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The Future of Community Development Investments

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(Excerpts from a panel discussion)

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On May 21, 2003, the Officers, Managers and selected staff of the Community Affairs Offices of the Federal Reserve System held a conference on community development issues which included a panel entitled "The Future of Community Development Investments." Panelists included Bob Taylor, Senior Vice President at Wells Fargo Bank and President of the Wells Fargo Bank Community Development Corporation, Dan Sheehy, President of Impact Community Capital, Frank Altman, President of the Community Reinvestment Fund, and Jim Reid, President of the Texas Mezzanine Fund. The panel was moderated by John Olson, Community Investment Specialist, Community Affairs Office of the San Francisco Federal Reserve Bank.

John Olson: To explore the issue of "the future of community development investments," we invited four distinguished panelists to offer their unique perspectives: Bob Taylor of Wells Fargo, to cover the perspective of a CRA-motivated investor, Dan Sheehy from Impact Community Capital, to cover the perspective of community development investors who are not motivated by the CRA, Frank Altman from the Community Reinvestment Fund, to share his views as a secondary market practitioner, and finally Jim Reid from the

Texas Mezzanine Fund, to give us an understanding of the "other side" as a CDFI recipient of community development investment. My thanks to each of you for participating today. I'd like to start with a broad overview from each of you on your role in the industry and trends that you're seeing—what are your reactions to some of the current issues we've been discussing today, such as possible changes to the CRA regulation and the impact of the proposed elimination of the tax on dividends.

Bob Taylor: I work for Wells Fargo and centrally manage community development investment activity for the bank in 23 states. The investments are centralized at Wells Fargo for a variety of reasons, but opportunities are identified within a decentralized management structure. We have a portfolio of $1 billion, roughly $500 million in Low Income Housing Tax Credits, $125 million in housing-related bonds, $125 million in real estate, and $150 million in equity equivalent investments. Our 2003 investment budget is $325 million, roughly the annual commitment in place since 1996. Prior to that, we had not done much investing, and at that time—when the new regulations came into effect—the industry didn't really know how much investing was going to be enough.

Over the last seven to nine years things have changed a lot. There's been an amazing increase in efficiency in the capital markets, not just nationally but internationally, and with that has come certain standards. People now put money at risk and expect a return; previously these activities had been thought of as "give-aways"—doing what we had been taught not to do in banking school. We have a staff of 50 on the ground, folks in cities and in rural markets to say what's going on and we try to address needs that are uncovered. Before, people said that this is CRA investing, just do it. Now, you must make investments that make good business sense—a whole financial discussion with both pricing and loss estimates. CRA's the right thing to do and it's growing—an emerging market with groups seeking opportunities. Benevolence is rewarded with cross-selling opportunities for

the bank. Especially considering competition from brokerage houses and others, it's a very competitive world. The motivation for an outstanding rating is still there, although it doesn't buy a safe harbor from protests in mergers.

If CRA went away and/or the investment test were scaled back, we would continue with Low Income Housing Tax Credits as we'd still get the tax relief as well as the potential for lending associated with the projects. We would still do intermediary-type lending as we have an active small business franchise and these firms also have needs for checking accounts and other banking services. As for the impact of the elimination of the tax on dividends, the result is more up in the air. We pay some $3 billion in taxes, and there would be some impact as a result of the change. But we do have profits needing offsets, so it's unlikely we would get out of the tax credit business.

It's an interesting business to be in. I continue to be amazed that there are still people in the bank who don't know what we do in the community development investment area. I'm proud to do it! You have to pick partners like Frank Altman or Jim Reid; people you can trust, so you don't have to spend a lot of time "underwriting" the people involved. If you give people money, you have to be able to trust them to re-loan it appropriately, to utilize it efficiently in real estate development, etc. It comes back to deals and pricing.

