Expanding Capital Resources for Economic Development:

An RLF Demonstration

Kelly Robinson

2001

The EDA Mission: Enhancing Community Success in Attracting Private Capital Investment and Lucrative Job Opportunities

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Research and National Technical Assistance
Economic Development Administration

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EXECUTIVE SUMMARY

Since the 1970s, the Economic Development Administration (EDA) has helped capitalize hundreds of revolving loan funds (RLFs) for economic development in America's distressed communities. The agency continues to seek innovative ways to make these RLFs more effective in bringing much-needed capital to these areas. Today, one of the biggest challenges facing RLFs is finding new ways to fund these economic development efforts without large public expenditures. For many years, financial experts have argued that securitization could become an important way to channel private capital into economic development lending. In the past decade, there have been a handful of isolated experiments in securitizing loans from economic development RLFs. The cost of securitization was high in these early trials, meaning either that RLFs sold their loans at a significant discount or that they were forced to provide reserve pools and overcollateralization that severely diminished the value of the deal. Despite this, the RLFs participating in these experiments have been happy with their outcomes.

Still, securitization as a whole has simply not caught on, in part because RLFs continue to believe they must accept large discounts to sell their loans in secondary markets. Sometimes this is true; sometimes it is not. Discounts have many sources, but they most often result because the loans being sold carry below-market interest rates, which reduces their value on sale. Discounts have also been inflated by the fact that both RLFs and investors have very little experience in markets for RLF loans and securities backed by those loans.

To help move securitization forward and make it a more viable RLF capitalization approach, EDA began a demonstration program in 1999 to promote several real-world transactions. EDA defines securitization broadly to include techniques such as the sale of loans to back security offerings in secondary markets, the pledging of the future income stream of a loan, and similar activities. The goals of the program were to

1. increase investor familiarity with RLF portfolios as a new type of investment asset;

2. provide RLF managers information they need to determine if securitization is an appropriate strategy for them and to pursue securitization more effectively; and

3. help government agencies identify policies to promote successful securitization.

EDA selected four organizations from a national competition to receive funding to conduct securitizations and report back to the agency on their experiences. Specifically, EDA funded the transaction costs of these participants, so they would not suffer any "breakup costs" if their transaction failed. Total cost of the four projects was approximately $900,000. Each participant in the study proposed using a different approach to securitizing their loans. As of spring 2001, the status of these projects was as follows:

- Racine County Economic Development Corporation, Racine, WI, has pledged its RLF portfolios for a revolving line of credit with local banks worth $700,000.

- South Dakota Rural Enterprise, Inc. has sold notes worth $1.75 million. These notes, known as "equity equivalent" investments, are uncollateralized, long-term obligations offering investors the possibility of Bank Enterprise Awards and highly leveraged credit under the Community Reinvestment Act (CRA).

- Community Reinvestment Fund (CRF) of Minneapolis, MN, has purchased 27 loans from EDA-funded RLFs, and used them to back securities sold via private placement primarily to institutional investors. The loan sales raised $1.2 million for the participating RLFs. CRF has purchased or committed to purchase additional loans with a market value of $3.1 million for a second security sale to be held later this year.

- Working with the National Association of Development Organizations (NADO) Commonwealth Development Associates, Inc. (CDA) of Harvey Cedars, NJ, has tentative commitments from RLFs nationally to buy approximately $5.6 million in loans and use them to back security sales. The goal of the CDA transaction is to sell a rated security. To date, CDA has been unable to acquire enough loans to obtain a rating at an attractive price. NADO and CDA have conducted extensive outreach to members of NADO's Economic Development Finance Service (EDFS) regarding the benefits and costs of securitization.

Overall the direct economic benefits of these transactions have been considerable. The demonstration project has

- raised $3.7 million in new lending for six participating RLFs;

- generated an additional $8.7 million in pending sales from eight more RLFs, to be included in future security sales; and

- set the stage for much larger, but difficult to quantify, future benefits in the form of new capital raised.

Of course, immediate economic gains are not the primary goal of this demonstration project. Its real benefit should be in the lessons it teaches that make securitization more viable in the future. The project has clearly shown that the major barrier to securitization today is the hesitancy of RLFs to sell their loans.

- The current hesitancy to sell loans comes partly from the fact that RLFs do not have a large need for liquidity right now. In the strong market of the late 1990s and early 2000s, demand for RLF loans is relatively low because nontraditional borrowers have been able to receive capital through conventional lenders.

Many RLFs said they would prefer to try securitization after others had, suggesting that fear of discounts remains high. However, RLFs participating in this project did not suffer deep discounts on the sale of their loans, even those with low interest rates.

- More than 100 loans priced in preparation of a transaction, with a median interest rate of 7.5%, suffered a median discount of just 6.3%. Several loans sold above par.

Nonetheless, low interest rates on the original loans remain the biggest contributor to discounts. For RLFs wishing to try securitization, the project generated several important lessons:

- All RLFs participating were allowed to retain servicing of their loans if they so desired.

