of the issue we're facing in the industry is trying to build the network of highly specialized institutions and nodes throughout the country, some of which are able to originate and understand the borrower very well. [Others], such as mortgage insurers, can add a kind of good housekeeping seal of approval to a loan or can help to take some of the risk and build the rich credit-enhancement requirements that are necessary so that the marketplace can become more liquid. And then, to be able to build to a scale where it is possible to issue securities that are much more like what's being issued in the capital markets and are rated.

Dan Letendre vouched for the fact that the investor interest is there for large-volume investments, but the community development community is not yet ready to provide volume product. He explained how the structured finance side of his operation wanted to add some community development loans to its pool:

They were very excited about the news, said “absolutely great.” And I quote: “I only need \$180 million to top off my pool and I can give you until the end of the month [to deliver the product].” I explained that this probably wasn’t going to work for my client set and that while my CDFI clients were very thirsty for the product and the capacity, this was like drinking from a fire hose. Mainstream investors’ appetite and the form of it is not exactly in line with what CDFIs and loan funds can yet provide. I do think, however, that CRA-motivated investors and socially motivated investors are at the place—maybe not mainstream investors yet—but CRA investors are at the place where they are already interested, willing, and quite active as investors in the secondary market for community development loans and asset securitization.

So how does the community development industry get there from here? Bob Schall from Self-Help warns against waiting for epiphanies. “I don’t think there will be an ‘aha’ moment when CD loans are instantly securitizable,” he said. “However, what we can do is select certain assets that are more likely to be securitized and change our lending practices to make the assets more homogeneous.”

In this effort, Greg Stanton counseled to “start off in the areas that require the least amount of subsidy to make it happen, show them as examples, and then work in, as opposed to doing the hardest to do.”

# Turning Uncertainty into Risk: Why Data Are the Key to Greater Investment

*Mary Tingertal*

*Senior Vice President, Community Reinvestment Fund*

**T**he role of data dominated much of the discussion at the Federal Reserve’s Secondary Market for Community Development Loans Conference. In our discussions of how to attract new investors to the field, the group reviewed all the things that investors are looking for: volume, geographic diversity, homogeneous assets, etc. But what became clear was that, above all, investors need data. 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.

In this article, I provide overviews of how investors use data and what data they need. I describe three case studies in CRF’s experience of providing data to investors, and I conclude with some suggestions for how the field can improve its data collection and reporting practices.

## **How Investors Use Data**

Different investors have different investment policies. The investment policy for an individual investor may have elements of asset allocation (How much do I want invested in stocks vs. bonds?), risk tolerance (Can I afford to lose principal?), and investment horizon (Am I investing for the long term, such as for retirement, or short term, to make home improvements a year from now?). With the institutional investor, this policy will contain many of these same elements, which are set down in an official written policy that an individual fund manager must follow.

The first step in the “whether or not” decision is often made based on descriptive data about an investment offering. Is it the type of investment I want (stock, bond, certificate of deposit)? Do I know the institution offering the investment? Does it appear to meet my return requirements?

Once the investor decides that the investment appears to fit its investment policy, the type of data and the importance of data that the investor reviews can vary widely. The chart below shows a spectrum of the type of data that may be provided by a community development lender that is seeking investments from institutional investors in pools of loans it originated and assembled. It is important to note that investments are made at all points on this spectrum. The point of the spectrum is to illustrate that the type of data the issuer is willing and able to supply will dictate the type of investor that will be attracted to the investment, and the amount of time that must be allocated to investor due diligence and to the negotiation of structural terms.



Community Development		➔	Mainstream Market
Type of Data Provided by Issuer	Self-described, non-comparative performance data		Data described by an objective 3rd party, such as a rating agency. Statistically supported, comparative performance data
Community Development		➔	Mainstream Market
Level of Independent Analysis by Investor	High		Low
Community Development		➔	Mainstream Market
Typical Investor Type	Socially-motivated or CRA-motivated investors with deep knowledge of the issuer		Institutional investors that may have limited knowledge of the issuer
Community Development		➔	Mainstream Market
Structural Characteristics of Pool	Smaller, non-rated loans or pools of loans with heavily negotiated structural terms		Larger, rated pools of loans with standard disclosures, representations and warranties and standard structure

Two primary assessments follow the decision to invest: (1) what level of risk will investors assign to the investment, and (2) what price are investors willing to pay for that level of risk? These two assessments cause many investors to turn to rating agencies for the risk assessment. A public rating provides a highly structured assessment of risk that uses similar investments as a comparative backdrop and is conducted by an objective third party. A public rating also provides the investor with an easier determination of appropriate price because the marketplace provides current information on other investments with similar structure and ratings.

The assessment of risk will generally be comprised of two components, credit risk and duration risk. Credit risk tells investors how likely it is that they will receive all payments for their investment. Duration risk tells them how likely it is that they will receive their payments in the timeframe forecast by the issuer.

**What Types of Data Does an Investor Need?**

The following are some typical components considered in the assessment of the credit risk of an asset-backed or mortgage-backed debt security:

- **Debt Coverage.** This is an assessment of the amount and timing of the cash flows from the underlying assets compared to the amount and timing of payments for debt being issued against the pool of assets.
- **Track Record of the Issuer.** This is an assessment of the performance of previous debt issued by the issuer.
- **Financial Status of the Issuer.** Depending on how much reliance the structure of the transaction places on the issuer, this assessment varies in importance. For example, if an independent third party is providing a guarantee for the transaction, the financial status of the issuer will have relatively less importance than if the issuer were providing credit enhancement to the structure by holding subordinate securities.
- **Stability of the Loan Servicing Arrangements.** Because the likelihood of the investor receiving payments is heavily reliant on the ability of the entity servicing the underlying loans, this assessment may include the provision of a backup servicer with significant financial stability. Such a backup servicer would step in to service the underlying loans in the event that the initial servicer suffered financial or operational difficulties.
- **Delinquency and Default/Recovery Performance of the Underlying Assets.** This assessment is time-consuming and it also can benefit the most from the availability of historical performance data based on comparable loans. These data are most valuable if they represent many loans that stretch over a long period (for example, more than ten years) in order to generate statistically predictive models. The profiles of the assets themselves and of the borrowers represented by the underlying assets are used to determine the benchmarks to which the pool will be compared. Data about the assets themselves will include term and amortization of the loans, interest rate, presence and type of collateral, loan purpose, and loan amounts. Data about the borrowers will include the location of borrowers, debt coverage ratios, loan-to-value ratios, and credit scores.

