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FEDERAL RESERVE BANK OF SAN FRANCISCO

Community Development INVESTMENT REVIEW

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Community Development INVESTMENT REVIEW

The Community Development 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. You may also contact David Erickson, Federal Reserve Bank of San Francisco, 101 Market Street, Mailstop 620, San Francisco, California, 94105-1530.

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Foreword

June 2006

By John Olson
Director, Center for Community Development Investments

The mission of the Center for Community Development Investments is to enhance access to capital in low-income communities. Frequently, the capital that is used to revitalize communities comes from mission-driven investors motivated by regulation, the fear of regulation, religious beliefs, or social justice. As any CDFI can tell you, the amount of capital available in this sphere is finite, and the competition over accessing these sources of capital can be fierce. A persistent dream of community development organizations has been to broaden the universe of investors, and ultimately access the institutional capital markets. The amount of capital available in these institutional markets is, for all practical purposes, and especially for community development purposes, infinite.

At first glance, the capital markets seem like an unlikely partner for community development organizations. The capital markets need volume, standardization, and lots of data to inform investment decisions, while community development organizations are often small, think of themselves as doing the non-standard deals that the conventional markets won't do, and don't have decades of readily available data. If one of the fundamental assertions of community development finance is that it's about deals that Wall Street won't do, on what basis can the field go to the capital markets for funding?

Yet, despite community development and the capital markets being unlikely bedfellows, pioneering community development practitioners have shown that a secondary market for community development loans, the intersection between revitalizing communities and the capital markets, is rich with possibility. Many of these pioneers are featured in this issue of the *Review*, proving that the process of selling or securitizing loans can unlock the door to the capital markets.

These successful efforts at securing institutional funding are worthy of further examination, and several questions suggest themselves: Why did these efforts work? What will it take to do more of them? What role can mission-driven investors and government play in bridging the gap between community development and capital markets? How can the field work together to overcome obstacles to the secondary market?

As we continue to address these questions, we'd be delighted to hear from you with your views on how even more institutional capital can be used to advance the goals of community development.

Securitization and Community Lending: A Framework and Some Lessons from the Experience in the U.S. Mortgage Market

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The purpose of this article is to provide a framework for analyzing the development of securitization as a vehicle for funding community economic development (CED) loans. Broadly speaking, there are two models for funding assets: the portfolio lender model, which typically involves banks or other intermediaries originating and holding the loans and funding them mainly with debt, most often deposits, and the securitization model, which involves tapping bond markets for funds, for instance, by pooling loans and selling shares in the pools. The focus here is on broad issues of when securitization is likely to be the more economic form of funding, some specifics of how the funding might be structured, and an analysis of the experience in the U.S. mortgage market.

It is important to consider why securitization has dominated the "prime" mortgage market in the United States, while it has not been nearly so successful in other markets and other places, and whether this dominance provides a good model for CED loans. Securitization might not matter as much as is often thought, and it is not necessarily an especially good tool for funding CED loans. In particular, a reasonable way of posing the problem of which funding structure is best is that it can be defined by a trade-off between the advantages of securitization as a low-cost and elastic source of funds with the disadvantages of securitization due to information asymmetry between investors and lenders and the costs of setting up deals. A priori, the balance could go either way.

A Framework

Securitization has become an important part of the U.S. financial system. It is the process by which lenders raise money in capital markets by selling shares in pools of loans. At the end of 2002, the outstanding volume of mortgage- and asset-backed securities was close to $6 trillion. Of this, over 80 percent was in the form of mortgage-backed securities. Credit cards and car loans, combined, were just over 10 percent.[1] Securitization is an important part of the system, but it has been largely confined to the mortgage market, particularly the "prime" market, which consists of relatively low-risk, single-family mortgages. This concentration in a single market is important, and it is important for reasons relevant to CED lending. Prime

1 See Davidson et al. (2003).

mortgages are among the most transparent financial instruments in the system, particularly because of the collateral that supports them and the legal system that supports foreclosure. That is less true for CED loans. As I will discuss below, while there is no particular reason that any asset cannot be securitized, it is not an accident that high-quality mortgages are securitized more successfully than other assets. They suffer least from asymmetric information and small volume problems that can present important barriers to securitization.

The main advantage of securitization is that it can provide an elastic and low-cost source of funds, particularly for long-term fixed-rate assets. In contrast, traditional funding sources for banks, such as deposits, are generally not elastic in supply and have variable rates. As I will argue, in a perfect, frictionless world, different sources of funds would have the same cost in an "all-in" sense, after adjusting for the value of characteristics like embedded options, hedging cost, and loan term. The choice of funding vehicle (e.g., traditional bank via deposits vs. packaging and selling into the bond market) would not matter. This does not appear to be the case in the real world. There are many "frictions," like asymmetric information, that make the choice important and make the public policy issue of barriers to securitization at least potentially important. To get a handle on this, it is best to begin with a very simple framework in which frictions are unimportant, and move from there to the real world by focusing on important frictions.

Modigliani-Miller

The point of departure is the much-celebrated "Modigliani-Miller Irrelevance Theorem" (henceforth MM) (see Modigliani and Miller 1958). Briefly, the theorem assumes perfectly competitive markets, no transaction costs, and widely agreed-on information. The liability structure of the firm is irrelevant; changing the way the firm finances its assets will not affect its "all-in" cost of funds because different liability strategies are simply different ways of rearranging the same cash flows from the firm's assets. In a well-informed, competitive market with a perfectly elastic supply of funds, arbitrage will assure that all structures will be priced so that none has an overall advantage.

Taken literally, the theorem implies that while there are lots of possible institutional structures for funding mortgages, for example, and lots of liability structures within the institutional structures, which institutions and structures are chosen does not affect mortgage rates. A softer version of the theorem is that any advantages of different structures are likely to be small. Because of very elastic supply curves, small advantages of one source of funding (e.g., some sort of subsidy or slightly lower transaction costs) can lead to big effects on how the financing is done, but with small effects on borrower interest rates.

The MM Theorem is one of those ideas that seems obvious, but of course it does not hold true in the real world. Real markets are not perfect, though they are often rather good. Asymmetric information is often the rule rather than the exception. And transaction costs

matter. MM has been debated extensively in the economics and finance journals, but the theorem is not a bad first approximation. It makes us ask the right question: Why should we expect one institutional setup to be better than another at financing a particular set of cash flows when they all compete in the same overall financial system? In particular, it suggests that some justifications for particular structures, like "getting assets off balance sheet" or "the high cost of capital relative to debt" or "allowing banks to shed the risk of low downpayment loans" are wrong, or at least suspect, pending analysis of what part of MM is violated.

Much of the focus in studying MM has been on debt vs. equity funding. However, the securitization issue is less about debt-equity structure than it is about the structure of debt funding, particularly as it relates to institutions that typically use different types of debt funding. For instance, the most common type of debt funding for financial institutions is deposit funding by banks, but the important alternative, especially in U.S. mortgage markets, has been securitization, typically performed by the government-sponsored enterprises (GSEs), Fannie Mae and Freddie Mac, or the government-owned Ginnie Mae (collectively, the "Agencies"). The starting point for our investigation, then, is to understand why there should be any difference between deposit funding and securitization.[2]

I. Community Development Lending

Public policy interest in CED lending has been alive, cyclically, at least since the Community Reinvestment Act of 1977. Here is a brief discussion of what it is and what characterizes CED loans.

What Is It?

Community economic development lending is not easy to define. Many CED loans are small business loans, and they are typically defined by lender and customer type rather than loan type. They are often supported by the federal government via a variety of grants, tax subsidies, and guarantees, which are typically "leveraged" with private funding. Community development lenders are generally small institutions, often not for profit, though they can also be commercial banks or work closely with commercial banks. Sometimes the loans are defined by specific tax benefits for which they are eligible or regions in which they operate.

The GAO (2003) study on barriers to securitizing community development lending defined CED loans by lender and customer: "Community and economic development (CED) lenders make loans to qualified businesses that are generally unable to obtain suitable financing from conventional private-sector sources."[3] The customers are typically low- to moderate-income borrowers with little experience or observable credit history, and the

2 The issue of subsidy via guarantee is not touched on to any extent here. Both sources of funds, deposits and Agency liabilities, have implicit or explicit guarantees, and the question of which is more valuable (at the margin) is not clear.

3 GAO (2003) cites five major types of lending sources: Community Development Financial Institutions, Microlenders, Community Development Corporations, Revolving Loan Fund Lenders, Intermediate Relenders, 504 Certified Development Companies, HUD Section 108, and Community Development Block Grant Programs.

loans typically have one or more types of subsidy. Community development loans are often mortgages, that is, loans secured by real property, but they are also often ordinary business and other loans without property as security. According to the GAO, the loans are perceived as risky and requiring a fair number of resources devoted to monitoring and technical assistance.

Policy and History

The theoretical underpinnings for the public policy concern follow a line of literature associated with the classic Stiglitz and Weiss (1981) paper on asymmetric information as a source of market inefficiency, leading to "underserved" markets. In particular, Weber and Devaney (1998) argue that information asymmetries are larger for marginal borrowers in rural or inner-city geographies, and this causes underallocation to these areas. The asymmetric information here is between borrower and lender, rather than between lender and seller as discussed above, but it presents a similar problem. Lenders know a lot less about projects and collateral than borrowers know, which makes lending difficult. This in turn creates an asymmetry of information between the lender and the potential buyer of the loans because the lender is closer to the borrower and is likely to have better information than an outside buyer, putting the buyer at risk of being selected against.

Other policy issues revolve around externalities, such as that increased lending in certain geographies produces external benefits for those communities. These are reasons for subsidizing the loans, however. They are not directly relevant to the securitization issue.

While there has been some interest in, and some success in, securitizing CED loans, securitization has not been a major factor in CED lending. The GAO estimated that less than $6.2 billion in nonfederally guaranteed loans was securitized from 1994 to 2001, and only $22 billion in SBA guaranteed loans.[4] In contrast, banks held around $450 billion in small business loans in 2001. The leading firm that does securitization of community development loans is the Community Reinvestment Fund (http://www.crfusa.com/). It is a private nonprofit, and it has bought over $300 million in loans.

Stylized Facts

In the GAO study, lenders cited several barriers to securitization. The key barriers were:

1. A lack of incentives for lenders to participate due to lack of knowledge of borrower demand.
2. A lack of capacity to securitize loans, due especially to small scale.
3. External requirements attached to funding sources (both statutory and programmatic).
4. Loans with below-market rates that would have to sell at a large discount.
5. A lack of lender standardization and performance information.
6. Mechanisms to support securitization, such as information links among capital

4 See GAO (2003) for a review of securitizations so far.

markets, lenders, and pool assemblers, are limited in number and capacity.

Taken together, these observations suggest that there are five major items that can be taken as basic "stylized facts" about CED loans. These "facts" are the focus of the analysis that follows:

1. There is a great deal of heterogeneity across CED programs and loan types.
2. Information about individual CED loans is poor and the loans are perceived as risky by investors.
3. Scale is small.
4. The loans require more work by lenders (technical assistance and servicing) than do most loans.
5. The loans may have to be sold at a discount to cover transaction costs and the present value of subsidies attached to the loans.

There has not been a lot of research in this area. The GAO (2003) could not get reliable estimates of the volume of CED loans, and there was little consistent overall performance data. Weber and Devaney (1998) look at rural vs. urban loans in the Lower Mississippi Delta Region and find some evidence of a dual system with less efficient lending in rural areas. DiPasquale and Cummings (1990) analyze barriers to securitizing low-income multifamily lending. A related area of research is that of "subprime" lending. Cutts and Van Order (2004) survey some of the economic issues in the area, and Straten and Yezer, eds., (a) and (b) are special issues of the *Journal of Real Estate Finance and Economics* devoted to the issue. Carr and Zhong, eds. (2002) is a volume of research on microlending.

Data and empirical work being scarce, the focus here is on first principles, taking the stylized facts above as given and analyzing the underlying economics of securitization and how it might be applied to CED loans. What follows is a discussion of U.S. experience, primarily in the mortgage market, and of the underlying economics that drives securitization, which will provide a framework for the discussion of CED loans.

II. Securitization Models

Securitization in the United States has been most successful in mortgage markets. Indeed, the structure of the U.S. mortgage market has changed dramatically in the last quarter century, largely because of the rise of securitization. This rise has come about primarily because of the standardization of mortgage-backed securities, brought on mainly by three secondary market agencies: Fannie Mae, Ginnie Mae, and Freddie Mac. Annual sales of mortgages to these three institutions have risen from under $100 billion in 1980 to over $2 trillion recently. They now own or are responsible for over half of the outstanding stock of single-family mortgages. This growth has been accompanied by a decline in the market share of savings and loans and banks.[5]

5 See Weicher (1999) for a discussion of some of the history of the secondary market. See also Frame and White (2005) and Van Order (2001).

Institutions and Instruments

The U.S. residential mortgage market is characterized by a rather unique set of financial institutions and instruments. What follows is a brief summary.

Fannie, Freddie, and Ginnie[6]

Fannie Mae, the oldest of the agencies, was established in the 1930s as a secondary market for newly created Federal Housing Administration (FHA) loans, which were insured by the government, but which had trouble gaining acceptance by investors during the Great Depression. Until the 1980s, it operated in some ways like a national savings and loan, a portfolio lender gathering funds by issuing its own short-term debt (rather than deposits) and buying mortgages that it held in portfolio. Because it held government-insured mortgages, it accepted almost no credit risk, but it was subject to considerable interest-rate risk. In 1968, it was restructured as a privately-owned, off-budget government-sponsored enterprise or "GSE," and was allowed to buy "conventional" (non-government-insured) loans.

Ginnie Mae was responsible for developing the major innovation in secondary markets, the mortgage-backed security (MBS). The MBS issuer, typically a mortgage bank, passes the payments from a pool of mortgages (both principal and interest, net of its fee) through to the ultimate investors, who typically receive pro rata shares of the payments. The issuer also guarantees the payment of interest and principal even if the borrower defaults (the issuer is covered by the government insurance for almost all the foreclosure costs), and Ginnie Mae guarantees timely payment even if the issuer does not make the payments. Hence, its guarantee is on top of the federal insurance and the issuer's guarantee. This has proven to be quite valuable in marketing government-insured loans. As with most pass-through securities, Ginnie Mae's are subject to interest-rate risk.[7]

Freddie Mac was created in 1970 as a secondary market for savings and loans. At the time, it dealt only with savings and loans, while Fannie Mae dealt with mortgage banks. Today, both institutions deal with the same originators. Like Fannie Mae, Freddie Mac is a GSE, and it too is off budget. Freddie Mac initiated the first MBS program for conventional loans in 1971, while Fannie Mae began its conventional MBS program in 1981. The MBSs of both institutions are similar to Ginnie Mae's in that both protect investors against credit risk but not interest-rate risk, though neither Fannie nor Freddie buys more than a small amount of federally insured mortgages, which almost always go into Ginnie Mae pools.

Because Ginnie Mae is on budget, its securities have a "full faith and credit" federal guarantee. In contrast, as GSEs, Freddie Mac and Fannie Mae are private corporations without an

6 Recent accounting problems at both Fannie Mae and Freddie Mac are not analyzed here for two reasons: One is that they involve somewhat arcane questions about accounting, economic vs. accounting income and hedge accounting that are far beyond the scope of this article and obviously are not applicable outside the United States. The other is that they have had little to do with or have little effect on the ways the companies operate or their economic function. (The author acknowledges being an extremely minor shareholder in one of the GSEs).

7 For more on mortgage-backed securities, see Fabozzi (2001), Havre (2001), and Hu (1997).

explicit guarantee, though they both have an "implicit" or "conjectured" guarantee because investors believe that if these institutions failed, the government would protect debt-holders, though it has no legal obligation to do so. This allows the GSEs to borrow money and sell mortgage-backed securities at more favorable rates than they would otherwise. Both are regulated by the Department of Housing and Urban Development for their public purpose missions and by the Office of Federal Housing Enterprise Oversight (OFHEO) for safety and soundness.[8]

Private-Label MBS

There is a growing "private label" MBS market that securitizes mortgages without using Fannie, Freddie, or Ginnie. This market operates mostly in areas not eligible for the Agencies, primarily loans with balances above the conforming loan limit (the maximum loan size eligible for purchase by Fannie and Freddie). It is about 10 percent to 20 percent of the market. Private-label securities resemble agency MBSs. However, the credit risk is typically managed by breaking pools into subordinated parts that take the default losses up to some amount (e.g., 5 percent of the pool balance) and senior parts that take the rest of the risk. This allows the bulk of the credit risk to be taken by the originator, or specialist, who has the best information about the risk. Senior parts (which typically have an AA or AAA rating) are open to a wide range of investors who do not want to manage the problems associated with mortgage credit risk. An alternate but less widely used credit enhancement tool is mortgage insurance on the pool, typically with limits on losses to the insurer. The existence of the private-label market provides some evidence that securitization can work even without government support. The senior/subordinate structure is also a popular way of securitizing commercial mortgages.

Another advantage that the agencies have, beyond their guarantees, is size and liquidity. Mortgage-backed securities and Agency debt trade in very large volume, second only to Treasuries. They are issued regularly, they have low transaction costs (low bid-ask spreads), and the setup costs have already been paid. This is less true of the private-label market.

Derivatives: CMOs

CMOs, or "collateralized mortgage obligations," break MBS pools into "tranches" that pay out the pool's cash flows in non pro rata ways.[9] The reason for this is that many investors find straight pools awkward investments and might just want, for instance, the "short" part of the pool and might buy a tranche that receives the first of the principal payments. There are different ways of structuring CMOs. Many of the ways are attempts to sell parts of the pool that look like straight bonds by selling prepayment risk to other investors. CMOs are also a way of parceling out credit risk in different ways, for instance, by having senior and subordinated tranches.

8 While Fannie Mae and Freddie Mac are off-budget, there is a separate federal credit budget that does analyze their risks. See Budget of the United States, 1992.

9 CMO has become a sort of generic name for structuring pools. REMIC is a largely equivalent name. Much of the history of these has revolved around tax and accounting issues.

The Economics of Securitization

The economic issues revolve around the asymmetric information and transaction-cost problems. The following analysis focuses on types of structures and how they solve these problems.

Basic Securitization Models

There are two basic models of securitization:

Model 1: the MBS (Conduit/Mutual Fund) Model

The simplest model of securitization is the standard MBS model as developed by Ginnie Mae and pursued by Fannie, Freddie, and some private-label securitizers. It is set up like a mutual fund. Mortgages are sold to a Special Purpose Vehicle (SPV), which manages the cash flows. In the agency case, the Agencies guarantee timely payment; generally there is also some other form of credit enhancement. In this model, the securitization is set up as a conduit device for packaging securities to open up a new source of funds from the bond market. The conduit need not sell pro rata shares to investors. It can sell different parts to different investors, like the CMOs.

Model 2: the Bowie (Financial Intermediary) Model

In 1997, David Bowie raised $55 million in the bond market by securitizing the future royalty income from twenty-five of his albums. This was not structured as a pass-through. It used an SPV as above, but investors did not get shares in the royalties; rather, they got a debt claim secured by the royalties. Royalty income is not especially transparent or stable, and bond market investors most likely would have felt they were at an informational disadvantage in holding straight shares. So the deal was structured by selling ten-year bonds with a fixed 7.9 percent rate. This approach is less like the conduit approach and more like the way a traditional intermediary works, by transforming messy assets into more transparent liabilities. Nonetheless, while it is a securitization, it looks like straight debt issued by a corporation whose assets are royalty rights. A version of this, used for some time by the Federal Home Loan Banks when they lend to banks, is to have borrowers issue debt that is collateralized by specific loans that remain on the on-balance sheet.