John: Thanks, Bob. To press further, there are various pressures at play in the investment decision-making process. It seems that CRA's not quite the same motivating force that it once was. How have community-based organizations responded to that shift? Have they had to reform the way in which they propose things to you?

Bob: Jim will have to answer part of that. To share an interesting analogy, my father was a 'beat cop' at one time and whenever he was accused of trying to meet a quota in writing someone a ticket, he always responded "no, I can write as many tickets as I want." The point is that we will occasionally stretch or bend things, but ultimately we want to make a difference in a community. Before, there was a big hammer over our head, but now there's some rationality in how we respond. In part it's because there are now fewer banks and even more cooperation in our responses.

John: Jim, let's turn to you to follow up on this. Have you had to approach banks differently than before?

Jim Reid: First, from our perspective, at the very start we developed a strategic plan for self-sufficiency. We set our own performance objectives before the CDFI Fund specifically required it of us. We welcome standards and accountability and we respond to trends in financing. There seems to be a tendency in the CDFI industry to say "more is better," with, for example, the number of certified CDFIs growing to some 637 now. However, as we've seen in the CHODO and SBIC industries, more is not necessarily better. We need to aggregate in certain markets in order to serve them more effectively.

Secondly, although the CDFI Fund has given us two awards, which we've appreciated, in the end this money is "chump change." The fact is that if there were as much priority in Washington placed on community developments as on tax breaks, then we'd have major funding for these activities. We need a national focus on community and economic development. The jury's still out on the New Markets Tax Credit (NMTC); certainly more players are brought to the table because of it. Moreover, if you look at the world of community development organizations around the country who have been slugging it out since the 1960's, none of them received credit allocations. And in terms of whether the NMTC will benefit

communities, I went to the first NMTC conference last year and saw none of the usual faces. I saw people from investment houses, attorneys, and tax credit professionals. It made me wonder how much of this money goes to those organizations that need it.

Third, in thinking about community development, we have a tendency to think only in terms of actual places, specifically bank assessment areas. However, while our fund targets incomes, specifically below 60% of area median, we also target minorities. National studies have shown that minority businesses have less collateral, less access to capital, yet the CDFI Fund said we needed a special Texas study to prove this. In thinking about the future of community development, there is a tendency to think about places like low-income communities. We also try to target African-American and Hispanic businesses and are still arguing with the CDFI Fund about the importance of this. We've even used a recent Milken Institute study to try to explain. Given that we will be a majority-minority country, how can we ignore the minority community?

John: To follow up just a bit, Jim, a couple of times in this conference people have mentioned some fear on the part of CDFIs of working with institutional investors. What's your take on that?

Jim: I have no fear. We don't just take money because it's available. We only do if the earnings objectives and the other objectives of the investors are in line with the mission of our organization—even without CRA as a motivation. We want more players at the table—especially players looking at business needs not related to the CRA. For example, we're looking at setting up a business fund for minority contractors here in Dallas.

John: Now let's bring Dan into the discussion. You're a relatively new player, representing insurance companies through your organization, Impact

Community Capital. What's motivating insurance companies to do this without a regulatory requirement?

Dan: I first want to say that I've been quite stimulated by the conversation thus far and, to a certain extent, the issues we're discussing are a prime example of why Impact's in the community investing business. For example, Bob says that he doesn't need CRA to motivate much of his community investment work. Impact and its insurance company investors don't need a form of CRA inducement either.. Impact's first deal in 2000 was a $40 million transaction. We now have direct investments or firm investment commitments at the $750 million level. Impact was formed by three nationally-focused insurance companies; they have been joined by seven others, all interested in demonstrating that there is a way to engage in community investing profitably and without regulation. However, insurance companies have felt perhaps a hint of the possibility of the imposition of some CRA-type mandate. And, of course, there are 50 different state insurance regulators. Pure altruism? Not necessarily, but the companies have a strong desire to create a connection between our community investment initiatives and the communities in which these companies write policies.