The following are some typical components considered in the assessment of duration risk for an investor in an asset-backed or mortgage-backed security:

- **Prepayment Performance.** This assessment will include the review of the terms in the loan documents regarding prepayment penalties, in addition to an assessment of the interest rates on the underlying assets compared to current market rates. Investors will assume that loans with interest rates well above current market rates have a greater likelihood of early repayment.
- **Priority of Payment for the Class of Securities.** This is an assessment of the projected maturity of the particular class of a security. Investors with a low tolerance for prepayment risk may buy classes with shorter maturities because they are less likely to be affected by prepayments.

- **Liquidity of the Securities.** Investors may consider their ability to trade securities to other buyers as a means of managing their risk over the long term. Many factors can affect this characteristic, but as a general rule rated securities are more liquid than those that are unrated.

## Case Studies in Providing More and Better Data for Investors

CRF has issued asset-backed securities for more than 15 years. During the first 12 of those years, all of CRF's securities were privately placed and unrated. Most of the pools of loans backing these securities were small (under \$25 million) and were placed largely with socially motivated and CRA-motivated investors. Over \$200 million in asset-backed securities were placed with investors during this time. CRF will continue to use privately placed and unrated asset-backed structures in the future when that is the most effective method of placing certain assets.

In 2004, CRF offered two privately placed securities that were rated by Standard & Poor's. The first was issued by CRF Affordable Housing No. 2 LLC (Affordable Housing 2) as an \$85 million Real Estate Mortgage Investment Conduit (REMIC) security backed by 50 mortgage loans made to owners of affordable multifamily rental projects that had been developed using the Low Income Housing Tax Credit. The second was issued by CRF-17 LLC (CRF-17) as a \$46 million revenue note offering backed by 128 loans made to owners of small businesses and secured by their business real estate. Both offerings presented considerable data challenges, but the challenges faced in the two cases were very different.

### *Affordable Housing 2*

In preparing the Affordable Housing 2 offering, CRF faced few challenges with providing the data needed by the rating agency. Standard & Poor's had previously reviewed many offerings backed by affordable multifamily rental housing loans, so their standards were relatively well known. Also, the REMIC security structure was well defined. The rating process resulted in 95 percent of the certificates being rated, with 75 percent of the certificates rated AAA.

The data issues arose when the offering was presented to investors. There is relatively little prepayment and default data for loans on projects developed using the Low Income Housing Tax Credit, and the particular loans in the pool did not have uniform prepayment penalties. In fact, many of the loans had no prepayment penalties or yield maintenance premiums at all. In response, investors varied widely in the assumptions they used to determine their duration risk. As a result, investors were pricing the securities at very different places on the yield curve (which at the time was a "normal" yield curve, with long-term interest rates higher than short-term rates). This in turn resulted in pricing that was worse than CRF had estimated in buying the loans. Eventually, CRF was able to provide information that allowed investors to price the securities at levels closer to those that CRF had expected and the sale was completed.

As a result of this experience, CRF has taken two actions to improve the results of similar offerings in the future. First, it has revised its pricing analysis to take into consideration the actual prepayment and yield maintenance terms of the loans it purchases. Second, CRF has presented information to the loan originators from which it purchases most of its loans to demonstrate the importance of including yield maintenance provisions in the loans they originate.

### *CRF-17*

In preparing the CRF-17 offering, the data challenges that CRF faced were quite different from those faced in the Affordable Housing 2 transaction. When preparing for the CRF-17 transaction, CRF was aware that there was little experience at any of the rating agencies with rating securities backed by pools of small business loans. Standard & Poor's (S&P) was the rating agency with the most experience and it had rated fewer than 25 such offerings in its history. Accordingly, CRF set out to develop a form of benchmark data. Working with the organization Wall Street Without Walls, CRF was able to obtain data on the performance of more than 40,000 loans totaling \$14 billion that backed Small Business Administration (SBA) debentures under its Section 504 program.<sup>1</sup> CRF had requested that Wall Street Without Walls obtain this information because the loans originated under the Section 504 program were similar to loans that CRF was purchasing under its Business Loan Program, namely, loans to small businesses that are secured by the owner-occupied commercial real estate in which the businesses operate. Thus, this data provided CRF with a proxy that it could use to describe the likely performance of its small business loan pool, which comprised fewer than 1,000 loans since its inception.

CRF worked with its financial advisor, Wilary Winn LLC, to analyze further the SBA 504 data to establish an appropriate Constant Default Rate (CDR), which is the security industry's accepted method of stating the rate at which loans can be expected to default during the life of a pool. CDR is a critical variable used by investors to structure the expected cash flows for a pool of loans. CRF also obtained historical prepayment data for the SBA 504 debentures from publicly available sources and, with the help of Wilary Winn, converted that data to the other widely used metric in securitization—Constant Prepayment Rate (CPR). Armed with these critical metrics developed using the SBA 504 data as its proxy, CRF was ready to present its small business loan pool to Standard & Poor's.

Standard & Poor's ultimately used a very different methodology for determining the default percentages for the "stress tests." S&P determined the subordination levels necessary to obtain ratings for the senior classes of the CRF-17 security. However, the base cashflows and CRF's methodology for valuing and pricing its small business loans were established using the SBA proxy data as a guide.

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<sup>1</sup> Wall Street Without Walls unpublished paper "SBA Section 504 Certified Development Company Program Analysis of Historical Debenture Performance," December, 2003

### **CRF-18**

The levels of subordination required by S&P for CRF-17 were disappointingly high, but CRF proceeded with the transaction with the knowledge that its next pool would likely receive better subordination levels. In fact, when CRF-18 was closed in June 2006, subordination levels improved by 15 percentage points. This meant that the percentage of bonds rated investment grade (BBB or better) increased from 66 percent to 81 percent. This was attributable in part to the fact that CRF achieved greater “granularity” with its loan pool, meaning that there were more loans (188 versus 128) and fewer very large loans (the top 7 percent of loans by count representing the top 30 percent of principal balances versus the top 8 percent of loans representing the top 41 percent of the principal balances). A bigger contributor to the improvement, however, was the development by S&P of a new statistical model for evaluating pools of small business loans. This model also utilizes SBA data, but from the SBA 7(a) program rather than the 504 program. The data analyzed by S&P contains data on loans from 10,000 originators that made 650,000 loans in all fifty states and contains static pool information stretching over twenty years.<sup>2</sup>

### **Lessons Learned About Data and Proxy Data for Other Types of Community Development Loans**

By moving beyond the relatively safe environs of nonrated pools of loans placed with socially motivated and CRA-motivated investors to the world of rated transactions, CRF was forced to learn about the loan characteristics and the metrics for expressing those characteristics that are important to achieving more efficient pooled transactions with investors. These exercises have resulted in value differences of well over \$800,000, realized through better executions on the securities it sells. Even if CRF chooses to use unrated transactions in the future, these same data and metrics can help in negotiations with investors to achieve more efficient transactions. At its heart, better data means that more institutional investors get to see how well these loans perform and what it means to have their dollars supporting minority-owned businesses, charter schools, health-care centers, and job creation. It would have been impossible for CRF to accomplish this groundbreaking research without the financial support of the MacArthur Foundation, the Heron Foundation, the Fannie Mae Foundation, the Prudential Social Investments Program, Wall Street Without Walls and others.