- The two organizations buying loans in the demonstration imposed very similar eligibility requirements, and required very similar types of documents for their due diligence process. CRF re-underwrites each loan, whereas CDA relies on credit scoring in their respective due diligence examinations.

- The project resulted in collection of a variety of loan sale, servicing, and collateralization documents that may serve as models for future transactions.

In seeking to increase investor familiarity with loan-backed securities, the project has

- gathered prior research on RLF loan performance into a single place. This research strongly suggests that credit risk from RLF losses are not much higher than those experienced by private banks, with default rates typically being under 8%, and loss rates being much lower than that;

- demonstrated the possibility for regulated banks to earn highly leveraged CRA credit by investing in RLFs; and

- highlighted several ways that investors can earn CRA credit for securitization, as well as restrictions on obtaining such credit.

The project has also highlighted key differences in the way that financial analysts and RLF operators perceive potential transactions.

- Many RLF operators have tended to view discounts as a cost that is only imposed as a result of securitization. Financial experts argue that these are opportunity costs that exist whether or not the RLF undertakes a securitization. They argue that these costs are imposed on RLFs by their decisions to make risky and/or low-interest loans in fulfillment of their public mission.

- Financial analysts have argued that the tendency for RLFs to overcollateralize their debt to an extreme degree is highly wasteful, because it prevents them from maximizing the amount of cash available for new lending. RLF operators often respond that they really do not need to borrow more than they have with the overcollateralized debt. They also argue that overcollateralization is a cost they need to accept in order to establish a strong record with local lenders. According to this view, they will expect to lower the collateral levels in future transactions.

Finally, the project led to key lessons for federal funders of RLFs:

- Several RLFs chose not to participate due to federal restrictions on how they could use their transaction proceeds, or because they feared that securitization would make them less likely to receive other federal grants.

- The federal government needs to subordinate or release any interest it has in RLF loans before they can be securitized. This needs to be done quickly to avoid interfering with loan transactions. This subordination can make tracking federal funds difficult in the future.

- Borrowers from federally funded RLFs must be monitored for regulatory compliance even after their loan is sold. Federal agencies approving loan sales need to be sure that provisions for this monitoring are included in any servicing agreements.

CHAPTER 1

INTRODUCTION

An Introduction to Revolving Loan Funds

Since their inception in the 1970s, revolving loan funds (RLFs) have become a standard tool for local economic development organizations. These funds typically serve as lenders of last resort—lending to nontraditional business borrowers unable to acquire all or part of the capital they need from traditional banks. These nontraditional borrowers may include women, minorities, and residents of distressed communities subject to current or past discrimination. They may also include borrowers with few tangible assets to serve as collateral, or startup firms with uncertain income. RLFs may also provide very small "microloans" that would normally be too small for commercial banks to offer profitably. Often, RLF lending consists of subordinated "gap" or "bridge loans" used to make a borrower more attractive to private banks and supplement the amount they can borrow. RLF loans are often made with balloon payments, subsidized interest rates, and other favorable terms to the borrower. In addition, RLFs often provide various kinds of technical and business assistance to their borrowers to help them succeed in their business. RLF loan servicing usually entails working closely with troubled borrowers.

In 1997, the nonprofit Corporation for Enterprise Development (CFED) identified over 600 funds supported by federal agencies, such as the Economic Development Administration (EDA), the Department of Housing and Urban Development (HUD), and the U.S. Department of Agriculture (USDA) (Levere, Clones, and Marcoux, 1997). CFED estimated that these funds have made more than $560 million in loans and created or saved more than 200,000 jobs. These numbers almost certainly underestimate the importance of the RLFs to economic development efforts. For one thing, CFED was unable to include many funds for which reliable data were not available.[1] Furthermore, the industry has grown tremendously since the CFED report was published.

RLFs may also have strategic importance in the communities they serve that is not adequately reflected in the shorter term by job creation and lending statistics. RLFs routinely support activities that are qualitatively different than those funded by the private sector. As a result, RLFs help add diversity to the local economy that would not be present otherwise—even if traditional lenders were to make more capital available. Likewise, while RLFs can be found in every kind of community, they tend to be concentrated in economically distressed areas where additional capital can have its greatest impact.

RLFs' Ongoing Need for New Capital

Estimating the capital needs of RLFs is complicated and subject to great uncertainty. However, there are several factors suggesting that RLFs will continue to require significant infusions of new capital:

- RLF use is continuing to grow. From the perspective of the federal government and nationally based nonprofit organizations, federal RLF programs provide an efficient means to channel funding to local groups that are most knowledgeable about local needs and capacity. As the RLF industry has matured, funds continue to expand their lending into new types of activities.

- In the 1990s, an exceptionally strong economy created large infusions of capital into private capital markets. This kept interest rates low and allowed many nontraditional borrowers to borrow from private banks for the first time. Their unprecedented access to private markets has probably suppressed borrowing from RLFs. As the economy cools and this capital surplus shrinks, many small firms and organizations are likely to find themselves less able to tap private capital markets, either because interest rates rise or because lending standards are tightened.