The two models have a lot in common: they both have to find a way of managing credit risk, either by having an agency take it, by having subordinated tranches take it, or by providing excess collateral. They also both tap the long-term bond market by putting the bond market investors down in the queue for credit risk so that they can get high (AA or AAA) bond ratings. The following discussion will focus on the MBS model because it has been most prominent in the United States. However, the discussion will return to the Bowie model in addressing alternative securitization structures. Indeed, it is a structure that is probably the more likely to succeed with CED loans.

Alternatives to Securitization

The main alternative to securitization is the portfolio lending of banks and savings and loans. Banks have a low-cost source of funds in the form of insured deposits, but that has not been as elastic a source of funds as the one coming from capital markets in general, which can be tapped quickly by the secondary market. As a result, banks sometimes have trouble raising money quickly, especially relative to the Agencies.

GSEs holding loans or pools of loans and funding the purchases with debt is similar to the portfolio lending model. However, they do not originate or service the loans, and they still have the problem of being selected against.

Unbundling and the Securitization Process

The traditional portfolio lender performs all aspects of the mortgage bundle. It originates the mortgage, services it, takes the risk of default (perhaps along with a private or government insurer), and raises money in the deposit market to fund it. The secondary market evolved by unbundling this package. The major contribution of Ginnie Mae, Fannie Mae, and Freddie Mac has been to facilitate the money-raising part of the bundle by taking on residual credit risk, and then packaging the mortgages so that they can be sold as relatively homogenous securities or financed with homogenous debt in the capital markets. This has allowed separation of the funding part of the bundle from the other three parts.

All four parts of the mortgage bundle can now be unbundled. Mortgage securitization typically has four major actors: (1) mortgage originators, who are large in number and sometimes small in scale, sell the loans themselves or act as agents for mortgage bankers or depositories, who in turn sell the loans;[10] (2) mortgage servicers, who sell the mortgages into the secondary market and either keep the servicing or sell the servicing rights to other mortgage servicers; (3) secondary market institutions and mortgage insurers, who take on credit risk; [11] and (4) investors, who buy mortgage-backed securities or GSE debt. Indeed, the last function has become further unbundled with the advent of derivative securities (e.g., CMOs).

Principal-Agent Problems

Unbundling takes advantage of scale economies and division of labor and promotes competition among the suppliers of the various bundles, but it occurs with a cost. The cost is that the players that focus on one part of the bundle depend on players in the other parts of the unbundling process to perform services for them as expected (e.g., sell them good loans) when it is not always in their interest to do so. Thus, there is a "principal-agent" problem: the principals (investors) depend on agents (originators and servicers) to perform as promised, even though it may not be profitable for them to do so.

For investors, or, more broadly, those who end up taking the risk, especially the credit risk, the major principal-agent issue has come from the reliance on originators and servicers

10 In 2002, over half of the loans originated were done through mortgage brokers.

11 It is typically the case that loans with down payments of less than 20 percent have private mortgage insurance. The insurance typically covers the first 20 to 25 cents on the dollar of loss.

to originate good loans and service them properly. The major risk is that sellers, with superior information about loans, will select against investors by keeping good loans and selling the riskier ones, relaxing monitoring, underwriting, or servicing, or even by intentionally making loans that are of low quality. This is particularly true for institutions that are in danger of bankruptcy, for which reputation is less valuable. Hence, to control credit risk, whoever is taking the credit risk needs to do things that align the incentives of originators and servicers with their own or get better information on risk.

Securitizing on a large scale, which keeps fund-raising costs low, has historically required that Fannie and Freddie not spend a lot of resources monitoring the credit risk of individual loans. Hence, the burden of controlling credit costs has largely fallen on: (1) the performance of mortgage insurers, who insure loans with down payments of 20 percent or less; (2) underwriting guidelines, which attempt to define the parameters of an acceptable mortgage; (3) the ability to monitor and provide incentives to induce originators to make good loans; and (4) the ability to foreclose on borrowers who do not make their payments.

This is all in contrast with the traditional mortgage lender, who had all the elements of the bundle under its control and was less worried that the part of the firm that originates mortgages would take advantage of the part of the firm that evaluates credit risk.[12]

Controlling Agency Costs and Competitive Balance

The balance between the role of securitization and the role of banks has largely depended on: (1) the balance between economies of scale and fund raising that the secondary market brings with the advantages of control over some important risks that the traditional portfolio lender brings; and (2) differences in the values of the guarantees received by the two.[13] That this balance has been favorable to the securitization of single-family mortgages has been due to advantageous circumstances in the market for single-family houses that make it easier to control principal-agent conflicts (and may not be easily replicable for other types of loans) and to put constraints on banks (who have to spend their subsidy in the deposit rather than the bond market).

The most important of the favorable circumstances is the ability to use a house as collateral, which comes from foreclosure laws and property registration, and the relatively good information that exists about house values. These two factors mean that lenders have a good idea of homeowner equity and can foreclose and thereby minimize losses. Consequently, home-owner equity is both a good deterrent to default (home owners will be reluctant to default and lose their equity) and cuts costs in the event of default. An important element of this is the ability to foreclose quickly. Otherwise, lost interest during the foreclosure period can easily overcome equity previously built up and leads to large downpayment requirements.

12 That is not to say that there is no risk. Compensation schemes could induce conflicts of interest inside the firm. The point is that conflicts inside the firm are easier to resolve.

13 See Van Order (2000a) for a more formal discussion.

As a result, the major concern of institutions that accept mortgage credit risk is the probability of equity becoming negative. The ability to treat houses and mortgages almost like commodities and default risk almost like a financial option (i.e., a "put" option, which gives the borrower the right to exchange the house for the mortgage) is a major factor in the success of the secondary market. Expected default costs then depend primarily on the initial loan to value ratio, which is known to everyone,[14] and on the probability of house values falling by enough to trigger default, which is not known equally well by everyone, but which can generally be estimated reasonably well by the secondary market. Other factors generally can be diversified away.[15]

These advantages are not common to many other markets. For instance, lending for rental housing is quite different. It is much more difficult to evaluate apartment building property values because these properties are much more heterogeneous, they trade less frequently, and incentives for inaccurate appraisals are greater. Moreover, incentives to take care of the property are weaker when owners are not also occupants.[16] Similarly, the markets for subprime mortgages and for business loans have not had a lot of securitization, and they have important principal-agent problems.[17]

Recent changes in information technology are also bringing about important changes in how risks are managed and on the level of competition in the industry. The major innovation has been the use of technology to evaluate credit risk, which, together with equity, is an important determinant of default risk. Historically, mortgage originators had better information about credit risk. However, Fannie and Freddie (and many other lenders and insurers) developed statistical automated underwriting systems, with credit history and equity as the major explanatory variables, that allow rapid decisions about what they do and do not want to purchase. The decision to purchase a loan can be made in five minutes, further reducing principle-agent problems.

Interest-Rate Risk

Long-term lending raises the question of interest-rate risk because banks tend to raise money in the deposit market and pay variable deposit rates. A major part of the U.S. financial crisis in the 1980s was the interest-rate risk taken by savings and loans in the 1970s and the subsequent rise in rates in the late 1970s and early 1980s. Securitization handles the risk to conduits automatically because the risk is passed through to the investor. However, not all investors want to take interest-rate risk, particularly the mortgage-specific risk of prepayments when rates fall. CMOs are a device to reallocate this risk, as is debt funding.

14 Of course this is subject to having a good appraisal of property value. For arm's-length purchases of single family houses, this is not a major problem; trading is usually deep and borrowers have incentives not to overpay. For refinancing (especially if the borrower is increasing the loan balance), there can be problems, as can be the case for apartment buildings and commercial property.

15 An alternative to use of equity is strong borrower liability. For instance, in some civil code countries, borrowers remain liable for residual liability after foreclosure.

16 It is the case that it is relatively easier to foreclose on a rental unit because it does require moving the occupant. However, it is difficult in many countries to evict tenants, which increases the risk of lending on rental units.

17 See Cutts and Van Order (2004) for some analysis of subprime markets.

Both Fannie Mae and Freddie Mac finance close to half their purchases with debt.[18] This can be interpreted as a move in the direction of the "Bowie/Intermediation Model," where heterogeneous mortgages (in terms of prepayment risk) are transformed into homogeneous liabilities for bond market investors. However, they do not run the deal through an SPV. Rather, they issue corporate debt backed by the whole portfolio, so, as discussed above, they are a bit like a portfolio lender, but with the same agency costs. While both GSEs have sizable holdings of mortgages that are funded by debt rather than by mortgage-backed securities, they have learned the interest-rate-risk lessons from the early 1980s, and neither company is short-funded. Both rely largely on long-term, callable debt or its equivalent (e.g., short-term debt and derivatives like interest-rate futures and options) to finance long-term mortgages. [19]

The advantage of debt funding is that debt is more transparent to investors than pass-through securities because: (1) if the debt is not callable, Fannie and Freddie take the call risk on the mortgages (and hedge it at a lower cost than most investors have) and the cash flows are known by investors with little uncertainty; and (2) even if it is callable, the circumstances under which it will be called are more transparent than the circumstances under which borrowers will prepay. The disadvantage to the GSEs is that it is not easy to hedge interest-rate risk because borrowers' prepayment behavior is not easy to model.

From an accounting point of view, MBS and debt are different because MBS funding takes the loans off the lender's balance sheet.[20] This advantage is more apparent than real if the lender keeps the credit risk (for instance, by selling with recourse or taking a subordinated position in the pool). Securitization could, then, simply be a way of avoiding capital regulations, and makes sense only because capital regulations are not really risk-based.[21] Securitization and regulation that are driven by accounting rules rather than risk management can lead to a poor allocation of risk.[22]

MM

So where does Miller-Modigliani fit into this? In the pre-secondary market world in the United States where banks (actually savings and loans) did the lending, deadweight losses and asymmetries were more or less the same for everyone. Capital structure was managed by regulation, and debt was primarily deposits, which were often inelastic in supply but

18 Most mortgages go into pools, and debt-funding comes primarily from repurchasing the pools rather than simply holding whole loans in portfolio. A reason for this is that it helps control the adverse selection problem faced by MBS investors if the Agencies use superior information about prepayment to decide which loans to put into pools.

19 A typical procedure is to do an interest rate "swap," for instance receiving an income stream indexed to LIBOR (and thereby offsetting short term borrowing rate fluctuations) in exchange for a fixed rate liability, then using a "swaption," which in effect is an option to undo the swap to handle prepayment risk. This gives the equivalent of long term callable debt.

20 This is done through a "special purpose vehicle" (SPV; in the United States, this is via a "grantor trust"), which buys the mortgages and manages the cash flows. A real advantage of this is that it assures MBS holders access to mortgages in the event of problems, in a way that balance-sheet activities cannot.

21 For instance, until the late 1980s it was possible for savings and loans to sell loans with recourse and not have to hold capital. The regulations have been changed to force them to hold capital against the risk they retain.

22 Much has been made recently of the size of Fannie and Freddie debt, as opposed to MBS. This is a silly distinction, which confuses balance-sheet status with risk. Fannie and Freddie keep the credit risk in either case and the question is the amount of interest-rate risk, which can be controlled and managed by stress tests and capital.

subsidized by deposit insurance. In that model, MM was violated because of regulation. Holding less capital lowered all-in costs to the banks because it allowed better exploitation of the deposit insurance guarantee. The price to be paid for this was that funding was forced through the deposit market, which is not the most efficient vehicle for funding fixed-rate mortgages.

The advent of a new institution type, the GSE, did not add or subtract much in terms of the existence of guarantees. It did, however, change the types of guarantees and the possible ways of operating and exploiting the guarantees by allowing institutions to get access to a new market, the bond market, which has lower transaction costs, a more elastic supply of funds, and is a better way of managing interest-rate risk. But the GSEs were forced, because they were secondary markets, to take on some asymmetric information problems that banks did not have to take on. So MM was still violated, but it was violated in different ways.

So there was some a priori ambiguity as to who–banks or GSEs–would be the winner. It turned out that in the United States the secondary market has been dominant, but that is not inevitable, and, indeed, GSE market share has been declining lately. Within the bond market framework, there are many ways of operating, including straight pass-throughs, CMOs, overcollateralized or "covered" bonds, and straight corporate debt (analogous to long-term deposits), some or all of which can be done by banks. Also, banks have access to the same hedging vehicles (e.g., interest-rate swaps and swaptions) as do the GSEs. MM suggests that these vehicles are all close competitors and small differences among them can greatly change what the market looks like.

III. Comments and Lessons

The mortgage business is an interesting, if not entirely clean, example of how securitization can work. It is clouded because subsidies in the form of guarantees exist for both of the competing structures, and it is not clear which subsidies are larger. Nonetheless, there appear to be some lessons that can be used to help think about securitization in other markets:

1. It is the function of connecting mortgage and capital markets that is important, not the institutional details, and there are several different ways of getting the function done. Securitization is one, but banks securitizing and/or selling bonds is another.
2. While working on the "back end," for example, doing some deals and getting some mortgages off banks' balance sheets, may be a good idea, it is getting the "front end" right, so that risk can be understood and managed. That is the essential feature of developing mortgage-backed securities markets, particularly if they are to operate on an ongoing basis. U.S. secondary markets have benefited greatly from U.S. foreclosure laws and improved information technology.
3. Allocating the risk properly, by putting it with the agents best able to handle it, is important. Mortgage insurance, agency guarantees, and senior/sub deals appear to be the most popular ways of doing this.

4. There is no single structure that is always best at accomplishing the function of linking mortgage markets with financial markets. The MBS/conduit model, the Bowie/financial intermediation model, and the traditional portfolio lender model can all work. All of the structures do much the same thing, and MM suggests there need not be strong a priori for supporting any one in particular. All the structures allow the institution that originates and manages the loans to take on the initial credit risk and pass through the interest-rate risk to bond market investors.

IV. Prospects for Community Development Lending

While it is clear that CED loans can be securitized, there is no compelling reason to expect securitization to be as attractive a form of funding as it appears to be in the mortgage market. Recall the basic stylized facts from Section I:

1. There is a great deal of heterogeneity across CED programs and loan types.
2. Information about individual CED loans is poor and the loans are perceived as risky by investors.
3. Scale is small.
4. The loans require more work by lenders in the areas of technical assistance and servicing than do most loans.
5. The loans will probably have to be sold at a discount to cover transaction costs and the present value of subsidies attached to the loans.

The least important item, in terms of economics, is the last one. The costs that get capitalized (either transaction or subsidy) are there no matter how they are realized, up front or over time. The first four do raise real barriers that restrict the scope of securitization. In particular, CED loans are information and servicing intensive, and their volume is small, which makes the cost per loan high. These items are areas of concern because they suggest greater potential for adverse selection and higher transactions costs than is the case in the mortgage market. So the question is: Why not have lenders hold the loans, mix them with other loans in their portfolio, avoid the cost of setting up a debt issue, and eliminate the agency costs of securitization?

One possible reason is to get long-term funding for long-term assets; another is to get the loans off the agency's or lender's balance sheet. As discussed above, the former is a fair reason, but the latter may or may not be depending on the risk retained by the seller. This is a close call because, as discussed above, banks can hedge interest-rate risk.

If loans are to be securitized, a reasonable structure is one that makes the loans as transparent as possible, which suggests something like the Bowie structure, where the originator keeps the servicing, keeps the "senior" part of the risk by overcollateralization (perhaps with a government guarantee), and sells homogeneous debt as a way of managing the heterogeneity of the assets. Again, this is not much different from keeping the loans and funding them with debt.

Experience So Far

As was discussed in Section I, there has been some, but not much, experience with securitizing CED loans. In general, the deals appear to be set up with a "Bowie" model in mind, where heterogeneous loans are used as collateral and homogeneous assets are sold to the public. For instance, SBA's 504 program regularly issues twenty-year bonds backed by SBA-guaranteed loans of varying terms and parameters. The Community Reinvestment Fund, mentioned above, acts as a loan conduit. It sells debt backed by the loans, as well as shares in pools of loans, to institutional investors, mainly as private placements.

The following observations can be made about the experience so far:

1. The deals tend to have a "Bowie Bond" structure, tapping the debt market.
2. The deals have generally had credit enhancement either through direct government guarantees or outside enhancement.
3. The loans tend to be long term.
4. The interest-rate risk is generally passed through, but the transformation of heterogeneous assets into homogeneous liabilities probably leaves open some residual risk, like prepayment risk.
5. There is little liquidity in the market.

This is what one would expect, from the analysis above, as devices for handling heterogeneity and asymmetric information. But it is not clear that it offers major advantages over the portfolio lender model.

Conclusion

Prospects for securitization of community economic development loans on any sort of large scale are not bright. This is primarily because the things that seem to be important for securitization in other markets (especially the mortgage market) do not appear to characterize CED loans, which are rife with adverse selection problems, are expensive to securitize, and exhibit a volume likely to be limited by the size of government programs. There is a niche for conduits that buy loans from small lenders, but as yet there does not appear to be a large volume of such loans.

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The Struggle to Establish a Vibrant Secondary Market for Community Development Loans

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Securitization of loans and their sale to long-term investors has revolutionized many areas of finance: real estate, autos, consumer credit. But despite many efforts, it has not taken hold in community development financing. The obstacles to creating a secondary market for community development loans are similar to obstacles other markets faced: lack of data, standardization of documents and loan process, and loan volume. Other markets have managed to overcome these obstacles. Yet despite recent advances, such as the Community Reinvestment Fund's issuance of rated securities in November 2004 and May 2006, the goal of a vibrant secondary market for community development loans seems as tantalizingly close today as it did nearly a decade ago, when a community development consultant wrote in *Community Investments* that "piece by piece, a secondary market is taking shape." This development was in the "not-too-distant future. And, with the trend toward reduced public support, the sooner the better."[1]

The benefits of a secondary market were put this way by the National Task Force on Financing Affordable Housing in its 1992 report, "From Neighborhoods to the Capital Markets":

> The lack of a fully functioning secondary market for multifamily loans also works indirectly to raise the costs of borrowing. Having to keep the loans in portfolio contributes to a mismatch between the terms on which lenders are willing to lend (shorter terms, variable rate) and those which are sustainable for this type of borrower (longer term, fixed rate). The resulting exposure of projects to interest-rate risk and refinancing uncertainties means that fewer affordable housing projects are developed, and more run into trouble than would be the case if lenders were encouraged to lend on terms more appropriate to this type of project and borrower.

The need for more capital for community lending seems urgent. CFED researchers, in a late 1990s survey of revolving loan funds in Ohio, found that eighty-five of the fund managers believed that they needed more funding to pursue their mission.[2] And the need for liquidity is particularly a problem for the larger and more successful Community Development Financial Institutions (CDFIs). (For a more detailed discussion of how CDFIs access the secondary market in various ways, see the several articles that follow this article in this issue.)

1 Kathleen Kenny and Frank Altman, "The Emerging Secondary Market for Community Development Loans," *Community Investments*, 9:2 (Spring 1997).
2 Andrea Levere, Daphne Clones, and Kent Marcoux, *Counting on Local Capital: A Research Project On Revolving Loan Funds* (Washington, DC: Corporation for Enterprise Development, 1997).