As the examples demonstrate, data are essential to any investment decision. CRF believes there may be other community development assets that can benefit from developing proxy databases and sample loan pools to test within the ratings environment in a manner similar to CRF-17 and CRF-18. CRF is currently participating in a group effort with seven other CDFIs to test this premise with a sample pool of loans made to finance the purchase of buildings to house charter schools. A similar effort may be forthcoming on a pool of loans made to owners of small multifamily rental properties.

<sup>2</sup> Standard and Poor’s Structured Finance publication “Standard & Poor’s Introduces U.S. Small-Business Portfolio Model,” February, 2005, provides an excellent description of the methodology they used in developing this model.

Important suggestions were raised at the conference on the development of a master servicer that could both reduce servicing costs for CDFIs and gather and centralize much of the data that investors would want. How this organization is funded and who might be in charge is still an open question. In the meantime, however, it would be important to find out what servicing responsibilities CDFIs are willing to outsource and to get investors (including rating agencies, public agencies, and foundations) to agree on a format for reporting. It might even be possible to use an existing platform that could be modified slightly to meet the needs of the community development investing community.

There seem to be a limitless number of tasks that need to be performed to get a clearer data picture going forward. Other efforts might focus on cataloguing what is currently being collected by the CDFI Fund, the Small Business Administration, the Opportunity Finance Network's CARS program, and the like. And on the other side, there is a long way to go to find out exactly what investors want. Fannie Mae, for example, collects a tremendous amount of data but tends to focus on a few key variables when it makes its assessment of investment worthiness. Perhaps institutional or capital markets investors could identify what their key variables are? They might also shed new light on what proxy variables might be the most useful for making performance predictions on new asset classes (for example, charter schools).

Finally, some entities—government or philanthropic—might consider subsidizing data collection. Many at the conference recognized that staffs are already overworked and assuming the responsibility for surveys or some other data collection tool on top of existing responsibilities seems unlikely. On the other hand, if there was an incentive to participate in a data-collection system (for example, a way to make something like loan servicing easier by using new software), there might be increased interest to participate. More data could bring a clearer picture of community development assets and help community development lenders get a fair price for their assets.

*Mary Tingerthal is Senior Vice President, Capital Markets for the Community Reinvestment Fund (CRF), a national secondary market for community development loans, based in Minneapolis. She joined CRF in 2000, after serving for four years as president and chief executive officer of the National Equity Fund (NEF)—one of the oldest and largest Low Income Housing Tax Credit funds in the country. Before joining NEF, Mary served as managing director for GMAC Residential Funding Corporation (GMAC-RFC), a major financial services firm that specializes in the securitization of real estate assets.*

## Growing Pains

*Douglas Winn*

*President, Wilary Winn*

Much has been said about the challenges of selling pools of loans into the capital markets via securitization or other techniques. In our experience, the actual sale is often the least difficult part of the process. The reason is that organizations can draw on the skills of a range of experts who can help with that part of the process. Attorneys are available who can guide organizations through the complexities of securities law; financial consultants offer advice regarding the proper accounting under generally accepted accounting principles and evaluate structuring alternatives; and investment bankers stand ready to market the securities. The belief at our firm is that the process leading up to the sale is often more challenging than the sale itself. What follows is an overview of the skills, resources, and risk management techniques needed to sell pools of loans.

### **Preparing to Access the Capital Markets**

While accessing the capital markets can lower an organization's cost of funds, it also has its own costs and risks. Accumulating a sufficient volume of loans to be able to efficiently access the capital markets puts pressure on an organization's financial resources and organizational infrastructure. It also introduces potential new threats to the firm's well-being, including interest-rate risk and additional challenges managing the balance sheet.

The first step an organization must take to access the capital markets is to build the right team. An organization needs to select attorneys that have extensive experience with asset-backed securities transactions in order to move quickly and efficiently through the numerous challenges associated with securitization-related documentation. In addition, it must select an investment banker that will play the critical roles of first interfacing with the rating agency to determine the optimal deal structure and then selling the notes created from the securitization transaction. In addition, the organization should identify a servicer, backup servicer, custodian, and trustee with capital markets experience.

Because securitization is a sophisticated transaction involving numerous outside experts, organizations will face complex negotiations on fees. Retaining a financial advisor to assist with these negotiations can help ensure transaction costs stay under control.

To effectively manage the accumulation and securitization processes, organizations may have to develop new financial models, or enhance their existing models. For example, in order to estimate the sales proceeds from securitization and the resulting gain on sale, we worked with one of our clients to develop and implement a financial model that produces Public Securities Association (PSA) standard cash flows from a loan-level collateral file. This

allowed our client to aggregate collateral cash flows to determine the optimal securitization structure and perform stress tests under various loss and prepayment scenarios.

By being able to model alternative securitization structures relatively quickly, our client was able to evaluate credit-enhancement alternatives. For example, they wanted to determine if using bond insurance would compress the spread required by the investors enough to pay for the cost of the insurance. In our client's case, they concluded that a senior/subordinated structure would result in less overall cost.

Organizations may also have to enhance their existing financial reporting. In our experience, many organizations do not carefully monitor the loans in their pipelines. We believe careful monitoring of loans in the pipeline is critical in order to minimize accumulation and interest-rate risk. For example, we have worked with our clients to develop systems to track the progress of the loans in the pipeline so that they know when the loans are likely to close and ensure they will have adequate financial resources in place to fund it.

### **Developing the Financial Wherewithal to Accumulate Pools**

Our clients often lack the internal financial resources to be able to accumulate pools of loans for sale. As a result, they enter into short-term borrowing arrangements with commercial or investment banks. The organization closes a loan and then borrows against the loan's value using a revolving line of credit. Often referred to as a warehouse line, the line of credit is repaid after the sale is executed. In general, a warehouse lender will not advance 100 percent of the loan amount. In our experience, the advance rate depends on the type of underlying loan and ranges from 75 to 98 percent. A typical advance rate for commercial loans is 80 percent. The organization accumulating the loans finances the difference, or "haircut," with its own cash.