- Even if demand were not growing, RLFs would still require occasional recapitalization to offset losses. Most studies have found these losses to be relatively small (see Chapter 5). Still, some defaults and delinquencies are to be expected. RLFs also may suffer long-term real losses because their loans are often made at low interest rates that do not offset inflation.

For all of these reasons, most RLF managers believe they need additional funding. In their 1997 survey of RLFs in Ohio, CFED researchers found that 85% of fund managers believed they needed further funding to pursue their mission properly (Levere, Clones, and Marcoux, 1997). Similarly, a study conducted for the Appalachian Regional Commission about the same time argued that (in Appalachia) there was a significant credit shortfall for "startups, high-growth firms, firms in non-traditional industries, and firms owned by non-traditional entrepreneurs" (Mt. Auburn Associates, 1998:104).

Securitization As a Source of Capital

One possible RLF capitalization source that has received increasing attention is securitization (Malone, 1992; Richardson, 1996). Technically, "securitization" refers to the process whereby loans or the income from loans are pledged to ensure repayment of bonds, notes, or other securities. The proceeds from these security sales are subsequently used for new lending, with payments collected from existing and/or new borrowers used to repay holders of the notes. For policy purposes, EDA uses a somewhat broader definition of securitization:

> Securitization refers to the technique of securing an investment of new capital with the stream of income generated by one or more (usually a large group of) existing loans. EDA broadly defines securitization transactions to include techniques such as the sale of loans, pledging the future income stream of a loan, and similar activities, to access investor capital to increase available funds for lending. (13 C.F.R. Part 308.8)

The main difference between this definition and the commonly used technical terminology is that EDA includes collateralized borrowing and similar types of transactions that pledge a loan or its income stream as security, even where no note or bond is issued. In this report, I shall use the EDA definition, although I shall try to be clear whether I am talking about collateralized borrowing or more traditional concepts of securitization when that difference is important.

Securitization provides local economic development lenders a way to attract capital from national and global capital markets by treating the payment stream from an RLF's economic development loans as a tradable commodity. The value of securitization to an RLF depends largely on the price it receives when it sells or pledges its loans to obtain new funds. I will discuss the determinants of price in greater detail in Chapter 4. However, it is critical for RLFs to understand that regardless of whether they issue notes themselves or sell their loans to an intermediary, the price they receive for their loans and the conditions of the sale depend heavily on the demands of investors operating in broader capital markets.

Usually, RLFs selling their loans will have to absorb some discount. That is, they will be paid less than the remaining balance of their loans because the loans pay below-market interest rates and/or because their loans are perceived by investors as being risky. Many RLF managers have avoided securitization precisely because they are unwilling to accept these discounts. Clearly, if the discount associated with the transaction is severe, it can erode the capital base of the RLF over the longer run. However, the long-term capital position of the RLF depends on much more than the discount. Most important, an RLF may very well increase its capital base over time, even with a significant discount, if it relends its funds at higher rates. An RLF may also compensate for a discount by collecting loan origination and/or servicing fees on new loans made. Of course, raising interest rates and charging fees entails cost to the borrowers and thus represents an important policy decision on the part of the RLF. In these kinds of financial matters, there is no shortcut to building spreadsheets and playing different scenarios out over time (Malone 1992; Richardson, 1996). In fact, the discounts absorbed by RLFs selling loans through the demonstration project were quite modest—usually under 10%. Establishing a competitive market for development loans should lower these discounts even further.

As important as these longer-term implications of securitization are, we should also not forget that securitization is fundamentally about gaining liquidity. The ability of an RLF to turn over and receive cash for its loans can be of great strategic importance. The most obvious benefit of securitization is where an RLF needs additional cash in a hurry to finance a uniquely important

development opportunity. In such cases, it may even be worthwhile accepting some erosion in the capital base. The experience of the demonstration participants suggests that it is unwise for RLF management to assume that this cash will be available immediately. These transactions take time to put together. Nonetheless, this capital will usually be available more quickly than waiting for existing loans to be repaid, or waiting for a recapitalization grant.

By allowing lenders to clear old loans from their books and make new loans, securitization can also help revolving loan funds alter the composition of their lending portfolios. This can be valuable to an RLF that wishes to diversify its portfolio, redirect lending to specific types of borrowers, or change the terms of its lending. RLF managers may also use securitization as a means to increase their future flexibility to respond to sudden challenges and opportunities by shortening the term of new loans made or by retaining some share of the transaction proceeds as cash.[2]

Obstacles to the Development of a Secondary Market for RLF Loans

Securitization is well established as a source of capital for home mortgages, automobile finance, and many other types of credit. However, it has only been used on a very limited basis for funding economic development. Why is this the case? As a nascent segment of the capital market, securitization of economic development loans faces something of a vicious circle. On the one hand, investors unfamiliar with economic development lending see these markets as risky and consequently avoid RLF-backed securities. On the other hand, this hesitancy by investors makes it difficult for the RLF community to complete the volume and variety of securitization transactions necessary to establish RLF-backed securities as viable investment assets. Of course, weak demand has contributed considerably to the high discounts imposed on RLFs selling their loans. These high discounts, in turn, further discourage RLFs from bringing their loans to market.