The Impact companies have a necessary focus on risk-based capital requirements and risk-adjusted investment returns. Their community investment dollars are sourced from each company's investment account, not from a charitable giving budget line. Insurance regulators look at safety and soundness of a company and its investments to ensure that, for policyholder protection, invested assets are safe and liquid. So, Impact's investment strategies needs to be consistent with those requirements and regulator attitudes. Some $600 million of our $750 million total funded and committed investments is or will be securitized with a significant portion of the resulting securities receiving investment grade ratings. In a typical transaction, each single loan purchased (one-off investments) will be pooled

and securitized; Impact's investors will include these rated certificates on their balance sheets, and Impact will hold the non investment grade piece. Credit enhancement (or the "securitization subsidy") is provided by the insurance companies via their funding of Impact's purchase of the non investment grade portion of the securitization.

We seek ways to purchase assets (mortgages) from CDFIs and from organizations like Frank's that work with CDFIs. We also rely on the banking community. For example, we're talking to Bob regarding a novel way of financing health care centers. In this situation, Wells would originate and service the loans and Impact would provide the permanent take-out.

John: Isn't it hard to buy a bunch of loans made by CDFIs; aren't they one-off, "story" loans? How do you bundle and securitize them?

Dan: You're correct; it's very difficult, at times. It is difficult for an investor to purchase 'one-off' community loans, in general, and that degree of difficulty varies among asset types. Community development loans and asset or loan types are more likely than not to exhibit aspects such as insufficient historical performance track record, poor credit history, high leverage, etc. However, once these loans, and asset classes, prove themselves, they can then be more readily pooled and sold to institutional investors. It's a process; it doesn't just happen. And there are a variety of reasons. Chief among them is the community development originators themselves, and specifically, the degree to which each possesses the capacity to produce investments palatable to the investment community. The community development world's undergoing significant change.

John: Now's a good time to turn to Frank, the guru of secondary markets for community development lending.

Frank Altman: Since I last spoke to this group, we (the Community Reinvestment Fund, or CRF), had done maybe $10 million. Now, we're growing rapidly and are pleased to have many good partners. For example, Wells Fargo has been a major investor. What we do, basically, is aggregate loans, "onesies" and "twosies," from CDFIs, purchase them, and create a financial product that can be purchased by organizations like banks and insurance companies. Secondary market intermediaries match community demand with capital, but also mediate between different kinds of institutions seeking to diversify. On the one hand, it's balancing areas with capital with areas that need capital. And on the other hand, it's intermediating between different kinds of institutions such as retail and commercial finance companies. We seek CDFIs and others with community development missions, then we work with them to think about their unique competency, then find other organizations to assist them with what they do well.
While I do feel it's important to keep the regulation, I think that in the future, we'll be moving from an industry driven by regulation to a market approach where market mechanisms start approaching capital. The issue is segmentation—finding the right role for different investors. CRF is national, with a charter to support non-depository lenders such as CDFIs, public agencies, etc. with little access to capital. They depend on dollars from the CDFI Fund, USDA and others, which are dwindling and therefore they must make better use of these funds. These organizations are not competing with banks, but rather are complementary. There is a role for philanthropy—purely social motivation—but we want to find a product that works as an investment vehicle.

Secondly, socially-motivated investors want their principal back, and some interest, but they also want a social return. Such investors include socially-motivated mutual funds, religious organizations, and banks with an appetite for EQ2s (equity equivalent investments). We raised 15% of our capital from such organizations, which in turn attracted the other 85% from other banks, pension funds and life insurance companies in a range of sizes. The largest

pension fund investor is the United Methodist Church, which has provided $100 million thus far. It's not the easiest product, but we're working to make it easier. So, we see the future of the community development investment industry as moving from regulations to markets, from funding to financing, and groups such as established CDFIs will have to learn how to finance themselves using market mechanisms.