The warehouse lines of credit generally include financial covenants that specify minimum net worth and limit the line of credit amount to a specified multiple of net worth – generally five or six times. Thus, an organization planning to accumulate \$100 million of loans for sale would need \$20 million of its own liquidity to finance a 20 percent haircut. It would also need \$16.7 million of net worth to support the \$100 million line, assuming the leverage ratio was six to one.

Thus, the accumulation of loans for a securitization can rapidly deplete liquidity as an organization funds the haircut. In addition, growing the balance sheet to accumulate the loans can strain the financial covenants contained in the organization's warehouse agreement and other financial contracts.

### **Telling Your Story to Investors and Rating Agencies**

We note that an organization that wants to access the capital markets needs systems that can provide data on the performance of loans originated by the organization, including detailed information on historical default, recovery, loss, and delinquencies. This performance



information is required by the rating agencies to help assess risk. Without this information, the investment bankers will not have any support for their discussions with the rating agencies on expected performance. This will most likely result in the rating agency making extremely conservative guesses as to the expected performance of the collateral and much less favorable securitization execution. In addition, historical prepayment speeds are needed to estimate the average lives of the securities and set pricing benchmarks. [For more detail on data issues, see Mary Tingerthal's article of this issue.]

## Managing The Risks

When an organization enters the world of using capital market investments, it is introduced to new risks. Three leading risks are loan pricing, interest-rate risk, and risks around managing a balance sheet.

Securitization adds complexity to loan pricing and organizations often have to develop new pricing models to match their securitization exit strategy. The securitization model scenario results can be used to develop loan pricing models that are in sync with the organization's expected securitization proceeds and gain on sale. Loan pricing should include the forecasted interest expense on the securities, expected future losses, costs to originate a loan, securitization transaction expenses, credit enhancement expenses, the required rate of return for subordinate retained interest positions, and the organization's required spread or margin of return.

The accumulation of long-term fixed-rate loans for a sale results in substantial interest rate risk because even relatively small increases in market interest rates can have a relatively large effect on the value of the loan because of its long duration. Depending on the type of loan, for every market movement of one percent the value of the loan changes by four to eight percent.

Organizations can mitigate interest-rate risk by developing and implementing an interest-rate risk management, or hedging program, designed to protect against changes in market interest rates. There are myriad potential hedges in the marketplace and the selection of the hedge that is right for an organization depends on the organization's overall hedging philosophy. One of our clients, for example, buys insurance for protection from a disaster by purchasing out-of-the-money interest rate caps. If market interest rates increase past the cap, our client receives payments from the hedge counterparty. If rates fall or rise, but not past the cap, the cap will expire without value to our client.

Another client hedges to protect the spread on the loans it originates and the projected gain from the sale of the loan. To do this, the client shorts U.S. Treasury securities futures with durations comparable to the underlying loans. If market interest rates increase, the hedge increases in value, offsetting the loss on the underlying loans. If, however, market rates decrease, the organization's projected gain on sale increases and its hedge positions decrease in value.

As another example, our clients allow customers to lock-in the rate on their loan before closing. We work with these clients to develop processes and programs to ensure that data on these commitments is accumulated at least daily in order for them to be able to adjust their hedge positions. Thus, our clients will have gains in their hedge positions to offset losses they would incur by funding loans at a loss if market interest rates have risen subsequent to their issuing a commitment to purchase the loan at a specified rate.

One of the keys to a successful hedging program is the quality of the information used to make the hedging decision. We have worked with clients to develop daily position and mark-to-market reports to ensure they have the information they need to make good hedging decisions, to forecast liquidity needs, and to facilitate proper financial accounting and reporting. (We note that marking the hedge to market is straightforward, as the hedge instruments trade daily in the capital markets, while marking the loans held for sale to market is more of a “art form,” which requires making estimated guesses.)

Finally, accumulating loans for sale can cause an organization’s balance sheet to swell and the organization to begin to bump up against the financial covenant limitations of its various debt agreements. To improve monitoring of these covenants and facilitate communication with its lenders, we have worked with clients to upgrade their financial forecasting capabilities so that they can reforecast expected results on a rolling twelve-month basis, including reforecasting of covenant compliance.

Retaining subordinate bonds arising from the securitization can create asset/liability management challenges. We have worked with organizations to forecast the timing of the estimated cash flow to be received from the subordinated positions in order to ensure our clients have sufficient long-term financial resources to be able to hold them.

Securitization also presents financial accounting and reporting challenges. In fact, the proper accounting for securitization has figured prominently in the recent requirements issued by the Financial Accounting Standards Board (SFAS’s # 155 and #156) and requirements that are apt to significantly affect the proper accounting and reporting for these sales is pending (exposure draft to amend SFAS #140).

## **Going Forward: Strategies For Growth**

Asset-backed securitization represents a powerful financial tool for the community development industry. From its relatively modest beginnings in the 1970s, the asset-backed securities marketplace has grown substantially and trillions of dollars of such securities are now sold each year. Nevertheless, accumulating and securitizing loans is a complex process. To be successful, organizations must ensure that they have sufficient financial resources to be able to undertake the transaction; that they properly manage interest-rate risk during the accumulation period; and that they have the proper financial infrastructure in place to manage the process. At the Federal Reserve’s securitization conference, two themes emerged that we thought were responsive to these challenges: the importance of collaborative network structures, and the need for training for CDFIs in the complexities of preparing these transactions.

We believe the complexities and challenges of securitization can be met best through collaboration. We are currently working with the Housing Partnership Network (HPN) and a group of nonprofit financial intermediaries to explore the feasibility of forming a conduit to accumulate charter school loans for sale into the secondary market. We are also working with HPN and a second group of financial intermediaries to explore the formation of a conduit to accumulate and sell single family residential mortgage loans. We believe conduits are an efficient way to accumulate loans in order to get to the scale required for a securitization, to manage the complexities of the process, and to spread the overhead costs related to the effort.

We started this article with the observation that the trickiest part of the securitization process is often the process leading up to the sale, including the process of acquiring or developing the finance skills necessary to engineer these transactions. We believe that a targeted series of trainings on these skills for CDFIs would be valuable to the industry, and could play an important role in increasing the number of organizations ready for the capital markets. A series of such training sessions might include:

- A session on building financial infrastructure (tracking loans, decreasing cycle times, developing systems to manage liquidity, determining the effect of accumulation on asset/liability management, securing and negotiating a warehouse line of credit) in order to be able to efficiently and more safely accumulate loans.
- A session on interest rate risk management that would show how to develop and implement hedges (swaps, caps, futures, etc.) to mitigate interest rate risk as loans are accumulated for eventual sale.
- A session on loan pricing – how to price loans based on the expected securitization execution (subordination levels and anticipated spread by ratings level); expected prepayment, expected default, expected loss severity, and required return.
- A session on the basics of securitization including: assembling the team and their roles; forms of credit enhancement and the relative advantages and disadvantages of each type; dealing with the rating agencies and bond insurers; the importance of servicing; and the roles of the trustee, master servicer and custodian, etc.