It is difficult to entice private investors to buy new types of assets under the best of circumstances. For RLFs wishing to securitize their loans, the problem is further complicated by several unique characteristics of economic development lending. Most obvious, economic development loans are often subsidized with low interest rates and made to people who cannot obtain all or part of the capital they need from private banks. These features may be important to pursuing economic development, but they may make economic development lending less profitable and riskier than traditional lending. Also in contrast to home and car loans, economic development loans are made for a wide range of purposes, with great variation in underwriting standards. This ordinarily raises the transaction costs and uncertainty associated with setting a price for loans and loan-backed securities. This problem is magnified by the fact that the RLF industry is largely unregulated and lacks common documentation. Finally, because RLFs tend to be small and locally managed, loans from several different funds must typically be pooled to obtain scale sufficient to cover the costs of putting a deal together.

Largely as a result of these challenges, RLF-backed securities have so far failed to attract the broadest range of private-sector investors possible. While some institutional investors have been willing to buy securities backed by development loans, they have often been investors that, while they expect to make a profit, are also willing to accept a lower return in order to pursue a social mission or to obtain credit under the Community Reinvestment Act (CRA). Of course, all these investors are important, but securitization is unlikely to become a reliable and efficient recapitalization strategy for the large number of RLFs currently operating until it can appeal to a much broader audience of profit-maximizing institutional and private investors.

On the supply side of the market, both RLFs and the government agencies that fund them have been slow to try securitization, partly due to their fear that discounts will deplete their capital base. Often, RLF managers have failed to understand that they are already eroding their lending capacity if they make loans at below-market rates—regardless of whether they securitize their loans or not. Securitization simply makes that loss more obvious and immediate. Skeptical RLF managers have also worried that investors will pressure them to adopt loan underwriting and servicing practices that undermine their economic development mission. They have worried, for instance, that investors will prevent them from lending to risky borrowers, prevent them from making below-market loans, and that investors will restrict the RLFs' ability to work with troubled firms rather than foreclosing on bad debt. Finally, in the event they attempt a securitization and the transaction is not completed—a distinct possibility in this immature market—RLFs will lose all fixed costs associated with assembling the deal, due diligence on the portfolio, etc. Few RLFs can afford these "breakup costs." As I show later in this report, these are all legitimate concerns, but none of them need rule out securitization as an important and responsible economic development tool. Finally, even when they accept that securitization can be a valued tool for economic development, many practitioners do not believe they have the expertise needed to participate in secondary markets.

Organization of the Report

In the fall of 1999, EDA initiated a demonstration project with the goals of lowering some of the barriers just described by enabling several real-world securitization transactions. Four different grantees were chosen, with significant variety in the type of transaction used and the type of organizations involved. By spring 2001, three of the four grantees had finished their transaction. The fourth had tentative commitments from RLFs to sell loans and was attempting to increase the size of its pool to lower the cost of issuing a rated security. The remainder of this report is devoted to extracting lessons from those experiences.

- Chapter 2 describes prior federal efforts to promote more informed use of securitization for community and economic development. It also describes the demonstration project and its final results in further detail.

- Chapter 3 provides a brief summary of the demonstration project, including its goals, how projects were chosen, requirements placed on selected grantees, and a brief description of each project as originally proposed.

- Chapter 4 describes lessons derived from the project of importance to RLF managers contemplating securitization. This includes information about how to evaluate whether securitization is appropriate for an organization. It also includes lessons for managers regarding specific topics such as how a portfolio is valued, credit enhancement, and regulatory issues. A great deal of emphasis in this chapter is placed on explaining discounts and how to reduce them.

- Chapter 5 includes information of importance to potential investors. This includes basic information about RLFs and their risk characteristics, a discussion of supply characteristics, and information about obtaining CRA credit for investments made.

- Chapter 6 describes lessons for government agencies that are considering allowing RLFs to securitize their portfolios. There are a large number of issues such agencies must tackle, including how to subordinate any governmental interest in the loans being pledged, and how to ensure compliance with federal regulations on borrowers.

- Chapter 7 is dedicated to a more thorough description of each of the four securitization transactions. In each case, I describe the basic transaction, pricing of the loans, elements contributing to any discount, credit enhancement included, and documents required.

Note there is no chapter dedicated to intermediaries. This is because the lessons of importance to them were usually also of importance to either buyers or sellers of loans. Consequently, lessons for intermediaries are dealt with both in the supply and the demand side of the market (in Chapters 4 and 5).

CHAPTER 2

ONGOING FEDERAL EFFORTS TO PROMOTE SECURITIZATION

A Brief History of Securitization

Much of the critical development of securitization as a means to raise capital has come in markets for residential mortgages. Prior to the large-scale use of securitization, local banks and savings and loans served as the dominant source of funds for mortgage lending. In most cases, they also served as the loan originator and loan servicer. These local banks were protected by regulations that restricted market entry by institutions in other areas or product lines. While this meant that lending was controlled by local interests, it also meant that the supply of capital available for lending was limited to the deposits of these institutions. Over the longer run, these deposits simply could not grow fast enough to meet the demand for housing in a growing economy. To expand the supply of capital available for home mortgages beyond the deposits of these local institutions, the federal government created the Federal National Mortgage Association (Fannie Mae) in 1938. Fannie Mae bought mortgages insured by the Federal Housing Administration (FHA), thereby providing private banks and savings and loan associations new cash for lending.