The CDFI Fund commissioned a report to assess the feasibility of fostering a secondary market for community development loans. Although the Fund never released the report, a Government Accountability Office (GAO) study cited an early version that indicated that very few CDFIs had actually tried to securitize their loans. The study argued that while "about one-third of the respondents have sold at least some loans they originated, CDFI participation in the secondary market for loans remains quite small."[3]

The GAO study, entitled "Community and Economic Development Loans: Securitization Faces Significant Barriers," also found that very few small business loans were securitized. From 1994 to 2001, only $6.2 billion of nonfederally guaranteed small business loans and $22 billion of SBA-guaranteed small business loans were securitized. This was a small percentage of the estimated $450 billion in outstanding small business loans held by commercial banks in June 2001.[4]

This article attempts to understand this puzzle, where there seems to be great need, much talk, and many efforts, and yet still no fully functioning secondary market for community development loans. To wrestle with that question, this article provides an overview of community development loan securitization (how it works and who the players are), looks at the early innovators in this field, and then traces more recent developments.

How It Works

While many of the articles in this issue deal with the selling of loans into a secondary market, a truly vibrant secondary market involves a process of securitization. Securitization turns loans into actual securities by taking existing loans on affordable housing, community facilities, or small businesses, or assets backed by their cash flows, and separating them into tranches that can be sold to investors. In this way, the lender, as the originator of the loan, gets a lump sum rather the interest and principal payments over the loan's term. This allows the lender to re-lend the capital to new projects. When this market is working efficiently, it connects the lowest-cost capital to community projects, increases liquidity for lenders, and helps lenders and investors better manage their financial risk.

Most transactions are not large enough to be securitized on their own (although for an interesting example of a large single-transaction securitization, see the David Bowie's royalties deal discussed in Robert Van Order's article in this issue). Smaller transactions require an aggregator that pools the loans that can be sold to investors. The most widely known aggregators are the government-sponsored enterprises (GSEs) for mortgages, Fannie Mae, Freddie Mac, and Ginnie Mae. There are other aggregators, including Sallie Mae for educational loans, and many private aggregators, such as Bank of America or GE Capital. One of the leading aggregators for community development loans is the Minneapolis-based Community Reinvestment Fund, which specializes in buying existing community development loans and selling them to investors (see Frank Altman's article in this issue).

3 GAO, "Community and Economic Development Loans: Securitization Faces Significant Barriers," October 2003, 36.
4 Ibid., 8–9.

When assets are securitized by an aggregator, the assets are transferred to another legal entity that divides the cash flow into senior and junior tranches. The financial institutions that transferred the assets to the new legal entity often retain the subordinate interest in the security. The senior interest is structured in a way that gives it first claim to cash flow and the underlying collateral in case of default. Investors are more comfortable with purchasing the senior interest as a security because the protections provided ensure that the risk of default is lower.[5] (For more detail on the mechanics of how an originator prepares loans for a sale, see the articles by Judd Levy and Kenya Purnell and George Vine in this issue.) In significant ways, this technique has transformed banks and finance companies from being portfolio lenders into loan brokers, managing the relationships between borrowers and long-term capital investors.

Securitization is an old technique, dating back hundreds of years, but its widespread application is a relatively recent phenomenon. Fannie Mae, which is synonymous with securitization, has been around since 1938, but its participation in the secondary market for mortgage-backed securities (MBS) did not start in earnest until 1970. Loans other than real estate were not securitized until the 1980s (e.g., auto loans in 1985 and credit-card debt in 1986). Securitization of MBS, and other asset-backed securities, or ABS, "has grown from a non-existent industry in 1970 to $6.6 trillion [in outstanding assets] as of the second quarter of 2003," according to Cameron Cowan, partner in the law firm Orrick, Herrington, and Sutcliffe.[6]

A vibrant and efficient secondary market has many advantages for all the participants in the transaction–borrower, lender, loan aggregator, and investor. For borrowers, it lowers their cost and can allow for more favorable loan terms. Lenders benefit greatly when their loans are more liquid. First and foremost, they get a capital infusion by selling old loans off their books. It also allows lenders to increase cash reserves, change lending terms, or diversify their portfolio by adjusting their concentration on certain geographies or types of borrowers. Finally, investors are attracted to MBS and ABS (compared to similar investments) through a combination of competitive yields, known risk parameters, flexibility of payment streams, and the desire to diversify their investment portfolios.[7]

Even though there is not a deep, well-used secondary market for community development loans, there have been many successful efforts of smaller securitizations for particular types of loans or assets, almost all of which were made possible by government guarantees (see Table 1).

5 Karl F. Seidman, *Economic Development Finance* (Thousand Oaks, CA: Sage Publications, 2005), 425.

6 Statement of Cameron L. Cowan, Partner Orrick, Herrington, and Sutcliffe, LLP, on behalf of the American Securitization Forum Before the Subcommittee on Housing and Community Opportunity Subcommittee on Financial Institutions and Consumer Credit United States House of Representatives Hearing on Protecting Homeowners: Preventing Abusive Lending While Preserving Access to Credit, November 5, 2003. http://financialservices.house.gov/media/pdf/110503cc.pdf.

7 Comptroller of the Currency, "Asset Securitization," November 1997, 4. www.fdic.gov/news/news/financial/1999/FIL99109.pdf.

Securitization Models and Lenders and Borrowers Involved[8]

Model	Lenders	Borrowers
SBA 504 Program guaranteed	Certified Development Companies	For-profit businesses that have qualified for conventional loans.
SBA 7(a) guaranteed	Commercial banks, credit unions, small business lending companies and other nonbank lenders	For-profit small businesses that have demonstrated they could not obtain financing without the 7(a) program
SBA 7(a) unguaranteed	Commercial banks, credit unions, small business lending companies and other nonbank lenders	For-profit small businesses that have demonstrated they could not obtain financing without the 7(a) program
HUD Section 108 guaranteed	CDBG grantees and their designated lenders	For-profit or nonprofit borrower
Community Reinvestment Fund	Nonprofit, for-profit, and government community economic development lenders	Local business, affordable housing, and community facilities borrowers

Obstacles to Creating a Secondary Market

Although the concept is relatively straightforward, in practice there are many obstacles to creating a secondary market–some inherent in developing any secondary market and others that might be unique to community development loan pools. To some degree, all pioneers of existing secondary markets had to find ways to standardize their lending practices and loan documents, collect and report consistent data, and overcome initial skepticism from the investor community. In the case of single-family mortgages, for example, many specific factors bear on an individual home's value (location, quality, design, etc.). It took years to establish a successful track record and create confidence in the investor community to believe pools of single-family mortgages could be turned into a commodity investment. This evolution would not have taken place without the careful management and credit enhancements from the federal government and GSEs. As important as building investor confidence was the work Fannie Mae and Freddie Mac played in establishing uniformity for applications and loan documents. The GSEs introduced the standard mortgage application in 1973 and followed with standard mortgage documents for all states in 1975.[9]

The creation of a secondary market for community development loans faces all the chal-

8 GAO, "Community and Economic Development Loans," 27.

9 Denise DiPasquale and Jean L. Cummings, "Financing Multifamily Rental Housing: The Changing Role of Lenders and Investors," *Housing Policy Debate*, 3: 1, 22.

lenges that the single-family mortgage market did (data, standardization, and interest from investors), but it has the added complications of low volume, thin spreads that make pricing difficult, and a business model that puts an emphasis on boutique loans with high levels of customer service that require intensive loan servicing. Furthermore, community development loans are complicated and "may include public and private-sector involvement on a number of different levels," according to former Federal Reserve Board Governor John P. LaWare in testimony on Capitol Hill. He explained that "a single loan to a program for the revitalization of a number of properties within a particular neighborhood could involve several borrowers having varying degrees of experience and financial capacity, and be supported by numerous state, federal, and private assistance programs."[10] With so many moving parts, it may be too difficult to make investors comfortable with community development investments.

Overcoming Obstacles

One response to such a complicated underlying asset would be to provide investors with a credit enhancement that ensures the investor against losses stemming from the underperformance of the underlying assets the way Ginnie Mae, Fannie Mae and Freddie Mac did for single-family mortgages. "External credit enhancements rely on third parties to provide additional assurance of timely payment of principal and interest to investors," according to the GAO report. "These enhancements can be governmentally provided (e.g., loan guarantees) or privately provided (e.g., loan guarantee insurance or letters of credit)."[11] In any case, the credit quality of the asset is based on the credit standing of the institution providing the guarantee. For example, pension fund investors do not need to understand the intricacies of the single-family mortgage market; they need to understand the credit quality of Fannie Mae or Freddie Mac.

Some internal credit enhancements are often arranged by the lender. One such structure is to have a senior and subordinate position where the senior securities have first claim on cash flow. Another is overcollateralization, where the value of the assets in the pool exceeds the value of the securities issued. And there are various ways to funnel cash flow into reserves as a way to give investors confidence of timely payments. Finally, lenders may be required to make a loan pool whole by substituting nonperforming loans with financially healthy ones.[12]

The Buy Side

Even under the best circumstances, however, there may be restrictions generated within the investor community that make securities backed by community development loans unat-

10 John P. LaWare, member, Board of Governors of the Federal Reserve System, Before the Subcommittee on Economic Growth and Credit Formation of the Committee on Banking, Finance and Urban Affairs, October 7, 1993.

11 GAO, "Community and Economic Development Loans," 31.

12 Ibid.

tractive. "Pension funds," according to Denise DiPasquale and Jean L. Cummings, "have a fiduciary responsibility, which results in a bias against investments that are perceived as risky relative to alternative investments."[13] Public pensions are regulated by the Employee Retirement Income Security Act of 1974 (ERISA) and private pension funds have similar guidelines. In addition to a regulatory environment that is hostile to community investments, DiPasquale and Cummings also find that pension funds and other institutional investors such as life insurance companies do not have the expertise to properly evaluate community development loan pools. If there is technical knowledge, it is often housed in the social-investments branch of the organization, which does not have the same access to investment capital as the mainstream investment side of the organization.

Investors also favor large investments; they have tremendous pressure to keep transaction costs low because they are getting a relatively low rate of return for their investment. This fact creates problems for community development lenders because they are not set up to do a high-volume of business. Their clients, almost by definition, have been passed over by the high-volume traditional lending community.

One answer to this problem is for loan aggregators to warehouse loans until they reach a threshold where they can pool and sell the loan securities. Warehousing, however, requires capital reserves. Loan aggregators, such as CRF, rely on socially motivated investors, program-related investments (PRIs), and other capital reserves such as Equity Equivalent Investments (EQ2s) to generate sufficient capital reserves to warehouse loan pools. Because there are so many fixed costs with assembling a loan pool and making it attractive to investors (e.g., getting the pool rated by one of the credit-rating agencies), the loan pools have to be relatively large. Frank Altman, president and CEO of CRF, estimates that the optimal pool size is above $100 million.

The Sale Side

There are also disincentives from the sell side of this market. The Economic Development Administration conducted a pilot project with revolving loan funds to sell loans to the secondary market and found that "many RLFs [revolving loan funds] indicated they were not interested in securitization because they had no need to make new loans," according to the study's author, Kelly Robinson. Although this seems to fly in the face of the comments by many practitioners, it does speak to the possibility that there is a dearth of high-quality projects to securitize, particularly in specific rural or small markets. It also might be true that the RLFs have insufficient staff resources and expertise to maintain a high volume of loan underwriting.[14] Put differently, it does not make sense to invest in the internal capacity to deliver loans to a pool, with all the added work that brings, if you are only completing a few loans per year.

Another issue is that many community lenders rely on keeping their loans on the books

13 DiPasquale and Cummings, "Financing Multifamily Rental Housing," 96.

14 Kelly Robinson, "Expanding Capital Resources for Economic Development: An RLF Demonstration," Economic Development Administration, 2001. http://www.eda.gov/ImageCache/EDAPublic/documents/pdfdocs/1g3_5f17_5fcapresources_2epdf/v1/1g3_5f17_5fcapresources.pdf.22.

so they can collect ongoing servicing fees as a way to finance their organizations. This can be particularly important when the lender is trying to show strong cash flow as a way to establish its financial credibility. In the EAD study, however, "the RLF managers we interviewed that had experience with securitization did not describe origination and servicing fees as an important source of revenue for their organizations," according to Robinson.[15]

Finally, many lenders or originators may not be motivated to securitize because the price is too high to attract investors to their largely low-interest loans. In other words, the discount–the difference between what is due on the loan portfolio and the market price that investors will pay–is too deep. There are at least two reasons why investors might demand a discount on community development securities: (1) the underlying loans may be below market rate (and therefore below their other investment options such as Treasury notes); and (2) the underlying assets (e.g., small businesses in low-income neighborhoods) are risky. Robinson estimated that the gross discount was around 10 percent on the 115 loans he examined in the EAD demonstration project.[16]

Early Securitization Innovators

There never has been national leadership from one of the GSEs, HUD, or some other agency on community development securitization. In this absence, a number of smaller securitization experiments around the country were focused on a region or asset type. Early efforts by community development lenders to access institutional capital got their start in the 1980s and early 1990s. The efforts were led by lender consortia such as Community Preservation Corporation (CPC) in New York City, Savings Associations Mortgage Company (SAMCO) and the California Community Reinvestment Corporation (CCRC) in California, and Community Investment Corporation (CIC) in Chicago.[17] These isolated regional efforts grew up alongside more national efforts to actually securitize specific types of loans, such as co-op loans securitized by a subsidiary of the National Cooperative Bank (NCB), or small business loans that were securitized with help from the Small Business Administration (SBA).

CPC was an early leader in establishing a secondary market for mortgages through private placements to the New York City Employees Retirement System. The State of New York Mortgage Agency (SONYMA) provided credit enhancement for CPC loans. "Each CPC loan has a 100-percent mortgage guarantee backed by SONYMA's extensive reserves (not the full faith and credit of the state of New York)," according to the GAO report "Expanding Capital." "These reserves accrue annually through a special surtax on all commercial mortgage loans." (For more on CPC's secondary market activities, see John McCarthy's article in this issue.) CPC has also partnered with the New York City Teachers Retirement

15 Ibid., 23.
16 Ibid., 25.
17 GAO, "Housing Finance: Expanding Housing Finance: Expanding Capital for Affordable Multifamily Housing," October 28, 1993, 57. http://www.gao.gov/cgi-bin/getrpt?RCED-94-3

System, the New York State Common Retirement Fund, the United Methodist Church, and Fannie Mae.[18]

The creation of the Community Reinvestment Fund in 1989 and its growth through the 1990s represented a major advancement in the effort to create a vibrant secondary market for community development loans. CRF has purchased more than $300 million in community development loans from over one hundred lending organizations located in almost half the states in the country, and, as described later in this article, has more recently issued rated securities backed by some of these loans.

"CRF has begun to harness the power of markets to organize disparate development lenders," according to CRF president and CEO, Frank Altman. "The secondary market structure not only enables development lenders to tap the institutional capital markets, but it also fundamentally changes the ways in which these lenders view themselves. The participants in CRF's secondary market no longer view government grants as the sole source of capital in their development loans. They will be able to sell them to private investors and thereby diversify the sources of capital on which they rely to fund new economic development loans." Altman stressed that "we must increasingly regard federal assistance as a catalyst or incentive for private-sector investment." These efforts translate into finding "ways to improve the productivity of each dollar," he said.[19]

NeighborWorks, a national network of affordable community development organizations, also has been a significant player in the inchoate efforts to securitize community development loans. Its subsidiary, Neighborhood Housing Services of America (NHSA), started securitizing CDBG loans in 1974. NHSA has operated "a specialized secondary market created to replenish the revolving loan funds and capital pools of local NeighborWorks organizations." By 2004, NHSA had purchased more than $650 million in loans from local NeighborWorks organizations and their local lending partners.[20]

NCB transacted the first securitization of co-op loans in 1986. Testifying before the Senate Committee on Banking, Bradford T. Nordholm, president of the Cooperative Funding Corporation, a subsidiary of the NCB, said his organization had continued to innovate with securitization by completing the first securitization of cooperatively owned mobile home park mortgages in 1992. In 1993, it "successfully completed the first-ever securitization of affordable housing mortgages, the Mortgage Investment in Low-Income Communities Security (MILC), a pioneering effort to increase the flow of capital into affordable housing nationwide applauded by HUD Secretary [Henry] Cisneros."[21]

Nordholm was also successful in securitizing small co-op business loans. Testifying to Congress in the early 1990s, he observed that "most types of small business credit are beginning to be securitized–revolving lines backed by receivables and inventory, intermediate-

18 http://www.communityp.com/index.php?sec=history&page=mortgageinsurance.
19 Frank Altman, president of CRF, testimony before the Subcommittee on Public Buildings and Economic Development–Committee on Transportation and Infrastructure, February 22, 1995.
20 NeighborWorks Annual Report 2004, 26–28.
21 Hearings Before the Senate Committee on Banking, Housing and Urban Affairs, September 9, 1993.

term loans and leases backed by equipment and longer-term real estate loans." Nordholm went on to point out that "efficient conduits must develop in order to facilitate securitization, conduits that can deliver a minimum of $10 million to $25 million, preferably $100 million of homogeneous financial assets, with good performance statistics on both the ultimate borrowers, conduit and servicer."[22]

Yet more than a decade later, very few small business loans have been securitized, and the ones that are usually have the financial backing of the SBA. SBA began securitizing small-business loans in 1985, "when it first allowed depository institutions to pool and sell the guaranteed portion of their SBA loans," according to the EAD report. "This was similar to the original 'pass through' on Fannie Mae guaranteed mortgages."[23] In the end, however, SBA may not be especially helpful in setting precedents for securitizing community development loans for the following reasons: (1) SBA underwriting is highly standardized, which provides high volume; (2) the loans are made by private banks at near-market interest rates, which are higher than most community development businesses could afford; and (3) most of the loans carry SBA's guarantee.

Early Efforts to Bring in the GSEs

In the 1990s, both the Local Initiatives Support Corporation (LISC) and the Enterprise Foundation made efforts to partner with the housing GSEs to securitize affordable housing mortgages. LISC's subsidiary, the Local Initiatives Managed Assets Corporation (LIMAC), partnered with Freddie Mac in 1991, but the program was suspended after two years with only one transaction completed (eight existing mortgages totaling $4.6 million). A subsidiary of Enterprise, Enterprise Mortgage Investments (EMI), partnered with Fannie Mae in 1994. Both partnerships received funding from the National Community Development Initiative (NCDI), which enlisted Jean Cummings and Denise DiPasquale to do an analysis of the programs, which were published in HUD's *Cityscape* in 1998.[24]

The stated goal of the LIMAC/Freddie partnership was to provide "a missing piece in the housing puzzle." The partnership planned to "target community development corporations (CDCs) and small banks that would not normally work with Freddie Mac." LIMAC would buy loans from approved Freddie Mac multifamily seller/servicers. They would pool the mortgages and swap the pools for Freddie Mac MBSs, which could be sold to institutional investors. There was a risk-sharing arrangement where LIMAC and the originating lender had the top 20 percent of losses and Freddie Mac would share the remaining 80 percent with the lender. LIMAC had to assemble the loans, which may have required warehousing. And lenders could retain servicing and earn a fee.[25]

The EMI/Fannie Mae program was different in that EMI was the originator, under-

22 October 7, 1993, Bradford T. Nordholm, president, Cooperative Funding Corporation.
Before the U.S. House of Representatives Committee on Banking, Housing and Urban Affairs.
23 Robinson, "Expanding Capital Resources," 9.
24 "Developing a Secondary Market for Affordable Rental Housing: Lessons from the LIMAC/Freddie Mac and EMI/Fannie Mae Programs," *Cityscape* 4: (1998).
25 Ibid., 25.

writer, and servicer of the loans. Fannie was the investor, funding the mortgages. The EMI/Fannie program also differed in that it allowed for other investors. For example, the United Methodist Church bought $10 million in Fannie Mae MBSs through the program. Initially, according to Cummings and DiPasquale, "the program was to focus on long-term, permanent mortgages for smaller, central city, multifamily LIHTC [Low-Income Housing Tax Credit] projects being developed by CDCs and other nonprofit organizations–a market segment that program participants felt was underserved."

