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# Financial Innovations Roundtable

## Developing Practical Solutions to Scale up Integrated Community Development Strategies

MICHAEL SWACK AND NOÉMI GISZPENC, EDITORS



BUILDING KNOWLEDGE FOR FAMILIES  
AND COMMUNITIES

Thanks to the F.B. Heron Foundation for their support of  
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Financial Innovations Roundtable:  
Developing Practical Solutions to Scale up Integrated  
Community Development Strategies

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THE CARSEY INSTITUTE  
THE UNIVERSITY OF NEW HAMPSHIRE



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# Introduction

MICHAEL SWACK AND NOÉMI GISZPENC

Call it “action-discussion.” No, it’s not an oxymoron. It’s the type of work done by the **Financial Innovations Roundtable**, a “think-do tank” housed at the Carsey Institute at the University of New Hampshire.

The Financial Innovations Roundtable brings together nearly 100 leaders from conventional financial institutions such as banks, mortgage companies, insurance companies, and investment firms as well as leaders from public agencies, community development financial institutions (CDFIs), foundations, pension funds, religious institutions, and universities. These participants collaborate on increasing the flow of capital and access to financial services in low-income communities.

The group convenes annually to address broad policy issues in the practice of community economic development. Members identify the challenges inherent in community development and create cross-sector partnerships to develop practical solutions. Over the course of the year, these partnerships engage in various initiatives and research, working to remove the barriers between conventional and nontraditional lenders, investors, and markets, and to create products and services that offer low-income communities greater access to capital and financial services. This publication presents several innovations that roundtable participants have created or are currently developing.

The first section looks at **capital markets** and community development. “Capital Markets for Community Development Lenders: Questions and Answers,” on page 7, gives an overview of the problems faced by CDFIs in accessing traditional capital markets. CDFIs generally lack sufficient liquidity because once they loan their money, they typically cannot lend to any new projects before being repaid, which is called keeping loans “in portfolio.” The alternative is to sell them to the secondary market or to borrow on the basis of assets.

Some CDFIs do sell to the secondary market. One example is the mortgage program run by Self-Help Ventures of North Carolina, described on page 16. A major feature of the program is its partnership with Fannie Mae, which has

## Community Development Financial Innovations Weather the Current Crisis

It would be difficult at this time (Fall of 2008) to ignore the fact that the term “financial innovation” has come into great disfavor following the collapse of financial markets, in large part due to certain kinds of “innovations,” or the lack of understanding or abuse of those innovations. Yet it would be a mistake to think that all innovation has been bad. Throughout this difficult period, we have been contacting various CDFIs and asking about the performance of their portfolios. The funds we have talked to, including those featured in this publication (e.g., the New Hampshire Community Loan Fund, Self-Help in North Carolina, and the Community Reinvestment Fund in Minneapolis, among others) are reporting that their portfolios are performing well. Self-Help, for example, which has a large portfolio of single-family homes, reports that their defaults are up only about 0.5%. They have ample reserves and capital and are doing well. Even if the economy performs poorly over the next couple of years, and their defaults increase due to macroeconomic factors (such as higher unemployment among borrowers), they are well positioned to weather the storm. In stark contrast to many subprime lenders, CDFIs relied on meticulous underwriting, carefully qualifying people based on real incomes, homeowner training, required down payments, understanding local markets and more. In New Hampshire, defaults in the Manufactured Housing Coops (see article, p. 22) are very low, and the coops themselves are current in their payments to the Loan Fund. It is important to note that large players in the financial markets such as Fannie Mae and the ratings agency of Standard and Poor’s, both described in various articles in this publication, approached the community development sector very carefully, performed due diligence and, in fact, contributed to the successful initiatives described in this publication.

*Over the course of the year, these partnerships engage in various initiatives and research, working to remove the barriers between conventional and nontraditional lenders, investors, and markets, and to create products and services that offer low-income communities greater access to capital and financial services.*

agreed to buy the loans and package them into mortgage-backed securities. Fannie Mae can do this because Self-Help obtained a grant from the Ford Foundation that allows it to guarantee the loans, covering most of the risk of default.

Investing in community development can be made more attractive by reducing risk, as Self-Help has done, or by reducing the perception of risk, which can be done by increasing the availability of information. To attract a greater number and wider class of investors for mortgage-backed securities and other asset-

backed securities from community development lenders, the Financial Innovations Roundtable has obtained a public rating for an asset-backed security (see “Creating the First Rated Pool of Securities Backed by Community Development Assets,” p. 11). The Community Reinvestment Fund issued a rated asset-backed security in 2004, which allowed stakeholders (foundations, for example) to buy more than they could when the assets were unrated and new players (insurance companies, mutual funds, banks) to buy for the first time. Replicating this model can make unlimited funds available to community development lenders.

Providing insurance for transactions both reduces risk and provides information, attracting more investors. “The Community Development Assurance Company” on page 18 describes how Financial Innovations Roundtable members have designed a company that can sell insurance to CDFIs on their transactions (such as selling their loans to the secondary markets). Having an insurance policy on the transaction reduces risk and therefore increases demand and improves terms for the transactions. The insurance company itself would be publicly rated, giving investors a clear picture of its financial strength and activities.

Lack of volume prevents many CDFIs from taking advantage of another source of funds, commercial paper. Many companies use these short-term loans, which are typically rolled over at maturity. Borrowing against their assets instead of selling their loans would be another way for CDFIs to obtain liquidity. Financial Innovations Roundtable members have designed a Commercial Paper Co-op that would aggregate the short-term borrowing needs of its CDFI members and present their assets in a framework understandable by ratings agencies (see “The Commercial Paper Co-op,” p. 22).

A second section of this report tackles the issue of **Mission-related Investing** and **Targeted Investing**. Most foundations place their endowment in traditional investments that will preserve the principal and generate ongoing dividends. Many worthwhile community development projects also generate returns, albeit not all at market rates. Some foundations and public pension funds have diversified their investment portfolio to include more mission-related projects. This section of the report examines the mission-related investing projects of the F.B. Heron Foundation and the targeted investments of CalPERS, the California Public Employees Retirement System (see pp. 27 and 32, respectively).

The Heron Foundation has developed a tool called the “Mission-related Investment Continuum” that allows it to examine investment opportunities in different asset classes within a framework of a set asset-allocation policy. Its staff

can find, investigate, and promote investment opportunities for review by investment managers. The foundation is eager to share its lessons with other foundations and institutional investors.

To overcome the challenge of being unable to make below-market investments, CalPERS has chosen to put some funds into investments that meet certain geographic and diversity criteria while maintaining the high standards for return required of all investments. These investments have proved quite successful both as revenue generators (their primary purpose) and as sources of benefit to the community.

A third section of the report examines a work in progress, **Resident Owned Communities USA**. Building on the success of the New Hampshire Community Loan Fund’s (NHCLF) Manufactured Housing Initiative, which has enabled the residents of 80 mobile home parks to purchase the land on which they live and run the parks themselves as cooperatives, ROC USA plans to take resident-ownership to scale by training practitioners, sourcing senior debt, and leveraging subordinate debt through credit enhancements (see “Manufactured Home Communities – ROC USA, p. 38). Participants of the Financial Innovations Roundtable are helping NHCLF analyze the process and launch ROC USA nationally.



# Capital Markets for Community Development Lenders: Questions and Answers

MICHAEL SWACK, CARSEY INSTITUTE, UNIVERSITY OF NEW HAMPSHIRE

Community development financial institutions (CDFIs) have grown significantly in size and scope in the past quarter century. After decades of lending where others were often reluctant to lend, many CDFIs have demonstrated a solid capability to manage risk in their markets and have developed strong portfolios. As they continue to expand to meet the ever-increasing housing, business, and facility demands of their communities, their funding needs are growing. At the same time, the traditional sources of community development capital, such as government and foundation funding, are diminishing, and many community development lenders are looking for new strategies and techniques to raise money. Some have turned their attention to conventional capital markets. Can this be done? If so, how? Is it a good idea? This article addresses a few of these questions.

## What are community development financial institutions?

CDFIs are financial institutions that are committed to meeting the credit needs of low-income individuals and communities. Typically, CDFIs are either community-based nonprofit organizations or national intermediaries with local community offices. They are sensitive to the community's financial needs, understand the local market, and are willing to invest the time and resources needed to find and cultivate sound lending opportunities in these neighborhoods. As such, they are able to develop loan and investment products that differ from conventional lenders' offerings, providing funding where traditional lenders may not.

Community development loan funds, community development credit unions, community development corporation loan funds, microenterprise funds, and community development banks are all considered CDFIs. All of these are private, nonprofit corporations, with the exception of community development banks, which are private, for-profit entities that have a community development purpose.<sup>1</sup>

Most CDFIs have been created since 1980, and most remain small by conventional standards. However, the CDFI industry has begun to scale up. The CDFI Data Project, a foundation-funded initiative, collects industry-wide data on CDFIs.<sup>2</sup> As of the end of 2006, about 1,000 CDFIs were operating in the United States. The Data Project collected data

from 505 CDFIs in 2006. Collectively the 505 controlled \$15.1 billion in outstanding financing and financed around 70,000 units of affordable housing in 2006. The CDFIs' net loan losses in 2006 were less than one-half of one percent of their out-

***CDFIs are able to develop loan and investment products that differ from conventional lenders' offerings, providing funding where traditional lenders may not.***

standing loans (matching the rate of conventional financial institutions), and they had sufficient reserves and equity bases to cover those losses.

## Where do CDFIs get their funds, and how do they operate?

CDFIs are generally financed through a mix of public and private funds that include loans, grants, and investments. Their growth has accelerated since 1995 owing in large part to the creation of the CDFI Fund, a program within the U.S. Department of Treasury. The CDFI Fund was established in 1994 to support CDFIs and to make capital available to CDFIs serving underserved communities and individuals. The CDFI Fund is the largest source of funding for CDFIs, providing since its inception more than \$860 million in awards to community development financial institutions (see [www.cdfifund.gov](http://www.cdfifund.gov)).

CDFIs lend this money to the communities in which they work and typically oversee every aspect of the loan. Most CDFIs review applications, originate loans, book the loans, service them, and hold them in their portfolios until the loans are completely repaid. This type of top to bottom (vertically integrated) lending is known as *portfolio lending*.

## How is this type of lending different from what conventional banks do?

In the 1970s and 1980s, banks began packaging and selling their residential mortgage loans to a secondary market in a process known as *securitization*. Banks no longer had to fund each loan through their deposits. Instead, they could sell their loans to investors and use the revenue to fund more loans. The birth of securitization allowed banks to originate more loans, generate more revenue on the fees from the origina-

### What's the deal with the subprime mortgage crisis?

Subprime mortgages were the source of the recent financial crisis. Does that mean securitization is a bad idea? What is the difference between subprime mortgages and CDFI lending?

Much of the blame for the subprime lending crisis lies with mortgage originators (lenders). It was the lenders (often mortgage brokers who may or may not have worked for a particular bank) who ultimately lent funds to people with poor credit and a high risk of default. Many of these originators used unscrupulous methods to encourage people to borrow money they could not afford to repay, particularly when the original interest rate on an adjustable rate mortgage reset to a higher rate after a few years. Often the originator did not care whether a borrower could repay the loan because the broker would earn a fee on the origination regardless and would have no responsibility for the repayment of the loan. The loans would then be sold and bundled into securities. Bundles of these high-risk loans were sold to investors as highly rated investments even though the underlying mortgages were very risky.

CDFIs underwrite their loans to a much higher standard. They carefully assess what each borrower can afford and establish rates and terms that match the borrowers' needs. Loans underwritten by CDFIs have served lower-income people well and have experienced much lower losses during this period.

tions, and sell off their risk of holding fixed-rate loans in their portfolios.<sup>3</sup> The process of originating loans and selling them, called *capital markets lending*, is now the standard for banks. Today, securitization accounts for trillions of dollars of transactions and involves mortgage finance companies and other specialty finance companies as well as banks.<sup>4</sup>

### What exactly are capital markets?

Capital markets are markets where individuals, governments, and businesses trade money. Those with excess funds transfer capital to those who need it. In return, the investors expect a rate of return on their money that is consistent with the amount of risk they are taking. Capital markets allow large amounts of money to be pooled, while giving individual investors an opportunity to diversify their risk. The stock and bond markets are two of the major capital markets.

### What is the difference between primary and secondary capital markets?

The primary market is where new securities are issued. A corporation or government agency that needs funds issues these rights of ownership, interest, or dividends to willing buyers, most often in the form of stock or bonds. The securities are usually underwritten by investment banks, which guarantee

a minimum price to the seller for the security. These banks then sell the securities to the public in the secondary capital market. Secondary markets are where securities are traded. The vast majority of financial transactions that occur through stock exchanges, bond markets, futures markets, or other mechanisms all happen in the secondary market.

### Can you give an example of how this works?

Consider the residential mortgage system in the United States. This system is made up of a primary market and a secondary market. In the primary mortgage market, banks provide funds directly to the new homeowner, who in turn issues a security, the mortgage, to the bank. The secondary market is where this mortgage loan is bought and sold by investors. The bank that made the loan in the primary market wants to sell the mortgage and use the money to originate more loans. Because the mortgage is backed by the homeowner's real estate, it is an attractive security for investors. In most cases, one of the two largest secondary mortgage market institutions—the Federal National Mortgage Association (Fannie Mae) or the Federal Home Loan Mortgage Corporation (Freddie Mac)—will buy the mortgage from the bank. Fannie Mae and Freddie Mac aggregate single- and multifamily housing loans into pools, and with the pools of mortgages and ultimately the real estate serving as collateral, they create mortgage-backed securities. (An asset-backed security is a security backed by assets that can include real estate and other assets.) To finance their future purchases, Fannie Mae and Freddie Mac sell these mortgage-backed securities to public investors at a fixed rate of return, maintaining the credit risk of these loans on their own books.

### So, investors around the country are trading my mortgage with my local bank?

Yes. The idea behind this secondary market is that while home loans are local loans, the system of finance for them need not be. National capital markets provide funds for local housing markets. With the proceeds from the sale of their mortgages, primary lenders replenish their money supply and use it to make more loans. Without this secondary market, primary lenders would be forced to keep all their loans in their portfolios. They could make loans only from the money they had in deposits, restricting their ability to serve the needs of new homeowners.

## **Aren't CDCs and CDFIs already involved in these primary and secondary capital markets?**

Yes, in a limited way they are. CDFIs are primary market lenders. They receive money from foundations and government agencies and lend it to individuals and communities that need funds.

## **That seems to work in my community, so what's the problem?**

The problem is that foundations and government have limited funds to meet the demand for capital in your community. People want to buy homes and start businesses. Organizations want to develop housing and community facilities. CDFIs are mostly portfolio lenders. Although they have become good at assessing risk and managing healthy portfolios, they are limited by the amount of money they receive in grants and donations. They cannot meet all their lending needs. Many CDFIs could expand their lending and better serve their communities if they complemented their portfolio lending with some capital markets lending. After all, there is a lot of money out there in the capital markets—and communities could use it. A CDFI involved in capital markets lending would employ methods, such as securitization, that would distribute its loans among a range of investors, instead of holding all of the loans in its portfolio. By selling their loans on the secondary market, CDFIs can increase their liquidity.

***Many CDFIs could expand their lending and better serve their communities if they complemented their portfolio lending with some capital markets lending. By selling their loans on the secondary market, CDFIs can increase their liquidity.***

## **We want Wall Street to buy our loans. What's the hitch? Do we have to discount our loans?**

Not necessarily. Investors will want to pay less than the face value of a loan if they think the loan will not perform. But CDFI loans perform and yield good returns. CDFIs simply have to demonstrate this success in a way that investors will understand.

## **How can CDFIs demonstrate success?**

First, the CDFI industry needs to change some collective behaviors in order to access these markets. In general, here's what the capital markets are looking for:

### ***Performance Data***

Capital markets like a lot of information and data. Investors want to know how CDFIs perform over time. What are the rates of delinquency, default, and recovery? Currently, most CDFIs have weaker standards of data collection and measurement than these markets want, and they often have different definitions of what constitutes a delinquency or default. To show the strength of their loans, CDFIs must illustrate performance using standard industry data and definitions.

### ***Standardization***

This is a big one. Capital markets like vanilla. Not caramel, not strawberry, not chocolate. Investors want CDFIs to standardize things within the industry so they can better understand the products and appropriately assess risk. The capital markets want not only standard data collection but standardized performance tracking tools; uniform ways of servicing, underwriting, and assessing risk; and a set method of collection.

The CDFI industry does not currently have any specific standards for these practices. However, trade associations of CDFIs are becoming larger and more sophisticated and have begun to promote operating practices among their members that enhance the industry's ability to meet the capital markets' standards. For example, the Opportunity Finance Network has developed a CDFI Assessment and Rating System (CARS™) that analyzes and rates CDFIs on their impact (effective use of their financial resources to achieve their stated mission) and financial strength and performance (overall credit-worthiness based on past financial performance, current financial strength, and apparent risk factors). It is the first step toward standardizing CDFI processes and procedures.

### ***Volume***

Capital markets like to deal with big numbers. They want pools of loans that are \$50 million or more in value. By comparison, CDFIs deal in very small numbers. Some CDFIs are developing mechanisms for pooling their loans to offer investors the big numbers they desire.

### ***Pricing***

The capital markets need products that are priced properly relative to risk and offer an attractive return. Not all CDFI products can meet the pricing criteria, but many can and do. CDFIs must identify and market these products.

### ***Credit Enhancements***

To make CDFI products more attractive, investors may want certain credit enhancements. Credit enhancements, such as insurance or letters of credit (an irrevocable commitment by a bank to pay), make loans less risky to investors by guaranteeing regular payments. CDFIs could leverage some of their government and foundation money as credit enhancements in, perhaps, a better use of these funds. (See p. 18 on the Community Development Assurance company, which will provide insurance for CDFI transactions.)