While the prospect of pooling and securitizing loans can be daunting, the number of lenders doing it successfully is growing, and the organizations and finance experts that can assist in the process are numerous. With the right combination of experience and expertise, access to the capital markets can become a key part of the funding strategy for community development organizations.

*Douglas Winn is president of Wilary Winn, a financial consulting firm that provides advice regarding asset-backed securitization, mortgage banking and interest rate risk management to organizations located across the country, including for profit and nonprofit financial intermediaries, banks and credit unions. Its nonprofit clients include Community Reinvestment Fund, Low Income Investment Fund, Housing Partnership Securities, Housing Partnership Network, and NCB Capital Impact.*

# Bridging the Information Gap between Capital Markets Investors and CDFIs

*Ellen Seidman*

*Executive Vice President, National Policy and Partnership Development  
ShoreBank Corporation*

**T**he problem of efficiently matching buyer and seller is both ancient and ubiquitous. It is, of course, the source of the concepts of brokerage and intermediation. The situation in which sellers are small, traditional and local and buyers large, sophisticated, and national or, indeed, global, is an especially difficult one to get right—especially from the perspective of the sellers. But it is also the situation in which modern technology may be most useful.<sup>1</sup>

This ancient dilemma resembles the problem of connecting the CDFI industry to the capital markets. The vast majority of CDFIs are small and local, and, to the extent anything can be traditional in an industry barely twenty-five years old, traditional in the sense that they are structured as vertically integrated portfolio lenders heavily reliant on low-cost funding. The capital markets are huge, efficient, market-based, and global. Even the most sophisticated CDFIs find them difficult and often frustrating to access.

The disconnect exists on a number of levels, including scale, structure, and systems. But as important as these items are, the lack of understanding by potential buyers and sellers of each others' needs may be a bigger barrier. In other words—and this was repeated many times during the September 2006, Secondary Markets Conference sponsored jointly by the Federal Reserve Bank of San Francisco and the Federal Reserve Board of Governors—information asymmetry may be at least as much a barrier as scale, structure, and systems.

## **Understanding the Motivation of CRA Investors: A Typology**

One way to bridge community development loan products to the investor community is to develop a better understanding of what motivates investors. Dan Letendre, director of Merrill Lynch Community Development Company, asserted that while the conventional capital markets, including the structured finance markets, may not be quite ready for CDFIs, capital markets investors with obligations under the Community Reinvestment Act (including, perhaps, some in industries attempting to avoid such obligations) are ready to deal. But it is critical that CDFIs understand what those investors want and that they do not all want the same thing. Moreover, even the same bank or other type of investor may want different things at different times, potentially even in different parts of the organization.

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<sup>1</sup> For a fascinating example of technology overcoming ancient barriers to sellers finding efficient markets, see "Information Technology to the Poor," in C. K. Prahalad, *The Fortune at the Bottom of the Pyramid*, Wharton School Publishing (2006).

Letendre posited a typology of three types of CRA-motivated investors: (1) volume investors, (2) innovators, and (3) yield shoppers.

CRA volume investors are organizations that know they will need loans beyond their own production on their books for their next CRA exam. These investors are in general looking to purchase high volumes of relatively short-term, low-risk, easily understood loans. Bigger is better; \$10 million is about the smallest transaction they are willing to do. They are most interested in working with organizations that can assure them of a steady stream of such loans year after year. The good news is that these investors tend not to be particularly yield sensitive, although, as with all capital markets investors, the loans must at least fully cover the investors' cost of funds, including transaction costs.

Innovator investors are at the other end of the CRA spectrum. These investors have in general satisfied their CRA volume expectations, but they are looking for that added "plus" of "innovative, complex, and flexible" to impress both examiners and the public. Like volume investors, innovators tend to be relatively insensitive to yield. They are also interested in nonstandard transactions, and frequently they have an appetite for somewhat higher-risk transactions. The bad news here is that these investors are willing to buy only relatively small volumes. And, as with all CRA investors (but especially this group), location matters. Although consolidation in the banking industry has made it relatively easier to meet the geographic targets of the largest institutions, even they have greater needs in some markets than in others, and for regional and smaller institutions location is an even greater issue.

Between volume and innovator investors are yield shoppers. These investors view community development lending as a business. They want volume, and they care about the fees and yields they earn. They are interested in usage. If they are willing to provide a \$10 million line of credit, the goal is to make sure the line is fully drawn down and remains outstanding over a long period. To keep transaction costs down, these investors are most interested in establishing structures, such as lines of credit, that can be created once and used for high volumes over an extended period.

Faced with this spectrum of investor needs, Letendre argued that at least the largest CDFIs should be able to find a market for much of their product. Doing so may require structuring transactions, including being willing to engage in swaps to turn fixed-rate CDFI paper into the floating-rate paper many investors want, and also a willingness to hold on to a subordinate piece of a transaction, or to structure a pool into tranches. But when a high-quality, strong, and productive CDFI finally becomes equity constrained, Letendre argued, the market will be there for the easiest-to-understand, least risky loans that were made at market rate.

Securitization is not an all-or-nothing situation. Like financial institutions hundreds of times their size, CDFIs will do best if they can execute a variety of strategies, including selling an existing portfolio of seasoned loans, originating for sale, and recognizing that the most complex and difficult transactions they do to meet the needs of their customers will most likely have to be held on their balance sheets.

## Other Investors, Other Needs

The concept of “know your investor’s needs” applies to philanthropic investors as well as to capital markets buyers. More foundations are beginning to do Program Related Investments (PRIs) and others are starting to look at Mission-Related Investments (MRIs).<sup>2</sup> Here, too, understanding investors’ needs is critical to being able to access these investments.

For foundation investors, the critical issue is program: What is the foundation’s mission, what is it attempting to accomplish, and, for many, where? For example, Christa Velasquez, director of social investments for the Annie E. Casey Foundation, said that her organization focuses on children and families, and it is interested in very specific geographic locations. It is a waste of everyone’s time to attempt to interest the Casey Foundation in small business loans, especially outside its target geographies. The implication is that, even among the foundations that do community development investing, it is important not to assume that because one foundation is interested in a transaction or a portfolio, the others will be also.