There was also a risk-sharing arrangement where EMI took the first 5 percent of loss and shared the remaining loss with Fannie Mae, although EMI's share of losses was not to exceed 20 percent overall. The EMI/Fannie Mae program got a late start because of lengthy negotiations over underwriting and what some saw as overly burdensome Fannie Mae documentation.[26]

In the end, these two programs did not accomplish their goals, but they did provide important insight into how the GSEs could be incorporated into a community development secondary market. And although the programs were different, they had some common themes of what did and did not work. For example, both were delayed in their rollout because the aggregators (EMI and LIMAC) had substantial differences with their GSE partners over what constituted a risk in the loan and how to underwrite and price the transaction. These divergent views created substantial back-and-forth negotiations that drained time and resources.[27] The transactions also required a considerable amount of extra work for borrowers, and according to Cummings and DiPasquale, "More than one potential lender dropped out of the program because of the amount of documentation required."[28]

It was possible to set the fees for part of the process up front, so the borrowers knew how much they would pay in points and rate to participate in the program. But Freddie Mac's guarantee was not priced until the end of the transaction in what was termed Freddie Mac's "black box." "This uncertainty overshadowed every step of the negotiations," according to Cummings and DiPasquale. "When the final price was set, both LIMAC and the lender felt that the price was too high, and the investor subsequently took a cut in its return to make the transaction feasible."[29]

A Changing Political Environment for Community Development

An important change occurred in the political climate in Washington over community development policies in the late 1980s and early 1990s. There seemed to be a growing consensus across the political spectrum that low-income communities were better off when a network of community groups, local and state governments, and elements of the private sector worked together to build housing and provide credit and social services.

Unlike previous antipoverty programs that produced such rancorous debates, the legislative deliberations for the new system redrew the battle lines in often unpredictable ways.

26 Ibid., 26.
27 Ibid.
28 Ibid., 29.
29 Ibid., 31.

Consider how the conservative Republican HUD Secretary, Jack Kemp, lobbied his liberal colleagues strenuously to reauthorize the LIHTC program. He urged liberals on the House Ways and Means Committee to "rise above the left-right debate and find consensus as to what our Nation can do to fight poverty."[30] The consensus he referred to was use of public-private partnerships to deliver social services. Kemp went on to praise both liberals and conservatives on the committee for their "willingness to walk away from ideology."[31] Some of this same rhetoric was present in the early 1990s debates over creating a secondary market for community development loans. A significant difference, however, was that community development finance advocates were not as successful as affordable housing advocates in securing federal funds to help create a secondary market of community development loans.

1992–1995: A Burst of Creativity at the Federal Level

In terms of building a secondary market, the developments leading up to 1993 tended to be small efforts, but starting that year there was a flurry of proposals at the national level. They included: (1) an effort by HUD to create a national credit enhancer on the foundation of FHA, the Federal Housing Corporation (FHC); (2) the FHA/State Housing Finance Agency Risk Share program; (3) new guidelines for Fannie Mae and Freddie Mac that directed them to buy more affordable housing mortgages; and (4) the Riegle Act of 1994, which helped foster community development finance and, at one point, contained a provision to create a new GSE for small business loans. Many of the proposals were generated by staff in the Clinton administration, and many of the same proposals were killed by the Republican majority in Congress after 1994.

1. FHC

In 1994–95, HUD put forth a proposal to "reinvent" FHA to be an organization that continued its traditional work but expanded into new areas of community development finance. This new organization, to be called the Federal Housing Corporation (FHC), would have combined an "entrepreneurial, market-driven mode of operation with a public-purpose mission and mind-set," according to Nicolas Retsinas, the HUD Undersecretary in charge of the proposed change.[32] The FHC "would continue to run the FHA single-family product mix," but it might also "experiment with pioneering mortgage products."[33]

Retsinas observed that many lenders "would like to increase their community reinvestment lending but cannot afford to tie up their capital in multiyear loans." Perhaps even more important, however, FHC credit enhancement might impose standardization on the documents and due diligence processes in community lending that "could help lenders attract secondary market capital and spur dramatic increases in community lending."[34]

30 U.S. Congress, House of Representatives, Committee on Ways and Means. *Low-Income Housing Tax Credit*, Hearing Before the Subcommittee on Select Revenue Measures of the Committee on Ways and Means, House of Representatives, 101 Cong., 2d sess., May 23, 1989.
31 House of Representatives, *Low-Income Housing Tax Credit*, 6.
32 Nicolas P. Retsinas, "Comment on Kerry D. Vanell's 'FHA Restructuring Proposal,'" *Housing Policy Debate*, 6: 2 (1995), 397.
33 Ibid., 405.
34 Ibid., 406.

The FHC, even though it hit many of the themes that made other community development programs successful, never was authorized. According to Retsinas, he could not get the idea past the "partisan gates of Congress."[35] A critical Price Waterhouse audit of FHA's multifamily loan insurance programs probably also contributed to the resistance in Congress to expand a loan insurance strategy at FHA.[36]

2. FHA Risk Share

In some ways, this flurry of activity at the national level was a continuation of exploring new ways to fund community development efforts that was an outgrowth of the political debates in the 1980s. The Cranston-Gonzalez National Affordable Housing Act of 1990, for example, charged the GAO to examine federal credit enhancements. Two years later, the GAO outlined four credit-enhancement options and Congress chose to pursue one, the FHA risk-sharing demonstration project. The proposed Risk Share program was an effort to find ways in which the federal government could put its credit capability behind the efforts of state housing finance agencies (HFAs) to bring down the financing cost of affordable housing.[37]

The FHA Risk Share program allowed experienced housing finance agencies to use their own underwriting standards and documents. The program, which still exists, "provides full FHA mortgage insurance to enhance HFA bonds to investment grade. HFAs may elect to share from 10 to 90 percent of the loss on a loan with HUD" depending on how much they share underwriting responsibility and risk of loss.[38] "Compared with 100 percent credit enhancement, a partial federal credit enhancement reduces the government's risks and potential costs, but generally subjects the loans to be securitized to an evaluation by the credit rating agencies or investors (for unrated securities)" according to the GAO.[39]

3. New GSE Guidelines

The Federal Housing Enterprises Financial Safety and Soundness Act of 1992 revised the regulations governing Fannie Mae and Freddie Mac. One section, entitled "Special Affordable Housing Goal," for the first time specifically required Fannie Mae and Freddie Mac to purchase affordable multifamily rental housing loans.[40]

35 Email from Nicolas Retsinas, June 10, 2006.
36 "Community and Economic Development Loans," 54.
37 GAO, "Housing Finance: Expanding Capital for Affordable Multifamily Housing," October 1993, 3.
38 http://www.hud.gov/offices/hsg/mfh/progdesc/riskshare542c.cfm.
39 GAO, "Community and Economic Development Loans," 51.
40 Ibid., 53.

4. Riegle Act

The Riegle Community Development and Regulatory Improvement Act of 1994 did many positive things for community development finance, including the creation of the CDFI Fund. But the proposal to create a GSE for small business loans did not make the final cut.

The debate over what became the Riegle Act echoed familiar themes: government-subsidized financing would help the community development network (including banks and other for-profit businesses) use the market to improve low-income communities. "[Senator Alfonse] D'Amato's [R-NY] approach favors a market oriented solution and avoids creating a massive bureaucracy," according to William Acworth, a finance reporter for the *American Banker*. He also wrote that the small business loan securitization bill had the backing of the Treasury and the Federal Reserve, but that its prospects were in doubt. Some bankers, according to Acworth, said that "small business loans are so different that pooling them into a viable security is extremely complex and often impossible. In their own view, the bill is simply a political gesture to small business, an important constituency on Capitol Hill."[41]

The Clinton administration and community development advocates were early and aggressive supporters of this bill, as were the real estate and banking industries. Donald Susswein told the House Committee on Banking, Finance and Urban Affairs, that "the Mortgage Bankers Association of America, the National Associations of Realtors, and the National Realty Committee would strongly support a bill that would lead to a broad-based commercial secondary mortgage market."[42]

An important part of the early legislation was the Venture Enhancement and Loan Development Administration for Small Undercapitalized Enterprises, or Velda Sue. This agency, similar to Fannie Mae in the mortgage market, would buy, securitize, and resell business loans to investors." This proposal, pushed by Rep. John LaFalce (D-NY), did not make it into the final bill.[43]

Merilyn Rovira, vice president of LIMAC, testifying in support of the Riegle Act to the House Banking Committee, acknowledged that there was an inherent tension with community development small business loans. "Many, if not most, of these loans are small, involve substantial technical assistance to borrowers, and have customized structures," she said. However, she continued, in an effort to "expand these kinds of lending efforts and promote the revival of healthy market dynamics in distressed communities, nonprofit lenders need to move beyond the portfolio lending that is now the norm in the industry and tap into broader sources of private funds."

Rovira went on to point out that one way to solve the problem of connecting low-volume,

41 William Acworth, "Top Bank Regulators Back Loan Securitization Bill," *American Banker* 3:35 (September 20, 1993), 1.

42 Written statement of Donald B. Susswein, Esq. on behalf of the Mortgage Bankers Association of America, National Association of Realtors, National Realty Committee, Before the Subcommittee on Economic Growth and Credit Formation for the U.S. House of Representatives Committee on Banking, Finance and Urban Affairs, September 23, 1993.

43 James C. Allen, "Asset Securitization: Borrower's Market Crimps Business-Loan Securitization Series: 15," *American Banker*, 160: 12, (January 19, 1995), 24.

boutique loans to a commodified institutional capital market was to rely on intermediaries such as LIMAC. "LIMAC's purpose is to show, with our small but growing track record, that these nontraditional community development loans, when properly underwritten, are not inherently risky and that they can be securitized," Rovira said. "The only way to document that risks can be taken is to take them."[44]

The Conference Report on the Riegle Act showed that not everyone got what they wanted.[45] The final version of the bill dropped the idea of Velda Sue, the community development GSE. As Paul Kanjorski (D-PA) said:

> Ironically, one of the other sectors of the economy left without effective access to a secondary market under this legislation is community development loans. Testimony given during my subcommittee's hearings clearly outlines the very real need for a secondary market for community development loans.[46]

The bill did create the CDFI Fund and other community development incentives, such as the Bank Enterprise Award.[47]

Tom Ridge (R-PA) did not agree with the Act's plan to promote CDFIs; he wanted to see more incentives for community lending at existing banks. "I have always believed that people left behind want to become part of the mainstream again." He argued, "Do not separate us with separate institutions."[48] Nevertheless, he was supportive of the bill, as were other well-known conservatives such as Toby Roth (R-WI), who said, "I will vote for the bill even though I have grave reservations about the bill's provisions that create a new Federal bureaucracy to create new subsidized nonbank lending institutions in urban inner-cities," referring to the creation of the CDFI Fund.[49]

By the end of the years'-long process, there was overwhelming support for the Riegle Act and it passed 410–12 in the House. It emerged from the conference committee in 1994 to become law.

Recent Developments

Since the mid-1990s, many advances have been made in all aspects of this secondary market story: early innovators have continued to innovate; certain advances are beginning to overcome securitization obstacles (e.g., lack of data); and new programs have been proposed at the federal level, some of which involve a greater role for the GSEs. That said, there still has not been a breakthrough that allows community development lenders to tap the massive pools of capital available from investors. The following is a discussion of these recent developments.

44 Testimony by Merilyn Rovira, vice president, Local Initiatives Managed Asset Corporation, House Banking, Economic Growth and Credit Secondary Market Development Act, October 7, 1993.
45 Conference Report on H.R. 3474, Riegle Community Development and Regulatory Improvement Act of 1994 (House of Representatives–August 4, 1994).
46 *Congressional Record*, H6786.
47 Riegle Community Development and Regulatory Improvement Act of 1994 (P.L. 103-325, 108 STAT. 2160).
48 *Congressional Record*, H6790.
49 *Congressional Record*, H6788.

Federal Efforts and GSEs

In recent years, there have been rumblings about new programs to create a secondary market, but they have not achieved any significant scale. In 1999, for example, HUD Secretary Andrew Cuomo proposed the creation of an expanded market for CDBG loans. Lauding the efficiencies in the single-family finance market, the Secretary said, "We don't have that in economic development (loans). If we did, it would be a fundamentally different system, and that's where we're trying to go." HUD already had experience with selling Section 108 economic development loans into the secondary market. "The thin edge of the wedge in the crack in the wall is there," Cuomo said. "It's a daunting undertaking, but there is some precedent." That program never got off the ground, however.[50]

A potentially more promising program from the federal government is one where the U.S. Department of Education is providing grants for credit-enhancing charter school loans. The Charter Schools Facilities Financing Demonstration Program has already scored some successful securitizations through groups such as The Reinvestment Fund (TRF), NCB, and the Low-Income Investment Fund. LIIF received a $3 million grant in the first round of this program and is using it "as loan loss reserve funds to leverage $64 million in private capital that LIIF and its partners are actively raising for further financing of charter school facilities."[51] Nancy Andrews, president and CEO of the Low Income Investment Fund, said, "With this grant capitalizing a loan loss reserve, we are now leveraging investments . . . from Citibank, Wells Fargo, Prudential, and other mainstream investment houses."[52]

There is also some interest in making a greater commitment to affordable housing part of the GSE reform legislation, which is currently being debated in Congress. One such proposal last year, the Reed Amendment, proposed that Fannie Mae and Freddie Mac set aside 5 percent of their profit to provide production grants in addition to credit enhancements for securitizing affordable housing mortgages. Nancy Andrews explained to the Senate Banking, Housing and Urban Affairs committee how this program might work. "The GSE would agree in advance to buy, say, $100 million of these loans and would establish a special loss reserve pool or 'credit enhancement' from the GSE Underserved Market Fund," she said. The "GSE would then pool these funds into a mortgage-backed security and provide credit enhancement that would confer its AAA bond rating on the pooled security. This security could then be sold in the capital markets."

The final pieces in this evolving story include innovation in solving some of the continuing problems of generating enough data to make adequate risk/reward pricing decisions, along with exciting breakthroughs by CRF in creating a rated community development security. Both of these developments are described below, followed by a description of recent secondary market innovations by the insurance industry and credit unions.

50 Ed Staples, "HUD Plans CDBG Secondary Market," *Mortgage-Backed Securities Letter* 14:6 (February 8, 1999), 1.
51 Susan Harper, "Funding Our Future: Charter School Finance 101," Low-Income Investment Fund, 3.
52 Congressional Quarterly, Capitol Hill Hearings Testimony, April 19, 2005, Senate Banking, Housing, and Urban Affairs , "Regulation of Government Sponsored Housing." Testimony by Nancy O. Andrews, president and CEO of LIIF.

Overcoming Obstacles to Securitization and Further Proving the Concept

As Alan Greenspan noted at the 2005 National Community Reinvestment Coalition Conference, the lack of reliable data is one of the industry's major handicaps, particularly as it migrates to using "new sources of equity–community development venture capital funds and secondary markets that securitize community development loan pools." Greenspan praised a number of efforts currently under way, including: (1) CDFI Fund's Community Investment Impact System, which collects standardized data on customers, transactions, and markets that use the New Markets Tax Credit program; (2) the Neighborhood Reinvestment Corporation's new data system that defines and measures the impact of community development programs; and (3) the Opportunity Finance Network's (OFN) "CDFI Assessment and Rating System" or CARS. "By consistently and reliably measuring outcomes, and thus helping current and prospective investors better assess their risks and predict their returns, community development organizations can attract more funding. Such accountability is crucial for any organization, regardless of size," he said.[53]

CARS is an important effort to try to standardize how CDFIs collect and report data. "Some CDFIs are actively trying to access the capital markets and have explored the possibility of obtaining a rating from a Wall Street firm," according to OFN. "While a CARS rating is not a Wall Street rating, the CARS process, over the long run, can help the rating agencies understand CDFIs and help CDFIs prepare for an eventual Wall Street rating or other transaction with the financial markets."[54]

Another recent breakthrough that might help clear the fog for investors interested in community development loans is a new small business portfolio model from Standard and Poor's. The model uses "a Monte Carlo–based algorithm that assesses loan portfolio default outcomes under various stress scenarios," according to a press release.[55] Using data from the SBA 7(a) program, and "after accounting for business sector and geographic correlation, one can generate statistically stable simulations of loan portfolio default outcomes." The model is designed for portfolios and not individual loans. The database has twenty years of history on 10,000 lenders with 650,000 small business loans.

Perhaps the most exciting recent development proving the viability of securitizing community development loans is the issuance of rated securities by CRF in 2004 and 2006. Previously CRF had been able to place privately hundreds of millions of dollars in community development loans, but by having its security rated by Standard and Poor's, it was able to attract new investors. For example, in CRF 17, issued in November 2004, the "first three tranches were rated AAA, which enabled eight new institutional investors with strict investing guidelines, including Northwest Mutual Life, to buy into the deal," as reported in an article in *Investment Dealers Digest*.[56]

53 "Remarks by Chairman Alan Greenspan at the 2005 National Community Reinvestment Coalition Confer ence, Washington, D.C., March 18, 2005. "Empowering Communities, Attracting Development Capital, and Creating Opportunities." www.federalreserve.gov/boardDocs/speeches/2005/20050318/default.htm

54 *CARS on the Road*–Edition 2. National Community Capital Association, 2005, 6.

55 Press release, "Standard & Poor's Introduces U.S. Small-Business Portfolio Model," February 5, 2005.

56 Elizabeth Wine, "Helping the Poor Via the Capital Markets," *Investment Dealers Digest*, February 28, 2005.

CRF is still working on improving the process. For example, many investors want to see a pool where no one loan is much bigger than the others; they prefer a pool of similarly sized loans (sometimes referred to as granularity). And there is a push to make sure that the pools are diversified geographically (though many bank investors are more interested in buying into pools with projects in their CRA assessment areas).

In May 2006, CRF rolled out its second rated security, CRF 18. According to Standard and Poor's Pre-Sale document

> The ratings assigned to CRF-18 LLC's $47.59 million CRF USA community reinvestment revenue notes series 18 reflect the credit enhancement consisting of overcollateralization, subordination, an interest reserve account, and excess spread. The ratings are also based on CRF's demonstrated servicing ability. This securitization is a pool of small business development loans that are not insured or guaranteed by any governmental agency.[57]

The Center for Community Self Help in North Carolina also has been generating a track record of performance with community development loans with Fannie Mae through its Community Advantage Secondary Market Loan Program. Self Help buys affordable mortgages and sells them to Fannie Mae, but with full recourse. A grant from the Ford Foundation helps underwrite a considerable amount of the financial risk for Self Help.