### **What are the barriers to entering capital markets?**

The first barrier is volume. To achieve larger volume, CDFIs can and have created cooperatives in which CDFIs pool their loans and sell them to an institutional investor similar to Fannie Mae. By enticing an investor with large volume and low risk resulting from the geographic dispersion of the loans, pooling can be a cost-effective way for smaller CDFIs to increase their liquidity.<sup>5</sup>

The second barrier is credit enhancements. A common tool used to promote the sale of loans is financial guarantee insurance. This insurance ensures that payments are made to investors who buy pools of loans. CDFIs could negotiate a financial guarantee through an established insurance company and provide a credit enhancement on a pool of community development loans. The enhancement would help the pool achieve a good rating from one of the rating agencies, which would signal that the pool was a sound investment.<sup>6</sup> The favorably rated security could then more easily be sold in the financial markets, where many insurance companies and mutual funds buy only highly rated securities.

### **Won't banks and lenders lose the close working relationships they have cultivated with borrowers when they sell the loans?**

Not at all. In most instances, lenders will continue to directly service their own loans. They will need to maintain a close relationship with borrowers, providing them technical assistance and monitoring their performance to ensure a healthy return to investors.

### **Will CDFIs have to adjust their portfolio to meet the specific "appetite" of the market, as opposed to the needs of the borrowers and communities they currently serve?**

Not necessarily. Many CDFIs will continue to do portfolio lending even if they are able to sell some of their loans. That

is, they will still have loans that meet certain unique needs or circumstances and require the CDFI to service and hold the loan to maturity. In fact, a CDFI might have many of these. But, many community development lenders have developed certain prepackaged loan products, such as housing or facility loans. These loans are underwritten in a consistent way and are "standard" within the CDFI's own portfolio. These are the types of loans that would best be packaged and sold to investors in the capital markets.

### **Will institutional investors really buy CDFI loans? Has anyone actually done anything yet?**

Yes, it can work, and it has. For example, both the Community Reinvestment Fund (CRF) of Minneapolis, Minnesota, and Self-Help of Durham, North Carolina, have successfully accessed capital markets and are providing increased liquidity to the community development field (see pp. 11 and 16, respectively). To attract institutional investors, CRF began pooling and underwriting loans that had been originated by a range of smaller community development lenders around the country. They have amassed more than \$700 million worth of loans and sold them to the secondary markets, bringing in capital for these small lenders. Self-Help developed and marketed a standard home mortgage product to attract investors and has underwritten more than \$4.5 billion in these mortgages for low-income communities. Both organizations' efforts have attracted a number of institutional investors to these community development projects, including Prudential Securities, MetLife, and Equitable Insurance.

### **Where can I find additional information?**

This publication details a number of current and future innovations to help CDFIs access capital markets developed by the Financial Innovations Roundtable. To learn more, visit <http://www.carseyinstitute.unh.edu/fir.html>.

<sup>1</sup> See <http://www.ncif.org/index.php/CDBIindustry/CDBIs/> for more on Community Development Banking Institutions.

<sup>2</sup> See [http://www.opportunityfinance.net/industry/industry\\_sub2.aspx?id=236](http://www.opportunityfinance.net/industry/industry_sub2.aspx?id=236) for more on the CDFI Data Project and to access publications based on its research.

<sup>3</sup> Securitization protects banks from interest rate volatility, reducing risk. Before securitization, banks would make a loan at 6% for 30 years. Several years later, they might suffer a loss, paying their depositors more than 6% if interest rates went up.

<sup>4</sup> Kirsten Moy and Alan Okagaki, "Changing Capital Markets and Their Implications for Community Development Finance" (Washington, DC: Brookings Institution, 2001), available at [http://www.brookings.edu/articles/2001/07/metroplitanpolicy\\_moy.aspx](http://www.brookings.edu/articles/2001/07/metroplitanpolicy_moy.aspx).

<sup>5</sup> See Gregory Stanton, "Unblocking Obstacles to Capital Markets for Community Development Lenders" (Manchester, NH: Community Economic Development Press, School of Community Economic Development, Southern New Hampshire University, 2003). For reprints contact [arc@snhu.edu](mailto:arc@snhu.edu) or for an electronic copy see [http://www.community-wealth.org/\\_pdfs/articles-publications/cdfis/article-stanton.pdf](http://www.community-wealth.org/_pdfs/articles-publications/cdfis/article-stanton.pdf).

<sup>6</sup> Ibid.

# Creating the First Rated Pool of Securities Backed by Community Development Assets

MICHAEL SWACK, CARSEY INSTITUTE, UNIVERSITY OF NEW HAMPSHIRE

Since 1994 when Congress directed the Department of Treasury to create the Community Development Financial Institutions Fund, Community Development Financial Institutions (CDFIs) have become more prominent players in community development lending. CDFIs are committed to meeting the credit needs of low-income individuals and communities. They are sensitive to local needs and they are able to develop loan and investment products that differ from conventional loan products. CDFIs are also sophisticated in their approach to meeting credit needs and providing assistance to borrowers, both organizational and individual.

There are different types of CDFIs, but they all share a commitment to providing credit and technical assistance to unconventional borrowers (that is, low-income individuals and community-based development organizations) and filling capital gaps that conventional lenders do not or cannot fill (see box).

The success of CDFIs may stem from special expertise in management and underwriting (analyzing the credit-worthiness of borrowers, that is, their ability to repay a given loan, and the suitability of the loan's purpose), the greater time CDFIs spend on project management, and the smaller number of projects they handle relative to conventional lenders.<sup>2</sup>

## Information Asymmetry

Conventional lenders may hesitate to enter the market for low-income individuals and communities because the lenders lack sufficient information or expertise to exploit the opportunities to earn a profit. In other words, they are suffering from "information asymmetry": they know less than other players in the marketplace, such as potential borrowers, about their likelihood of repayment.<sup>3</sup> Unlike conventional lenders, CDFIs know much more about low-income individuals and communities, which allows them to operate more successfully.

Conventional capital markets often lack information on CDFIs also. CDFIs are generally small institutions that often customize their products for their borrowers. Counter to the trend in conventional finance, CDFIs are more often vertical-

## The Special Role of CDFI Lending

*The following are types of activities, including lending, that*

*CDFIs offer in low-income communities:*<sup>1</sup>

1. Predevelopment financing in the early stages of a project, which allows the project to reach the stage where it is bankable;
2. Junior financing (subordinate debt that has a right to the borrower's assets only after senior debts have been paid), which cushions conventional loans above certain loan-to-value ratios (for example, loans over 75% loan-to-value ratio);
3. Seasoning loans (holding them for a certain length of time) to demonstrate their safety so conventional institutions can later purchase or refinance them;
4. Demonstrating the effectiveness of new lending approaches, underwriting methods and loan products so that conventional institutions can become comfortable with the new approaches and products;
5. High transaction cost loans: loans that are too small or complicated and thus cost too much because of the time involved;
6. Loans that allow community development organizations or entrepreneurs to gain experience and a track record so they can use conventional lenders in the future; and,
7. High-risk loans in general, for reasons such as lack of organizational financial strength, lack of take-out financing, difficult neighborhood, scattered sites, or a nontraditional income stream.

ly integrated, carrying out most functions internally (for example, loan origination, servicing, and technical assistance). Such a structure helps CDFIs maintain close contact with their customers, but this operating model also creates higher

***Customized loans with differing underwriting standards and insufficient information about the field make it difficult for the community development field to engage in securitization.***

"transaction costs" (costs involved in the process of making and monitoring a loan) and less efficiency.<sup>4</sup> Moreover, CDFI underwriting standards and loan documents are frequently nonstandardized.

The lack of standardized performance data in community development lending perpetuates the perception that com-

munity development loans are risky.<sup>5</sup> For any emerging asset class, such as community development loans, to gain credibility in the capital markets, it must have five years of reliable performance data.<sup>6</sup> This allows investors to assess risk over time. The CDFI field has no large body of data that is uniformly collected and highly reliable.

Customized loans with differing underwriting standards and insufficient information about the field make it difficult for the community development field to engage in securitization, the process of packaging a pool of similar financial instruments into a new instrument that can be sold to investors (see previous article, p. 7).

### **The Community Reinvestment Fund: A Rated Securitization Model<sup>7</sup>**

The Financial Innovations Roundtable has increased knowledge about community development lending by catalyzing a *public rating* for an asset-backed security transaction of pooled community development loans. The roundtable brought together a loan aggregator (the Community Reinvestment Fund of Minneapolis), a Wall Street ratings agency (Standard and Poor's), capital markets specialists (Wall Street Without Walls volunteer financial experts), private foundations (Fannie Mae and Heron Foundations) and other financial professionals to accomplish this goal. The first transaction, described below, closed in November 2004.

**Community Reinvestment Fund (CRF)** is a Minneapolis-based 501(c) 3 corporation that began operations in 1988 and provides new loan capital for community-based development organizations by creating a secondary market for community development loans. These development loans are distinguished from traditional commercial loans in that, in addition to financial objectives, they emphasize social objectives such as job creation, affordable housing, and community revitalization in economically distressed communities or among economically or socially disadvantaged groups.

CRF purchases loans, sells loans it has purchased to special purpose entities (SPEs), facilitates the issuance of asset-backed securities supported by the loans owned by the SPEs, services the loans it has sold to the SPEs, and manages New Markets Tax Credits entities on behalf of investors.

Prior to 2004, CRF successfully issued 16 series of its *Community Reinvestment Fund Revenue Bond and Note Program* with a total par (face or nominal) volume of more than \$300 million. In addition, CRF released a \$74.6 million affordable housing note issue in 2001. CRF never submitted

any of these transactions for a public or private rating.

CRF conducts extensive credit reviews and analyses on the loan originators and each loan. Their diligence is reflected in the performance of these loan pools, which has exceeded general expectations. To date CRF loan portfolios have experienced a cumulative loan default rate of 0.57%.

Combining its mission and this financing experience, CRF has a proven ability to analyze loan originators and project accurate loss expectations. Socially responsible institutional investors have expressed their confidence in CRF's capabilities by purchasing CRF's asset-backed securitizations. In fact, many of CRF's institutional investors hit their limit on the maximum exposure to nonrated community development loan-backed securities held in their respective portfolios.

### **A New Approach and the First Rated Community Development Securitization**

During a Financial Innovations Roundtable meeting in early 2002, a consensus of attendees suggested that the best way to demonstrate the marketability and underlying credit quality of selected community development loans was to assist an existing aggregator in underwriting the first rated asset-backed securitization supported by a pool of community development loans. To increase the marketability of this security, the original plans also called for purchasing financial guaranty insurance on the issue as a credit enhancement (for reasons described below, this did not take place).

The structure of this rated issue would serve as a template or model for future transactions. A rated security would also attract new investor classes, thereby creating an unlimited flow of new capital into the community development sector. Likewise, current socially responsible investors in this asset type would no longer be constrained by internal or external caps imposed on unrated securities.

To expedite the selection of a potential issuer, roundtable participants chose to identify an existing loan aggregator with the operating experience and the support of an existing team of financial intermediaries, including bond attorneys, investment bankers, quantitative financial analysts, and others. CRF met these qualifications and agreed to work with Wall Street Without Walls.

### **"CRF-17" Transaction Overview**

The CRF issued the *CRF USA Community Reinvestment Revenue Notes, Series 17* as part of its ongoing mission to create a

## TRANSACTION TERM SHEET

TABLE 1: CRF-17 DESCRIPTION

Issuer	CRF-17 LLC
Servicer	CRF, Inc
Loan Originators	Various community development corporations, community development financial institutions, governmental, non-profit and other community development lenders.
Trustee	Wells Fargo Bank, NA
Back-Up Servicer	Wells Fargo Bank, NA
Rating Agency	Standard & Poor's

TABLE 2: RATINGS AND YIELDS ON NOTES

Class	Par	Rating	Yield
Class A-1	\$8,871,000	AAA	2.79%
Class A-2	8,610,000	AAA	3.62
Class A-3	8,610,000	AAA	4.25
Class B	7,674,000	A	5.79
Class C	6,523,000	BB	8.60
Class D	3,000,000	NR	6.59
Class E	2,814,000	NR	6.33
	<b>\$46,102,000</b>		<b>6.54%</b>

TABLE 3: LOAN POOL

Number of Loans	123
Number of States	19
Largest Geographic Concentrations	25.7% Northern California 15.3% Southern California 13.1% Minnesota
Largest SIC Codes	7.9% Gasoline Service Stations 7.8% Apartment Building Owners 7.5% Hotels and Motels
Avg. Loan Balance	\$373,058
Weighted Avg. Loan Rate	7.25%
Weighted Avg. LTV	72.4%
Weighted Avg. Loan Seasoning	22.7 months
Security of Loans	First and second mortgages on commercial real estate; equipment liens
Issuer's Counsel	Perkins Coie LLP, Chicago, Illinois
Initial Purchaser	Piper Jaffray & Co., Minneapolis, Minnesota

secondary market for selected community development and affordable housing loans, allowing loan originators to reinvest the proceeds of selling loans back into their respective communities. CRF sells these loans to an issuer—a bankruptcy-remote, special purpose entity—that in turn issues the notes, secured by the purchased loans.

The CRF-17 issue was priced in October 2004. The accompanying term sheet provides an overview of the transaction.

## Foundation Support

The Fannie Mae Foundation was committed to improving access to capital markets for community development loan originators. The foundation provided financial support to the Financial Innovations Roundtable and to Wall Street Without Walls, including their assistance to CRF. The foundation recognized that the successful sale of the CRF transaction was an essential first step in facilitating new flows of capital into the community development and affordable housing sectors. Foundation support facilitated the CRF transaction in several important ways, including injecting the needed capital and information.

Capital was necessary because CRF-17 was almost three times the size of the CRF program's largest previous transaction. Given that loan originators cannot always wait to sell their loans at closing, CRF maintains a bank line of credit to purchase and "warehouse" loans until closing. However, the size of its credit facility was insufficient to satisfy the number of loan purchases that were projected for CRF-17. CRF's bank was willing to increase its warehouse line if CRF could raise additional capital. The Fannie Mae Foundation and the F.B. Heron Foundation lent the necessary funds to CRF. CRF repaid this loan early.

Although CRF's historical loan performance (defaults, losses, and recoveries) was impressive for the commercial banking industry, Standard and Poor's considered it too limited. Another representative source was required. FIR selected the Small Business Administration's Section 504 Certified Development Company Loan Program as the alternative information source because its credit underwriting criteria closely resembled those of CRF and the CRF-17 loan portfolio. FIR used foundation funds to purchase data from the SBA loan program and performed the first "external" analysis of it. The comprehensive analysis of this \$13.9 billion (and 39,139 loan) program proved to be an acceptable benchmark for Standard and Poor's. The program provided invaluable data on loan defaults, losses, recoveries and prepayments, which were projected into the CRF-17 cash flows.

## Standard and Poor's

An essential part of Standard and Poor's due diligence analysis focused on CRF's portfolio performance, which was substan-

*During the 14-month evaluation, Standard and Poor's gained confidence in the CRF team and the credit-worthiness of the loan portfolio.*

tially better than the SBA program. After hundreds of hours of discussion, examination, and reexamination of the structure and supporting financial models, and countless "stress tests," Standard and Poor's recognized the credit-worthiness of community development loans, the strength of CRF's management, its credit underwriting standards, and its credit analysis capabilities. This is evidenced by the public ratings awarded by Standard and Poor's.

Standard and Poor's initially in 2002 questioned the economic feasibility of rating a relatively small transaction (originally planned for \$25 million), particularly one involving a new asset type. They believed the smaller deal size would not support Standard and Poor's minimum rating fee of \$75,000.

Between July 2003 and March 2004, when CRF made its formal presentation to Standard and Poor's, Wall Street Without Walls advisors and the CRF team recognized and began to address these and other issues and concerns. The concerns ranged from transaction size, to loan accounting systems, servicing capabilities, underwriting standards of loans and their originators, loan documentation, diversification issues, loan performance criteria, and loan modifications.

Early discussions with Standard and Poor's representatives enabled the CRF team to be better prepared in their formal ratings request. The team recognized early on that the Standard and Poor's approach always includes a "worst-case" stress test.

Standard and Poor's extensive review process occurred in April and May 2004 and was followed by a week-long on-site visit to CRF in mid-summer. Standard and Poor's was willing to devote the time necessary to understand the community development sector and its sometimes limited financing capabilities; evaluate the performance and financial strengths of selected CDFI loan originators; and conduct a thorough evaluation of CRF and its capabilities. Initially, Standard and Poor's intended to use its statistical/actuarial model to evaluate the CRF portfolio, but because the number of loans was small, senior managers decided to use their

"Monte Carlo" model. This model is generally used for relatively small portfolios of assets and is more time-consuming in that it requires evaluations of individual loans in the portfolio.

During the 14-month evaluation, Standard and Poor's gained confidence in the CRF team and the credit-worthiness of the loan portfolio. The rating agency and CRF continually evaluated, tested, and modified the structure and its supporting financial model. Both parties agreed on the final structure and cash flow, and Standard and Poor's Credit Committee approved the ratings in August 2004. Standard and Poor's will monitor the transaction until its final maturity (the bonds mature between 2006 and 2013).