For the next thirty-five years, this system was gradually expanded to keep increasing the funds available for mortgage lending in a growing economy. Fannie Mae began purchasing other types of federally guaranteed mortgages (in 1944), and eventually conventional home loans (in 1972). When Fannie Mae was converted to a private institution in 1968, Ginnie Mae was created to maintain the governmental side of the business. Freddie Mac was created in 1970 to further expand the supply of funds available, and operates as a private corporation similar to Fannie Mae. Despite this ongoing expansion, growth in the demand for home loans continued to outpace the growth in deposits available in local institutions. Ginnie Mae issued its first mortgage-backed security in 1970, with Fannie Mae and Freddie Mac following shortly thereafter. While there were minor differences among them, most of these early offerings consisted of some form of "pass-through" security, in which loan payments were transferred to investors along with a guarantee of repayment (either by guaranteeing the loans themselves or guaranteeing the securities).

Securitization meant that funds for lending were no longer limited by the deposits of the institution making the loans. However, the early offerings were not very successful for a variety of reasons. Initially, these bonds were subject to double taxation—once when the loans were sold to the bond issuer and again when the bonds were sold to investors. This problem was solved by setting up trusts to handle the transfer of funds. Even then, however, many institutional investors were prevented from investing in asset-backed securities. There were also

a variety of state "blue-sky" (full disclosure) laws with the potential to cause difficulties. All of these problems were complicated by the fact that laws varied from state to state (Ranieri, 1998).

As many of these legal barriers were gradually solved and market circumstances changed, the use of securitization exploded in the 1980s. Fannie Mae issued its first mortgage-backed securities for conventional loans in 1981, vastly expanding the supply of loans available to securitize. At the same time, banking deregulation lowered the barriers that had prevented competition in loan origination and servicing. There was also increasing standardization in underwriting and servicing, as loan originators began to make loans specifically for securitizing that were consistent with criteria laid out by Fannie Mae and Freddie Mac.

In 1983, securitization took a major step forward with the introduction of the collateralized mortgage obligation (CMO), a tool that had been used in municipal bond markets for many years. Rather than issuing a single bond that looked a lot like the underlying loans, the CMO treated a loan pool as a set of cash flows that were paid out to a series of securities in a prespecified priority. Each security in the offering had a different maturity date and risk characteristics. Relatively safe, lower yield securities would be paid first. Then, as cash flow allowed, lower tier (junior) securities would be paid in succession. This allowed investors with low tolerance for risk to buy the safest securities in the pool. More aggressive investors could purchase the riskier (less senior) securities in return for a higher yield. In this fashion, the lower tier securities effectively "credit enhanced" the more senior notes (Ranieri, 1998).

By the 1990s, securitization had come of age. Today, automobile loans, credit card receivables, student loans, and many other kinds of standardized borrowing are all securitized routinely. In the early 1990s, securitization was widely used to convert the assets of failed savings and loans to cash that could be used to reimburse depositors. In fact, by early 1994, the Resolution Trust Corporation had securitized more than $40 billion in assets, including large quantities of mortgages that did not meet the traditional underwriting standards of Freddie Mac and Fannie Mae (Jungman, 1998). The structure of security offerings has also become far more complex. Today, a large securitization may involve dozens of different security classes or "tranches." Likewise, many securitizations today (e.g., credit cards) involve revolving pools of receivables, where new debt is swapped into the pool as existing debts are paid.

EDA and other federal agencies have recognized the potential for securitization to provide new capital for economic development in distressed communities throughout the country. They have also recognized that there are features unique to economic development lending that make these loans difficult to securitize. In response, several federal agencies have taken actions to make securitization a more viable capitalization strategy for local lenders.

Small Business Administration

The Small Business Administration (SBA) began securitizing small business loans in 1985, when it first allowed depository institutions to pool and sell the guaranteed portion of their SBA loans. This was similar to the original "pass through" on Fannie Mae guaranteed mortgages. In 1992, SBA expanded this by allowing lenders without deposits (e.g., finance companies) to securitize the unguaranteed portion of the loans they originate. In 1999, SBA went a step further by allowing depository institutions to securitize the unguaranteed portion of their loans. As a result, SBA has generated a genuine and robust secondary market for small business lending, with approximately $25 billion in loan guarantees and $1.3 billion in nonguaranteed portions of loans having been securitized as of 1999 (SBA, 1999).

Unfortunately, the lessons from the SBA experience are only partly applicable to economic development lending. First, the underwriting of SBA loans is highly standardized and consequently able to generate the volume necessary to make securitization a very cost-effective and safe investment. Second, and also in contrast to RLF loans, SBA loans are usually originated by private banks. Interest rates on these loans are typically close to market price, and many current borrowers from economic development RLFs either cannot qualify for or cannot afford SBA loans. Third, a large share of these loans are guaranteed by the United States government.