The Center for Community Capitalism at the University of North Carolina at Chapel Hill has been studying the performance of these loans, which "could not otherwise be readily sold in the secondary market because of their perceived higher risks." These loans have:

> flexible underwriting and typically include one or more of the following features: low or no down payment, higher debt-to-income ratios, approval of borrowers with spotty credit records or no established credit, and waivers of private mortgage insurance and the usual requirement that a borrower have at least two months of loan payments available as a cash reserve at the time of closing. [58]

There also have been developments in the secondary market by both the insurance industry and credit unions, which seem to be driven by the desire to show that they are doing innovative work around community development without the stick of CRA-like legislation for their industries. The insurance industry launched Impact Community Capital (Impact), which has been providing capital to community development lenders (for a more complete discussion of a transaction with Impact as purchaser, see George Vine's article in this issue).

The National Federation of Community Development Credit Unions launched its secondary market program with a purchase of single-family mortgages that were originated by Self Help for recent immigrants at the end of 2005. The loans use Individual Taxpayer Identification Numbers (ITINs) rather than social security numbers. Federation Executive Director Cliff Rosenthal said the Federation plans to purchase other loans, including co-op loans and manufactured housing mortgages. "The goal of the CDCU Secondary Market is

57 http://www2.standardandpoors.com/servlet/Satellite?pagename=sp/sp_article/ArticleTemplate&c=sp_article&cid=1145743573642&s=&ig=&b=2&dct=19.

58 Michael A. Stegman, Roberto G. Quercia, and Walter R. Davis, "Sharing the Wealth Through Homeownership: A Preliminary Exploration of the Price Appreciation Experiences of Low- and Moderate-Income Families Who Bought Homes Under the Community Advantage Secondary Market Loan Program," July 21, 2004 (revised July 8, 2005). Center for Community Capitalism, University of North Carolina at Chapel Hill.

to purchase nonconforming loans at a fair price from credit unions, season them, aggregate them, and then resell them when and where appropriate," according to Terri J. Fowlkes, the recently appointed director of the CDCU Mortgage Center.[59]

Conclusion

The possibility of a fully functioning secondary market for community development loans holds the promise of dramatically increasing the flow of cheaper capital to struggling low-income communities. Over the last twenty-five years, that promise has been realized at points in time and in fits and starts. But the overall goal remains elusive. It is not clear what program, policy, or product might break the bottleneck and help bring about this market. In the meantime, however, creative and talented community development financial practitioners will continue to lay the groundwork–collect the data, prove the concept, build new models–in order to find ways to more fully engage the capital markets in community development.

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59 Rafael Morales, "New Secondary Market Launched: Federation Begins Purchase of Affordable Mortgages," NFCDCU Press Release. http://www.natfed.org/i4a/pages/index.cfm?pageid=994.

Manufactured Housing Finance and the Secondary Market

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Manufactured housing, or mobile homes, is often the most attractive housing option for many low- and moderate-income Americans. Reinforcing the concept that it is expensive to be poor, the financing of manufactured housing is often much more expensive than it needs to be. This article reviews how the current financing for manufactured homes functions, explores why it is so expensive, and suggests an important strategy to reduce its costs by pursuing a secondary market for manufactured home mortgages.

The benefits to low- and moderate-income home owners of a more efficient manufactured home mortgage market would be substantial, for as many as 10 million families live in manufactured homes. Many are low-income families, the group for whom home ownership is one of the only sources of wealth and financial stability. Indeed, manufactured housing is a key resource when it comes to providing home-ownership opportunities for low- and moderate-income families, accounting for two-thirds of this country's new affordable housing production in recent years.[1]

There are many obstacles to creating this more efficient mortgage market, but that was also once true for site-built homes when credit was expensive and home-ownership rates were low. Over the past fifty years, however, the U.S. mortgage market has created ample capital flows and continued product innovation that have contributed to a home-ownership rate over 70 percent and a climate–unique in the international context–in which an 80 percent loan-to-value, thirty-year mortgage is considered "plain vanilla." The following explores how that same vibrancy can spread to the manufactured housing market.

Current Financing of Manufactured Housing Is Expensive

Although most families who live in manufactured housing consider themselves home owners like any other, the process by which they purchase and finance their home is radically different. This contradiction, in part, is a relic of the manufactured housing industry's origins in the travel-trailer industry of the 1940s and 1950s. The technology used to produce manufactured homes has evolved in leaps and bounds, resulting in a product that today can be virtually indistinguishable from site-built construction. But even though a manufactured

1 William Apgar, Allegra Calder, Michael Collins, and Mark Duda, "An Examination of Manufactured Housing as a Community- and Asset-Building Strategy," Report to the Ford Foundation by the Neighborhood Reinvestment Corporation in collaboration with the Joint Center for Housing Studies of Harvard University, September 2002, 16.

home today bears no resemblance to a "trailer," it is still all too frequently sold and financed like one.

The trailer-inspired sales and finance system imposes unnecessary costs on owners of manufactured homes. For example, most manufactured homes are titled as personal property and consequently their financing is handled through personal property–or "chattel"–loans rather than normal real estate mortgages. Consider data provided by two different lenders who deal predominantly in manufactured home chattel loans. Don Glisson Jr. of Triad Financial noted that his loans start at 7 percent, but only 20 percent to 25 percent of customers receive this rate. Others pay up to 10.5 percent, which is reserved for those with the lowest credit scores who are borrowing on a single-wide unit. David Rand of Origen Financial noted that his average was 9.5 percent with a range of 7.5 percent to 15 percent.

The prevalence of chattel loans tends to push up the finance costs for the average borrower. The Affordable Housing Survey shows that manufactured homes on rented land have median terms of 9 percent interest for 15 years (or 8.7 percent interest for 18 years if on owned land), compared to median terms of 7.5 percent interest over 25 years for single-family site-built homes.[2]

Although many manufactured home purchasers try to access the mortgage market as a way to get cheaper financing, they are rejected by lenders at a higher rate than homebuyers with similar credit scores who purchase site-built homes. Manufactured housing mortgage purchase applications were rejected 30 percent more often than applicants for site-built houses at every level of income (see Figure 1), according to 2004 lender data reported in compliance with the Home Mortgage Disclosure Act of 1975 (HMDA).[3] In fact, people well above the median income are rejected for manufactured housing mortgage loans at much higher percentages than those with incomes below the median who apply for site-built home mortgages.

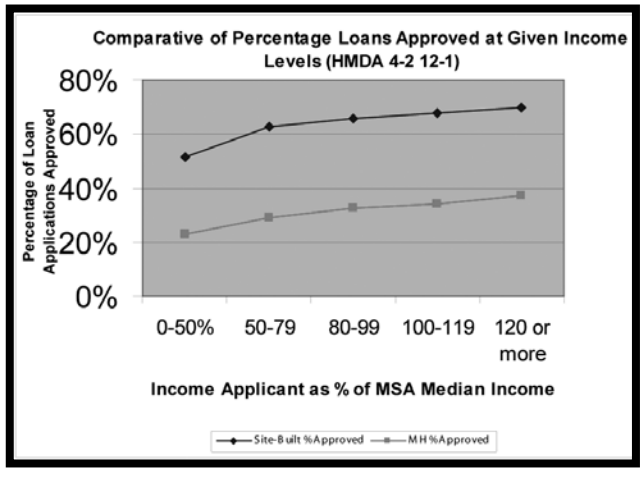


Figure 1

2 Ibid., 12.

3 HMDA data is available at the Federal Financial Institutions Examination Council website: http://www.ffiec.gov/hmda/.

Finally, for those customers who are able to secure a conventional (non-chattel) mortgage, the loan is more expensive than site-built home loans. Specifically, more than 50 percent of manufactured housing loans are made at rates that are three percentage points higher than Treasury rates, while only 11 percent of site-built home mortgages are made at these higher rates (see Figure 2).

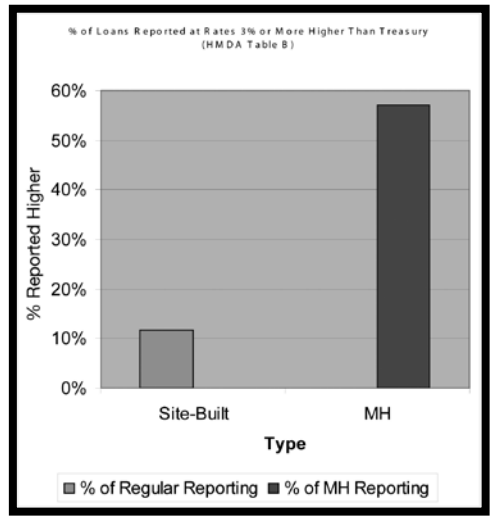


Figure 2

Current Obstacles to an Efficient Mortgage Market

Many aspects of the current market for manufactured homes make them difficult candidates for long-term, conventional mortgages, including how they are sold, sited, titled, and appraised.

Dealers

Most new manufactured homes are sold through dealers. In many instances, dealers steer buyers into the personal property loan route because those loans are fast and simple, even though they are more expensive. Moreover, loans are often referrals from dealer to lenders, where the dealer captures a fee–sometimes a percentage of total financing–in return for the referral. These fees can come as direct transfers, bonuses for pushing particular products, or bonuses based on the performance of the loan. Finally, some dealers aggressively try to steer purchasers to their own financing program, which often is less competitive than a home mortgage.

In addition to pushing more expensive financing options, some dealers also create confusion around the price of a manufactured home. The practice of pricing a manufactured home varies from state to state. In California, dealers are required by law to display the Manufacturer's Suggested Retail Price (MSRP). The MSRP information includes invoice price, recommended dealer markup, and the home's specifications. This allows consumers (those shopping dealers' lots, as opposed to those buying a home that has already been affixed to real property), to make apple-to-apple comparisons between different models and dealers. In many states, however, this is not yet standard practice. Although many lenders demand invoice information for a personal property, or chattel loan, consumers are often in the dark on their home's true price.

High dealer markups lead home buyers to take a bigger loan to cover the higher price that results from the markup, reducing the amount of home equity achieved through their down payment. This also raises the loan-to-invoice ratio, which increases the interest-rate lenders charge. In the conventional mortgage market, there are several safeguards to protect

borrowers, but there is very little supervision of predatory lending practices with personal property loans. Not all manufactured housing loans are governed by the Real Estate and Settlement Procedures Act, the Truth in Lending Act, or the Home Ownership and Equity Protection Act, for example, which protect borrowers from abusive or nontransparent practices, including exorbitant costs and kickbacks.

Manufactured home sellers who put a premium on the home buyers' utility could set better examples for the existing dealer network. For example, CFED's Innovations in Manufactured Homes (I'M HOME) initiative supports nonprofit affordable housing developers that are placing high-quality, affordable manufactured homes in communities around the country and selling them directly to home buyers. Potterhill Homes of Cincinnati is a leading example of a for-profit developer that also works directly with homebuyers, allowing them to bypass the dealer network. Bringing responsible dealers and developers, whether for-profit or nonprofit, into the sector will contribute to setting new standards for fair, efficient, and equitable treatment of consumers. It also, in many cases, brings consumers directly into the pipeline for traditional mortgages.[4]

Flight Risk: How Mobile Is a Mobile Home?

Once a customer buys a manufactured home from a dealer, he or she will site the home on a lot that could be either owned or leased. Even though many manufactured homes are sited on leased land, they are rarely moved–by one estimate, as little as one percent are ever moved.[5] In part, this is explained by the cost of moving and the limited options of where to go: "relocating a 'mobile' home costs $1,500 to $5,000, and most parks won't take one more than ten years old," according to a Ford Foundation report. [6]

Manufactured homes are also increasingly likely to be placed on privately owned land rather than leased lots.[7] Yet these homes, even when permanently affixed to land to which the home owner has fee simple or cooperative ownership, are essentially still treated like travel trailers by some lenders. This phenomenon is explained, in part, by a Catch-22 situation where you cannot title a home as real estate until you attach it to the ground, but you cannot attach it to the ground until you buy and transport it home.

4 Similarly, the entrance of major banks into the manufactured housing mortgage market holds potential to improve competition, standards, and practices, which in turn would make manufactured housing mortgages more enticing to a secondary market. More mainstream mortgage lending would also bring greater consumer protection to the manufactured housing market.

5 Allan Wallis, "Manufactured Housing," in *Encyclopedia of Housing*, ed. Willem van Vliet, 347–51 (Thousand Oaks, CA: Sage Publications, 1998).

6 Kevin Krajick, "The American Dream on Wheels," Ford Foundation Report, Spring 2003. http://www.fordfound.org/publications/ff_report/view_ff_report_detail.cfm?report_index=392.

7 CFED, 2005. http://www.cfed.org/focus.m?parentid=317&siteid=317&id=581.

The Problems with Title and the Importance of Owning the Asset as Real Estate

Title to manufactured homes is also complicated. Nearly one-third of manufactured homes are titled as real estate, with the vast majority being titled instead as a car or boat would be: as personal property. [8] In more than 40 states, it is possible to convert the title of the manufactured home from personal to real property (in many cases the central requirement is that the home is affixed to a permanent foundation). [9] Yet the numbers themselves indicate that home owners are not pursuing this option. It is unclear whether this is because of a lack of information during the purchasing and financing process, or because of the complexity of the titling process.

While the reasons that most manufactured homes never get converted to real property may vary from case to case and state to state, the way in which the home is titled will consistently influence the home owner's financing options. Homes that are titled as personal property rather than real estate will qualify only for personal property financing or nonconforming mortgage financing. Both types of financing are more expensive than standard conforming mortgages.

Appraisals, Value, and the Resale Market

A final consideration that complicates the manufactured housing market is the current process of valuation and appraisals. Appraisers used to dealing with site-built housing are often at a loss as to how to fairly appraise manufactured homes. Guidelines such as Fannie Mae's requirement that two out of three comparable sales used for the appraisal be manufactured homes may further confuse things, particularly when manufactured housing is used for infill development alongside site-built homes.[10] Steve Hullibarger, industry consultant, notes that "the low number of HUD code homes in many urban locales makes it tough or impossible to locate manufactured housing comps to satisfy the Fannie Mae requirement."[11] Efforts to train appraisers on modern manufactured housing do exist, such as a partnership between the Manufactured Housing Institute (MHI) and the Appraisal Institute. Appraisals without solid backing affect both new and existing homes, increasing the general uncertainty of the resale market for manufactured housing.

For asset-building strategies to provide low- and moderate-income families with a meaningful path to financial security, families must be able to acquire assets, preserve or grow their value over time, and eventually realize the accumulated value of that asset. George McCarthy, program officer at the Ford Foundation, refers to these three elements as the "asset-building trinity." [12] Yet the constrained resale market for manufactured housing is the weakest part of this market's "trinity." Owners of these homes cannot simply assume that

8 Ronald A. Wirtz, "Home, sweet (manufactured?) home," Federal Reserve Bank of Minneapolis, Fedgazzette, July 2005. http://minneapolisfed.org/pubs/fedgaz/05-07/cover.cfm.
9 Cathy Atkins, "Manufactured Housing: Not What You Think," National Conference of State Legislatures, January 2006, http://www.ncsl.org/programs/econ/housing/manufacturedhousing.html.
10 Fannie Mae Announcement 03-06, June 3, 2003. "Mortgage Eligibility and Servicing Procedures for Mortgages Secured by Manufactured Homes," 9. http://www.efanniemae.com/sf/guides/ssg/annltrs/pdf/2003/03-06.pdf.
11 Steve Hullibarger Interview, February 2, 2006.
12 George McCarthy Interview, February 3, 2006.

their investment will result in a nest egg when they are ready to sell, in part because financing options for existing manufactured homes are scarce. Fannie Mae's standards, for example, do not allow the purchase of mortgages on anything but new manufactured homes. This limitation severely curtails capital for the sale of existing manufactured homes. Inasmuch as the lack of a resale market limits the collateral value of manufactured homes, a vicious cycle is created. The lack of credit available for purchase of existing manufactured homes severely restricts the pool of potential buyers. Fewer buyers who are willing and able to buy an existing home means lower collateral value: as demand shrinks, lenders' perception of risk–for both new and existing manufactured housing–grows. After all, what would happen if the home owner needs to sell before the loan is paid off?

Making the Manufactured Home Market More Like the Site-built Home Market: A Promising Example

The Ford Foundation and the New Hampshire Community Loan Fund (NHCLF) are proving that a home financing system that mimics the single-family, site-built home mortgage market can work for manufactured housing. Ford provided $3 million in low-interest capital to help NHCLF originate retail mortgage lending services to residents of the 78 manufactured housing parks that it has helped to convert to resident ownership. NHCLF makes mortgage loans for new home acquisition, purchase of existing homes, refinance, and repair to borrowers at rates between 8 percent to 9 percent for up to 25 years. NHCLF also provides first-time home buyers access to state Housing Finance Authority loans at 6 percent interest over 30 years. The Loan Fund has also been successful in selling mortgages to CRA-motivated lenders. This is a crucial point, given that the development of a vibrant secondary market for manufactured housing loans is one of many obstacles that must be overcome before it is possible to realize the potential savings for the millions of low- and moderate-income families that own manufactured homes.

Toward a Secondary Market for Manufactured Housing Mortgages

Overview

Securitization is "a process of packaging individual loans and other debt instruments, converting the package into a security or securities, and possibly enhancing their credit status or rating to further their sale to third-party investors."[13] The key purpose in securitizing loans is to move from illiquid loans to liquid investment vehicles. This makes raising capital easier for lenders and, in turn, allows them to lend at lower rates. This also provides more available funding and a variety of credit forms for consumers. For the loan originator, securitization allows for the turnover of capital more quickly and for increased profits. Investors receive more options for diversification, profit possibilities from trading, liquidity, and yields based on rated levels for risk. Finally, investment banks have opportunities for new products, and for trading volume and profits.[14]

13 Kendall, Leon T. and Fishman, Michael J. eds, *A Primer on Securitization* (Cambridge Mass.: The MIT Press, 1996), 1-2.
14 Ibid, 13.

The process of securitization begins with a lender making loans that it continues to service as protection against default. These loans are purchased by a trust that issues securities that are protected by the underlying collateral. These loans are then rated by credit-rating agencies; they receive the highest rating if they are backed by the full faith and credit of the U.S. government, or with the highly regarded credit backing of a Government Sponsored Enterprise (GSE). This rating provides investors with a heuristic to measure the worthiness of the loan and decide what level of risk they are willing to take for a given yield–as well as indicate how easily they can resell the security. If a loan does not merit the desired credit rating on its face, credit enhancements such as a letter of credit or a bank insurance policy, as well as use of subordinated debt, reserves, or overcollateralization, can work to enhance investor confidence.[15]

GSEs

For the site-built market, Fannie Mae and Freddie Mac are the chief actors who purchase loans from lenders and package them as securities that can be sold to investors. As a result of the above risk and perceptions of risk, investors and the GSEs, such as Fannie Mae and Freddie Mac, have been reluctant to get more involved in the manufactured home market where they suffered significant losses in the recent past. Yet the losses they suffered were the result of an "easy credit" boom, which has now passed and from which the entire industry has learned major lessons.