## Financial Guaranty Insurance

A representative of the Financial Innovations Roundtable submitted the CRF transaction to five financial guaranty insurance companies for their consideration. Insurance would further reduce the risk for investors but would also lower yields slightly. None of the five insurers agreed to insure the transaction, even though no one doubted the credit-worthiness of the assets or the transaction structure. They declined to insure instead because of the deal size, the new asset type, capital constraints at two companies, and the departure of the assigned analysts at two companies. All five companies insisted on a Standard and Poor's shadow rating (a non-public rating) before performing a complete analysis. The responses of the insurance companies indicated they would likely respond favorably to a similar transaction in the future.

## Conclusion

CRF-17 is the first publicly rated securitization of a pool of community development loans. The structure of the transaction and its underlying credit strength has served as model for subsequent transactions and has become a standard model for CRF. Perhaps the most significant benefit is that the structure and rating attracted new, first-time institutional investors, including Northwest Mutual Life, Western Asset Management, CRA Fund Advisors, and Glacier Bank, thereby successfully achieving the initial goal of bringing new classes of investors into the community development and affordable housing sectors.

## Promoting Further Innovation

The CRF securitization allowed community development lenders to sell existing loans. The capital markets did not impose standards on the underwriting given that lenders had



already originated these loans under existing CRF guidelines before CRF approached Standard and Poor's. Although not all loans originated by CDFIs will qualify for sale, clearly a number of these loans will (and do) qualify. CRF was also able to price loans according to the interest rates set by the originator. Although highly subsidized loans originated by community development lenders were discounted, it was not perceptions of risk that spurred discounting; loans originated at near-market value were subject to very little or no discounting. This addresses the community development lenders' concern about price. Finally, the CRF loan structure allows originators to continue to service their loans, if they choose. Clearly there are opportunities for collaboration between the community development sector and conventional capital markets in ways that address the concerns of the community development lenders. Further innovation in the field will require collaboration and a measured approach to integration.

### **Collaboration**

Collaboration is needed on a number of fronts. Community development lenders must collaborate with one another to develop basic standards for collecting data that capital markets need. The field must also develop a standard and efficient infrastructure to collect data, track performance, perform back-office tasks, develop collection systems, troubleshoot, and report data. Community development lenders also should reach scale by more actively and deliberately pooling loans. CRF functions as an aggregator of loans, but more aggregators are needed. Regional aggregators can diversify pools of loans geographically and by asset class, work with ratings agencies, and help service the loans of those lenders who need it.

In addition, collaboration is needed with foundations, government agencies and conventional capital markets. Government and foundations can enhance the credit of loan pools just as the Ford Foundation did with Self-Help (see p. 16). The CRF model involved a unique amount of collaboration among the ratings agency, the aggregator, foundations, and individual lenders.

### **The Challenge of Integration**

Can there be a downside to success? Ratliff and Moy raise interesting issues involved in integrating CDFIs into the financial mainstream.<sup>8</sup> They note that promising community development products and services are often tested in commu-

nity development organizations and adopted by mainstream financial institutions. But what are the appropriate roles of CDFIs in this process? Should they serve as the research and development arm of more conventional financiers, as a broker between low-income communities and mainstream financial institutions, or in other roles?

The second question that arises is how best to structure a relationship between CDFIs and the mainstream. Such integration is the challenge facing CDFIs now. Ultimately the challenge is how to grow while maintaining a focus on the mission to support underserved individuals and communities. Not every organization can achieve scale. But for CDFIs as a group, the challenge is to develop the standards and practices that allow them to integrate with the financial mainstream and thus scale up, while not losing sight of their mission, and expand their base. This will require adopting standards, size, and data required by Wall Street while maintaining the flexibility, creativity, and commitment that created the field in the first place.

***For CDFIs as a group, the challenge is to develop the standards and practices that allow them to integrate with the financial mainstream and thus scale up, while not losing sight of their mission.***

<sup>1</sup> D. Leibsohn, "Meeting Capital Needs in Low-Income Communities" (San Francisco: Low Income Housing Fund, 1995), pp. 3-4.

<sup>2</sup> D. DiPasquale and J. L. Cummings, "Accessing Capital Markets for Affordable Rental Housing." In *From the Neighborhoods to the Capital Markets*, (Washington, DC: National Task Force on Affordable Housing, 1992), p. A-27.

<sup>3</sup> C. Beshouri and S. Glennon, "CRA as Market Development or Tax: An Analysis of Lending Decisions and Economic Development" (Washington, DC: Office of the Comptroller of the Currency, 1996).

<sup>4</sup> K. Moy and A. Okagaki, "Changing Capital Markets and Their Implications for Community Development Finance" (Washington, DC: Brookings Institution, 2001).

<sup>5</sup> G. Yago, B. Zeidman, and B. Schmidt, "Creating Capital Jobs and Wealth in Emerging Domestic Markets" (Los Angeles: Milken Institute, 2003).

<sup>6</sup> G. Stanton, "Unblocking Obstacles to Capital Markets for Community Development Lenders" (Manchester, NH: Community Economic Development Press, Southern New Hampshire University, 2003).

<sup>7</sup> I am indebted to Wayne Marsden for his initial draft of the case detailed here.

<sup>8</sup> G. Ratliff and K. Moy, "New Pathways to Scale for Community Development Finance" (Washington, DC: Aspen Institute, 2004). Available at [http://www.chicagofed.org/community\\_development/files/12\\_2004\\_pnv\\_new\\_pathways\\_to\\_scale.pdf](http://www.chicagofed.org/community_development/files/12_2004_pnv_new_pathways_to_scale.pdf).

# Self-Help's Affordable Home Loan Secondary Market Program

MICHAEL SWACK AND NOÉMI GISZPENC, WITH ROBERT SCHALL

Self-Help is a leading nonprofit community development financial institution (CDFI) headquartered in Durham, North Carolina. It consists of the nonprofit Center for Community Self-Help and two financing affiliates, Self-Help Credit Union and Self-Help Ventures Fund. Its mission is to create ownership and economic opportunities for minorities, women, rural residents, and low-wealth families. Since 1980, Self-Help has provided more than \$5.3 billion in financing to more than 63,000 small business enterprises, not-for-profit organizations, and homeowners. It operates eight regional offices in North Carolina and maintains offices in Washington, D.C. and Oakland, California.

In the 1990s, the Self-Help Ventures Fund began to address the problem of limited capital for affordable home loans. As described elsewhere, lenders providing conventional mortgages had begun to bundle them and sell them to investors on the secondary market, accessing a virtually limitless supply of cash to make more loans. In contrast, “nonconforming” loans made by lenders trying to meet Community Reinvestment Act (CRA) requirements were severely constrained. Having no outlet to sell these loans, lenders would limit the number or stop making them altogether.

Self-Help's response began with a pilot program in 1994, when it purchased a \$20 million CRA loan portfolio from a North Carolina bank looking to increase its originations in support of its CRA program. The lender's portfolio contained loans with high loan-to-value ratios and no mortgage insurance and loans to borrowers with blemished credit histories and limited incomes. This initial stage proved that the risk of affordable home loans could be effectively managed.

These loans were underwritten to avoid the problems associated with the subprime and alt-A loans that are now so toxic to many of our financial institutions. The loans purchased by Self-Help are 30-year fixed rate loans with no interest rate re-sets or payment shocks. Borrower income is verified and loans are underwritten for the ability of the borrower to pay over the full term of the loan. Furthermore there are no prepayment penalties that prevent borrowers from refinancing

should they qualify for a better loan. Consequently Self-Help's Secondary Market loan portfolio has performed well during the current mortgage crisis when subprime mortgages are defaulting at record rates.

In 1998, Self-Help's secondary market expanded nationally with the convergence of two partnerships. First, Self-Help received a \$50 million grant from the Ford Foundation (at that time the largest commitment made by a philanthropic institution to promote homeownership), which it used as a loan loss reserve to cover

the credit risk on financed loans. With this reserve, Self-Help could guarantee loans with credit characteristics, such as low credit scores, high loan-to-value ratios, or no mortgage insurance, that could have made them ineligible for sale. With Self-Help bearing most of the risk in case of borrower defaults, Fannie Mae agreed to purchase the pools of credit-enhanced mortgages, bundle them into securities, and sell them in the capital markets. Banks around the country committed to redeploy the proceeds by making additional low-income mortgages.

Fannie Mae's initial commitment was to purchase \$2 billion in Community Advantage Program mortgages over five years. By 2004, Self-Help exceeded its \$2 billion target, leveraging the Ford grant 40 times over, and Fannie Mae agreed to extend the program. Since 1998, Self-Help's Community Advantage Home Loan Secondary Market Program has produced \$4.5 billion in mortgages to more than 49,500 families nationwide. The program's flexible terms accommodate the financing needs of lower-wealth, higher credit-risk borrowers. Borrower income must be at or below 80% of area median income or 115% of area median income in low- and moderate-income or minority census tracts. Higher and more flexible ratios (e.g., single ratios of 42%, and loan-to-value ratios up to 100%) and minimum down payments as low as 1% or \$500 allow low-income borrowers to purchase the homes that are available in their area. Manual analysis of credit, or lower than standard credit score floors (as low as 580), help address the needs of borrowers who may be credit-worthy now but have blemished credit histories. In addition, there may be no mortgage insurance requirement, and it is permitted for clos-

***Although flexibilities are built into Self-Help's loan products with lenders, all its products are crafted to prevent the presence of multiple exceptions to conventional credit criteria in the same loan.***

ing costs to be gifted by family or friends. Although such flexibilities are built into Self-Help's loan products with lenders, all its products are crafted to prevent the presence of multiple exceptions to conventional credit criteria in the same loan. This allows it to expand homeownership boundaries while maintaining the financial integrity of its loan programs.

After ten years of operating history, studies have shown that Community Advantage borrowers:

1. have an income 64% of their respective area's median
2. are 46% minority borrowers
3. saw the median value of their home equity increase by \$17,500 between 1998 and 2002
4. rarely miss a payment: more than 80% of borrowers have never been delinquent in making a mortgage payment (still true in 2008, as the financial crisis unfolds)

The loans performed well in the first five years of the program. Loan loss rates were very low (average annual loss rate of 0.13%) even compared with conventional mortgages. From the program's inception to September, 2008, Self-Help has taken 0.8% loan losses on over \$4.5 billion in mortgages, with this year's losses higher than past years at around 0.45%. These rates are very low, even by prime loan standards. A study completed in 2003 by the University of North Carolina at Chapel Hill revealed that 0.7% of Self-Help's secondary market borrowers had defaulted on their mortgages compared with an average 1.1% default rate among all borrowers nationwide during that time period. From January 2007 through June 2008, delinquency rates have risen, as they have throughout the industry, but this has not led to many more foreclosures. This year, about 1.2% of Self-Help's loans will be foreclosed on, compared to 2.75% of mortgages nationally (by the end of the second quarter). This may, in part, stem from Self-Help's active role in servicing the loans, particularly default management. Self-Help's loss mitigation strategies include loan counseling programs, flexible alternatives to foreclosure, and special initiatives to address sudden and unforeseen events.

Through the Secondary Market Program, Self-Help demonstrated that, with responsible lending, low-wealth families make good borrowers and sound investments. The Program affords Fannie Mae an opportunity to better understand the risks associated with nontraditional mortgages and refine its performance measurements. Many private financial institutions have also developed products similar to Self-Help's, significantly expanding the market for responsible low-income mortgages. This work provides an important counterpoint to

the irresponsible practices that fueled the current subprime crisis.

*For more on this program, contact [secondarymarketinfo@self-help.org](mailto:secondarymarketinfo@self-help.org), or see [www.self-help.org](http://www.self-help.org).*

# The Formation of Community Development Assurance (CDA)

WAYNE A. MARSDEN

EDITOR'S NOTE: Several of the articles in this document point to the ever-growing capital needs of the community economic development and affordable housing sectors and ways to attract new and efficient capital sources. The article on the issuance of a rated asset-backed security by the Community Reinvestment Fund (p. 11), in which we read that several companies rejected CRF-Series 17 for other than credit quality reasons, demonstrated that seasoned financial guaranty insurance companies lack familiarity with community economic development assets. This article describes a solution: the creation of a publicly-rated, specialty financial guaranty (municipal bond) insurance company with a focus on insuring financings in these sectors. This paper will provide insights into Community Development Assurance ("CDA"), which is currently seeking some \$300 million in initial equity capital.

Financial guaranty insurance is an irrevocable, non-cancelable, third-party guaranty of the timely payment of principal and interest (as scheduled) on the insured transaction. The public rating of the financial guarantor transfers to the transaction, thereby enhancing the borrower's credit, lowering the cost of borrowing, and improving the marketability of the transaction. A wider range of potential investors can be attracted by the added security and liquidity of the insured transaction.

## A New Company to Address the Problem

Today there are no financial guaranty insurance companies providing credit enhancement guarantees in the community economic development ("CED") sectors. There are a number of reasons: unfamiliarity with the underlying credit quality, small deal sizes, and differing underwriting processes and disciplines between the asset types that make up their current core business and CED transactions, which may include characteristics found in public, mortgage, corporate and structured finance. There is little incentive for seasoned and higher rated financial guaranty companies to expand their focus and serve the CED market segment. The global credit crisis of 2008, initially caused by the sub-prime mortgage meltdown and entailing downgrades in the ratings of many of the financial guarantors, makes it even more unlikely that these companies will commit the time and resources to serve

the CED sectors.

CDA will be the first financial guaranty insurance (bond insurance) company with a focus on insuring qualified CED sector financings. The term CDA refers interchangeably to Community Development Assurance Holdings, Inc. (a Dela-

*CDA will be the first financial guaranty insurance (bond insurance) company with a focus on insuring qualified CED sector financings.*

ware incorporated holding company) and its wholly-owned subsidiary, Community Development Assurance Company, a new state-regulated insurance company, which will become operational after a planned capital stock offering.

The size and underlying credit quality of the CED sectors are not well known in the capital markets. It is envisioned that CDA will help to establish minimum credit underwriting standards for these sectors. Over time they should become recognized as the industry standard by those CED originators and aggregators who look to the capital markets. CDA's entry and positioning in the market will provide the targeted sectors with improved access to the capital markets. As both socially responsive and market-return investors become more aware of the underlying credit quality of the sectors, participants will benefit from a growing supply of available capital at more attractive rates.

## The Focus of CDA

CDA will offer financial guaranty insurance, credit-related insurance products and technical financial assistance to qualified participants in its targeted sectors. The CDA organization will provide credit enhancement guarantees through the issuance of insurance policies on financial transactions whose proceeds will either:

- create new jobs;
- improve community facilities and services;
- support small business finance;
- enhance efficient energy sources or the environment; or
- increase the supply or improve the quality of affordable housing.

## Target Markets and Business Types

CDA will target the following types of municipal and CED financial transactions in both the primary (new issue) and secondary (seasoned, previously issued) markets:

- Public and Small Business Finance, including:
  - small business loans;
  - affordable housing (single and multi-family): workforce, military, immigrant, Native American, people of color and senior housing;
  - industrial and economic development;
  - education: charter schools, vocational schools, community colleges and other post-secondary institutions;
  - lease financings;
  - community service and facility improvements;
  - nonprofits;
  - environmental, resource recovery and alternative energy sources; and
  - healthcare: long-term, specialty and community-focused.
- Structured Finance, such as:
  - asset-backed securities backed by: small business loans, micro-finance loans, financial institution capital notes, trade receivables, tax credits, and lease receivables; and
  - mortgage-backed securities: single- and multi-family residential with an affordable component, immigrant mortgages, workforce housing, military, and senior housing.

**CDA will not insure derivative or synthetic CDOs. It will require “hard” asset collateral and iron-clad security provisions.**

- Possible specialty products may include:
  - portfolio insurance;
  - deposit and loan guarantees;
  - performance / surety bonds;
  - forward insurance commitments; and
  - credit protection insurance products.
- Financial technical advisory: on a fee basis, the service company will provide:
  - deal structuring, when insurance is not used;
  - social impact reporting;
  - portfolio credit monitoring / surveillance; and
  - administration and management of established guarantee funds.

In the future CDA will consider insuring international CED transactions.

CDA will be responsive in balancing the needs of institutional investors and CED sector participants. The primary beneficiaries of CDA’s presence in the market will include, among others:

- Community development and small business loan originators, such as banks, CDFIs, and community development credit unions;
- socially responsive investors;
- assets aggregators, investment managers;
- affordable housing mortgage originators;
- affordable housing developers and managers;
- community development corporations;
- community service providers; and
- related organizations.

At the same time, CDA will be addressing the needs of philanthropic and mission-related investors looking for, in addition to social impact, leverage of their limited resources, sustainability, credit analysis, and deal structuring. The pri-

***By offering products targeted to CED sectors that also conform to the expectations of institutional investors, CDA will build a bridge from philanthropy and community developers to the capital markets.***

mary beneficiaries of CDA’s core business, however, will be institutional investors. These capital market players are looking for return, security, soundness, ratings, standardization and scale, Community Reinvestment Act/socially responsible investor (CRA/SRI) credit, tax credits, and credit surveillance (monitoring). By offering products targeted to CED sectors that also conform to the expectations of institutional investors, CDA will build a bridge from philanthropy and community developers to the capital markets.

## The Importance of Ratings

CDA plans to seek an “A” claims-paying ability rating by at least one national statistical rating organization (Standard & Poor’s, Moody’s, or Fitch). CDA requires a public rating to facilitate business opportunities with its strategic business partners, such as reinsurance companies and other financial institutions. CDA intends to maintain sufficient capital levels and be managed to sustain its public rating.

A financial guaranty insurance company’s public rating

conveys (“passes through”) to the transactions it insures as evidence of the credit enhancement to investors. An insured and rated transaction pays less interest, while improving its marketability.