Socially responsible investors are similar, according to Bruce Sorensen of Piper Jaffray. Some are interested in specific types of products, such as health clinics or charter schools, and many have specific geographic interests. Understanding those needs, and matching the CDFI’s product and sales pitch to them, is critical to obtaining the investment.

## How Can We Improve CDFI Access to Investors?

Conference participants reached four major recommendations about how better to match CDFI and investors:

- Establish some sort of dynamic information exchange. Conference participants had many ideas, ranging from establishing a MySpace-type network, to creating a “deal clearinghouse,” to “speed dating” sessions among CDFIs and investors. Enacting such ideas would better enable the buyers (including socially motivated investors) and sellers to find each other. The critical element of this recommendation was that the information needed to be dynamic and up to date. Participants did not discuss issues such as requirements for access (of both potential buyers and sellers), which would need to be part of the development of such a system.
- Improve the financial capacity of the most capital-markets-ready CDFIs. This idea has multiple dimensions, including understanding and meeting the special needs (such as warehouse lines, hedging) of organizations that are moving to significantly higher volumes, and to originating loans with the intention of selling them; understanding the needs of the markets and how to structure transactions to be attractive to investors; and having the vocabulary and contacts to be able to access the

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<sup>2</sup>Program Related Investments (PRIs) are transactions with concessionary terms that are made out of a foundation’s program budget and count against the foundation’s annual distribution requirements. Mission-Related Investments (MRIs) are part of a foundation’s investment portfolio, and, while they further the foundation’s mission, they are market-rate investments.

markets and make the best deals from the perspective of the CDFI. Potentially the CDFI Fund could make special, matched grants to high-performing CDFIs for this purpose, which would enhance the ability of those institutions not only to increase scale but also to serve as aggregators for smaller institutions.

- Find the successor to the equity-equivalent investment, or EQ2. The EQ2, a deeply subordinated loan, usually at below-market rates, with a flexible maturity date, has been important to many CDFIs, but it has become virtually extinct. One conference participant characterized EQ2s as “private equity at risk-free rates,” not, in general, an attractive instrument. Mary Tingerthal of the Community Reinvestment Fund, however, said that the rate was not the important element for many CDFIs, but rather the deep subordination. Subordinated debt that was treated as equity by other lenders would help CDFIs leverage their funds dramatically. Would it be possible to develop a market-rate EQ2, perhaps as an MRI?
- Consider development of mechanisms, such as some sort of insurance or wrap product or an industrywide interest-swap mechanism, that would make the CDFI-investor relationship more like that of other sellers into the capital markets, rather than a series of special needs and “story” investments.

## Conclusion

It is not surprising that CDFIs and capital markets investors have trouble finding each other and creating an efficient market. But there are willing buyers and willing sellers. Helping each understand the needs of the other in a dynamic and efficient manner could significantly improve results for both sides.

*Ellen Seidman is Executive Vice President for National Policy and Partnership Development with ShoreBank Corporation, the nation’s first and leading community development and environmental bank holding company. She was the Director of the Office of Thrift Supervision from 1997 to 2001.*

# Strategies for Selling Smaller Pools of Loans

*John McCarthy*

*Executive Vice President, Community Preservation Corporation*

In September 2006, the Federal Reserve hosted a conference on secondary markets for community development loans. A theme that emerged was that techniques, programs, and structures that work for large loans do not necessarily work for small ones. In this article, I briefly outline why smaller deals can be more difficult to finance, and describe two ways in which the Community Preservation Corporation (CPC) has used unrated transactions to overcome these obstacles. Finally, I suggest that a broad secondary market for small loans is more likely to grow organically from numerous small transactions, rather than by a herculean effort to create a copy of the commercial mortgage-backed securities market. I also suggest how the Federal Reserve could help speed this growth.

## **The Need for Different Techniques for Smaller Deals**

Despite the well-known obstacles to creating a secondary market for community development loans, it is possible to get pools of these loans rated and sold to investors. The Community Reinvestment Fund proved this with two rated securities, CRF-17 and CRF-18, which were salable in the general capital markets. CPC attracted institutional investors in a different way by swapping mortgage pools for investment-grade GSE securities (in two transactions totaling \$70 million). These are laudable achievements. They could be replicated for other similar asset pools, but many community development assets are not at all similar to these. In fact, we have found that securing a rating, whether from a public ratings agency or from a GSE, is not a workable strategy for large numbers of community development assets.

A rated security transaction can work for some community development asset types, but not for others. First, the transaction costs are too high for small deals. Public ratings cost \$75,000 or more—plainly prohibitive on small deals—and legal fees are also a high fixed cost. Second, many community development originators do not collect the extensive project-level data that GSEs require, nor are project owners on these loans accustomed to supplying this information. Intensive data collection not only raises transaction costs, but it may alienate both originators and borrowers of community development loans. Lenders in this area pride themselves on flexibility in financing complex projects, and may have difficulty enforcing inflexible, non-negotiable demands for copious data on their customers. Finally, community development loans often do not have the historical data necessary to forecast prepayment rates, delinquency rates, and other data required for the sale of investment-grade securities.

Given these obstacles, another approach to consider is the issuance of an unrated security. Two successful ways of using this approach are discussed below, one using insurance and the other employing pooling and tranching.



## State and Local Government Mortgage Insurance

Both the State of New York and New York City have entities that insure community development mortgages. They are the State of New York Mortgage Agency (SONYMA) and the City's Residential Mortgage Insurance Corporation (REMIC). Both were created in the 1970s to encourage investors to purchase risky urban long-term mortgages. The state funds SONYMA with dedicated tax revenue and the city funded REMIC with a capital grant. The capital bases of both entities grew over time from new investment and from premiums. Losses in these programs have been negligible, and the SONYMA is rated AA.

SONYMA and REMIC pay first losses on a default, up to a cap. The cap amount varies from 20 percent to 75 percent of the loan amount, depending on loan type, though loans owned by public employee pension funds receive 100 percent insurance. The "loss" definition is comprehensive, covering interest, principal, and the costs of litigation and property protection. Payment is made upon conclusion of foreclosure or deed-in-lieu. Mortgages bought by public employee pension funds receive monthly periodic payments for the two years following four consecutive months of default.

SONYMA and REMIC provide insurance on individual whole loans (REMIC currently is not writing new insurance business). Both insurers review the underwriting of the individual loan. This loan-by-loan review is workable, as both agencies are local, and so are thoroughly familiar with the markets and developers, including the special features of community development loans. This familiarity, and the staff's responsiveness, makes this mortgage product a highly effective and flexible tool to credit enhance mortgage loan pools.