As a result, GSE involvement is almost nonexistent in manufactured housing. Typically, Fannie Mae and Freddie Mac do not buy chattel loans, and though the properties that are titled as real estate can be purchased by the GSEs as manufactured housing mortgage-backed securities (MH MBS), less than half of one percent of Fannie Mae's holdings are manufactured housing loans.[16]

In addition, Fannie Mae buys only a very small subset of manufactured home mortgages that have specific characteristics. In order for Fannie Mae to purchase a manufactured housing loan, the home must meet HUD-dictated building standards, be classified as real property, be on owned land or cooperatively owned land, meet specific space requirements, be attached to a permanent foundation, be on a public or community owned street, have permanently connected utilities, and have all improvements fully paid.[17]

Data that do exist often reflect the worst of the market. For example, Fannie Mae charges a 50 basis point risk premium on manufactured housing loans based on the poor performance of their manufactured home mortgages acquired from their takeover of a failed chattel lender. Even though this data set does not represent the full spectrum of manufactured housing loan performance, Fannie Mae's policies compromise the entire marketplace. According to Steve Hullibarger, Fannie's policies "have really chilled the market and spooked many developers

15 Ibid, 2–6.
16 Ronald A. Wirtz, "Ginnie Mae I buy a Manufactured Home?" *Fedgazzette*, July 2005, http://minneapolisfed.org/pubs/fedgaz/05-07/buy.cfm
17 Fannie Mae Announcement 03-06, June 3, 2003 (see footnote 9).

into either using more expensive modular homes or simply backing off [from manufactured housing] entirely."[18]

While Michael Collins of Policylab Consulting believes that "Fannie and Freddie have to do it first to get the bigger lenders into the market, while also playing some retraining role to help lenders to understand the market," others look outside the GSEs for secondary market options.[19] As McCarthy points out, "The GSEs now buy less than 50 percent of site-built loans–Citibank, Chase, and others are getting as big or bigger than Fannie or Freddie. Citibank is trying to decide if manufactured housing is enough of an emerging market to get into."[20]

Collateral Risk

One significant challenge to creating a secondary market for manufactured housing mortgages is understanding the value of the underlying asset. In other words, does manufactured housing appreciate or depreciate, and by how much under different circumstances? Part of the problem in answering this question is the recent turmoil in the manufactured housing market.

The manufactured housing and chattel lending industries have experienced remarkable upheaval since the mid-1990s. During a phase of solid performance up to the mid-1990s, industry expert Martin Lavin explained that there was a period of "free-wheeling retail lending terms, when many long-time industry loan provisions were discarded." [21] Such relaxed underwriting soon led to a performance crisis in the chattel lending industry, ultimately culminating in the highly publicized bankruptcy of lender Conseco (formerly Green Tree Financial) in December 2002. While Conseco may have generated the most headlines in the mainstream media, it was not the only casualty. Lavin estimates that by 2000, when the "asset backed securities . . . bomb detonated . . . about two-thirds of the lenders had perished."[22] Home shipments also dropped precipitously as failed loans flooded the industry with excess product in the form of repossessed homes.

The assumption that a manufactured home does not appreciate like a "regular" home is deeply ingrained in the public's consciousness. There are proponents of this view within the industry itself: David Rand of Origen asserts, "We still have a depreciating asset. When you map out the amortization curve on one of these units over thirty years, the customer is under water."[23] This assessment may reflect the market as it is–with many imperfections and irresponsible lending practices–rather than the market as it could be if it had better rules and products. It most likely does not reflect quality of construction, which has risen dramatically over the years to the point where MHI estimates that manufactured housing's life expectancy today approximates that of comparable site-built housing.

18 Steve Hullibarger Interview, February 2, 2006.
19 Michael Collins Interview, February 1, 2006.
20 George McCarthy Interview, February 3, 2006.
21 Martin V. Lavin, "Chattel Lending Today: Is It Dead or Alive?" MHI, Modern Homes, November–December 2004, 13–15. http://www.martylavin.com/writings/Feat-Chattel%20Today.pdf.
22 Martin V. Lavin, "It's the Affordability, Stupid," *Manufactured Home Merchandiser*, March 2002, 1–3. Available online at http://www.martylavin.com/writings/its-the-affordability-stupid.pdf, accessed March 31, 2006.
23 David Rand Interview, February 7, 2006.

There is a small but growing body of data that suggests that manufactured housing appreciates under the right circumstances. Consumers Union, for example, analyzed manufactured housing data and found that "average appreciation rates of manufactured homes packaged with owned land are statistically in line with the site-built market" (emphasis added).[24] However, the Consumers Union study did find that there is a wider variation in appreciation and depreciation of manufactured housing than site-built housing, as illustrated in Figure 3.[25] The fact that more manufactured housing units depreciate tends to lead people to assume that most, if not all, of these units depreciate.

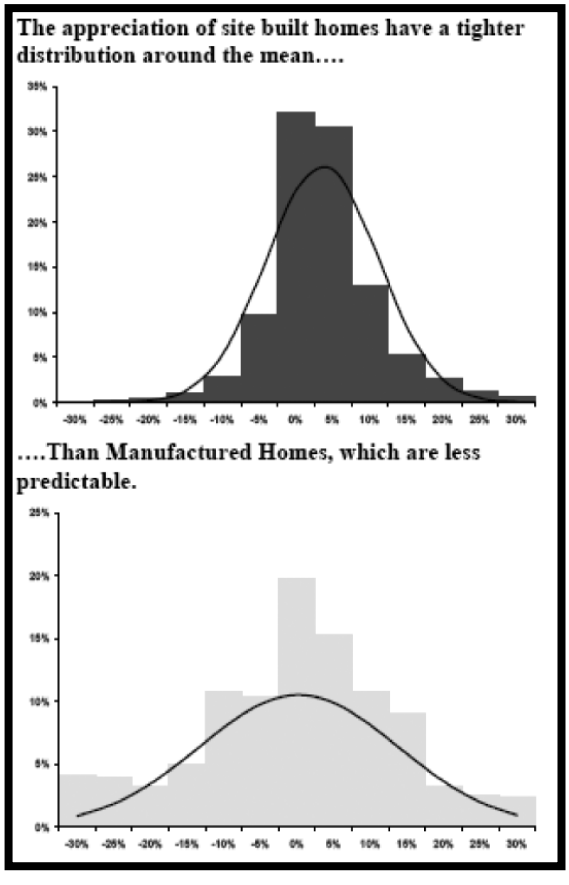


Figure 3[26]

NHCLF has accumulated anecdotal evidence that homes in resident-owned communities appreciate faster than those in land-lease communities. The organization is now working with the University of New Hampshire to track appreciation more generally.[27]

The experience of California, the first state to prohibit zoning restrictions based solely upon construction method, is instructive as well. For nearly 25 years, industry consultant Steve Hullibarger has maintained a database of more than 1,500 manufactured homes on infill lots that have been converted to real property. Appreciation rates of the more than 500 of these homes that changed hands during this period track similarly to surrounding site-built homes.[28] Finally, both MHI[29] and HUD's Partnership for Advanced Technology in Housing (PATH) review academic studies that suggest that manufactured homes, when architecturally compatible to their neighborhoods and affixed on permanent foundations, can appreciate. [30]

24 Kevin Jewell, "Manufactured Housing Appreciation: Stereotypes and Data," Consumers Union (April 2003). http://www.consumersunion.org/pdf/mh/Appreciation.pdf.
25 Ibid. This is also true generally for cheaper housing, whether it is manufactured or site built.
26 This graph in the Consumer Union source (see note 24) is based on data from the American Housing Survey. http://www.census.gov/hhes/www/housing/ahs/ahs.html
27 Paul Bradley Interview, February 2, 2006.
28 Steve Hullibarger Interview, February 2, 2006.
29 Manufactured Housing Institute. http://www.manufacturedhousing.org/lib/showtemp_detail01.asp?id=129&cat=3.
30 Stephen Winter Associates, "A Community Guide to Factory-Built Housing," September 2001. http://www.huduser.org/publications/destech/factbuilt.html.

Default Risk

Researchers at the University of North Carolina found that controlling for everything but manufactured housing status (though analyzing refinancing loans), the odds of default are only 11 percent higher, while prepayment risk is 43 percent less that of site-built home mortgages.[31] This means that, while it is somewhat more likely that a manufactured home loan will go into default, it is far less likely that the borrower will prepay.[32] In the end, these risks do not seem to explain the much higher interest rates for manufactured housing over site-built housing.

Strategies to Reduce Risk

Risk, or perceived risk, to investors of manufactured home mortgage securities currently impedes a functioning secondary market. Risk can be reduced through the following credit enhancing strategies:

Subordinated Debt and Overcollateralization

One way to make manufactured home mortgages more attractive to both lenders, and ultimately secondary market investors, would be to borrow a strategy used by the New Hampshire Community Loan Fund (NHCLF) for co-op conversion loans for residents to purchase their mobile home parks. "The key strategy," according to Andrea Levere, president of CFED, "is to bring in Community Development Financial Institutions to provide subordinated debt to back up the first mortgage." This approach of sorting out the debt, with a senior piece that is less risky, has been a very successful strategy for NHCLF. "That's how New Hampshire built its whole market," Levere said. Over time, as conventional lenders get more comfortable with the loan product, "then the subordinated debt can get smaller and smaller."

The same strategy could be employed at the individual mortgage level. In this case, you could have a first mortgage that was relatively small compared to the value of the collateral (the manufactured home). This approach would accomplish two objectives: (1) make lenders more comfortable with making manufactured home loans; and (2) create a type of loan that would be attractive to investors after it was pooled and securitized. In this case, you might have a CDFI, philanthropy, government agency, or some other socially-motivated lender make the subordinated second loan on the manufactured home.

31 "The Impact of Predatory Loan Terms on Subprime Foreclosures," in *The Special Case of Prepayment Penalties and Balloon Payments*, ed. Roberto G. Quercia, Michael A. Stegman, and Walter R. Davis, Center for Community Capitalism, Kenan Institute for Private Enterprise, University of North Carolina at Chapel Hill, January 25, 2005.
32 Prepayment risk is generally of greater concern to lenders because it is unpredictable and cannot be mitigated; whereas default risk can be controlled by insurance.

Insurance

Mortgage insurance could play some role in supporting a secondary market for this industry. This type of policy exists for other "risky" or small-scale loans. The Federal Housing Administration (FHA) provides mortgage insurance for loans with as little as three percent down, which vary from plain vanilla mortgages to mortgages that have rehabilitation built into them. FHA will provide insurance for single-family houses, houses with two to four units, condominium units, and houses needing rehabilitation under its 203(b) and 203(k) programs. In the case of default, following foreclosure the lender can be reimbursed for the unpaid portion of the loan after filing an insurance claim with HUD. If this policy were extended to manufactured housing, lenders would be able to loan with more confidence–reducing rates and making the loans much more attractive to secondary market investors. Beyond FHA and HUD, mission-driven organizations could provide low-cost insurance in pursuit of meeting their goals. [33] On the for-profit side, private insurance could also be used to reduce the risk of these loans.

Guarantees

Guarantees in the primary sense exist through mortgage insurance programs described above; however, guarantees could also be useful on the secondary market side. The Government National Mortgage Association (Ginnie Mae) provides a guarantee of interest and principal payment to secondary market investors for all loans insured by the variety of government agencies discussed above that are backed by the full faith and credit of the U.S. government. This is in pursuit of its mission "to expand affordable housing in America by linking global capital markets to the nation's housing markets."[34]

Ginnie Mae's guarantee extends to manufactured housing; however, under its current guidelines, most manufactured housing loans do not meet eligibility criteria. Among other requirements, the loan must be insured by FHA (the Title 1 program) or the Department of Veterans Affairs (VA), and interest rates for a given pool of loans must be within 1.5 percent of each other.[35] According to HMDA data, less than 17 percent of all manufactured housing mortgages (this is excluding personal property loans) approved in 2004 were approved under Title 1 or by the VA, and the sheer amount of interest-rate variation in manufactured housing loans due to the lending practices described in the previous section disqualify most mortgages.[36] Loosening these requirements, and exploring ways for Ginnie's secondary market guarantee to extend to a greater portion of manufactured housing loans, would do much to interest secondary market investors.

33 Federal Citizen Information Center, "Guide to Single Family Home Mortgage Insurance"), February, 2005. http://www.pueblo.gsa.gov/cic_text/housing/home-insure/mortgage.htm#how.
34 Ginnie Mae, "About Ginnie Mae," http://www.ginniemae.gov/about/mission.asp?subTitle=About.
35 Ginnie Mae, "Chapter 30: Manufactured Home Loan Pools and Loan Packages–Special Requirements," Ginnie Mae 5500.3, Rev. 1 30-1, (July 2003). http://www.ginniemae.gov/guide/pdf/chap30.pdf.
36 Housing Mortgage Disclosure Act National Aggregates, Tables A-1 and A-2, Federal Financial Institutions Examination Council 2004. http://www.ffiec.gov/hmdaadwebreport/NatAggWelcome.aspx

The same holds for Fannie Mae and Freddie Mac. As publicly traded entities, they have the freedom to pursue many types of mortgages, but their guarantees are backed by their own credit, not that of the U.S. government. However, credit markets rate their paper with the highest confidence–in large part because some believe there is an implied guarantee by the government. Yet even though manufactured home sales can be as high as 20 percent of all new homes in a year, Fannie and Freddie's manufactured housing holdings are less than half of one percent of their total holdings.

It is in the interest of many agencies and mission-driven organizations to increase the stock of affordable housing. To this end, an individual manufactured home guarantee program could be created with funding across agencies, or it could be created within one of these agencies. Further, any investor or foundation with the financial wherewithal could endow such a guarantee program.

Reserves

Another approach to this problem would be to capture the entire surplus that is currently going to dealers and lenders and find a way to funnel that money (or a portion of it) into reserves that make manufactured housing mortgages less risky. For example, tens of thousands of borrowers currently pay 14 percent on their loans; imagine what one could do to make loans less risky with the difference between that interest rate and an 8 percent mortgage?

This demonstrated willingness-to-pay by millions of consumers could be redirected to reserves that would be used as a reserve account for the trust that issued the securities. The reserves would be subordinated to all other interests and could be released over time after the underlying collateral hit specified performance targets. The freed-up financial reserves might fund deferred maintenance, or park upkeep (in the case of a co-op ownership), or be released back to the borrower.

How to Pay

The many types of credit enhancements explained above are expensive but provide a significant bang for the buck. One policy consideration would be to analyze how existing government housing programs (Community Development Block Grants, LIHTC, NMTC, HOME funds) might fund credit enhancement for manufactured home mortgages. Other sources of financing that should be explored are the proposed Single-Family Affordable Home Housing Tax Credit or the American Dream Downpayment Fund.

Conclusion

In a world where only one-third of all manufactured homes are titled as real estate, there is clearly a long way to go before there is a vibrant mortgage market, much less one that benefits from the liquidity and lower borrowing costs that a secondary market can generate. But the potential benefit–both to the borrower and the financial industry–is spectacular. It is hard to overestimate the impact that low-cost mortgages for manufactured homes could

have. This new efficient financial system could create new markets for mortgage lenders and Wall Street firms; develop a new affordable housing tool for CDCs and local governments; and provide banks with a new CRA-qualified lending product (and investment, if EQ2s or Community Development Venture Capital were used as credit enhancements). Most importantly, however, it would promote asset creation, pride, and the dignity of home ownership for millions of low-income American families.

Perceptions that manufactured housing is an innately risky housing stock, along with market imperfections in both the for-sale and resale markets, create formidable barriers for lenders. Yet it is worth distinguishing between unacceptably high risk and unfamiliar risk. Michael Collins believes "once you get the lenders over their stereotypes, they'd be more than willing to enter the market. The biggest issue is not the product, but the lack of education. A lot of people got burned in the 1980s and early 1990s. Others just don't know and are going on stereotypes and assumptions."[37] In this sense, all the players necessary to stimulate the growth of a healthy mortgage market for manufactured housing – lenders, GSEs, mortgage insurers, and other investors – need to feel that they are not taking on unknowable, unmanageable risks by entering this market. And what does that take? In the site-built market, such confidence is based on familiarity with the product, market data, accurate valuation of collateral, and confidence in a thriving resale market.

Sean West recently received a Master of Public Policy degree from the Goldman School of Public Policy at UC Berkeley, and completed this paper, as well as a larger survey of manufactured housing finance, as part of his degree program, with sponsorship from the Federal Reserve Bank of San Francisco. He has also authored papers on foreign policy and international security, and was recently hired as a consultant working with the federal government in Washington, D.C.

37 Michael Collins Interview, February 1, 2006.

Case Study: Selling Affordable Housing Loans in the Secondary Market

George Vine
Consultant for the California Community Reinvestment Corporation

The California Community Reinvestment Corporation (CCRC) is a nonprofit Community Development Financial Institution (CDFI) formed by a consortium of California commercial banks in 1989 to provide permanent mortgages for affordable housing projects. The corporation has funded over $360 million in first mortgages, most secured by Low Income Housing Tax Credit projects.

CCRC provides long-term mortgage and bond financing for new construction, acquisition, and rehabilitation. Funded by more than fifty member banks in California providing in excess of $360 million in resources, CCRC offers CRA lending, investment, and service test credit to commercial banks and savings and loans through a variety of loan pools, investments, and service opportunities. Historically, CCRC has funded its mortgage program through a credit line provided by its fifty member banks, but it has bumped up against its credit limit as it has increased loan production.

One solution to this problem has been selling loans to free up credit-line availability for new loans. CCRC had bad experiences with early efforts to sell loans to federal agencies. But in the late 1990s, it returned to this strategy when it again outran its credit availability. Its renewed interest in sales coincided with the insurance industry's creation of its own consortium, Impact Community Capital, to head off statewide CRA-like legislation that would regulate insurers.

CCRC and Impact partnered on CCRC's first large loan sale. The transaction included twelve loans totaling $40 million, and it sold at an aggregate price of par. Since both organizations were learning by doing, the transaction was protracted and painful, but it finally closed in August 2000. CCRC has held ten more loan sales since 2000 totaling over $200 million (including the first Impact sale). The sales ranged from a single loan of less than $1 million to a portfolio of more than $46 million. Buyers have included two other secondary market purchasers of community development loans (the Community Reinvestment Fund, based in Minneapolis, and the Community Development Trust, based in New York) as well as a CCRC member bank (Bank of the West). Impact is CCRC's largest loan purchaser, thanks to two subsequent loan-pool sales (see Table 1).

Table 1. Recent CCRC Loan Sales to Impact Community Capital		
	March 2004	August 2005
Portfolio Total	$38,441,502	$46,242,763
# of Loans	25	48
Average Loan Size	1,537,660	963,391
Minimum Loan	167,841	185,042
Maximum Loan	5,159,265	3,913,427
# of Housing Units Financed	1,812	2,377
% LIHTC Projects	96%	89%
Weighted Average DCR	1.38	1.56
Weighted Average LTV (restricted value)	64%	64%
Weighted Ave. Months Since Funding	43.2	64.0
% of Loans that Re-price	68%	56%
Weighted Average Coupon	7.51%	7.48%
10 Year T-Note Yield at Price Fix	4.16%	4.17%
Sale/Offer Price Premium/ (Discount)	3.50%	5.81%

CCRC's Loan Sales Process

Selling loans is a lot like selling used cars. The seller usually knows much more about the product than the buyer, and the buyer is naturally suspicious about the seller's motivation for selling. To counter this "asymmetric knowledge" discount, CCRC works to create a bid package that contains everything an analyst needs to value each loan without leaving his or her desk. When delivering the package to interested buyers, CCRC requests bidders to price each loan in the portfolio subject only to confirming the information in the bid package.