The ultimate public ratings on CDA-qualified transactions will be based on:

1. the structure of the transaction;
2. credit enhancements within the structure of each transaction, including, among other things, over-collateralization, reserve accounts, interest spread accounts, and debt service reserves;
3. primary financial guaranty insurance;
4. letters of credit;
5. reinsurance;
6. other third-party guarantees; and
7. first loss coverage.

CDA intends to be actively involved in structuring each transaction it insures and will rely on input from potential institutional investors. When appropriate, CDA will co-insure or reinsure (cede) senior credit tranches to higher-rated primary insurance and reinsurance companies. Transaction structures may also use “cut-through endorsements” by which the rating of the reinsurer will convey, and thereby apply, to the specific transaction. Possible reinsurers will include mono-line reinsurance companies, banks, pension funds, foundations, mortgage insurance companies and multi-line insurance companies with Financial Enhancement Ratings (“FERs,” issued by Standard & Poor’s) of “A ” or higher.

Another advantage of a public rating accrues to the company’s reinsurers and co-insurers in the form of reduced risk-based capital charges.

Like many regulated financial institutions, insurance companies are required to maintain risk-weighted reserves. If the risks retained and assumed are well-understood and rated, the capital requirements will be correspondingly lower, allowing greater leverage and higher returns to equity.

Ratings reduce uncertainty and increase standardization. Thus, acquiring insurance on a transaction from a rated company takes the “story” out of the instrument: investors no longer need to know very much about it—its origin, purpose, beneficiaries, etc.—to decide whether or not to buy it. A public rating also aids in mark-to-market valuations.

***Acquiring insurance on a transaction from a rated company takes the “story” out of the instrument: investors no longer need to know very much about it—its origin, purpose, beneficiaries, etc.—to decide whether or not to buy it.***

## CDA’s Equity Investors

CDA should be attractive to both mission-related and market-driven equity investors. The benefits include: double-digit rates of return; a public-purpose business strategy with on-going tracking of social impact and likely exit strategies; bringing new efficient sources of capital investment into community development sectors; and revenue opportunities from collaborating on proprietary insurance products.

Perhaps the greatest benefit that CDA offers to mission-related investors is a very high leverage ratio, providing a big bang for socially-responsive bucks. A direct philanthropic or social investment or guarantee leads to only a one-to-one impact—\$1 million financed is \$1 million financed, end of story. An equity investment in CDA, on the other hand, can be multiplied many times. The plan assumes a relatively conservative leverage ratio of more than 40-to-1 in total principal and interest exposure to capital and equivalents (the historic industry average was as high as 160-to-1).

The substantial economic impact comes with a healthy rate of return to equity investors. CDA will be managed to achieve a greater than 15% rate of return on its equity, in addition to any capital gains that come from stock appreciation.

## CDA Business Objectives

CDA’s primary business objective is to provide capital markets access to the CED sectors, which will ultimately lower CED issuer borrowing costs. The company will facilitate and structure transactions of near-investment grade credit quality that meet its own minimum credit standards and criteria. A CDA policy will enhance the credit quality and subsequent

credit rating of securities and obligations issued by qualified sector participants. More importantly, as investors become more familiar with CDA and the underlying strength of the issues it insures, market access will

be enhanced, resulting in lower borrowing costs.

A simplified example transaction will show the economic benefit of a CDA credit enhancement. Take a \$10 million, 20-year, tax-exempt, “BB equivalent” unrated, charter school financing with an uninsured 6.75% coupon. If this bond issue is insured by CDA, the resulting “A” rating on the issue would generate an apparent yield savings (for simplicity’s sake) of approximately 1%. With lower interest payments on the bonds, even after deducting the CDA insurance premium,

the bond issuers would save the present value of \$275,000 in debt service.

The market will accept lower yields as it becomes familiar with CDA's unencumbered financial strength and its conservative underwriting standards. A CDA policy will improve the quality of the transactions by providing an unconditional and irrevocable guaranty of the timely payment of principal and interest as scheduled. CDA may insure entire transactions or just subordinate credit tranches, or it may provide first loss coverage on a selective basis. In contrast with bank letters or certain other credit enhancements, CDA can provide longer-term guarantees, because in the event of a default, there is no acceleration of debt service. In the event that the issuer is unable to make a scheduled debt service payment, a claim will be submitted by the trustee on the transaction, CDA will make the missed payments on schedule, while it initiates remedial action to resolve the cause of the default. When the problem is corrected and the issuer experiences a positive cash flow and resumes its debt service payments to investors, it will be required to repay CDA for its missed payments, plus interest.

CDA will require that all financing submissions have an underlying credit quality of "BB" or higher, with a high probability of making debt service and with iron-clad security provisions. CDA will use its expertise and competencies in credit analysis, risk management and surveillance (monitoring) to analyze, select, and manage transactions.

When analyzing a submitted transaction, CDA's credit underwriters will consider: use of proceeds; essentiality; likelihood of paying debt service (in terms of financial ability and willingness); authority to enter into the transaction; deal structure; and covenants and protections (security, collateral and guarantees). CDA will publish detailed underwriting guidelines and criteria for each financing type and asset type it insures. CDA will also require security provisions and financial covenants, such as gross revenue pledges, state aid intercepts, mortgages, funded debt service and liquidity reserves, additional debt restrictions, etc. With all of these underwriting measures, CDA should experience "zero loss probability in the event a claim is paid".

CDA will employ other measures to manage potential credit risk exposure. These include: use of a profitability model, pro-active portfolio surveillance, reinsurance, standby credit and capital facilities.

## **CDA Business Plan**

CDA's financial results will be based on its two operating business segments: bond insurance on municipal and CED bonds and selected structured finance (asset-backed securities) as well as financial and technical advisory services. A range of services and products are being designed for issuers and institutional investors. Each transaction will be structured to attract a wide universe of institutional buyers. In fact, CDA plans to employ at least one marketing professional to focus exclusively on developing relationships with institutional buyers. In general, CDA will be opportunistic in its business development activities by exploiting its core competencies: credit analysis, risk management, surveillance, financial soundness and sector knowledge.

The launch of CDA promises to put in place an essential piece of the puzzle to capital market access for the community development and affordable housing sectors.

# The Commercial Paper Co-op

CHARLES TANSEY, NEIGHBORWORKS AMERICA

## The Purpose of the Co-op

Other articles have described the advantages of selling assets such as community development loans to the secondary capital markets as a way to replenish liquidity and originate more loans. Some larger CDFIs are already aggregating loans from smaller CDFIs or from conventional lenders. But before those aggregators can offer asset-backed securities to investors, they must establish a sufficient volume of loans. In the interim, aggregators must “warehouse” the loans, holding them in a portfolio until they can be bundled as securities and sold. Each CDFI providing aggregation and warehousing services must obtain a separate line of credit from its bank.

To expand the range of borrowing options available to high-capacity CDFIs and help them to lower their funding costs, members of the Financial Innovations Roundtable have proposed creating a Commercial Paper Cooperative owned by CDFIs. The co-op would provide its members access to the commercial paper market, and reduce the time, complexity, and cost of borrowing. Due to the current credit crisis in 2008-09, this effort is temporarily “on hold.”

## Commercial Paper’s Relevance to CDFIs

Commercial paper is a form of short-term borrowing (an unsecured promissory note) used by many corporations to finance a wide range of assets with diverse maturities and varying levels of risk. Assets financed include credit card debt, used car loans, home mortgages, and small business loans. Although the maximum maturity of commercial paper is 270 days, most commercial paper issuers roll over their notes at maturity, effectively borrowing long-term at short-term rates. They are able to do this because banks and other large financial institutions provide a combination of liquidity and credit enhancement to protect the commercial paper investor from any losses from the inherent asset-liability mismatch. Commercial paper (unlike bonds) is also exempt from Security and Exchange Commission registration, which lowers issuance costs. For most institutions, particularly in the financial sector, commercial paper provides the least expensive form of (non-deposit) financing over time.

*The co-op is designed to help banks provide the same flexibility and cost advantage to their best CDFI clients.*

Banks allow their best customers to issue commercial paper, borrowing from the bank at the prime rate, or a spread over Federal Reserve funds; the London InterBank Borrowing Rate (LIBOR), which is the cost at which banks lend to one another; or another similar index. The co-op is designed to help banks provide the same flexibility and cost advantage to their best CDFI clients. CDFIs do not have access to this kind of funding primarily because they lack access to the commercial paper market. They lack this access because of the size of borrowing need and because rating agencies are unfamiliar with the types of assets that CDFIs originate. The co-op is designed to overcome both impediments by aggregating CDFI borrowings so they are of sufficient scale and by placing CDFI secured and unsecured obligations in a funding framework that obtains the highest quality ratings and lowest available rates.

## Summary of the Co-op Proposal

Six large, high-capacity CDFIs are forming a cooperative to access cutting-edge, short-term funding. The co-op has the following features:

- \$100 million in size, with up to \$75 million extended to the six CDFIs at any time
- Warehouse financing to the six member CDFIs in amounts up to \$15 million each
- Sub-limits for co-op members relative to the type and quality of the assets being financed by the CDFIs
- Ability of CDFIs to borrow for 30 days and roll over the maturity until the pledged assets are sold or replaced; CDFIs borrow for periods matching the length of time they hold the assets, but not for more than 270 days
- Access to a range of pricing options, including commercial paper, LIBOR, prime, Federal Reserve funds, and other indices
- Approximately \$20 million in capital from foundations and social investors
- Loans to CDFIs are secured by the loans that CDFIs pledge. Rather than paper, CDFIs use the Mortgage Electronic Registration System for tracking and monitoring security.



- Stop-loss triggers to ensure quality collateral and compliance by CDFIs
- A liquidity facility (such as a letter of credit) provided by banks guaranteeing payments of principal and interest to investors, enabling the co-op to issue top-quality, short-term notes to a commercial paper conduit that issues commercial paper to the public.

## Summary of the Benefits

### *Reduced Rates*

Several CDFIs borrow from banks to fund the origination and aggregation of loans they intend to sell. In return for funding, CDFIs pledge the loans they are originating and aggregating. When they sell the loans, they pay off the warehousing lines. At present, the warehousing lines are individually negotiated, and the terms and conditions vary considerably from one CDFI to the next. By gaining access to the commercial paper market via a centralized cooperative, participating CDFIs can minimize their borrowing rates and the risk associated with working with a limited number of lenders.

### *Reduced Costs*

The pledging process involves, among other things, the physical transfer of promissory notes and related documents from a CDFI to the lender when the CDFI borrows, and the return of the physical documents when the loan is paid off. The proposed framework will enable CDFI participants to transfer documents electronically instead. Although the co-op still cannot perfect a security interest electronically (that is, take all the necessary legal steps and file all the required papers to establish a claim on the asset), the electronic transfer does reduce the potential for error and speeds the transaction. With its capital and layered protections, the co-op insulates the commercial paper investors and banks that are providing the liquidity facility from the risk of eliminating paper transactions. In addition to the time and cost associated with this activity, the warehousing lines often involve annual renewal, renewal fees, legal costs and other requirements. The co-op will consolidate and absorb these on behalf of the participating CDFIs.

### *Increased Flexibility*

Many warehousing lines provided by banks restrict the borrower to pledging only new loans. One of the chief objectives of the co-op is to enable the participating CDFIs to pledge existing loans that conform to the allowable terms and conditions for each asset class. Clearly seasoned loans are less

risky than new loans, and in addition to providing the CDFI borrower with more flexibility, this expansion also produces a potentially higher quality of collateral. The moral hazard inherent in this structure is mitigated because the borrowers also own the co-op; there is no incentive to pass on or pledge weak loans (which in any case would not be accepted if they did not fit the previously agreed-on standards).

### *Access to the Rating Agencies*

One of the chief benefits of this structure is that participating CDFIs can place their assets in a facility that rating agencies will monitor or evaluate on a dynamic basis. Participation will also allow CDFIs to showcase their capacity to service assets, another key area that rating agencies do not currently monitor routinely evaluate. Exposure in both areas will help move CDFIs toward the ultimate objective of being rated on

***The co-op, however, is not designed to replace existing bank warehousing lines. Its purpose is to augment existing relationships.***

their organizational and financial strength. The electronic rather than paper-based security interests (claims on assets) of the co-op could accelerate this process. These benefits are not limited to the participating CDFIs. Over time, as the exposure expands to more CDFIs, this structure will accommodate greater risk parameters, including unsecured loans.

The co-op, however, is not designed to replace existing bank warehousing lines or other lending facilities. Although participants may choose to reduce the lines, the co-op cannot replace the relationship or the range of funding options that banks can provide. Its purpose is to augment existing relationships and provide the key banks with an alternative, and potentially more effective and remunerative, method for lending to the community development field (see “Structure of the Co-op,” below).

## Potential Participants

The six potential participants include:

- Self-Help (single family first mortgages)
- Neighborhood Housing Services of America (single-family first and second mortgages)
- NCB Capital Impact (multifamily and community facility first mortgages)
- Community Reinvestment Fund (small business first and second mortgages)

- Impact Community Capital (multifamily mortgages)
- New Hampshire Community Loan Fund (multiple types of loans; see Manufactured Housing article, p. 38)

Each of the six participants has assets in excess of \$50 million, has been in existence for more than 10 years, and has warehousing lines from commercial banks to support their borrowing and aggregation activities. None of the participants has been delinquent on any of its loan agreements in the past 10 years.

## Structure of the Co-op

### *Existing Commercial Paper Conduit*

A number of lending institutions serving the CDFI industry have multiple commercial paper conduits. Using an existing conduit will reduce the start-up costs. However, the primary purpose is to ensure that the funding obtained for CDFI borrowing is indistinguishable from any other paper in the market. One of the chief objectives of the co-op is to eliminate the need for subsidy and the collateral consumption of scarce social investment and foundation resources. In keeping with market practice, the conduit must assure commercial investors they will be paid. As a result, the conduit requires that the co-op provide a 100% liquidity facility that guarantees timely payment of principal and interest. Under this structure, market investors will not look to the underlying CDFIs or their assets, nor will the rating agencies need to evaluate them. In

effect, CDFI assets will benefit from an A-1/P-1 rating without being scrutinized by either investors or rating agencies.

### **Banks**

The co-op will work with a lead bank to arrange a syndicate (a group of banks that share equally in the risk) for the liquidity and credit enhancement features. The lead institution will first invite banks currently providing credit or warehouse lines to the participating CDFIs. This will limit the learning curve associated with the inherent risks, which has proved a material impediment for many conventional lenders and capital markets. The co-op will provide the banks with reduced risk-based capital allocation against the same assets; the same CRA benefits that pertain to bank warehousing lines; and at minimum, a market return. (See also box on banks, below.)

### **The Co-op**

The co-op will be CDFI-owned with the sole purpose to enable participating CDFIs to access funds provided by the commercial paper market and banks on a consistent, low-cost, easy-to-use basis. The co-op will require the following of the participating CDFIs: regularly reported, sound performance data; maintenance of financial condition; compliance with stop-issuance triggers; and security interests appropriate to the transaction. The stop-issuance triggers and security interests are similar to those required by the banks. The co-op will have an administrator and a transfer agent who are distinct from the banks in the liquidity facility. The co-op will also hire

## What's In It for the Banks?

The chief difference between the proposed co-op and existing bank warehousing lines is that the banks' obligor (debtor) is the co-op. Rather than having a direct security interest in the loans being warehoused by six different CDFIs, banks will have a direct security interest in the notes of CDFIs, which are secured, in turn, by those loans. In effect the banks are one step removed from the assets.

However, in substitution for the direct claim on assets, the banks will receive the following:

1. **FIRST LOSS:** A direct claim on co-op capital. The capital serves as a first loss against the total \$100 million value of the facility. Because the co-op is designed to generate surpluses, this is likely to grow as a percentage of the total facility.
2. **ASSET SECURITY:** First lien interest in the co-op's assets. The co-op's assets consist of CDFI notes that are at least 90% secured by mortgages.
3. **COLLATERAL CUSHION:** The co-op will make advances against CDFI short-term secured notes on a borrowing base formula that provides a collateral cushion specific to the assets being financed.

4. **LIQUIDITY:** The co-op will maintain a minimum of 15% of the total facility in high-quality investment-grade instruments.
5. **EARLY WARNING:** The co-op will enforce "stop issue" triggers designed to identify deteriorating trends at a member CDFI and to terminate its ability to roll notes over if the trends are negative.
6. **THE CAPACITY OF THE OBLIGORS:** Members are selected on the basis of their size, longevity, and performance.
7. **A DIVERSIFIED PORTFOLIO:** For the same dollar of community investment, the bank gets a much more diversified portfolio in terms of obligor, geography, asset class, and risk.

In effect, the banks will be gaining a first loss reserve, liquidity, trigger mechanisms, and portfolio diversification they previously did not have. These factors enable the banks to reduce their capital allocation against community development assets of the type being financed.

The estimated capital allocation banks must set aside is 0.58% (the norm is 6% to 8% capital set-asides on the balance sheet). If the bank charges 0.375% as expected (see "Cost Assumptions," below) for the liquidity facility, the return on capital to banks is 64.66%, which should be reasonably attractive.

one to two full-time employees to manage the interests of the CDFI owners. The configuration of the staffing is to be determined.

### CDFI Borrowers

CDFI participants will have the option to borrow under their existing credit facilities with their banks or with the co-op. Depending on events in the market on any given day, the co-op may or may not be more attractive than the financing provided by the banks. As with their corporate counterparts, it will be up to the CDFI treasurers to determine which funding source is preferable. The procedures for borrowing under warehousing lines are currently cumbersome, costly, and paper-intensive. The co-op will minimize the time and money associated with the secured CDFI notes.