Department of Housing and Urban Development

In the early 1990s, the U.S. Department of Housing and Urban Development (HUD) sponsored research by Cleveland State University to explore issues associated with securitizing housing rehabilitation loans from RLFs capitalized with its Community Development Block Grant (CDBG) funds (Dommel, 1995.) This research included a survey of 294 grantees that were known to have RLFs. Of the 168 grantees responding to the survey, only 12 reported having tried to sell loans. The researchers then developed case studies from experiences with securitization in Washington, DC; Denver; St. Paul; Raleigh; Kalamazoo; Milwaukee; Baltimore; Cincinnati; and Saginaw. The HUD RLFs have many similarities to economic development RLFs, suggesting that their experience may provide important lessons for economic developers. Like economic development RLFs, the HUD RLFs tend to be concentrated in needy communities. Loans are often made at below-market rates with favorable payment and servicing terms to the borrower. Usually, the borrowers are unable to obtain credit from commercial banks and the loans are risky as measured by standard criteria, such as loan-to-value and debt service-to-income ratios. In many cases, HUD's RLFs take a subordinated position with respect to repayment and collateral. Also in similarity to economic development lending (and in contrast to commercial lending for housing), there is great variability in underwriting practices and documentation. Finally, the involvement of the federal government raises many similar issues for rehabilitation and economic development loans.

Taken as a whole, the 12 HUD securitizations resulted in the sale of 548 loans, raising approximately $4.6 million in new cash. Individually, each of the HUD cases illustrated the

complexity and variability of securitization approaches. The Cleveland State study yielded many important lessons:

- The municipalities studied typically suffered large discounts due to the low interest rates charged on the loans. On average, this discount was 19.1%. The average interest rate charged on the original loans sold was 6.2%.

- None of the buyers of the HUD-backed loans were institutional investors evaluating the investments with traditional criteria such as income potential. Over half the buyers were local banks at least partially motivated by the need to gain credits under CRA. In several instances, the buyers were nonprofit organizations.

- The average time to complete a first-time transaction varied from 7 to 18 months, with an average around 14 months. For subsequent transactions, this time dropped dramatically to just over 8 months. Most, but not all of these subsequent transactions were to the same buyers. In at least one case (Denver), delays in completing a transaction contributed to the collapse of a deal, because continuing repayment during the delay significantly decreased the value of the portfolio.

- Buyers used a variety of means to protect themselves from credit risk. First they tended to buy the least risky loans in any portfolio. Second, buyers usually required that the seller agree to repurchase or substitute loans in the case of delinquency or default. Some transactions also required sellers to maintain a reserve account.

- In most cases, documentation necessary to complete the transaction was present but poorly organized. In many instances, documentation was not made according to industry standards. In a few cases, key documents such as notes and insurance policies were missing altogether. These inadequacies in documentation were central to the collapse of at least one transaction, and led to delays in others. The study did not determine if poor documentation contributed to the level of discount on sale.

- The practice of making deferred loans turned out to be a major deterrent to securitization, since deferred payment provisions tend to reduce the income from lending and make it less predictable for investors.

While many of the lessons from the Cleveland State study are valuable for economic development RLFs, the HUD loans included in the research are for housing rehabilitation rather than business development. Partly because of this, these loans tend to carry lower interest rates and slightly longer terms than economic development loans.[3]

In addition to the sale of the housing rehabilitation loans included in the Cleveland State study, there have been several other isolated sales of loans made with CDBG funds. The most significant of these was in 1994, when the South Carolina Jobs-Economic Development Authority (JEDA) sold a security backed by economic development loans to the MacArthur Foundation.[4] JEDA is an intermediary that helps capitalize local loan funds[5]. The securitized portfolio of $11 million included loans pooled from RLFs that JEDA funded. This portfolio was divided into two classes. The RLF's best-performing loans were placed into a $7 million senior security that was sold to MacArthur. The remaining $4 million was retained by JEDA, with loan payments flowing to the senior security first so that JEDA only got paid after the Foundation. This credit enhancement allowed the senior bond to be sold at par, with a yield of 7.45%. At the time, this yield was equivalent to the return on a treasury security of similar maturity, plus 1.5%. According to Richardson (1996), this represented a below-normal spread for the risk inherent in the bonds, estimated to be of BBB quality. The Foundation was further protected from loss by a reserve account funded from payments on principle to the junior portion. JEDA retained servicing of the loans, and collected a small servicing fee.

Based on its experience in pilot securitizations like those described above, HUD issued a directive on securitizing loans funded by CDBGs in December 1995 (HUD, 1995). This directive points out that existing programs available at HUD not only allow for securitization, but can provide additional funds for credit enhancement in the form of loan or security guarantees and reserve pools. The directive goes on to raise certain issues involved with securitizing CDBG loans. Among other items they point out is that any federal requirements imposed on borrowers when the loan was originated must remain in effect even after the loan is sold. Also, the directive outlines rules governing the use of new funds raised from the securitization. While the loan repayments transferred to investors as a result of the sale cease to be program income, the capital raised from the loan sale is classified as program income it must be used consistent with CDBG program rules.