CCRC will vary the contents of the bid package depending on what it is selling and to whom (see Table 2). Because it takes so much effort to evaluate a loan portfolio, CCRC limits the distribution of bid packages to encourage each prospective bidder to conclude that its chances of winning the bid are good enough to be worth the effort.

Table 2. Contents of a Typical CCRC Bid Package	
Loan Spreadsheet	Containing 50 or so data items per loan
Individual Loan Summaries	Short narratives summarizing the structure, credit, real estate, and participants
Loan Reviews	Dated within one year with a spread of historical operating statements
Collateral Inspections	Dated within 6 months, containing photographs of the project
Payment History Reports	From loan inception
Legal Documents	Loan agreement, deed of trust, note

The choice of loans to include in a sale depends on the seller's objectives and the needs of the prospective buyers. If the seller's goal is to obtain the highest possible price, for example, the seller should choose the loans with the highest interest rates and strongest credits. In selecting a recent sale portfolio, CCRC first eliminated all of the loans closed within the last year due to insufficient seasoning for the prospective buyers. It then eliminated all "problem" loans that would not be salable to the prospective buyers. Of the remaining loans, CCRC selected those from its largest borrower concentrations (to reduce exposure concentrations), and those with the lowest interest rates (to take advantage of the low market rate environment) to make up the sale portfolio.

After selecting the sale portfolio, CCRC takes the following steps:

1. **Prepare the bid package.** The package includes current loan reviews, collateral inspections, and financial information. Any credit issues must be thoroughly documented and explained.
2. **Identify potential bidders.** Distribute to interested parties a "sanitized" (i.e., with all confidential customer information deleted) loan spreadsheet and a confidentiality agreement. Request interested bidders to return the signed confidentiality agreement, if they want the bid package. This serves to get an early read on the extent of bidder interest, weed out inappropriate bidders, and protect sensitive customer information.
3. **Distribute bid package to bidders.** Ask bidders to respond within 30 days with a letter of intent (LOI) containing a loan-by-loan pricing, other significant terms, sample seller representations ("reps") and warranties, and the buyer's source of funds and approval process.

4. **Evaluate responses and select the best proposal.** Evaluate and compare bids on price, costs of sale, terms, any requirements for residual guarantees, required reps and warranties, and approvals required.
5. **Buyer due diligence.** This may require as long as 90 days for the selected buyer to review every loan file, conduct collateral inspections, obtain title endorsements, and negotiate a loan purchase agreement. Due diligence also requires considerable seller's resources to answer file reviewers' questions, collect additional information from borrowers, and, often, to correct deficiencies in documentation.
6. **Closing.** The closing involves assigning loan documents and sending loan files to the buyer and confirming the receipt of the sales proceeds.

Who Are the Buyers?

The buyers of CCRC loans have been the specialized community-development secondary market firms and commercial banks. When considering potential purchasers, it is important to understand how they are funded because this will affect the types of mortgages they can buy and in general their flexibility. For example, a common reason for rejecting a loan from a sale is that it is not "Fannie Mae" compliant. In contrast, a purchaser intending to securitize the affordable housing loans in a larger securitization has the ability to take loans with blemishes (although the price likely will be reduced) as a few of these loans in a large securitization can be accommodated through a larger subordination level (i.e., a larger unrated portion of the resulting security).

In general, we have found that the federal mortgage agencies are not flexible enough to be purchasers of these loans. The agencies are designed to handle large volumes of highly standardized product, and neither quality typically applies to CDFI loan production.

How Are Loan Portfolios Priced?

Bids on portfolios of CCRC loans have usually resulted in a wide range of prices. For example, bids on CCRC's last sale ranged from 101 (i.e., a 1 percent premium) to 105. It is best to get bids from bidders who are familiar with the affordable housing field because they take into account loan strengths that other bidders may not understand. An example is the strength that the presence of a well-known tax credit syndicator can add to a loan with relatively low debt-service coverage.

A recent Ernst & Young survey found that at any one time, as many as 34 percent of LIHTC projects show a below break-even debt-service coverage (DSC).[1] A low debt-service coverage will result in a rejected loan or a low price, unless the seller can convince the buyer that the low DSC is temporary. Other "events" that cause challenges for loan sellers are construction defect litigation, pending changes in property managers or general partners, the receipt of a notice of noncompliance from the tax credit agency, recent rehabilitation expenses, and the many other challenges that all properties face. Because such "events" can

1 "Understanding the Dynamics II," Ernst & Young, June 2004. The report is available at the following link: http://www.ey.com/global/download.nsf/US/Afforable_Housing/$file/Understanding_the_Dynamics.pdf.

occur at any time, it is in the seller's interest to minimize the time between the acceptance of a letter of intent and the closing of the sale.

It is important to consider exactly when the portfolio price is fixed during the sales process. In recent sales, CCRC has received offers that fix the price at the acceptance of the letter of intent. This eliminates CCRC's interest-rate exposure during the time between the acceptance of the LOI and the closing–a period of up to 120 days when the ten-year U.S. Treasury note rate has varied by as much as 50 basis points. A change of 50 basis points can mean the difference between a sale at a healthy premium and a sale at a discount.

CCRC prices its sale portfolios beforehand with a spreadsheet model that simplistically discounts the loan cash flows to a present value without taking into account optionality (the borrower's option to prepay). This model has been surprisingly accurate in the aggregate, although it sometimes misses on individual loans. CCRC's portfolio valuation provides a benchmark against which to measure prices offered in LOIs.

Lessons Learned

There are many compelling reasons to pursue a loan sale. First, it brings in additional investors to create more competition for loan-pool purchases. For example, by securitizing its loan purchases, Impact Community Capital is able to create attractive investments for insurance companies that are otherwise constrained in the amount of whole mortgages they can hold. Similarly, the Community Reinvestment Fund has been able to attract pension-fund investment into affordable housing. This increased competition ultimately lowers the cost of capital for the industry.

Second, securitization creates liquidity. Successful lenders will ultimately outgrow their credit capacity and will be forced to sell loans or slow or even stop their growth. Loan sales are also a way for lenders to manage their exposure concentrations so that they can continue making loans to good customers without exceeding prudent borrower, geographic, or other exposure limits.

Third, loan sales can improve balance sheets. In a falling interest rate environment, selling high-yield loans can result in substantial sale premiums, which go directly to the CDFI's bottom line. Sales will also cause the recognition of any related deferred loan fees and the reversal of loan loss provisions, which also go to the bottom line. Nearly half of CCRC's fund balance is the result of these effects of its loan sales. Loan sales can also demonstrate to a CDFI's creditors and investors that its assets are properly valued (or not, depending on the price received) and provide them with additional comfort as to the CDFI's underwriting skills.

A CDFI should consider several disadvantages before selling loans. Lenders will lose servicing and interest-rate spread income they would otherwise have received from the sold loans. Loan sales will also increase the volatility of a CDFI's financial statements and cash flow. A sale early in a fiscal year may offset the loss of servicing and spread income with the income recognition resulting from the sale, as discussed above. However, a sale at the

end of a fiscal year may result in a "boom" year (the sale year) followed by a "bust" year (the following year when revenue is low because of the loss of servicing and spread income and the absence of an extraordinary income event).

Another major concern for selling loans is the loss of control over subsequent customer contact on a loan that continues to be associated with a CDFI. CCRC has found that some customers whose loans were sold have valid complaints about the attitudes or lack of affordable housing knowledge shown by subsequent servicers. It is not surprising that a multi-billion-dollar servicing operation would have a different servicing approach than a "boutique" specialized lender like CCRC, and, as a result, the transfer of servicing may create an additional obstacle to getting the customer's next loan. Sellers can insist on retaining loan servicing, but they will thereby eliminate bidders who intend to securitize the loans. Such securitizations usually require credit ratings from national credit agencies, which in turn usually require that the loan servicers be "rated." (Most CDFIs will not qualify as "rated" servicers.)

CDFIs may also confront issues from their funding sources resulting from sales. They should be wary of breakage fees or prepayment penalties for repaying a mortgage line early. Warehouse lenders may experience costs from getting their money back earlier than anticipated, and they may try to pass these costs on to the CDFI.

CDFIs should resist providing residual guarantees that are sometimes required as a condition of the sale. These guarantees can greatly diminish the benefits of the sale. They will require continual uncompensated monitoring. A CDFI that retains the top 10 percent loss position in a sold loan is not really reducing its exposure concentration to that borrower. Nor is it getting paid for bearing the residual credit risk.

This brings us to the core of the decision to sell loans: how to strike an appropriate balance between mission and loan liquidity. The secondary market values standardization in types of loans, loan terms, and loan documentation. Many CDFIs, however, value their ability to customize credit facilities to better meet their customers' needs. Standardization and customization stand in direct conflict; so too do the secondary market values of large volumes and market risk-based pricing versus CDFI values of local orientation and making difficult projects happen. These conflicts force CDFIs into a delicate balancing act.

Further Innovations

CCRC is in the midst of conducting its first sale of tax-exempt bonds. We expected a thin market for CCRC's small private activity housing bonds with no credit enhancement but were pleasantly surprised by the level of interest we found. We selected a bid from a member commercial bank because it seemed the most certain to close according to the proposed terms, but we were intrigued by a proposal from the broker/dealer subsidiary from another member bank to securitize the portfolio. The feasibility of securitization depends entirely on the existence of a large enough spread between the sale portfolio yield and the market rate for investment-grade rated tax-exempt securities to cover the high expenses of the transaction, so a securitization will not always work. Nevertheless, we need to develop disposition

alternatives for tax-exempt bonds since CCRC's major secondary market loan purchasers as of yet have little appetite for the product.

George Vine has worked with CCRC since 1996 in secondary market sales, new product development, credit quality, and portfolio management. Most recently he organized the CCRC Workforce Housing Fund, a private equity fund for affordable for-sale housing projects in California.

Case Study: The Community Development Trust Taps Wall Street Investors

Judd S. Levy and Kenya Purnell
The Community Development Trust

The Community Development Trust (CDT) is the country's only real estate investment trust (REIT) devoted solely to providing debt and equity capital for financing community development projects. CDT was created in 1998 by the Local Initiatives Support Corporation (LISC), a national nonprofit community development intermediary, and 17 socially motivated institutional investors. As a private, mission-driven REIT, CDT operates much like a mutual fund, combining the capital of institutional investors to acquire or provide financing for affordable housing. In line with our mission, all CDT investments must satisfy Community Reinvestment Act (CRA) requirements. Through our debt-and-equity financing programs, CDT invests: (1) long-term debt capital by purchasing smaller, fixed-rate multifamily mortgages from community lenders; and (2) equity capital either in cash or by providing a tax-advantaged transition for existing properties to a new set of owners committed to long-term affordability.

CDT's initial effort to meet its mission was the introduction of the debt program, which focused on creating a secondary market for smaller (under $3 million) Low Income Housing Tax Credit (LIHTC) loans. CDT's equity capital was insufficient to fund and retain the whole loans created under the program. As a solution, CDT sought out institutional investors to purchase a 90 percent senior interest in each loan with CDT holding a 10 percent subordinate interest. In this way, every $1 million of CDT's equity capital would finance $10 million in loans. CDT entered into a participation agreement with a socially motivated pension fund, the General Board of Pensions and Health Benefits of the United Methodist Church (the Board). Under this agreement, the Board agreed to purchase a senior interest in each mortgage loan subject to certain underwriting criteria, and CDT agreed to retain the subordinate interest.

The initial commitment from the Board was for a $30 million facility. By 2004, as the program became more successful, the Board had increased the facility to $100 million. CDT had fifteen active originators around the country and volume was increasing to the point that additional capacity beyond the existing $100 million was needed.

CDT approached the Board with a proposal to repurchase a portion of the Board's senior interests and then combine them with the CDT-retained subordinate interests. CDT would then securitize the whole loans for sale in the open market. CDT also included several whole loans that it had not yet syndicated. In aggregate, the pool totaled $44.9 million and consisted of thirty-one affordable multifamily housing mortgages and more than two thousand units of affordable housing. CDT swapped the mortgages for an equal amount

of Fannie Mae Mortgage-Backed Securities (MBS). The MBSs were then sold to JPMorgan Chase (JPMC).

The loans had an average balance of $1.4 million and were secured by properties in eight states. The majority of the loans were on properties having LIHTCs. By repurchasing the senior interests CDT had previously sold to the Board, CDT was able to increase its program capacity with the Board and at the same time demonstrate its ability to securitize the previously illiquid senior interests. According to David Zellner, Chief Investment Officer of the Methodists Pensions and Health Benefits Board, "This transaction was a terrific way to illustrate the high quality of the affordable housing mortgage portfolio that we have been purchasing from CDT."

The transaction provided several advantages to the Board and to CDT. First, the Board's ability to sell its senior interests at market prices validated the underlying value of the senior interests. Second, a securitization provided liquidity to CDT by freeing up capital committed to its existing subordinate pieces. Furthermore, under the securitization, CDT's credit enhancement was reduced to a level below the level provided to the Board. Finally, the Board agreed that the repurchase of the seasoned senior interests would allow CDT to deliver new senior interests on a dollar-for-dollar basis, thus increasing the capacity of the facility with the Board.

Evaluating the Options

CDT had to evaluate several alternatives for structuring the securitization transaction.

Senior Investor Facility

The first alternative CDT considered was to deliver senior interests on the mortgages through an existing participation facility with another large institutional investor. This structure was similar to the senior/subordinate agreement in place with the Board. However, each senior interest would be sold on a stand-alone basis and consequently CDT would not capture the value generated from pooling the mortgages. Furthermore, the facility limited the senior investor to a par purchase price. The mortgage loans were well seasoned with an excellent credit history and all were originated in a much higher interest-rate environment; thus, the pool was worth well above par.

Real Estate Mortgage Investment Conduit (REMIC)

The second option was to pool the mortgages and issue securities via a REMIC with CDT retaining the below investment grade interest. Some REMICs are entities that own pools of mortgages used for collateral to issue Commercial Mortgage Backed Securities (CMBS). Assets held by REMICs must comply with IRS regulations, and all securities issued by non-GSE (Government Sponsored Enterprise) REMICs must have a rating assigned from at least one of the nationally recognized rating agencies. Post issuance, the rating agencies are required, at a minimum, to monitor asset performance annually. However, on average,

rating assignments carry a $100,000 upfront fee and a $15,000 annual surveillance charge. In addition, legal fees and other transaction costs can be substantial. The cost of a rated transaction relative to the small size of the pool was likely to result in an inefficient execution. The minimum size for a REMIC transaction is generally at least $100 million.

Guaranteed Mortgage-Backed Securities (MBS)

The third option was to pool the mortgages and issue securities credit enhanced by a GSE to a broker dealer. Broker dealers have access to a wider variety of investors in the capital markets and may elect to include the CDT securities in a much larger securitization. The GSE guarantee would allow CDT to issue AAA-rated securities without going through the rating-agency process. The AAA rating would result in a higher price for the securities and alleviate investor uncertainty regarding affordable housing mortgages. In exchange for the GSE's credit enhancement, CDT would provide a collateralized first-loss guarantee. The first-loss guarantee could be secured by cash, by retaining a percentage of the securities, or by providing a payment guarantee backed by a letter of credit. This obligation would remain constant for the life of the securities and would not decline as the underlying mortgages amortize.

However, the MBS option presented challenging corporate finance, tax, and accounting issues specific to CDT's REIT status. Some of the major issues included: (1) selling the loans and foregoing the future income stream of principal and interest payments; (2) assessing the financial and administrative costs to provide CDT's first-loss guarantee; and (3) managing the potential gain/loss on sale and any tax implications.

Transaction Overview

CDT chose the MBS route. The primary reasons were costs and time. Under the MBS structure, we did not need to incur the costs of securing a rating from one of the independent rating agencies. Our legal costs were also substantially less than under the REMIC structure. At the time we were considering the securitization, the ten-year U.S. Treasury was trading at a level that would generate substantial value from the securitization. Any significant increase in the U.S. Treasury yield would eliminate much of the economic value of the transaction. A prolonged process would expose CDT to this risk, whereas the MBS execution appeared to have significant benefits in terms of coming to market quickly.

CDT swapped the mortgages for an equal amount of Fannie Mae Guaranteed Mortgage-Backed Securities (Securities) and then sold the Securities to JPMC. The portfolio was separated into nine smaller pools as required by Fannie Mae's Mortgage-Backed Securities program. Securities were exchanged on a per pool basis; thus, CDT received a total of nine Securities.

Fannie Mae Pool Stratification
Interest Basis – 30/360 vs. A/360
Amortization – based on fully amortizing vs. balloon mortgage
Unique Call Protection – non yield maintenance or defeasance, fully prepayable without penalty, declining prepayment premium
Maturity – loan terms of 30 or more years
Coupon Variance – for any given pool, the spread between the highest and lowest coupon may not exceed 200 bps

Rhoda Newman, senior account executive of Fannie Mae, said, "CDT's first securitization with Fannie Mae was a milestone. It helped to achieve Fannie Mae's continued goal to support affordable housing and CDT's goal to expand program activity. With Fannie Mae and CDT's common commitment to affordable housing, we view this as a model for future securitized transactions."

For a more efficient capital market execution, JPMC worked with Fannie Mae to exchange the securities into a single bond, FNGT 2004. The bond was divided into two tranches (Class A and an I/O class)[1] and sold to four institutional investors (a bank and three insurance companies).

Although the entire pool of loans was sold to Fannie Mae, CDT is still responsible for ongoing asset management of the securitized loans. Because of the ongoing asset management and administrative costs of managing the transaction, CDT will receive an annual administration fee. An annual fee is also payable to CDT to compensate for the credit enhancement it provided. These amounts were determined by using comparable fees charged in similar transactions.

Key Portfolio Characteristics

The high DCRs and the seasoned nature of the loans, along with the duration and geographical and borrower diversification of the pool, resulted in a subordination level or guaranty obligation substantially less than the average CDT-retained subordination interests on individually syndicated loans. The reduced subordination level illustrates the benefits of completing a pooled transaction. To back its credit enhancement, CDT provided a letter of credit to Fannie Mae.

The participation of experienced, quality business partners, coupled with the proficiency of CDT's employees, virtually eliminated the need to engage outside consultants. However, CDT did work closely with its independent auditors and outside legal counsel to address corporate accounting and legal issues.

1 Class A–senior tranche in which cash flow from principal and interest payments on the underlying mortgage loans are used to pay Class A note holders. I/O–(interest only) note holders repaid only from interest payments of the underlying mortgage loans.