### Grants and Program-Related Investments

To attract the liquidity facility from banks as required by the conduit, the co-op will approach financial institutions and foundations both grants and program-related investments (for more about PRIs, see Heron Foundation article, p. 27). The present target is for \$5 million in grants and \$15 million in program-related investments at 1% for 10 years (although

**Members of the co-op, who are also the borrowers, will determine the level of surpluses.**

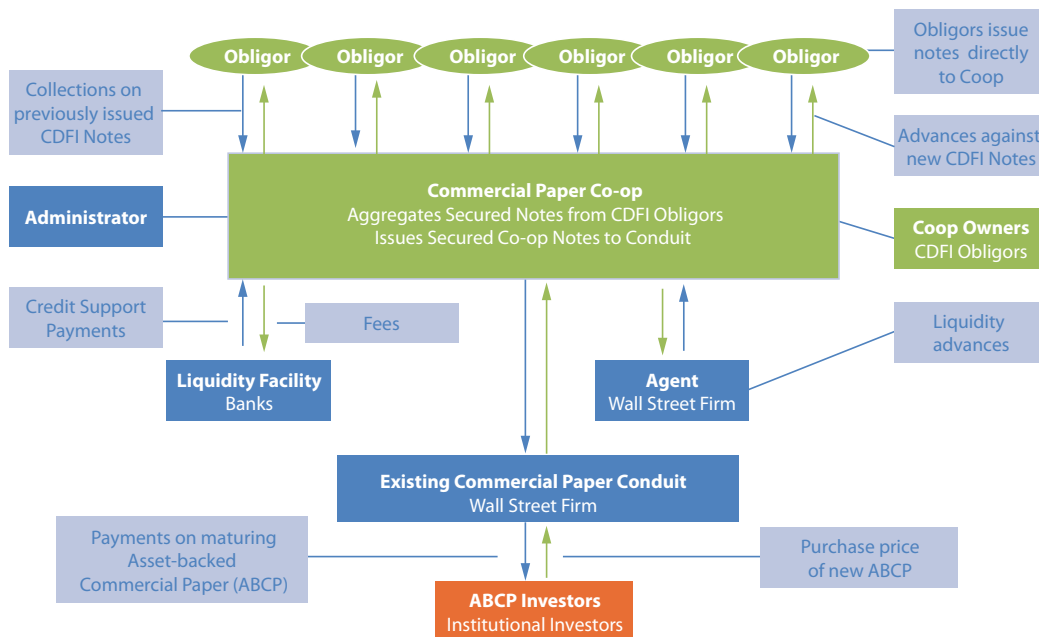
more might be needed in the current market). Together with start-up costs, this amount will serve as the only social investment subsidy in the co-op structure, as the co-op is designed to be self-supporting and generate surpluses. The capital is expected to grow over time via the co-op surpluses. Members of the co-op, who are also the borrowers, will determine the level of surpluses.

### Borrowing Process

A CDFI would access the commercial paper market in the following steps:

1. It asks to borrow \$5 million from the co-op for 30 days to fund loans it is warehousing.
2. The co-op immediately borrows \$5 million for 30 days from the commercial paper conduit. The conduit has been selected by the co-op to issue commercial paper on the co-op's behalf. The conduit is operated by a major financial institution.
3. The conduit issues A-1/P-1 rated commercial paper in the amount of \$5 million for 30 days. The commercial paper is purchased by institutional investors.
4. The co-op, which has issued short-term promissory notes to the conduit in the amount of \$5 million for 30 days, receives the proceeds of the conduit's commercial paper issue.
5. The CDFI, which has issued short-term promissory notes to the co-op, receives the proceeds from these notes.
6. The transactions are simultaneous.

CHART 1: COMMERCIAL PAPER CO-OP



At the end of 30 days, the CDFI sells the warehoused loans and retires the debt to the co-op, which in turn retires the debt to the conduit. If the warehoused loans are not sold, or if new loans are to be warehoused at maturity, the CDFI may pay the notes off with the issuance of new notes. This effectively rolls the debt over and extends the term of the financing. Most entities participating in the commercial paper market borrow on 30-day maturities to get the lowest rates, and they tend to roll them over at maturity.

The co-op assumes most borrowers will want to borrow for

30 days at a time to benefit from the lowest pricing and roll over three or four times before repaying through loan sale or other means. It also assumes that funding needs typically do not exceed 120 days and in no event exceed 270 days.

At present, only loans that are funded by banks under their warehousing lines will be eligible as assets to be financed. These loans and mortgages are typically in the process of being aggregated by the CDFI for sale, securitization or other form of off-balance sheet placement. The co-op will also seek to include loans and mortgages that have already been origi-

nated, are seasoned and are on the balance sheet of the borrowing CDFI. The key focus for the co-op will be on developing a relatively homogeneous set of asset classes with a portfolio distribution that is compatible with CDFI participant needs.

### Looking to the Future

Over time, the performance of the co-op should allow more flexibility and fewer costs. As the CDFIs and their assets perform, the level of first loss protection can be reduced; the overall facility can increase from \$100 million to \$200 million, \$500 million, or more. Alternatively, the co-op can introduce higher risk or less common forms of assets, such as social enterprise, predevelopment or nonprofit working capital assets. The co-op might also fund positions longer than 30 days.

One of the most important effects of the co-op will be the emergence of data sets of sufficient size and quality to establish solid conclusions about the performance of community development lenders and the loans that they make. This should contribute to the ratatability of the CDFI participants, and eventually to the ratatability of other CDFIs and their assets.

### Key Cost Assumptions

<b>FEES:</b>	0.25% for the Letter of Credit, payable quarterly each year 0.125% for the bank syndicate manager payable quarterly each year Set-up fee to be determined.
<b>MANAGEMENT:</b>	Estimated at \$250,000 per year, rising at the rate of inflation. This is probably high. It is unclear whether the co-op will require more than one full-time employee to manage the interests of the members. This need will be determined by the co-op members.
<b>ANALYSIS:</b>	The CDFI Assessment and Rating System and/or other annual financial analyses for evaluating the financial health and performance of the six CDFI members is expected to cost \$10,000 per analysis.
<b>DEALER:</b>	The fee for the administrator/dealer is 0.25% on total outstanding obligations.
<b>MISCELLANEOUS:</b>	Miscellaneous expense allowance of \$50,000, rising at the rate of inflation.
<b>CHARGE-OFFS:</b>	Assumptions about charge-offs depend on the risk allocation among asset classes and the total outstanding obligations. This assumption errs on the side of caution given that none of the CDFI borrowers has been delinquent on loans during the past ten years and there have been no charge-offs. Nevertheless, the estimated cushion allows for alterations in other items. <ul style="list-style-type: none"> <li>• Collateral reserves at CDFIs are calculated at ten times the estimated charge-off rate.</li> <li>• Co-op capital required is also 10 times the estimated charge-off rate.</li> </ul>

#### On the revenue side:

<b>INTEREST RATE:</b>	The co-op will charge its borrower-members 75 basis points (0.75%) over the A1/P1 commercial paper rate. Borrowers will also have the option to borrow at 75 basis points over LIBOR, or at the equivalent spread over alternative bank cost of funds. This spread is designed to cover a large portion of the costs of the co-op.
<b>INVESTMENTS:</b>	The co-op will invest contributed capital and PRI funds, as well as cash, in high-quality, short-term and long-term investments, earning revenue and contributing to surpluses.

*Charles Tansey is the author of Securitizing Organizational Risk in Capital Markets: Wins, Losses, and Opportunities for CDFIs, which details the Commercial Paper Co-op Project, the Capital Exchange, the Mini-Fed, and aligned efforts to access the capital markets, along with the reasons for their mixed results and recommendations for future success, particularly once the current turmoil in markets has eased.*

# Expanding Philanthropy: Mission-related Investing at the F.B. Heron Foundation

MICHAEL SWACK, CARSEY INSTITUTE, UNIVERSITY OF NEW HAMPSHIRE

**F**ounded in 1992 with the mission of helping people and communities to help themselves, the F.B. Heron Foundation came into being during one of the greatest economic booms in U.S. history. The strong financial markets of the 1990s not only spurred rapid growth of Heron's asset base but also served to reinforce its focus on asset building and community economic development, given that so many Americans did not benefit from the wealth generated in the heated economy.

Faced with the challenges of making effective grants and managing a growing endowment, Heron's board of directors understood all too well that the scope of the social problems it sought to address required more significant resources than its mandated 5% payout. At a regularly scheduled meeting in 1996, Heron's board reviewed a particular investment manager's performance for what seemed like hours, leaving little time for program matters. This imbalance caused the board to step back and evaluate the effectiveness of the foundation.

After much discussion, the board suggested that because of Heron's social mission and tax-exempt status, the foundation should be more than essentially a private investment company that uses its excess cash flow for charitable purposes. Without changes, in the board's view, there could be very little to distinguish the foundation from a conventional investment manager.

The board began to view the 5% payout requirement as the narrowest expression of the foundation's philanthropic goals. By looking to the other 95% of assets, the "corpus," the board could conceive a broader philanthropic "toolbox" capable of greater social impact than grant-making alone.

Spurred by this "tipping point," the board encouraged staff to explore ways in which Heron could engage more of its assets through a combination of grant-making and "mission-related" investment strategies. The board made a deliberate decision to find ways to leverage an increasing amount of Heron's resources in pursuit of its mission and therefore maximize the foundation's impact in low-income communities.

"We recognized that the endowment, left perpetually warehoused, was losing the time value of its potential mission impact," says William M. Dietel, the foundation's chair. "We wanted to behave more responsibly as stewards of philanthropic funds."

## The Difference Between Mission Investing and Socially Responsible Investing

As defined by FSG Social Impact Advisors in its report "Compounding Impact: Mission Investing by U.S. Foundations," mission investments are "financial investments made with the intention of (1) furthering a foundation's mission and (2) recovering the principal invested or earning financial return." Socially responsible investing focuses primarily on (negative) social screening and proxy activity in public equities, while mission-related investing is a proactive approach in use across asset classes.

## The Road to Mission-related Investing<sup>1</sup>

Developing a mission-related investment strategy did not happen overnight. Heron spent time refining its mission and determining how it could be enhanced through a proactive investment strategy. Initially, there was some uncertainty about how far and how fast the foundation could move, and therefore a reluctance to establish specific mission-related investment targets.

By adopting an incremental philosophy, the foundation was able to test the concept without making any major missteps. Staff was encouraged to explore opportunities in core program areas that would build on existing networks and expertise, and to share lessons learned along the way.

**The First Steps.** Heron's first step was to transfer some of its actively managed investments into index and enhanced index funds. This decision was based on research, unrelated to mission investing, that showed no substantial long-term active management premium in many core asset classes. In addition to reduced investment-management fees, taking this

step allowed Heron to redirect its resources away from managing dozens of active investment managers and toward building a mission-related investment portfolio. Investment performance is now as good as when the entire portfolio was under active

management but comes at a lower cost.

**Assembling the Skills: Internal Capacity and Investment Consultants.** The board soon realized the extent to which it was challenging conventional thinking. As a result, the board

***"We recognized that the endowment, left perpetually warehoused, was losing the time value of its potential mission impact," says William M. Dietel, the foundation's chair.***

***By adopting an incremental philosophy, the foundation was able to test the concept without making any major missteps.***

decided to build internal management capacity, bringing certain functions in-house. In addition to encouraging staff to take advantage of training opportunities, the board authorized a new position, vice president of investments, that would be separate from the finance and administration functions. The foundation also conducted a search for an investment consulting firm that would appreciate Heron's commitment to mission-related investing, eventually retaining Evaluation Associates in 2004.

**Learning from Foundations and Other Institutional Investors.** Early on, Heron looked to other foundations and institutional investors (including commercial banks, insurers, and public pension funds) for examples of alternative asset deployment. Heron learned about below-market investments from both the Ford and MacArthur Foundations, the earliest and largest practitioners of program-related investments. Heron also found willing partners among large commercial banks, which, motivated by the federal Community Reinvestment Act, invested in so-called double-bottom-line real estate and venture-oriented private equity funds as a way to deliver both market-rate financial returns and positive social impact. In expanding its role beyond that of traditional grant-maker, Heron found itself in the company of other types of institutional investors and gained access to potential partners and co-investors.

**Looking First at Existing Relationships.** Through partnerships with community-based organizations and financial intermediaries, Heron has witnessed firsthand the transformative power of investing in America's low-income communities—primarily through home ownership, enterprise development, and access to capital. As such, Heron determined that its grantee pool was a natural place for below-market program-related investments, which the foundation began to make in 1997. Because Heron understands the management and operational histories of its grantees, the quality of the underwriting is often better than it otherwise might be. Today, nearly 75% of the foundation's program-related investments are in groups with which Heron has or has had an established relationship.

### Program-Related Investments

The Internal Revenue Service defines these charitable investments using three criteria: (1) the investment's primary purpose must be to advance the foundation's charitable objectives; (2) neither the production of income nor the appreciation of property can be a significant purpose; and (3) the funds cannot be used directly or indirectly for lobbying or political purposes. Under these criteria, all program-related investments are mission-related investments because they contribute to the foundation's mission. However, not all mission-related investments are program-related investments given that some mission-related investments seek a market return.

**Bridging the Program and Investment Functions.** Initial discussions with grantees about potential program-related investments began with Heron's program staff, who reviewed business plans and discussed capital needs, management capabilities, and financial projections, but who also needed guidance in understanding the investment risks involved and how best to structure deals to mitigate those risks. As the foundation's prospecting efforts turned into a pipeline of tangible deals, Heron began a conscious effort to bridge the program and investment functions—a significant departure from how typical foundations are organized and staffed. Although many program staff members appreciated the benefits of having access to a new philanthropic tool, others did not feel as comfortable with the training, mentoring, and analysis that making program-related investments demanded. The result was some staff turnover through attrition—not uncommon with any significant programmatic change. In replacing staff, Heron looked for, and attracted, officers who felt comfortable with the financial analysis and the investment process. It took time, but Heron now enjoys a collaborative model, with staff in the two functional areas working side by side, and investment staff as the “tie breaker.”

**Creating a Pipeline of Market-Rate Investment Opportunities.** Heron's staff works to build the foundation's market-rate portfolio of mission-related investments in three primary ways:

1. Conducting active outreach efforts to identify opportunities within various asset classes;
2. Creatively adapting traditional investment vehicles and asset managers to mission goals; and,
3. Researching and developing new investment vehicles, such as the Community Investment Index, a positively screened, best-in-class method used to identify publicly traded companies with superior records of engaging with underserved communities (see box on page 29).

**Leadership for Successful Implementation.** To be successful in developing a mission-related investing strategy, a foundation must have the support of its board. While a foundation's executive and professional staff may lead the board to a discussion of mission-related investing, a foundation will miss the transformative effects of this shift in strategy without a true and dedicated commitment of its board. The staff, then, is responsible for successful implementation. The success of mission-related investing relies, in large part, on the ability of front-line staff members to think creatively and analytically about where and how they will identify, recommend and underwrite investment opportunities. A chief executive officer who encourages openness and flexibility in achieving goals will engender confidence in staff members responsible for implementation.

### The Community Investment Index

In 2005, with assistance from Innovest Strategic Value Advisors, Heron created a methodology for selecting companies in each industry in the Standard and Poor's 900 on the basis of the quality of their engagement with low- and moderate income communities in the United States. The resulting Community Investment Index takes into account corporate strategy, workforce development, wealth creation, and corporate philanthropy.

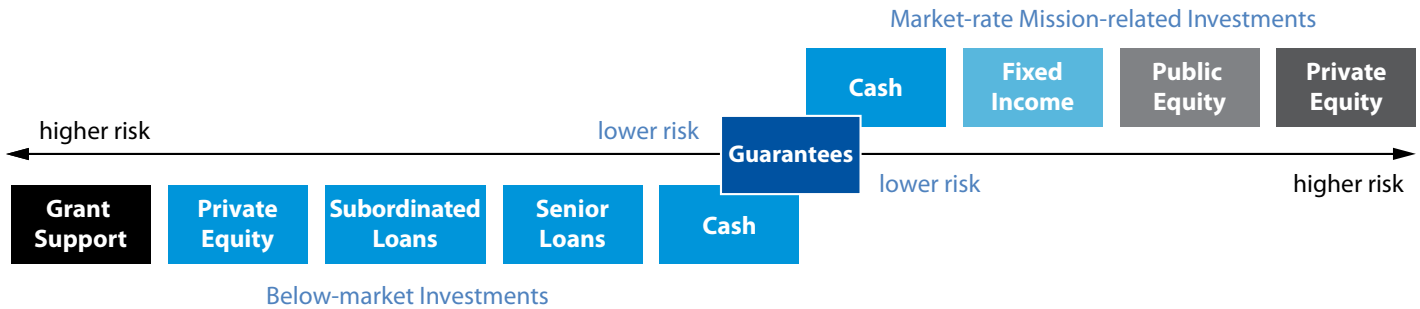
Past performance of the selected equities looked promising, so Heron committed a portion of its capital to test the index's approach. Managed by State Street Global Advisors, the index returned 15.0% in 2006, versus 15.3% for the Standard and Poor's 900 and 13.2% for the Domini 400, the most widely used benchmark for large-capitalization, socially responsible equity investing. Heron is creating a commingled investment product that the foundation hopes will be attractive to other institutions committed to investing in low-income communities. The performance of the index continues to compare well during the current market turmoil. In 2008, the index fell 17.99% in the first three quarters of the year, bringing the performance since inception (from November 2005 to September 2008) to -0.30%. The S&P 900 total return fell 18.89% in the first three quarters of 2008, and the Domini 400 fell 17.20%. In the fall of 2008, both benchmarks were just about at the same level they were three years before.