Lessons from the HUD experience are clearly important to RLFs considering securitization of their portfolios. However, the scale of transactions to date still has been very small. Securitization is a complex topic and there are many more important questions that need answering. As an example, most of the HUD securitizations have been local or regional in scope. Consequently, they have not tested the use of national pooling arrangements that could possibly reduce discounts received by the RLFs involved. Likewise, HUD's studies tended to focus on the immediate sale of loans, with much less analysis of the securities that are issued using the loans as collateral. It is unclear, for instance, whether it makes sense to obtain ratings for loan-backed securities, or whether these transactions can support more complicated forms of structured finance.

Early EDA Securitization Efforts

Parallel to HUD's efforts, EDA actively encouraged RLFs to experiment with securitization between 1993 and 1998. As a result, the agency approved several requests by RLFs to sell or securitize their loans. However, most of these transactions were never completed. Two notable exceptions to this were transactions involving the New Jersey Economic Development Authority and the Virginia Small Business Financing Authority. Both of these are large RLFs with considerable finance expertise. In March 2001, as part of the demonstration project, EDA staff went back and interviewed staff from these RLFs to identify lessons they had learned from their experience.

New Jersey Economic Development Authority [6]

The New Jersey Economic Development Authority (NJEDA) provides business financing throughout New Jersey, with a strong focus on distressed communities. Typically, these loans are for gap financing where NJEDA provides 25% of the financing needed by a business, guaranteeing an additional 25%. The remainder is provided by private banks, with NJEDA taking a subordinate position on repayment. While NJEDA's share may be as low as $50,000, it is more often in the $250,000 to $500,000 range. The term on NJEDA loans is set to match those of the bank loans, with loan terms usually between 5 and 10 years. Interest rates on the NJEDA loans are made at one percentage point (100 basis points) above prime—significantly below-market rates for most NJEDA borrowers. Interest rates are variable, with a ceiling set to protect borrowers from having to make excessive payments in the event of macroeconomic volatility.

In the economic downturn of the early 1990s, nontraditional borrowers in New Jersey found it increasingly difficult to borrow from private banks. As a result, NJEDA found its own reserves strapped as it tried to meet the demand for affordable credit. In 1995, NJEDA pledged a $28.3 million portfolio with an average interest rate of 5.9% to NatWest Bank to collateralize a letter of credit (LOC). The loans were effectively pledged at par (with no discount) because the value of the LOC was equal to the assessed value of the portfolio. The LOC, in turn, was used to back a bond sale. Under this arrangement, state bonds were issued by NJEDA to be repaid solely by drawing on the letter of credit. Under this direct-pay LOC, NJEDA immediately reimbursed NatWest for payment made to bondholders.[7] Use of the LOC allowed the bonds to earn a AA rating in the market—the rating of the bank itself. The bonds were 6-year variable-rate obligations. Other notable features of the transaction included the following:

- All income from the existing loans and any new loans made after recapitalization were pledged to payments on the LOC.

- The RLF was required to maintain a reserve account equal to 30% of the bonds outstanding to guarantee their repayment (equal to $8.5 million at the time of the bond sale).

- NatWest Bank required NJEDA to retain a cash reserve of at least 125% of the debt service due each month. If cash flows from the portfolio were to fall below 125% of debt service on the bonds, NJEDA could be required by the bank to repurchase bonds. To date, this has not happened.

- NJEDA was required to pay a monthly credit enhancement fee to the bank of .8% of the outstanding bonds.

The New Jersey transaction highlights an important difference in the way many financial analysts and RLF managers evaluate these transactions. From the perspective of many private-sector analysts, this was not a highly "efficient" deal for the RLF. Most notably, Richardson (1996) points out that the large reserve fund requirement meant that $8.5 million was unavailable for new lending. Likewise, the fact that the new loans were pledged as collateral precluded the RLF from securitizing or borrowing against the new loans. In effect, these provisions acted as a hidden discount.

The RLF's view is quite different. NJEDA was strongly committed to retaining ownership and servicing of its loans. Under this arrangement, it was able to do so, and with no discount. From its perspective, the reserve requirement is very different from a discount, because the cash in the account reverts to the RLF when the bonds are repaid. Furthermore, it is earning usable interest on that cash in the interim.

Another major issue in the transaction was the choice to issue variable-rate bonds, which potentially exposed the RLF to considerable interest rate risk. Because the rates on the underlying portfolio were relatively fixed, NJEDA could end up paying more on the bonds than they earned from the portfolio if interest rates rose dramatically. In fact, interest rates did rise significantly after the transaction was completed. However, NJEDA had done extensive sensitivity analysis beforehand to determine what would happen in just such an event, and it reports that yields paid on the bonds never exceeded 5.5%. At the time of the transaction, the portfolio was earning approximately 5.9%, and this actually increased over time as older loans were retired and new ones underwritten at higher rates.

The NJEDA transaction has provided valuable information regarding the types of financing structures that are available to RLFs wishing to retain ownership of their portfolio. It has also provided valuable information about the issues RLFs must consider when structuring a deal. Despite the concerns raised by private financial analysts, this was a highly successful transaction from the perspective of the RLF, because it was able to obtain new capital in the short-run and still have longer-term growth in the portfolio.