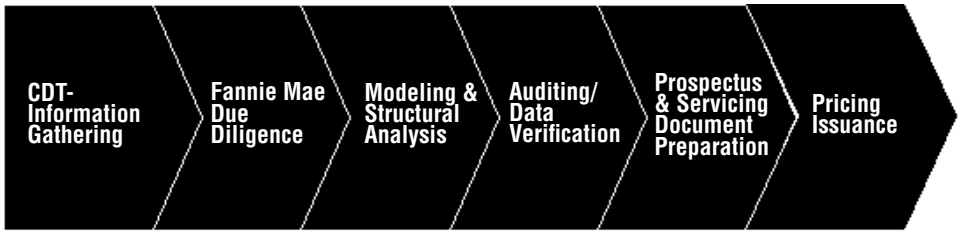
Collateral Characteristics	
Initial Balance	$44,918,184
Number of Pools	9
Number of Loans	31
Weighted Average Coupon	7.92%
Weighted Average DCR	1.24x
Weighted Average LTV	72.7%
Weighted Average Remaining Maturity (months)	203
Weighted Average Remaining Amortization (months)	293
Weighted Average Seasoning (months)	30
Expected Weighted Average Life (years)	13.31

Geographic Distribution	
Texas	25%
Pennsylvania	23%
California	22%
Wisconsin	11%
South Carolina	5%
Connecticut	5%
Louisiana	4%
Tennessee	3%
Ohio	2%

Asset Affordability	As % of UPB
LIHTC	88%
Non-LIHTC/Other affordable program	12%

The Securitization Process

The securitization was one of CDT's most complex fixed-income transactions to date. Despite the complexity, CDT was able to complete the entire process within ninety days. This is a significant achievement for a first-time issuer. The chart below summarizes the process step-by-step.



Midland Loan Services, Inc. (MLS), a Fannie Mae approved servicer, was the current servicer for a large portion of the loans in the portfolio. Fannie Mae's agreement stipulated that the entire mortgage pool be serviced by a Fannie Mae–approved servicer. As a result, CDT transferred all of the non-MLS servicing rights to MLS. This step was specific to this transaction and unnecessary for most newly originated CMBS deals.

Due Diligence

The aggressive time line was achieved largely because of the quality of information and CDT's rapid response time in providing the required due diligence items to Fannie Mae and JPMC.

Sample List of Required Due Diligence Documentation	
Promissory Note	Legal Opinion
Deed of Trust/Mortgage	Partnership/Operating Agreements
Title	Inspection Reports
Survey	Environmental Reports
Endorsements	Property Financials
Assignment Documents	Rent Rolls
Reserve Agreements	Loan Agreements
Management Agreement	Regulatory Agreements
Certificate of Borrower	Appraisal/Market Study

CDT submitted much of the material electronically. Individual loan files were indexed and scanned into portable document format (PDF) and then transferred to compact disks. Rather than sift through stacks of hard copies, the electronic format made the review, retrieval, and forwarding of information much more manageable. Through this strategy, the due diligence time frame was reduced by at least three to six weeks.

Conclusion

The transaction was a milestone for CDT as well as for the entire community development industry.

CDT	Community Development Finance Industry
Increased forward commitment capacity with the Fund	Created a model for future securitized transactions
Reduced credit and interest rate exposure by selling subordinate interests and warehoused whole loans	Validated that smaller LIHTC whole loans could be securitized as AAA securities and sold for a premium
Created an income stream to cover ongoing administrative expenses and guarantee fees	Illustrates the value of high quality affordable housing mortgages

The fixed costs associated with MBS issuance will continue to provide challenges to the community development finance industry. These extremely high costs can be a barrier to entering the MBS market, and intermediaries often lack the ability to generate the loan volume needed for an efficient execution. The industry will continue to look to GSEs to design new programs and develop innovative strategies such as the Fannie Mae MBS program. The MBS market has slowly expanded to include community development assets, and CDT looks forward to continuing to work with experienced partners such as Fannie Mae and JPMorgan Chase to create liquidity for community development finance investments.

Judd Levy is the founder, President, and CEO of CDT, and has been a leader in affordable housing for thirty years, including serving as Deputy Director at the New Jersey Mortgage Finance Agency and heading Merrill Lynch's Housing Finance Department for ten years.

Kenya Purnell is an acquisitions associate in CDT's Equity department. Prior to joining CDT in 2003, Ms. Purnell was an investment banking analyst with the Fixed Income Capital Markets team at JPMorgan Chase.

Financing Hope

Frank Altman
President and CEO, Community Reinvestment Fund

At its core, community development finance is different, and more difficult, than traditional finance because social outcomes are among its essential products. Not only must development lenders structure sound loans that will be repaid, but they must often do so in the context of inadequate collateral, borrowers with limited personal equity, and in locations that are increasingly described as "emerging domestic markets." Financial risks are high, but they can be managed. While opportunities for lasting community impacts are also high, they must be nurtured.

Over the last decade or so, the community development industry has risen to these challenges. New institutions, such as the Community Development Financial Institutions Fund, helped to create hundreds of mission-oriented financial institutions throughout the United States dedicated to strengthening communities by improving the supply of affordable housing, or more recently by investing in job-creating businesses in low-income neighborhoods.

In addition, these institutions have created sophisticated financial and risk-management tools, from high loan-to-value loan products to asset development accounts that employ leading-edge financial technologies. In fact, the Community Reinvestment Fund, USA (CRF), the organization with which I am associated, has been in the forefront of these industry trends by bringing increasingly sophisticated financial technologies such as asset securitization to the community development field. CRF and its lending partners have delivered more than $500 million in capital to communities for small business expansion, job creation, entrepreneurship, and affordable housing. We now operate at a significant scale with the potential to bring even greater amounts of capital to communities.

This focus on financing hope—seeing a community as it can be rather than as it is—provides a major motivator for those who work in this field. Our missions are not simply to make loans that will be repaid or to run our institutions at a profit. We have an added responsibility: to see to it that those businesses in which we invest spin off benefits to the larger community. Improving neighborhoods improves lives. Creating opportunities for people moves more people into the American middle class.

The challenge of transforming capital into hope and hope into opportunity comes at an increasingly difficult time. The record federal deficit is not a friend of increased government funding for community development. Even the New Markets Tax Credit, which provides incentives to private investment into low-income communities, cannot fill the demand that exists in emerging markets. Moreover, while these tools move capital at the margins, they are not adequate to meet the wide variety of needs in many low-income communities.

CRF is helping to fill the increasing void left by shrinking subsidy dollars by applying financial technologies in partnership with local, mission-driven lending organizations to increase the amount of capital funneled into economically underserved communities. The organization helps community development lenders accomplish their missions by providing them with greater access to capital. At the same time, CRF helps institutions and social investors meet their investment goals.

By purchasing loans from community development lenders and pooling them into asset-backed debt securities sold to institutional investors through private placements, CRF provides lenders with the capital needed to make more loans and drive more dollars into disadvantaged communities. This secondary market has become an expanding resource for community development finance nationwide. Working closely with its network of more than 110 lending partners across the country, CRF brings hope to individuals, families, small business owners, and entrepreneurs–many of whom could not obtain financing from any other source. From charter schools and tortilla factories to bakeries and pharmacies, CRF and its partners help people realize the American Dream.

For example, the Greater Brunswick Charter School, which provides education to students in kindergarten through eighth grade, had moved four times during its first five years of existence. They needed a new and permanent home. In this case, CRF provided the capital (with a boost from the New Markets Tax Credit program), and New Jersey Community Capital (NJCC) financed the opportunity.

NJCC provided the Greater Brunswick Charter School a $1.4 million loan with a low interest rate and twenty-five-year term. The loan payment is lower than the monthly rent the school was paying at its previous location. Now the school has a more modern educational facility with the capacity to add 100 more students, serving up to 250 children.

Similarly, the Bay Area Development Company stepped in to help a family-owned tortilla factory in San Jose, California, with a $210,000 loan to fund a new warehouse property for business expansion. The expansion created five new jobs and increased business in an underserved community. The Bay Area Development Company then sold the loan to one of CRF's affiliates.

The City of Minneapolis Department of Community Planning & Economic Development (CPED) partnered with CRF to provide the owners of Shabelle Grocery Store–run by two Ethiopian immigrants–and Shega Bakery, which makes injera, a thin spongy bread that is a hallmark of Ethiopian cuisine, with the capital needed to purchase a new building. The goal was to transform a decaying property into an anchor for community revitalization.

In business for several years now, the project has been a dramatic success, serving as an inspiration to other Ethiopian and Somali immigrants in the area. In addition to housing the grocery store and bakery, the building owners have attracted an unlikely combination of tenants, including a Sierra Club chapter, a state association of pool leagues and tournaments, a construction company, and a chiropractor.

CRF also partnered with an economic development agency in Montana to give a Native American woman the capital needed to purchase a new facility for her pharmacy. The deal enabled the entrepreneur to own her place of business for the first time. It also allowed for the retention of eight jobs and the creation of at least two new jobs in the economically distressed area.

While CRF and its many partners have transformed numerous lives, businesses, and communities across the country, we see ourselves as a vital node in a growing network of development organizations. That network must continue to break new ground to continue to advance and stimulate growth within the community development industry. But breaking new ground is not sufficient. The outcome must be economic opportunities in low-income communities throughout this country. That is how we finance hope.

Frank Altman is President and CEO of CRF, which he has led since its inception in 1989. A pioneer of community development financing, Mr. Altman has advised key governmental and business leaders on using market forces to meet public needs. Mr. Altman serves on the Advisory Committee of the Center for Community Development Investments at the Federal Reserve Bank of San Francisco. Prior to founding CRF, Mr. Altman was a member of the cabinet of Minnesota Gov. Rudy Perpich. Mr. Altman holds a masters degree in public administration from the Hubert H. Humphrey Institute of Public Affairs at the University of Minnesota and an AB degree from Brown University.

Taking Capital for Social Purposes to a New Level

Nancy Andrews
President and CEO, Low Income Investment Fund

What links all of us who are committed to community development is a belief in the power of the idea that capital employed for social purposes can multiply itself many times over. In the past two decades, that belief has birthed a field in community investing unlike anything else in the world.

Consider how far we've come. Twenty years ago, LISC and the Enterprise Foundation were just getting started and were still finding their way in the world. My organization, the Low-Income Investment Fund (LIIF), had just been incorporated and had only $200,000 in capital under management. The community capital movement was still more an idea than reality.

Twenty years ago, I was also a young program officer at the Ford Foundation. I made one of my first PRIs, a $500,000 loan, to the Institute for Community Economics (ICE) and clearly remember my investment recommendation to the officers of the Foundation: "ICE is creating a network of community-based loan funds and this PRI will be used to seed their creation." Then, boasting a bit about the scale of this new community loan fund network, I said, "There are twelve of these organizations across the country with $27 million in capital." At that time, $27 million nationwide seemed like a large and impressive number.

Today, we know that there are more than five hundred community loan funds, with $18 billion in capital nationwide. LIIF now manages $2.5 billion in assets and has helped to create affordable housing for the working poor; special needs housing and services for the homeless; housing for victims of domestic violence and people with disabilities; unique home-ownership developments; and community facilities such as child-care centers and charter schools. At the same time, in twenty years, this half a billion dollars in lending has produced losses of only $192,000: a capital-loss rate of only 0.12 percent, or one-eighth of one percent.

In many ways, we succeeded beyond our expectations, and our success has ignited new ambitions. Now we are focused on creating scale in our industry and on building a bridge between private-capital markets and poor communities.

The private-sector capital most accessible to us, the banking industry motivated by the Community Reinvestment Act, is regulated. It simply cannot do the types of loans that we do and still pass muster with its auditors and regulators. So, two major trends are combining at once: we need the scale the private sector offers, but we are too weird and funky, or, in polite terms, "nonconforming," to be accepted by the private sector.

To meet the capital demands of our borrowers, we must take the weird, funky, nonconforming community loans and make them palatable to the capital markets, and we are pursuing many strategies to accomplish this. For example, a number of CDFIs and nonprofit developers have banded together through the Housing Partnership Network to create a $100 million relationship with Freddie Mac where we can sell our projects. We are looking for funds to serve as the first loss cushion. Whether we succeed is largely a function of our ability to raise these risk-absorbing funds. Likewise, LIIF is working with Fannie Mae on a large-scale transaction that does the same thing.

Another example is the $35 million loan pool that LIIF is now assembling for charter schools. We are using a $1.7 million Department of Education grant as the cushion against losses, though it could just as easily have been funds from a foundation or the proposed Affordable Housing Fund, which was included in GSE reform legislation last year. That's a leverage ratio of more than 20 to 1. Citigroup is our lead investor in the pool; Prudential, Merrill Lynch, and LISC are involved, as is the Annie E. Casey Foundation. The ultimate result of this collaboration will be thousands of low-income kids attending high-performing schools and receiving a quality education. The financial leverage in this example is huge. The human capital leverage can be measured only in the lives of the kids touched by the chance to have a high-quality education that prepares them to enter the economy of the information age.

Another potentially revolutionary strategy would have the GSEs take the lead in helping to securitize community-development loan pools, which could trigger a flood of new capital for community development. A GSE could make a commitment to buy pools of loans from high-performing CDFIs like LIIF, the Enterprise Foundation, the Reinvestment Fund, Self-Help, and LISC, all of which finance housing for extremely low-income populations. These loans are considered "nonconforming" because they do not meet the highly structured traditional underwriting standards of the banking community or the GSEs. Yet they perform like the highest-quality assets. While these loans are perceived as risky, the truth is that our industry has a loss rate of less than one percent with more than twenty years of history behind us.

Here's how the idea would work. The GSE would agree in advance to buy, say, $100 million of these loans and would establish a special loss reserve pool or "credit enhancement" from the GSE Affordable Housing Fund. The GSE would then pool these funds into a mortgage-backed security and provide a credit enhancement that would confer its AAA bond rating on the pooled security. This security could then be sold in the capital markets.

It is important to point out that while any individual loan may bear some risk, the exposure of the GSE would be limited and highly diversified. First, the organizations selling the loans would likely provide a top-loss guarantee, probably five percent. We would be on the hook, ensuring disciplined lending. Second, these loans all have substantial collateral, which could be used to absorb capital losses. And finally, the special loan loss reserve established by the GSE would be tapped before there is any impact on the GSE. Given that the historic loss rate on these portfolios is less than 1 percent, it is unlikely that any losses would trickle

down to the GSE. The leveraging potential is enormous. The social return on investment is enormous.

LIIF has already structured this kind of transaction in New York, working with the State of New York Mortgage Agency (SONYMA). LIIF established a guarantee of $260,000 to leverage SONYMA insurance for a $2.6 million loan to a homeless shelter in New York City. The investor was the United Methodist Pension Fund. Given the AA credit enhancement from SONYMA, LIIF induced even the most hard-boiled, profit-oriented firm on Wall Street to invest in a homeless shelter on Staten Island. In this example, you see the real power of leveraging and credit enhancement. You see a way to multiply the bang for the buck.

These kinds of transactions would have enormous positive implications for distressed communities across America. GSE securitization would provide our institutions with much-needed capital liquidity to be able to make greater volumes of loans for deeply targeted housing. With the GSE credit rating in place, it would bring the longest terms (30 years) and the best prices of the capital markets to bear in a highly targeted project in a safe and sound fashion. This idea would yield leveraging of perhaps $100 for every dollar committed, given our record of capital losses. The cost to the public at the end of the day would be negligible, yet the community benefits would be tremendous.

Together, we have proved that the idea of investing capital for social purposes works. We have proved that the idea of investing in communities works. We have taken an idea that started in the 1960s with action in the streets and transformed it into capital invested in neighborhoods throughout this country. Now we need to take the next step: scale and leverage.

Nancy Andrews is currently the President and Chief Executive Officer of the Low Income Investment Fund (LIIF). Ms. Andrews' background spans 30 years in the community development field, with positions at the Ford Foundation, as the Deputy Director of the Ford Foundation's Office of Program Related Investments and Chief Financial Officer of the International Water Management Institute, a World Bank-supported international development agency. Ms. Andrews consulted for the Department of Housing and Urban Development and the Department of Treasury, helping in the establishment of the Community Development Financial Institutions Fund. Ms. Andrews did her graduate work at Columbia University where she received a M.S. in Urban Planning, with a concentration in Real Estate Finance.

Leverage: Securitizing Community Development Construction Loans

John McCarthy
Executive Vice President, The Community Preservation Corporation

By securitizing construction mortgages, the Community Preservation Corporation (CPC) has met demand for financing that far exceeded its existing capital sources. CPC loans fund new construction and substantial or moderate rehabilitation of affordable apartment buildings in long-neglected New York neighborhoods. In recent years, housing construction here has risen to thirty-year highs. Areas have been repopulated after decades of blight and abandonment and–obviously–negligible housing investment. Today, more than $700 million is outstanding in CPC-originated loans in these areas. This situation would not have been possible without enlisting other investors, since CPC's main source of debt capital is a credit line capped at $300 million.

When we began seeking other investors, high due-diligence costs were a major obstacle. Not only were most projects small, but many of their builders were not typical bank customers. They included immigrants and small contractors. Even though they had the knowledge and the will to redevelop small sites, many were not traditionally "bankable." Moreover, the project locations, in emerging areas, were unfamiliar. A ten-unit rental building might be a good deal, even in long-neglected north Brooklyn. However, an investor's overhead to verify that fact could easily cost more than the loan would generate in revenue. Loan-by-loan review was simply not feasible.

Our solution was a structure that made the loan originator–CPC–absorb the first 20 percent of losses in a multiloan pool. Its key features:

- We pool loans shortly after closing, and sell a senior tranche (80 percent of the pool, in our case). "Senior" means that the investor is paid first out of each month's collections.
- CPC retains the other 20 percent, which is subordinate. As originator and loan servicer, we therefore deal with the vagaries of late payments or borrower issues.
- We streamlined securitization with internal processing. We use standard underwriting and standard loan documents, and we electronically scan all files into Adobe PDF format. Investors receive all documents by email or CD-ROM and can do file reviews in their own office.

All of these procedures dramatically cut the time and cost for investors to conclude that 80 percent tranches are bankable. Our 20 percent first loss turns a pool of 75 percent loan-to-value loans into a very safe 55 percent loan-to-value bank position. The first loss being pool-level credit support (not loan-by-loan) makes it even better. (To date, no 80 percent tranche has suffered a late payment.) Investor approvals have been simple and quick, given

the manifest strength of pooled tranches with credit enhancement. Streamlined process and standardization cut costs too.

CPC is a nonprofit lender founded in the 1970s during New York City's fiscal crisis. In our early years, while loan volume slowly grew, we rarely had to seek capital from conventional markets. Instead, our lending was supported by credit lines from institutions familiar with "the CPC story," chiefly the bank consortium that had founded the company.

When volume began to outstrip our traditional capital sources, as it did in recent years, we needed for the first time to find additional funding elsewhere. Securitization tapped a wide field of conventional lenders to fund our mission.

This success is replicable, but with limits. The limits are seen in the special features that made our pooling possible:

- Steady deal flow, so pools were frequent. Rapid growth in loan volume made pooling necessary for CPC, but it also made it possible. Investors knew the pools were regularly available, and they asked to buy them. In our earlier history, small volumes would have allowed only infrequent "one-offs." Securitization would not have worked then.

- Similarity of individual deals. Multifamily loans are not quite plain vanilla, but standard underwriting covers most credit parameters. Deal-specific peculiarities can be manageably few. This streamlines due diligence. It would be much harder to pool small deals, each with unique, significant complexities.

- CPC's balance sheet must carry the whole pool, since the 20 percent first-loss feature precludes "true sale" accounting treatment, which would get the pool off the books. Therefore, the 80/20 structure supplies cash liquidity, but it does not relieve capital-ratio constraints on lending growth. Our core capital still limits the aggregate loan volume supportable by our own credit enhancement.

CPC's pool structure has been highly effective in leveraging our origination capacity. It has enabled us to enlist capital from sources that otherwise could not invest in these loans. Other community originators may find it a tool for accessing conventional capital, when the circumstances are right.

John McCarthy is the Executive Vice President of The Community Preservation Corporation, a nonprofit 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.

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