### Developing a Mission-related Investment Continuum

To sort through the opportunities that mission-related investing presents, the foundation's staff developed the "Mission-related Investment Continuum," which lays out a set of asset classes available to mission-related investors. On the left side are below-market investments, including grants and program-related investments (private equity, subordinated loans, senior loans, and cash). On the right side are mission-related investments that generate market rates of return (cash, fixed income, public equity, and private equity). The least risky investments are in the center of the continuum; the risk level increases as one moves toward either end. (Guarantees are the exception, as their risk level depends on how they are structured.)

In developing the continuum, Heron staff considered the central tenets of traditional investing discipline: asset allocation, performance benchmarking, and security or manager selection. Heron's asset-allocation policy has not changed to accommodate its mission-related investing practice. That

CHART 2: HERON'S MISSION-RELATED INVESTMENT CONTINUUM



strategy is based on total return, as well as liquidity and diversification, which determines how its investments should be distributed among different types of investment classes and is paramount to portfolio performance. Rather, the foundation considers mission-related investing opportunities within the overall asset-allocation framework of a well-diversified portfolio.

Heron also has identified appropriate performance benchmarks by asset class to evaluate relative performance and to compare both risk and return for its mission-related investments versus standard, capital market measures. In choosing its mission-related investments, staff consider several variables, including track record, investment strategy, and market opportunity.

*Heron has identified appropriate performance benchmarks by asset class to evaluate relative performance and to compare both risk and return for its mission-related investments versus standard.*

Heron has taken advantage of mission-related investment opportunities across the continuum. In some ways, Heron's mission is well suited for such opportunities. Foundations that are active in fields of more limited investment and lending may find it challenging to identify the same breadth of opportunities. As such, not all foundations will employ mission-related investing along the entire continuum; one or two asset classes may be sufficient. In these cases, determining where to start depends on opportunities presented that are most consistent with mission and investment goals.

### Examples of Below-Market Investments

As its program-related investment portfolio grows, Heron has found many investment opportunities with different risk and return characteristics:

**Grants.** Even though they provide no financial return, grants arguably represent the riskiest below-market "asset class." Grant-making helps the foundation establish and develop relationships with organizations on the road to "investment readiness";

**Cash.** Insured deposits in fledgling, rural credit unions at below-market rates through intermediaries such as the National Federation of Community Development Credit Unions;

**Senior loans** to small business loan funds, such as North Carolina-based Self-Help Ventures Fund, that invest in businesses and community facilities in low-income communities;

### Using Grants and Program-Related Investments Together

The Heron Foundation provides both grant support and investment to The Reinvestment Fund (TRF), a national leader in financing neighborhood revitalization. Grants help fund operating costs, loan loss reserves, and policy work, including developing tools that help guide investments. Heron's half-million dollar investment in TRF's capital base is targeted to its small-business lending program, which TRF uses to make loans to businesses located in and hiring from low-income communities. In different ways, Heron's grants and program-related investments sustain TRF by helping meet its need for capital while also supporting Heron's program and mission goals.

**Subordinated loans** to provide credit enhancement for affordable housing development, such as the New York City Acquisition Fund, LLC; and

**Private-equity** venture funds, including New Markets Venture Capital Companies, Rural Business Investment Companies, and community-development venture-capital funds.

At nearly \$20 million, Heron's program-related investment portfolio offers a steady return, measured against a benchmark of the long-term inflation rate plus 1%, without any losses to date.

### Examples of Market-Rate Investments

**Cash.** The Certificate of Deposit Account Registry Service (CDARS), a service of Promontory Interfinancial Network that allows community banks to "pool" their \$100,000 FDIC coverage limits to attract larger deposits, allows investors to make deposits in certain institutions, including more than a dozen community development banks, of up to \$30 million with full FDIC insurance coverage. Heron places \$5.8 million in deposits in a number of the nation's 60 community development banks and more than 1,000 "low-income designated" credit unions, selecting those institutions that have a significant portion of their lending activity in asset-building activities in low-income communities.

**Fixed Income (Bonds).** With input from Heron, the foundation's fixed-income manager, Community Capital Management, identifies investment-grade, fixed-income securities issued by both public and private entities. Mission-related bonds range from down-payment assistance for low-income, first-time homebuyers in Texas to "blight bonds" issued by the city of Philadelphia as part of its Neighborhood Trans-



formation Initiative. Some of the securities in Heron's fixed-income portfolio are backed by pools of loans originated by community-based nonprofit organizations and aggregated by the Community Reinvestment Fund. Community Capital Management has also worked with the Small Business Administration to add information to loan descriptions about borrowers' location in low- and moderate-income census tracts and number of employees. This information helps to develop pools that more closely fit Heron's mission. Heron's mission-related fixed-income portfolio stands at \$21 million and has outperformed its benchmark, the Lehman Brothers Aggregate, since inception.

**Public Equity.** Heron uses its Community Investment Index to invest in publicly traded equities (see box on page 29).

**Private Equity.** Heron's private equity is focused on real estate, such as commercial properties in inner-city communities, and later-stage venture financing. It currently has \$16 million in outstanding market-rate private equity commitments, measuring their performance against a benchmark of the Russell 3000 plus 3%. The real estate portfolio is generating net returns ranging from the low to the upper teens, and venture funds are producing net returns on realized investments of more than 20%.

## Managing the Portfolio

Heron pays close attention to several factors to fulfill its fiduciary duty.

**Asset Allocation.** Heron's current asset allocation, established by the board, is approximately 65% in equities, 25% in fixed-income securities, and 10% in alternative investments, such as private equity. This allocation governs all investing, both traditional and mission-related.

**Investment Fees.** With nearly one-half of its investment portfolio in index and enhanced index investments, Heron's investment management fees were 34 basis points in 2006. This is below the mean of other private foundations in widely known investment surveys.

**Underwriting and Due Diligence.** Outside third-party consultants assist both program officers reviewing below-market, mission-related transactions and investment staff underwriting market-rate, mission-related investments. This "second pair of eyes" provides Heron with an independent, arm's-length review that supplements, but does not supplant, staff's judgment.

**Monitoring.** Heron monitors all aspects of its portfolio, with staff meeting quarterly and third-party monitoring reports by experts in each asset class. Monitoring efforts have revealed a number of issues that investees face, such as leadership transitions, fundraising disappointments and market changes that sometimes lead to deteriorating financial health. In most cases, Heron has taken steps to stay with its investees through tough times.

## The Results: Better-than-Average Portfolio Performance

Contrary to the perception held by many other foundation trustees and staff that there is a trade-off between financial return and social impact, Heron's experience during the last 10 years demonstrates that competitive investment returns are possible, even when incorporating mission-related investments into an overall portfolio and asset allocation. As of December 31, 2007, Heron's total fund performance was in the second quartile of the Mellon All-Foundation Total Fund Universe on both a trailing three-year and five-year basis, with 20% of assets in market-rate mission-related investments; 6% in below-market, program-related investments; and 3% in grants.

Today's mission-related investing environment is very different from the one Heron encountered in 1996. Now, there are mission-related investment vehicles in virtually every asset class. As Vice President of Investments Luther M. Ragin, Jr., says, "That is really the story here. While each foundation will have to work at visualizing its own mission through an investment strategy, there is no need to reinvent the wheel."

The F.B. Heron Foundation has moved well beyond the tipping point toward a fully diversified, mission-related investing practice. Indeed, Heron continues to expand its vision and investment horizons, using its broad experience in working with community-based organizations to bring the full weight of its resources, and those of other investors, to bear on its mission. No longer does Heron view low-income people and neighborhoods merely as candidates for grant funding. It views them as good investments.

*No longer does Heron view low-income people and neighborhoods merely as candidates for grant funding. It views them as good investments.*

<sup>1</sup> A full copy of the case study is available at [www.fbheron.org/snhu\\_heron\\_casestudy.pdf](http://www.fbheron.org/snhu_heron_casestudy.pdf).

# Public Pension Funds and Targeted Private Equity Investment: The CalPERS California Initiative

NOÉMI GISZPENC

**P**ension funds can earn attractive risk-adjusted rates of return on targeted private equity investments in underserved capital markets. Targeted investing is designed to achieve both a financial and social return. This article details the experience of the CalPERS pension fund with targeted equity investment.

The California Public Employees' Retirement System (CalPERS) is the largest U.S. public pension fund.<sup>1</sup> Since the early 1930s, CalPERS has provided pension benefits to state, public school, and local public agency employees, retirees, and their families. The population of workers and retirees served by CalPERS since the 1930s has grown over a hundred times, from 14,000 state employees in 1933 to 1.5 million active workers and retirees in 2008. Assets under management have expanded from \$2.6 million in 1933 to approximately \$250 billion today, an increase of nearly one hundred thou-

*Approximately three of every four dollars paid in retirement benefits come from investment earnings.*

sand times. Most of the income—and source of funds for paying benefits—comes from investment rather than member and employer contributions. Approximately three of every four dollars paid in retirement benefits come from investment earnings.<sup>2</sup>

## CalPERS Investment Policy

Given the importance of investment earnings, CalPERS must pay close attention to its returns. CalPERS is led by a 13-member Board of Administration, which, as its investment committee, also oversees the management of CalPERS assets. CalPERS employs a 180-member internal investment organization plus thousands of outside managers and advisors.<sup>3</sup> The starting point for successful returns on investment is asset allocation—strategically diversifying among stocks, bonds, cash and other categories of assets. This captures the greatest return at the least overall risk to market volatility. Many factors, including liabilities, benefit payments, operating expenses, and employer and member contributions, are considered when determining the appropriate asset allocation mix.<sup>4</sup>

CalPERS follows a strategic asset allocation policy that de-

termines the percentage of funds to be invested in each asset class. Policy targets are typically pursued over several years through market declines and dollar cost averaging. The major asset classes are global equities (targeted at 66%, including a 6% target for alternative investments, which includes private equity and other vehicles), global fixed income (targeted at 26%), real estate (targeted at 8%), and the rest in inflation-linked assets and cash equivalents. Consistent with its guiding principles, CalPERS manages its assets through “the highest quality, secure and innovative programs” designed to obtain “the highest return on our investment portfolio to survive, prosper and grow in a safe and prudent manner.”

## Alternative Investments and the California Initiative

Unlike a private foundation, a public pension fund may *not* make below-market investments. Fiduciary duty requires public-sector pension funds to put financial obligations front of their ing. However, also have a est in ensuring healthy com- in turn sup- contributions While keeping ciples of sound ament, a fund such as target a portion of its investments within certain geographies and under- served markets. The California Initiative is one of CalPERS' innovative programs within the alternative investments asset class. It seeks investment opportunities in California that offer attractive, risk-adjusted returns, commensurate with their asset class.<sup>6</sup>

*While keeping with the principles of sound financial management, a public pension fund such as CalPERS may target a portion of its investments within certain geographies and underserved markets.*

The CalPERS Alternative Investment Management (AIM) team, directed by the investment committee, launched the CalPERS California Initiative in 2001. The California Initiative aims to invest private equity in “traditionally underserved markets primarily, but not exclusively, located in California,” by finding and investing in opportunities that other sources

## What Are Underserved Markets?

Source: Pacific Community Ventures. (2007). *CalPERS California Initiative: Impacting California's Underserved Communities 2007*. San Francisco, CA: Pacific Community Ventures.

Underserved markets are less efficient and have the potential to provide superior investment performance. The three criteria for designating a market as underserved are: 1) companies located in areas where access to institutional equity capital is limited, 2) companies that employ workers who reside in economically disadvantaged areas, and 3) companies with female or minority management.

### ***Areas with limited access to equity***

Between 2001 and 2007, about three-quarters of all California companies receiving private equity investment were concentrated in just 153 of the state's 1,700+ zip codes, and they received more than nine-tenths of all the private equity dollars invested in the state. In the United States as a whole, nearly one-half of all companies receiving private equity investment are located in 774 postal codes, and they receive four-fifths of all dollars invested in private equity. For the purposes of the

California Initiative, companies based outside these 774 zip codes are "in areas where access to institutional equity capital has traditionally been limited." About one-half of California Initiative companies (California-based and nationwide) were headquartered outside the areas that traditional investment targets.

Areas traditionally overlooked by equity capital investment can offer some unique advantages. In urban areas, underfunded companies are often near centrally located business and transportation hubs. They can also benefit from large and diverse labor pools and access to real estate, local consumer demand, and government incentives. Underserved rural areas offer strategic opportunities, including inexpensively priced land and office space, available workers, lower living costs, government incentives, and potential for development of technology and infrastructure.<sup>9</sup>

### ***Economically disadvantaged areas***

Economically disadvantaged areas are low-to-moderate income (LMI) census tracts. More than 40% of the employees at California Initiative portfolio companies live in areas composed predominantly of LMI census tracts, and more than 80% of California Initiative portfolio company em-

ployees live in areas that overlap with LMI census tracts. Although these latter employees might not reside in lower-income communities, they live next to them and are in a position to contribute economically to the LMI community. As a frame of reference, 35% of all employed Americans and 38% of all employed Californians live in LMI census tracts.

### ***Female or minority management***

The third criterion of underserved markets is companies whose officers or key managers are women or minorities. California Initiative companies report a total of 344 officers. Of these officers, 13% are women, 3% are Hispanic or Latino, 5% are African American, and 6% are Asian/Pacific Islander. Among the companies' 1,668 reported key managers, the distribution of women and minorities is mostly greater or about the same as among officers. This compares favorably with U.S. businesses with more than \$1 million in annual revenue (as is typical of companies receiving institutional equity capital investment). Of these, approximately 10% are owned by women, 2% are owned by Hispanics, less than 1% is owned by African Americans and 4% are owned by Asian/Pacific Islanders.

of investment capital may have bypassed.

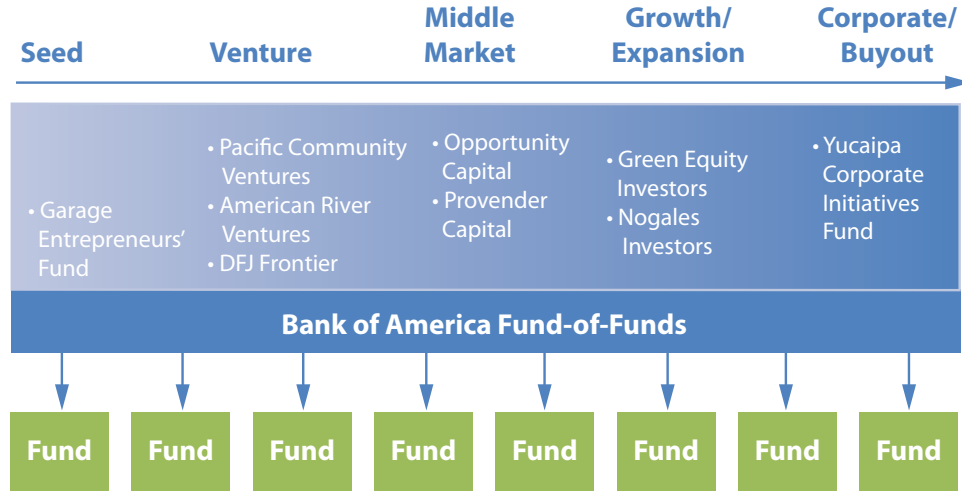
The primary objective of the California Initiative is to generate attractive financial returns, meeting or exceeding private equity benchmarks.<sup>7</sup> Early results are positive. As of September 30, 2007, the initiative reported a net 18.2% internal rate of return since its inception.<sup>8</sup> As an ancillary benefit, the California Initiative seeks to have a meaningful impact on the economic landscape of California's underserved markets.

The California Initiative has been implemented in two phases. Phase I was approved in May 2001 and consists of a capital commitment of \$475 million to nine private equity funds and one fund-of-funds (see diagram on page 34). The fund-of-funds, the Banc of America California Community Venture Fund (BACCVF), is managed by Banc of America Capital Access Funds (BACAF), and its investment objectives parallel those of the California Initiative. In October 2006, CalPERS announced a second allocation, a \$500 million capital commitment to be managed by Hamilton Lane, a leading

private equity investment manager. CalPERS and Hamilton Lane established an investment vehicle known as the Golden State Investment Fund (GSIF), which seeks to invest in both partnerships and direct co-investments primarily located in California. (The second phase allocation was later increased to \$550 million.) The Golden State Investment Fund managed by Hamilton Lane includes as partners DFJ Frontier, Levine Leichtman Capital, Pacific Community Ventures, and RLH Investors.

By September 30, 2007, the California Initiative had invested in 217 companies and GSIF had invested in nine companies.<sup>10</sup> This portfolio is expected to grow significantly. Among the 197 Phase I company investments, 115 were made through the nine private equity funds while the remaining 82 were made through 13 funds in the BACCVF. Banc of America expects its funds to ultimately invest in 150 to 175 companies.

CHART 3: CALIFORNIA INITIATIVE PARTNERS



## Ancillary Benefits

### Job Creation

Companies in the California Initiative portfolio employ more than 75,000 workers across the United States. Two companies experienced a sharp decline in jobs (3,445 jobs lost), causing overall job growth in the portfolio to lag national trends. Not counting those two companies, however, the job growth nationally among companies in the first phase of the California Initiative was 18%, and the job growth in California was 31%. This compares with general U.S. and California employment growth of 8% between June 2000 and June 2007.

### Job Quality

California Initiative companies generally compare equally or favorably to state and national trends in employee benefits offered. They compare particularly well in offering medical coverage and retirement plans, with nearly all the companies offering medical coverage (versus about 60% nationwide) and approximately four in five companies offering a retirement plan (versus one-half of companies nationwide).

### Supplier Relationships

California Initiative companies also support California employment by doing business with other companies in the state. In total, Phase I companies have maintained active relationships with more than 48,000 suppliers. Approximately 10,000 of these suppliers are located in California. The four GSIF

companies that provided data for the ancillary benefits report maintain more than 4,700 active supplier relationships, 24% of which are with California companies. Two of the four GSIF companies have programs in place to track minority supplier relationships, which total 174 suppliers or 5% of their total supplier base.