## Tranches in Pools<sup>1</sup>

CPC was forced to consider different securitization strategies, however, because SONYMA and REMIC did not insure construction loans, which are a substantial need in our markets. CPC also faces capacity constraints. Its annual construction loan origination volume is roughly twice its warehouse line capacity.

While a standard private loan sale worked well for large construction loans—investors re-underwrote each loan and purchased pro rata shares with priority on remittances equal to CPC's—the same technique did not work for small construction loans. Because banks allocate administrative overhead for investments, earnings after overhead on a 50 percent share of a small loan generally would be insufficient to meet a bank's revenue requirements. To create the needed transaction size, CPC pooled these smaller construction loans and sold senior tranches in the pools. As CPC closes new loans, it assembles pools to meet investor needs. Pools have been as small as \$3 million, and the largest have been more than \$50 million. Importantly, CRA-motivated investors can receive pools of loans located in low- and moderate-income census tracts in the banks' assessment areas.

<sup>1</sup> For a fuller explication of these securities, see the article in the June 2006 *Community Development Investment Review* at <http://www.frbsf.org/publications/community/review/062006/mccarthy.pdf>.

Typically, these pools have a senior tranche that is 80 percent of the pool and CPC retains the other 20 percent. The senior investor has first call on remittances on all loans in the pool and CPC receives the remainder. If delinquencies late in a pool's life were to cause shortfalls for the senior tranche investor, it can "claw-back" previously received sums from CPC.

This credit structure substantially simplifies an investor's conclusion of investment strength. If, for instance, all pool loans were underwritten at 75 percent of cost, the 80 percent senior tranche is, in effect, a 60 percent-of-cost position. In other words, investors at the senior tranche level have a 40 percent cushion before they would experience real economic losses. This would be a relatively low-risk credit even for a single loan. The pool is even less risky through diversification among all the loans in the pool. This strong credit structure in favor of the senior tranche investor enables more streamlined due diligence, and therefore lowers the administrative costs. In nearly three years, in over \$400 million in pools, there has not been a single month in which a senior tranche share failed to be paid in full. Finally, there is no interest-rate risk since the loans in the pool have a floating rate.

The tranche structure created a secondary market by bundling community development construction loans and creating a tranche asset as a stronger credit than any one individual loan. This credit strength by itself, though, only partly addressed investors' need to control administrative overhead in reviewing and closing the investment. The bundling yielded a strong credit but also enabled a shorter, faster due diligence review to verify the credit strength. In this review, it was not necessary to re-underwrite each loan, as would have been the case for single-loan, *pari passu* participations.

In this review, however, bank investors still had to note features of individual loan assets. To keep this process as efficient as possible, CPC adopted standard loan documents and prepared loan files with standard naming conventions (i.e., the same document always has the same name). There is also a standard file order (i.e., the same document is always in the same location). These naming conventions streamline the reviews of multiple files. Lastly, all documents are scanned in Adobe PDF format, suitable for electronic delivery. Prospective investors can review all loan files electronically, in their own office, and can make on-site visits to inspect individual loan files if necessary.

The tranche structure has been very popular with both CRA-motivated investors and other investors who simply seek a strong, floating-rate asset, with roughly a two-year life. CPC now uses this structure for most of the construction loans it closes. Investor demand for this loan product exceeds the supply. CPC has also begun to use it with the permanent loan pools.

## Conclusion

From the secondary investor's point of view, a viable secondary market depends on an ability to: (1) acquire a meaningful volume of loans, (2) ascertain the soundness of the loan assets, and (3) execute transactions with acceptable transaction costs. For many community

development originators, these criteria may be met with relationships with secondary market investors that, for various reasons, “know the story” of the originator and its community development asset type. These investors, while favorably inclined to buy the assets, will buy even more readily with credit enhancement. Unfortunately, given the small size of most community development investments, their heterogeneous loan terms, and other factors, investment-grade enhancements are unlikely to be achievable.

A secondary market for community development assets is more likely to grow organically out of experiments in vehicles that are less costly and less complex than public ratings or GSE structures. This “organic” growth, however, will more quickly lead to larger, better vehicles if the experimenters are encouraged to standardize themselves as much as possible. For this to be possible, standardization criteria would be published on an advisory basis, and a centralized tracking mechanism would be established to record secondary sales. It would disseminate information on innovations, experiments, and sales as they occur, and evaluate the degree of conformity with the advisory criteria. The Federal Reserve might be a good candidate to fill this role. Eventually, numerous local experiments would probably converge on standardized parameters. A national model based on this approach could scale up to the point that it could access conventional markets and thereby bring the liquidity and pricing advantages now enjoyed by originators with access to today’s CMBS and GSE outlets.

*John McCarthy is the Executive Vice President of The Community Preservation Corporation, a non-profit affordable housing lender operating in New York and New Jersey. He is an attorney and a board member of various nonprofits active in affordable housing and community development.*

# Check Your Guns at the Door: How to Get Together to Establish a Secondary Market

**Catherine Dolan**

*Director, Community Development Finance  
Wachovia Corporation*

## Who Moved Community Development Finance's Cheese?

Most organizational development professionals are familiar with Spencer Johnson's book *Who Moved My Cheese?* Johnson's tale is simple but insightful and reveals profound truths about change. The four characters in the story live in a maze and they need to look for cheese to nourish them and make them happy. The characters are Sniff, Scurry, Hem, and Haw. "Cheese" is a metaphor for what you want in life, and "maze" is where you look for what you want.

In the story, the characters face unexpected change, and each deals with it differently. The interesting parallels that exist between the story and the current state of community development finance are telling.

In the community development finance industry, the "cheese" is capital. The "maze" is where one looks for capital. Historically, most corridors in the community development maze have led to banks and foundations. That's where the cheese was. Then one day the industry awoke to find that the cheese in these corridors was no longer plentiful and it didn't taste quite as good as everyone remembered from the old days.

While the traditional providers of capital, banks, and foundations will continue to be important sources for "cheese," the industry must find a way to access a new source—the global capital markets.

So what's a mouse to do? Do we mimic the behaviors and thoughts of Hem, who bemoans the fact that someone has taken away his cheese, and it's simply not fair because he is entitled to the cheese? Or do we look at the behaviors of Haw, who learns new processes that enable him to continually adapt to change so that he is better prepared the next time "someone moves his cheese"?

