

The Secondary Market for Community Development Loans

Conference Proceedings

David J. Erickson

Federal Reserve Bank of San Francisco

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

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

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

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

I. Overview

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

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

Bank vs Bond Model

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

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

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

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

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

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

The Example of the Mortgage Market

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

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

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

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

The Mortgage Market: Lessons for Community Development?

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

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

Two Securitization Models

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

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

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

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

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

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

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

Which One Is Better? Does It Matter?

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

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

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

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

II. Why Evolve?

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Leverage

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

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

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

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

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

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

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

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

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

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

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

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

III. Strategies for Getting There

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

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

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

1. CRA Volume Shoppers

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

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

2. Innovators

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

3. Yield Shoppers

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

Creating Product that Investors Want

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

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

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

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

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

Overcoming the Data Hurdle

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

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

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

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

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

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

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

Making a Market

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

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

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

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

Public Policy

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

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

Networks

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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