## Lessons Learned

### Getting Started in Targeted Investing

As is the case in foundations (see Heron MRI article, p. 27), engaging in targeted investment at a public pension fund usually requires a board-level champion to build support among board members and board consultants.<sup>11</sup> Once the board agrees to consider a targeted investment, pension fund internal staff typically commission an expert study of these investment opportunities. Generally staff chooses an outside expert with whom they are comfortable. The study can take as long as one year to complete. During this time, both staff and board increase their comfort levels with targeted investing. CalPERS hired McKinsey and Co. to analyze targeted investment programs with staff. "They scoured ETI [economically targeted investment] programs to see what worked and what didn't work," reports Joncarlo Mark, Senior Portfolio Manager of the CalPERS Alternative Investment Management Program, in a personal interview in June 2008.

The report guides the board in choosing the asset class and level of investment most appropriate for targeted investment

given their current asset allocation. Often staff are asked to issue a Request for Proposal (RFP) or Request for Information (RFI) from external money managers in the chosen asset class. Board and staff will look for proposals from top quartile performers with a track record of successful targeted investments. CalPERS spent significant time marketing the program, and generated much interest from external money managers, receiving 67 proposals. “We’re lucky,” says Mark. “California is a pretty big market with lots of underserved markets. You want to be diversified, and the size was meaningful.”

### ***Best practice in targeted investment***

**PENSION FUNDS CANNOT BE MARKET MAKERS.** Private equity is one part of the investment solution for underserved markets. As Mark says, “The big takeaway is that institutional private equity is just a piece of the pie.” Many opportunities may not meet private equity return expectations. In the case of severely blighted areas, for example, pension funds cannot act as market makers. They can begin to invest and provide liquidity after more appropriate government or nonprofit actors have begun making subsidized investments without expectation of return and transformed the nature of the target area. Mark adds, “Not every company wants or needs private equity... A lot of community development or SBA money is a lot less expensive than what’s available in the regular market.”

**IT IS BETTER TO USE GEOGRAPHIC RATHER THAN SOCIAL TARGETING.** Boards should set broad geographic targets for both internal staff and external money managers. When investment fund managers receive a broad investment preference, *Investments are more likely to be successful when the social impacts are not dictated.* managers receive a broad investment preference, for example, to the pension fund’s own state or to low- and middle-income areas, they can select the best investments for the fund in that geography. “They need not pay a lot of attention to social considerations,” Tessa Hebb, a senior research associate at the University of Oxford, explained in an interview in April 2008, “because by extension investments in companies will have positive impacts in their locations in terms of job creation, tax base enlargement, real estate renewal and revitalization.” Investments are more likely to be successful when the social impacts are not dictated. Social goals are best achieved by partnering with a local nonprofit organization whose purpose is to achieve social outcomes.

### ***A more targeted investment program***

Joncarlo Mark of the CalPERS Alternative Investment Management Program explains that starting with a broad mandate in Phase I of the California Initiative allowed them to attract and find good managers, whom they will continue to use. “If we had been too heavy-handed,” he says, by limiting investments to California, “we couldn’t have found them.” The problem, however, is that although 70% of the companies that received funding in the first phase are located in California, only 40% of the invested dollars went to California.

In Phase II, one-half of the investment capital will go to California-based funds, and one-half as direct co-investments into California companies. “This time around, we are going to make sure we get California on a dollar basis,” says Mark. The initiative not only hopes that managers invest in the state, but it is directly investing or driving at least one-half of the funds to the California market, without sacrificing desired returns. “Hamilton Lane is still using underwriting criteria in evaluating deals and looking to generate a 20% return,” says Mark. “They have a dedicated team of people talking to people in the community and potential investment partners, promoting what we are doing and finding investment opportunities. They are co-investing with any manager who has a deal in the pipeline that meets the criteria for underserved markets and returns. We are seeing some pretty interesting deals.”

**A BROAD, ATTRACTIVE MANDATE CAN ATTRACT OTHER INVESTORS AND LEVERAGE AN INSTITUTION’S INVESTMENT.** What the California Initiative found, reports Mark, is that although less than half of the first phase investment of \$500 million went to California companies, the fund managers raised an additional \$700 million from other investors for a total of \$1.2 billion – and when half of that pot goes to investments in California, it is equivalent to the entire CalPERS investment having gone to California. “This is a very important consideration,” says Mark. “Foundation or program capital is only a sliver of what is available. With a broad mandate that allows fund managers to make money, you may only be achieving 50% targeting, but you can attract ten times as much investment.” And, say Kruzel and colleagues in a recent report, “Having other investors with ‘skin-in-the-game’ not only serves to multiply the impacts of an institution’s capital, but also helps to validate the original investment thesis.”<sup>12</sup>

**MEASURE SUCCESS IN TERMS OF RISK-ADJUSTED RATES OF RETURN.** “Targeted programs have a tremendous political risk,” says Hebb. “If an investment is unsuccessful, it can tarnish the whole program.” The mid-to-late 1980s and 1990s saw a trend toward “economically targeted investing” directed toward social impact. Investments were meant to be market-rate, but in reality ancillary benefits took precedence, and business plans were not as sound as they should have been. As

a result, the targeted number of jobs did not materialize, and the failure caused a backlash. As Kruzel and colleagues note, “regardless of the type of mandate considered, it is paramount that at the core of the program, performance is the primary driver for investment. Committed capital should ONLY be deployed to investments within the targeted mandate that can demonstrate a return commensurate with the [investment] risks...”<sup>13</sup> Mark agrees, emphasizing, “*First and foremost* the goal is to generate acceptable returns commensurate with the invested asset class.”

**AVOID INTERFERENCE IN INVESTMENT SELECTION.**

“One of the biggest challenges facing targeted programs is the natural tendency for political considerations to find a way into the investment decision process,” according to Kruzel and colleagues.<sup>14</sup> In selecting fund managers, boards should choose top-quartile investment vehicles and look at track records and relationships, but they should refrain from picking investments. Using external money managers insulates pension funds from charges of political interference in investment selection. As Kruzel and colleagues advise, “Allowing an outside party to have a role in the decision making process will help put in place a ‘firewall’ against political influence.”<sup>15</sup>

**A FUND-OF-FUNDS STRUCTURE ALLOWS LARGER INVESTMENTS.** Many pension funds and other institutional investors have large sums of money to invest—much more than most companies or even single funds can handle, particularly without running up against the pension funds’ limits on being too large or significant an investor. A fund-of-funds structure with an external manager allows the project to invest large sums of money, to be placed in smaller amounts in the funds and from there into companies.

This approach, however, may lead to significant costs: generally fund managers take a commission on the profits (20% is typical) and the manager of a fund-of-funds may take an additional 5% to 10%. Kruzel and colleagues find that using a fund-of-funds structure “has historically been the model for starting a targeted program,” but that seasoned private equity and venture capital investors may prefer using a co-investment model.<sup>16</sup> In fact, the second phase of the CalPERS California Initiative, the Golden State Investment Fund, uses a hybrid investment vehicle that is half direct co-investment in companies and half investing in funds.

**FUNDS-OF-FUNDS AND POOLED FUNDS ALLOW DIVERSIFICATION AND REDUCE RISK.** Fund-of-funds vehicles can provide diversification for pension fund investors. Pension funds can also diversify targeted investment and reduce

risk by placing money in commingled, pooled funds with reciprocal investment capability. For example, a state pension fund with \$100 million in a large multistate fund could request that the fund look for an equivalent \$100 million investment in opportunities in its own state. The Golden State Investment Fund managed by Hamilton Lane carefully constructs the direct co-investment half of the portfolio to provide diversification in terms of vintage year, strategy (such as venture, expansion, or buyout), region, and sector, from aerospace to bakeries. “Effectively, it gives us more control,” says Mark.

**DEVELOP APPROPRIATE COMPENSATION TO INCREASE BUY-IN.** Programs must create appropriate compensation packages for internal money managers of targeted investment portfolios, particularly if investments are relatively small, requiring more work and generating less revenue. For example, if a portfolio is doing well, managers might receive a bonus to their annual salary.

**OUTREACH AND PROMOTION CAN IMPROVE THE INVESTMENT ENVIRONMENT.** CalPERS has been an investment leader in underserved markets. Other institutions have been slow to adopt such strategies. CalPERS was also one of the few pension funds to target private equity in addition to real estate or fixed income. Now significantly more institutional capital is being placed in the private equity asset class. In addition, entrepreneurs in underserved markets have come to more readily accept private equity. “It’s hard to give up control to outside parties,” says Mark, “but as a result of all the ETI programs and the kind of outreach CalPERS and its partners have done, there is an improved acceptance among entrepreneurs in underserved markets of accepting third party money.” Minority entrepreneurs are also seeing the advent of new money managed by minority investors.

**SENSITIVITY TO EMERGING TRENDS PROVIDES EARLY MOVER ADVANTAGE IN RAPIDLY SHIFTING MARKETS.** As Mark says, CalPERS has demonstrated that when crafted carefully, innovative strategies can generate returns that would please any fiduciary. He points to a second success story: an environmental technology program that invests in clean air, water, and energy. “Sometimes there’s good reason that money isn’t flowing into a particular strategy,” says Mark, “but sometimes you can be a contrarian and see a demand and readiness among management teams and entrepreneurs, but an absence of capital. There’s risk in investing where there are not a lot of people competing with you, but it provides an environment for potentially good investment returns.”

## The last word

“It feels good to meet both your fiduciary obligation and your double bottom line.” –Joncarlo Mark

<sup>1</sup> Information for this article was drawn from the CalPERS website ([www.calpers.ca.gov](http://www.calpers.ca.gov)) as well as the works cited in the following endnotes.

<sup>2</sup> Applied Research Center. (2007). *The Economic Impacts of CalPERS Investments on the California Economy*. Sacramento, CA: Applied Research Center, California State University. Available at <http://www.calpers.ca.gov/eip-docs/about/press/news/economic-engine/eco-study-calpers-inv.pdf>.

<sup>3</sup> Mark, J. (2007). *CalPERS Alternative Investment Management (AIM) Program: Investing in California's Underserved Markets*. Inner City Economic Forum: 5th Annual Summit, October 18. Philadelphia, PA.

<sup>4</sup> Applied Research Center (2007). See Note 2, above.

<sup>5</sup> Hebb, T. (2006). *Pension Funds and Urban Revitalization: California Case Study A: Private Equity: CalPERS' California Initiative*. Cambridge, MA: Labor & Worklife Program, Harvard Law School.

<sup>6</sup> Pacific Community Ventures. (2007). *CalPERS California Initiative: Impacting California's Underserved Communities 2007*. San Francisco, CA: Pacific Community Ventures.

<sup>7</sup> The AIM team generally uses as its standard the Venture Economics benchmark for private equity—see <http://www.calpers.ca.gov/index.jsp?bc=/investments/assets/equities/aim/programoverview.xml> for more on the AIM performance comparisons and investment policy.

<sup>8</sup> Pacific Community Ventures and Golden State Investment Fund. (2008). *California Initiative Update*. February. Available at <http://www.calpers.ca.gov/eip-docs/about/press/news/invest-corp/item06a-01.pdf>.

<sup>9</sup> CalPERS. (2008). “Press Release: CalPERS California Initiative Program Deploys Private Equity Capital to Overlooked Markets.” CalPERS Office of Public Affairs: Sacramento, CA. February 19. Available at <http://www.calpers.ca.gov/index.jsp?bc=/about/press/pr-2008/feb/initiative-program-deploys.xml>.

<sup>10</sup> Pacific Community Ventures and Golden State Investment Fund (2008). See Note 8, above.

<sup>11</sup> This section is based on work by Tessa Hebb and Joncarlo Mark, cited above, and also draws on Kruzel, J. (2008). *Targeted Alternative Investment Programs: Common Best Practices Identified for the Creation and Implementation of Targeted Programs by Limited Partners*. Toronto, ON: Task Force on Targeted Alternative Investment Programs, ILPA. Presented to the ILPA RBS Committee. Institutional Limited Partners is a 200-member not-for-profit association serving limited partner investors such as public pensions, corporate pensions, endowments, foundations, family offices, and insurance companies in the global private equity industry.

<sup>12</sup> J. Kruzel et al., (2008), p. 10.

<sup>13</sup> *Ibid.*, p.10.

<sup>14</sup> *Ibid.*, p. 12.

<sup>15</sup> *Ibid.*, p. 13.

<sup>16</sup> *Ibid.*, p. 11.

# Manufactured Home Communities – ROC USA

PAUL BRADLEY, PRESIDENT, ROC USA

Today roughly 3.5 million homeowners live in an estimated 50,000 manufactured home communities in the United States. Generally somebody else, usually an investor landlord, owns the land on which their homes sit and charges residents a monthly fee or lot rent. This relationship leads to insecurity for the homeowners; they worry about the land being sold or the rents rising quickly. As a public policy issue, the insecurity of these communities threatens the availability of affordable housing. Manufactured home communities represent a sizable source of affordable housing for low- and moderate-income people in most rural states. As an example, roughly 4% of New Hampshire's 1.2 million people live in manufactured home communities.

*Most of the families living in manufactured home communities want control and the opportunity that home- and land-ownership represents.*

Most of the families living in manufactured home communities want control and the opportunity that home- and

## What is a Manufactured Home?

SOURCE: reprinted with permission from Lance George and Milana Barr, *Moving Home: Manufactured Housing in Rural America*. Washington, DC: Housing Assistance Council, 2005.

**MANUFACTURED HOME.** A manufactured home is a factory-built housing unit designed to meet the federal Manufactured Home Construction and Safety Standards, also known as the HUD Code. A manufactured home has a chassis that supports the structural integrity of the unit and is designed to be transported to a building site. Factory-built units that meet the HUD Code and were constructed after the code took effect on June 15, 1976 are classified as manufactured homes.

**MOBILE HOME.** Factory-built units constructed on a chassis and completed before June 15, 1976, are generally classified as mobile homes.

**TRAILER.** Trailers are technically recreational vehicles that do not conform to local building or HUD Code standards. Although considered antiquated and often derogatory, the term trailer is still colloquially used when referring to manufactured or mobile homes.

**MODULAR HOME.** Modular homes are factory-built to meet the state, local, or regional codes where the homes will be located. Under this process, modules are assembled in three dimensions at a factory. The modules are then towed to the building site and put together in a variety of ways to construct the unit.

land-ownership represents. However, their wishes are not often realized owing to a lack of systematic local technical support and appropriate financing when communities are put up for sale. Less than helpful public policies present another barrier: most states lack a right-to-purchase statute giving

## What is a Manufactured Home Community?

**MANUFACTURED HOME COMMUNITY.** A manufactured home community, or “mobile home park,” is generally defined by state jurisdiction as a single parcel of land on which sit two or more manufactured homes. In most instances, manufactured home communities are owned by investor landlords, and the homes are owned by their occupants. The rental relationship between community owner and homeowners is generally a matter of state law or local ordinance and generally is not incorporated in a lease.

**RESIDENT-OWNED COMMUNITY.** Resident ownership refers to community ownership by the homeowners. In most instances, homeowners form a corporation (or cooperative) to acquire the community as a whole and operate it for the benefit of the homeowners. Support for this model of ownership exists because it also helps the broader community preserve an affordable community. Homeowners can also achieve resident ownership through subdivision, although local zoning regulations generally have posed a significant barrier to sub-dividing existing communities.

residents the right of first refusal when an owner wants to sell the land, and in general the policy environment favors single-family residences. For a complete list of state “opportunity to purchase” policies, see the National Consumer Law Center website, [www.nclc.org](http://www.nclc.org).

## The New Hampshire Experience: Financing, Technical Assistance, and Public Policy

Since 1983, the nonprofit organization New Hampshire Community Loan Fund (NHCLF) has been providing training, technical assistance, and financing to help homeowners transform their communities into resident-owned cooperative associations. In 1984, the NHCLF made its first loan, \$43,000 to 13 families in Meredith, New Hampshire. The residents purchased their community with the funds to avoid the risk of community closure and eviction due to change of use. In the quarter-century since then, the Loan Fund has made \$40 million in loans and leveraged another \$100 million in bank debt for resident acquisitions. The Loan Fund and bank lenders have not experienced any charge-offs or foreclosures.



***Homeowners in “for sale” manufactured home communities need access to timely and appropriate financing, and they need access to timely and expert technical assistance.***

Homeowners in “for sale” manufactured home communities face two barriers to resident ownership. They need access to timely and appropriate financing, and they need access to timely and expert technical assistance for pre-purchase and post-purchase support.

### **Financing**

Below is a typical financing package in New Hampshire for a 60-unit park with \$1.3 million in development costs (including purchase price, improvements, and other closing costs):

Bank (8.25% for 30 years) — \$800,000  
 NHCLF (8.25% for 30 years) — \$485,000  
 Resident Equity — \$15,000 (60 x \$250 per share)  
 Total Financing — \$1,300,000

The low share price paid by individual members results in a down payment for the cooperative’s purchase of the manufactured home community. The financial gap between what residents can raise through the proceeds of selling membership shares and the 75% to 80% loan-to-value ratio that a bank will provide is filled by the Loan Fund in a senior/subordinate debt package.

Private banks followed the lead taken by the New Hampshire Community Loan Fund and the New Hampshire Housing Finance Authority, a quasi-public agency, in entering this market. Banks gained confidence that this was a legitimate and safe line of business. These deals are a stretch for bankers owing to ostensible challenges such as the lack of fixed leadership, no personal guarantees, little “cash” equity, likely history of disinvestment in the property, a democratically controlled borrower, and a new line of business for the borrower. However, since 1988, banks have reliably provided first mortgage financing for cooperative purchases and now compete for deals.