We can learn from the experience of developing countries. Thirty years ago, these countries relied heavily on Western banks for their source of financing. When Mexico defaulted on its bank debt in the early 1980s, the market for future capital to developing countries shut down, particularly in Latin America. And the market did not open again until some smart corporate finance professionals learned how to bypass the banks and tap the global institutional markets. These markets are comprised of pension funds, insurance companies, hedge funds, investment banks, mutual funds, and the like. The investors have different investment profiles than banks—different risk tolerances, time horizons, liquidity requirements, and accounting and regulatory standards, to name a few. Finance ministers in developing

countries, with the help of investment bankers and consultants, learned what the new investors wanted and designed products that would appeal to their appetites.

We can also learn from other sectors of the economy. Below-investment-grade companies, credit card companies, and first-time homebuyers experienced a similar reception from the banking industry and also found a way to reach beyond the appetite and risk profile of banks to tap the global capital markets. It may be time for the community development industry to do the same.

So how does the community development industry move beyond the old paradigm governing the availability of capital and get to these new sources? Once again, we can take some lessons from Johnson's story. One of the lessons that Haw takes away from his experience in the maze is that "Old Beliefs do not lead you to New Cheese." He also learns that "The Sooner you let go of the Old Cheese, the sooner you find some New Cheese."

To make a market in a new product or a new sector, size matters. Everyone knows that Government Sponsored Enterprises, or GSEs (Fannie Mae, Freddie Mac, and Ginnie Mae), make markets in home mortgages. They are a large enough source of liquidity for originators of home mortgages that they can set the standards for how mortgages must look to meet their requirements for purchase. Although there is no single capital provider large enough in the community development industry to make the market, if a number of the larger CDFIs, banks, foundations, and insurance companies that are currently active were to join forces, there might be an opportunity to set some standards and protocols that can begin to create inroads into the capital markets beyond the old corridors in the maze. Given their affordable-housing mandate, there is certainly a role for the GSEs, as well.

The key to getting started is to collaborate in making some small but important first steps. Put aside competitive rivalries, political positioning, and pride and reach consensus on practical objectives and efficient protocols. Identify a handful of successful examples of sourcing capital from the institutional markets and focus on replicating what works. Create standards for loan documentation. Adopt common accounting procedures. Collect and report loan performance data on a common platform. Partner with one or two investment banks and law firms to provide enough volume to reach economies of scale.

Many viable ideas such as these were identified at the meeting recently convened by the Federal Reserve. What we need now is courage to move out of our comfort zone and into the maze in search of new cheese.

As Haw came to realize, "It is Safer to Search in the Maze than Remain in a Cheeseless Situation." We should take to heart these simple words and join forces to make an overdue breakthrough into the global capital markets.

*Catherine Dolan is Director of Community Development Finance at Wachovia Corporation and is responsible for providing financial solutions targeted at the community development industry across the country. Wachovia's focus is on affordable housing, community service organizations, and economic development.*

## Attendees

Frank Altman

*Community Reinvestment Fund*

Nancy Andrews

*Low Income Investment Fund*

Dudley Benoit

*JPMorgan Chase & Co.*

Thomas Bledsoe

*The Housing Partnership Network*

Jeff Brenner

*NCB Development Corporation*

Mark Calabria

*Senator Richard Shelby's Office*

Bedelia Calhoun

*Board of Governors of the Federal Reserve System*

Linda Davenport

*CDFI Fund*

Robert W. Davenport

*The National Development Council*

Catherine Dolan

*Wachovia Corporation*

Annie Donovan

*NCB Development Corporation*

Leonard English

*The United Methodist Church  
General Board of Pension and Health Benefits*

David Erickson

*Federal Reserve Bank of San Francisco*

Joseph Firschein

*Fannie Mae*

Cheryl Fitzgerald

*Fannie Mae Foundation*

Mike Flanagan

*Rural Community Assistance Corporation*

Art Fleming

*Opportunity Finance Network*

Terri Fowlkes

*National Federation of CDCUs*

Ed Furash

*City First Bank of DC*

Alyssa Greenspan

*CRA Fund Advisors*

Ken Gross

*Neighborhood Housing Services of America*

Donald R. Hinkle-Brown

*The Reinvestment Fund*

Joy Hoffmann

*Federal Reserve Bank of San Francisco*

Cristal E. Jones

*Standard and Poor's Rating Services*

John Kastellic

*Key Bank*

Andy Kelman

*Friedman, Billings, Ramsey & Co., Inc.*

David Leopold

*Bank of America*

Dan Letendre

*Merrill Lynch Community Development Company*

Andrea Levere

*CFED*

Judd Levy

*Community Development Trust*

Beth Lipson

*Opportunity Finance Network*

Sheila Maith

*Board of Governors of the Federal Reserve System*

Wayne Marsden

*Wall Street Without Walls*

John McCarthy

*Community Preservation Corporation*

Jonathan Miller

*Senate Committee on Banking,  
Housing and Urban Affairs*

John Moon

*Board of Governors of the Federal Reserve System*

Kirsten Moy

*Aspen Institute*

Didem Nisanci

*Senator Jack Reed's Office*

## Attendees

John Olson

*Federal Reserve Bank of San Francisco*

John M. Quigley

*University of California, Berkeley*

Sharon Rapport

*Senator Jack Reed's Office*

Janneke Ratcliffe

*UNC Center for Community Capitalism*

Rebecca Regan

*Boston Community Capital*

Jack Richards

*Federal Reserve Bank of San Francisco*

Buzz Roberts

*Local Initiatives Support Corporation*

Clifford Rosenthal

*National Federation of CDCU*

Ruth Salzman

*Ruth Salzman Consulting*

David F. Sand

*Access Capital Strategies LLC*

Julia Sass Rubin

*Rutgers University*

Robert Schall

*Self-Help Ventures Fund*

Ann Schnare

*AB Schnare Associates*

Ellen Seidman

*ShoreBank Corporation*

Bill Shear

*Government Accountability Office*

Patience Singleton

*Senator Paul Sarbanes' Office*

Bruce Sorensen

*Piper Jaffray & Co.*

Greg Stanton

*Wall Street Without Walls*

Kara Stein

*Senator Jack Reed's Office*

Charles Tansey

*Neighborhood Reinvestment Corporation*

Jim Taylor

*Fannie Mae*

Kerwin Tesdell

*Community Development Venture Capital Alliance*

Mary Tingerthal

*Community Reinvestment Fund*

Scott Turner

*Federal Reserve Bank of San Francisco*

Robert Van Order

*Stephen M. Ross School of Business,  
University of Michigan*

Mary V. Vasys

*Vasys Consulting Ltd.*

Christa Velasquez

*The Annie E. Casey Foundation*

Douglas Winn

*Wilary Winn*

Betsy Zeidman

*Milken Institute*

Barry Zigas

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