The third area I want to touch on is CRF's work on advance commitments. With support from the Rockefeller Foundation, we are working to standardize documentation. Volume is growing significantly. The New Markets Tax Credit (NMTC) represents a recognition of what was going on, specifically what tax incentives can do. The NMTC will provide $15 billion in private investment over ten years, bringing a huge opportunity and I hope everyone will embrace it in a positive way. We think the credit will result in long-term loans and equity with a real exit strategy.

Audience question: Usually when securitization is done, it's a byproduct. With community development loans, what kind of portfolio mix is used: is it by different type of loan such as housing or small business, or by loan quality?

Dan: By loan or asset type. A bona fide cost effective, price efficient capital markets type securitization, is accomplished with one asset class. For example, loans to community development entities (CDEs), residential mortgages and small business loans van be separately pooled, but not cominglrd. However, there are less formal ways of achieving asset aggregations. They are commonly referred to as pools or participations, but are not, in the capital markets sense, securitizations. Frank has mentioned a successful approach to pooling which combined different asset types.

Frank: We do mix assets in pools because we have investors willing to buy them. It's a process of introducing an investment product that meets the

requirements and builds scale. You want diversification in other ways rather than just using the same asset class, and that's usually achieved geographically or by using risk profiles. Dan's aimed at getting a rated security and there you can't mix the asset classes. Our securities are privately placed. Nevertheless, we are doing a fair amount of work educating the rating agencies about what we do.

Audience question: Regarding the previous point about a difficult loan needing time to season, who's problem is this, the Mezzanine Fund's or the investors'?

Dan: I believe the problem resides with the originator and the mezzanine lender, so it's their responsibility to nurture out of that mode to the next phase.

Jim: At the Mezzanine Fund, the big issue is getting deals done. There are lots of CDFIs who don't want to sell their portfolios because they don't have the tools to access additional capital.

Audience question: Without CRA, or with a de-emphasis of the investment test, will there be a scaling back of this activity and in relationship lending, too?

Bob: While it's hard for me to say, exactly, I think the answer is no, not on relationship lending or potential relationships. I think we'd continue to invest, especially where there's a clear need.

John: What could we in Community Affairs at the Federal Reserve do to assist?

Bob: We try to understand our markets, work with organizations to help quantify demand. Activists always say we're not doing enough, but how

much is enough? We see lots and lots of organizations looking for good quality loans. What markets aren't being filled? The Fed would be a logical place to explore these questions.

Jim: CRA's helped show that there's money to be made in community development investing and in working with emerging markets.

John: What can we do to help with the growth of the industry?

Dan: The community development industry needs leadership, a focal point, a rallying point, a forum to discuss and devise ways to recast itself. And for those of us who are seeking to make community investments in scale, we would encourage this leadership. Without prodding and absent any CRA type mandate, Impact formed a community development entity (CDE) and received a $40 million New Markets tax credit allocation. The investments will be structured differently than our affordable housing investments. They'll be a little more return sensitive, and focused in areas such as health and child care rather than commercial real estate.

Frank: Most people look at CRA geographically. However, since CRF works because of its pooling, we then have to assign certain loans in order to get the geographic focus desired by the CRA-driven investors. Even still, we get lots of questions on whether these banks will in fact get CRA credit. There's three areas where we could use help. First, there's not liquidity in the securities, even though they've demonstrated that they're good credit risks, with less than half a percent in losses. Secondly, the portfolio's doing well, but the next step is getting a rated institution to put up a letter of credit to allow it. Finally, there's not a liquid marketplace. Banks could be a liquidity backstop. Wells Fargo has done a little bit of this—making a market in securities they already purchased.

John: Well, I know we could keep talking for hours on these subjects—there's so much to discuss, but our allotted time is coming to a close. We hope that the new Center for Community Development Investments can serve as one of the focal points for the discussion as it continues. Please join me in thanking our panelists, Dan Sheehy, Bob Taylor, Jim Reid, and Frank Altman.