### **Training**

The Loan Fund has also evolved into a specialty technical assistance provider because, in addition to capital, community groups need customized information and training at the right time and place to reach their goals. Many people would not even begin to organize, believing ownership impossible. The Loan Fund, through its Cooperative Assistance Team, helps homeowners in New Hampshire manufactured home communities navigate the process of cooperative conversion by:

- Assisting homeowners in organizing as a cooperative and establishing a board of directors and committees;
- Helping to arrange financing or lending funds to the resident-owned cooperative for predevelopment work, deposit financing, purchase and rehab; and
- Providing ongoing technical support and training.

The Loan Fund is committed to developing effective cooperative management systems and practices in every community by providing training and support to directors and members. A frontline staff of five full-time specialists in finance, infrastructure, and organizational development provides one-on-one and group technical assistance and training. They also generate a statewide newsletter, run a leadership training program, and convene a biannual conference.

### **Policy**

In New Hampshire, a partnership between tenant activists and community economic development practitioners has resulted in protective regulations for owners of manufactured homes in manufactured home communities and a sense that remaking the industry based on resident ownership is possible. In 1988, the Loan Fund joined the Mobile Homeowners and Tenants’ Association (MOTA) to argue for an “opportunity to purchase law” for residents. The New Hampshire Legislature adopted the law that gives residents in manufactured home communities 60 days’ notice and an opportunity to negotiate in good faith to acquire the community when the investor puts the property up for sale or accepts an offer to sell it. Under the law, the investor is allowed to sell for fair market value and in a timely manner, while the residents gain the potential benefits of landownership through their right to purchase. The law’s passage was a virtual endorsement for resident-ownership, an acknowledgment at the time that owning a home on rented land was simply bad public policy.

Also, under New Hampshire law, once installed on site, a manufactured home is defined as real estate rather than as personal property. It is taxed, sold, and recorded as real estate. Home loans are secured by mortgages, eliminating the repossession risk that plagues consumers in states where manufactured homes are treated and financed as personal property. Treating manufactured homes as real estate is also key to attracting conventional residential lenders, who can provide far more favorable financing terms than personal property lenders.

Finally, the state’s co-op statute is easy to use and ensures long-term affordability and security. The statute is rooted in a democratic “one member/one vote” principle. Members elect directors and officers at prescribed annual meetings, and the

assets of the corporation cannot be sold without a membership vote. Were the co-op to sell its park, the proceeds beyond each member's share and home value would be turned over to a 501(c)3 nonprofit corporation.

## The Benefits of New Hampshire's Cooperative Model

There are currently 88 resident-owned communities in New Hampshire, representing approximately a 20% market share of all manufactured communities and nearly 5,000 units. Experience in New Hampshire has shown that when homeowners come together to convert their manufactured home community to resident-owned, they achieve financial independence and economic security, and their pride in their neighborhood and community increases. The Carsey Institute at the University of New Hampshire recently documented the financial benefits of resident ownership, including lower monthly site fees over time, better home price appreciation, and faster home sales.<sup>1</sup>

- Homeowners in resident-owned communities pay, on average, \$40 less per month after five years of ownership than homeowners in investor-owned communities.
- Residents of resident-owned communities are nearly twice as likely as residents of investor-owned commu-

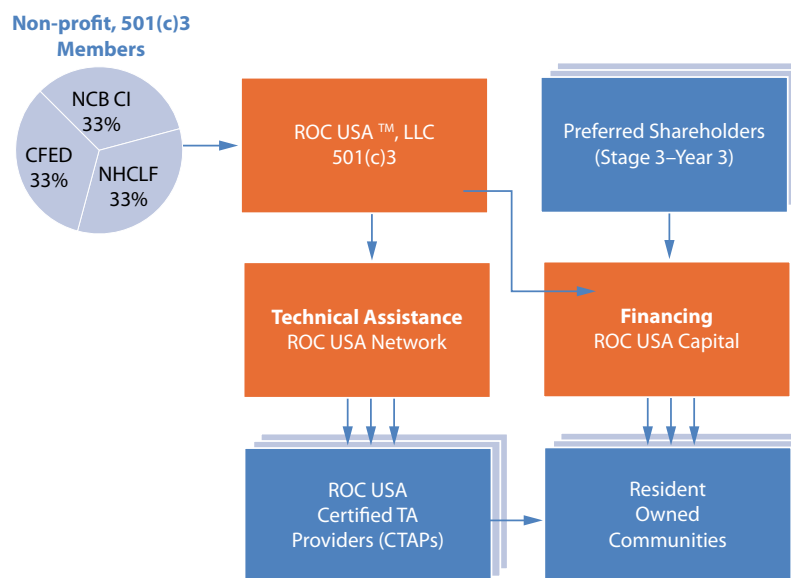
nities to have a home mortgage, and that mortgage is significantly more likely to be fixed-rate.

- These homeowners see their assets appreciating because of lower monthly fees and improved financing options (the availability of loans increases the effective demand for housing, and this contributes to greater appreciation in housing values), evidenced by a 12% price per square foot margin over homes sold in investor-owned communities.
- These homeowners are safe from community closure and change-of-use evictions.
- These homeowners are maintaining and improving their water, septic, and road systems because revenues are used locally, not exported as profits.

## About ROC USA

The experience and expertise developed in New Hampshire over nearly a quarter-century is being extended to the nation through a new organization, ROC USA™, LLC. In 2004, the Loan Fund began training other nonprofit organizations in the United States on resident ownership, and in 2006 began infusing ROC USA with intellectual capital and logistical support.

CHART 4: ROC USA



The Loan Fund and the Corporation for Enterprise Development (CFED), a Washington-based nonprofit organization focused on market and policy-based asset-building strategies, became the founding members of ROC USA in December of 2007.

NCB Capital Impact later joined as a third member. Through those members and the Ford Foundation and Fannie Mae, ROC USA has more than \$8 million in seed funding.

The organization, headed by Paul Bradley and Cheryl Sessions, two of the most experienced leaders in resident ownership, launched in May 2008, and it is now a free-standing, incorporated, 501(c)3 with its own staff and governance structures. Governing ROC USA is a board of directors, who are currently drawn from the LLC members and will expand to include homeowners, nonprofit Certified Technical Assistance Providers, and other industry experts.

As in New Hampshire, the strategy to change the manufactured home market will be three-pronged, covering training and technical assistance, financing, and public policy advocacy. ROC USA will provide technical assistance and financing through two subsidiary branches: ROC USA Network and ROC USA Capital.

The ROC USA Network will provide the training and technical assistance that helps homeowners buy their community. ROC USA Certified Technical Assistance Providers (CTAPs) are local and regional nonprofit organizations dedicated to providing high-quality and timely services to homeowner groups when their communities are for sale. ROC USA has certified and trained an initial group of local technical assistance providers who will work directly with homeowners and communities on pre-purchase and post-purchase technical and organizational needs. Nine CTAPs provide services to manufactured home communities in 28 states (see box on page 42).

ROC USA Capital will originate high loan-to-value community purchase loans, holding subordinate pieces and selling senior notes to established community development and private lenders. ROC USA will use its competitive advantages of offering qualified technical assistance, high loan-to-value lending, deep experience, and knowledge of how to develop the manufactured home market to achieve its goals:

- Preservation and improvement of affordable communities,

- Building of individual assets, and
- Fostering of healthy, mutually supportive communities.

Its mission of making quality resident ownership nationwide involves more than just working with residents of investor-owned parks. A comprehensive homeowner-oriented manufactured housing sector strategy also involves manufacturers

who produce quality homes and responsible intermediaries who distribute homes without predatory practices which have historically typified the market, such as dealer kickbacks and referral fees, agreements between lenders and dealers, sales-price excesses, and so on. Home-purchase financing represents another

crucial step, and should be conventional residential financing, not the subprime and other high interest loans that currently compose two-thirds of the market. Manufactured homeowners have long been categorized as “subprime” because of their housing choice, not because of their credit quality.

The New Hampshire Community Loan Fund, however, has demonstrated the viability of standardized home mortgage loans to these residents and paved the way for traditional banks to increasingly serve this market.

### **ROC USA Capital**

To carry out ROC USA’s national mission, a specialized financing entity must play a role. ROC USA Capital, a subsidiary of ROC USA with additional outside preferred shareholders, provides affordable loans to resident-owned entities or cooperatives formed by homeowners in manufactured home communities. These groups are seeking financing to acquire or improve the land where their homes sit. ROC USA Capital’s goals are to:

- Provide affordable manufactured home community loans,
- Provide high loan-to-value financing,
- Operate sustainably,
- Manage interest rate risk,
- Maintain loan performance,
- Lend on a national basis,
- Maximize lending capacity, and
- Develop multiple exit strategies over time.

The last three goals are closely related. To obtain the lending capacity needed to operate nationally at scale, ROC USA Capital must sell or finance a significant portion of its loan portfolio position. Numerous strategies exist with various loan channels to execute the strategy.

## Conclusion

ROC USA is a social enterprise focused on a specific market segment in need of specific resources and expertise to deliver better benefits to low-income homeowners. It enters the market after 24 years of market testing in New Hampshire, with market position and intellectual property. It has leveraged the investment of powerful members and supporters, capitalized its financing facility with equity and established exit channels, and organized nine existing nonprofit organizations as local technical assistance providers. ROC USA represents a national scale strategy in community economic development that is seeking to fulfill its mission of making resident ownership a reality nationwide.

## Certified Technical Assistance Providers

**CASA of Oregon**, Newberg, Oregon. Market Area: Oregon  
**Community Resources Group**, Fayetteville, Arkansas. Market Areas: Arkansas, Texas, Tennessee, Mississippi, Louisiana, Oklahoma

**Crossroads Urban Center / Utah Resident Owned Communities (UROC)**, Salt Lake City, Utah. Market Area: Utah

**New Hampshire Community Loan Fund**, Concord, New Hampshire. Market Area: New Hampshire

**Northcountry Cooperative Foundation**, Minneapolis, Minnesota. Market Areas: Minnesota, North Dakota, South Dakota, Wisconsin, and Iowa

**NeighborWorks Montana**, Great Falls, Montana. Market Area: Montana

**Real Estate Advisory and Development Services, Inc. (READS)**, Metuchen, New Jersey. Market Area: New Jersey

**Rural Community Assistance Corporation**, West Sacramento, California. Market Areas: Alaska, Arizona, California, Colorado, Idaho, Montana, New Mexico, Nevada, Oregon, Utah, Washington, Wyoming

**Rural Opportunities, Inc. (ROI)**, Rochester, New York. Market Areas: New York, Ohio, Pennsylvania

<sup>1</sup> S. Ward, C. French, and K. Giraud. (2006) *Building Value and Security for Homeowners in "Mobile Home Parks:" A Report on Economic Outcomes* (Durham, NH: Carsey Institute, University of New Hampshire), available at [http://www.rocusa.org/3B1\\_carsey\\_report\\_3C7A.pdf](http://www.rocusa.org/3B1_carsey_report_3C7A.pdf).

## About the Authors

**MICHAEL SWACK** is a professor at The University of New Hampshire, where he holds appointments at The Carsey Institute and The Whittemore School of Business and Economics. He has more than 25 years experience in the fields of community economic development, microfinance, development finance and development banking. Swack's current projects at UNH are in the area of community development finance, including projects looking at mechanisms to take community economic development to scale, new financial innovations for the field, and research on mission related investment by foundations and other nonprofits.

Swack was the founder and former dean of the School of Community Economic Development at Southern New Hampshire University. He has been involved in the design, implementation and management of a number of community development lending and investment institutions both inside and outside the United States. He was the first chairman and served for 17 years as a board member of the New Hampshire Community Development Finance Authority, a state-chartered equity fund for community economic development ventures and projects. He is the founding president and a current board member of the New Hampshire Community Loan Fund. He was a founding board member of the National Association of Community Development Loan Funds (now the Opportunity Finance Network), a trade association of Community Development Finance Institutions, and a current member of the Community Development Advisory Council of the Federal Reserve Bank of Boston. Internationally he has been involved in microfinance and development finance work in Africa, Asia and Latin America.

Swack has published in the areas of community economic development and development finance. He received his doctorate from Columbia University, his master's degree from Harvard University and his bachelor's degree from the University of Wisconsin-Madison. He can be reached at michael.swack@unh.edu.

**NOÉMI GISZPENC** is a consultant in community and economic development. She has worked as a research assistant at the World Bank in the office of the chief economist and has also worked to help managers expand employee participation as an editor at the *Nonprofit Quarterly* and also as a consultant and principal at Ownership Associates, a small consulting firm serving employee-owned companies throughout the United States and abroad. She has contributed as a writer and speaker to employee-ownership publications and events. She has an undergraduate degree from the Massachusetts

Institute of Technology and a master's degree in Community Economic Development from Southern New Hampshire University.

**PAUL BRADLEY** is the founding president of ROC USA™, LLC. Prior to his appointment at ROC USA, he served as vice president for the New Hampshire Community Loan Fund (NHCLF), where he managed and grew the Loan Fund's 24-year old Manufactured Housing Park Program (MHPP) by expanding its cooperative development program and initiating single-family lending and new production. During his tenure, loan receivables increased from \$3 million to \$30 million and the number of Resident Owned Communities more than doubled from 40 to 82, increasing resident-ownership's market share in NH to 19 percent. Single-family lending exceeded \$10 million in three years and a major sector change objective was met: an unprecedented \$10 million initiative by Fannie Mae to finance single-family homes in Resident Owned Communities. Under his direction, the MHPP developed the nation's first manufactured home community consisting entirely of EnergyStar® rated manufactured homes.

In 2004, Bradley initiated a national training program for nonprofit organizations that were interested in developing resident-ownership programs outside of New Hampshire. It was the success of this program, known as The Meredith Institute, that led the Ford Foundation to provide planning support for the development of ROC USA. ROC USA was launched in May, 2008.

Bradley, a native of New Hampshire, received his bachelor's degree in economics in 1986 from the University of New Hampshire. In 2008, he graduated from the NeighborWorks® America Achieving Excellence Program, an executive training program offered through Harvard University's Kennedy School of Government.

**WAYNE A. MARSDEN** With 30 years of experience in credit-related insurance, banking and business development, Marsden, since 2002, has been assisting the community economic development and affordable housing sectors in accessing the capital (debt) markets. He is currently actively engaged in raising the required equity capital necessary for Community Development Assurance (CDA) to begin operations.

He was a co-founder and the senior business development and marketing officer of ACA, the first domestic "A" rated financial guaranty insurance company. Under his supervision, ACA became the most successful start-up company in the financial guaranty industry. Marsden held senior marketing

## About the Authors

and planning positions at the following financial guaranty insurance companies (all were rated “AAA” at the time): Am-bac Indemnity, Capital Guaranty and College Construction Loan Insurance Association (“Connie Lee”). Marsden was the corporate money manager and then National Coordinator of the Financial Services Division of Johnson & Higgins, a leading international insurance intermediary. He also served as a corporate lending officer and cash management consultant for Manufacturers Hanover Trust (now J.P. Morgan Chase). Marsden is an active board member and volunteer for several not-for-profit organizations in the Washington area. He currently serves as Chairman of Mercy Health Clinic, a nationally recognized free healthcare provider, serving uninsured, low income patients. For more information, contact Wayne A. Marsden, President, Community Development Assurance, 1720 N Street, N.W., Washington D.C. 20036 (202) 375-7765 wamarsden@verizon.net

**CHARLES TANSEY** is the Senior Advisor for the Neighborhood Reinvestment Corporation’s National Programs, Initiatives and Research Department in Washington. From 1974 to 1988, Mr. Tansey engaged in corporate banking and corporate finance at the Chase Manhattan Bank, the Bank of New York, and Commonwealth Capital Partners. Since entering the community development field in 1988, he has served as the Interim Executive Director of both the Minority Investment Development Corporation (RI) and the Rhode Island Coalition for Minority Investment. During the recession of 1991-2, Mr. Tansey helped set up and manage the \$1.3 billion bailout agency for the privately insured banks and credit unions in the state of Rhode Island.

During the Clinton administration, he served as Associate Deputy Administrator for Capital Access at the SBA, managing the \$50 billion in assets of the 7(a), 504, Microloan, PRIME, trade finance, and venture capital programs. In addition, he co-chaired the Inter-Agency Work Group on Micro-enterprise, and served as a member of the Advisory Board of the CDFI Fund. Mr. Tansey has had articles published in the Brookings Institution’s *Capital Exchange*, the *Economic Development Quarterly*, and a number of other publications. He has lectured at Harvard’s Kennedy School of Government, and is a member of the Financial Innovations Roundtable. He presently serves on the Board of Directors of Partners for the Common Good, is Chairman of the Advisory Board for Wall Street Without Walls, and is on the Advisory Boards of the

Center for Rural Entrepreneurship and the National Foundation for Teaching Entrepreneurship.



## About the Carsey Institute

The Carsey Institute at the University of New Hampshire conducts research and analysis into the challenges facing families and communities in New Hampshire, New England, and the nation.

The Carsey Institute sponsors independent, interdisciplinary research that documents trends and conditions in America, providing valuable information and analysis to policy makers, practitioners, the media, and the general public.

Through this work, the Carsey Institute contributes to public dialogue on policies that encourage social mobility and sustain healthy, equitable communities and strengthens nonprofits working to improve family and community well-being.

The Carsey Institute was established in May 2002 with a generous gift from alumna and noted television producer Marcy Carsey.

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# CARSEY INSTITUTE

BUILDING KNOWLEDGE FOR  
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