What the NJEDA transaction does not tell us is how RLF loans might be priced in the open market. After all, it was the letter of credit from the bank, not the underlying portfolio, that determined the value of the bonds sold. There is also some question regarding the replicability of

the approach. NJEDA required eighteen months to put this deal together, and is an exceptionally large and sophisticated organization, with a highly trained staff by RLF standards. It also retains large deposits in the bank that helped in its negotiations. Whether less-well-heeled organizations can repeat this approach has yet to be seen, but certainly they can take lessons from it.

Virginia Small Business Financing Authority

Between 1977 and 1994, EDA made a series of grants to the Commonwealth of Virginia worth a total of $8,675,000 for the purpose of establishing revolving loan funds.[8] Much of this money was loaned through Independent Development Authorities (IDAs), which acted as intermediaries and reloaned the money to local businesses. The RLFs frequently took a subordinate repayment position. In 1996, the Commonwealth consolidated the RLFs into a single fund, the Virginia Small Business Financing Authority (VSBFA). In 1999, VSBFA sought to expand its lending activities and planned an aggressive marketing campaign for that purpose. To enable this increased lending, the RLF raised capital by selling 19 loans from its EDA funds as part of a larger package (Malone, 1998). The average interest rate charged on the loans was 6.75%. The prime rate was in the range of 8.25% to 8.50% at that time. For most of the loans included, the loan amount was over $100,000. The loans typically had terms between five and seven years, although they were seasoned to different degrees. At the time of sale, the outstanding principle of the EDA loans was $5.6 million. VSBFA received approximately $4.7 million for the loans, representing a discount of 19%.[9]

To identify potential investors for their portfolio, VSBFA invited approximately fifteen nationally known financial organizations to express their interest in purchasing or investing in the loans. The solicitation included information about VSBFA as well as the detailed information about each individual loan being offered for sale. The initial invitation did not specify that the transaction had to be a whole loan sale. VSBFA also considered other securitization options. VSBFA received three responses to the invitation, eventually choosing Cargill Financial Services Corporation as the buyer. VSBFA also hired two financial consultants, Laurelwood Capital Inc. and Capital Access Group, LLC (CAG) to assess the purchase offer made by Cargill, to determine the source of any discount imposed on the sale, and to help the RLF in reviewing legal documents associated with the sale.

Prior to the actual sale, CAG estimated that the final discount would be approximately 19.5%—very close to the actual figure. CAG further estimated that 10 percentage points of this were due to the low interest rates charged on the loans. About five percentage points of the discount were attributable to the underlying delinquency and default rates on these loans. Three percentage points were to cover the costs of servicing the loans, and the remainder of the discount was to cover transaction costs of due diligence, legal fees, etc. In estimating the portion of the discount attributable to underlying riskiness of the loans, CAG assigned the portfolio a conservative default rate of 12%. This is 2.5 times the actual default rate for the portfolio (5%). VSBFA had carefully selected the loans to be sold, excluding any problem loans where buyers might need special treatment.[10] In fact, the EDA loans in the portfolio had no record of

delinquencies at the time of sale. The risk factor also accounted for the fact that the sale was nonrecourse, meaning that the buyer could not pass any losses back to VSBFA or EDA if the borrowers failed to perform. In performing due diligence on the portfolio it purchased, Cargill did its own loan-by-loan analysis.

To proceed with the transaction, VSBFA had to obtain permission from EDA to sell the loans. Before approving the transaction, EDA required that any proceeds of the sale be reloaned within two years of the sale in a manner consistent with the RLF's lending plan. Using average benefit figures from lending by EDA RLFs overall, the agency estimated that new loans made from the proceeds of the sale would create at least 750 new jobs and leverage about $9.5 million in additional private-sector financing. As a condition of the sale, the buyer requested that VSBFA relinquish servicing of the loans. In return, EDA required that VSBFA retain the right to repurchase any loans in the event foreclosure proceedings were initiated, and that Cargill inform VSBFA before foreclosing. In addition to seeking permission for the sale of the loans, VSBFA also obtained an amendment to its lending plan to ensure that loans made from the proceeds of the Cargill sale would meet the same eligibility criteria EDA had imposed on the original loans.

There are several interesting points to be made about this transaction:

- According to VSBFA, Cargill never intended to, and has not, resold or issued securities using the loans it purchased from them.

- In contrast to NJEDA, VSBFA was quite willing to sell their loans, and was not especially concerned with giving up either ownership or servicing of the loans. In fact, VSBFA staff indicated that it might have been difficult for them to handle the workload of servicing both the original loans and new loans anticipated after the sale.[11]

- Also in contrast to NJEDA, VSBFA staff were not very concerned about the discount imposed on sale of the loans. While it would have been desirable to have a lower rate of discount, they viewed the discount itself as an acceptable cost of acquiring new capital.

- Although the initial impetus for the loan sale was to generate new lending, VSBFA found it more difficult to make new loans than expected. This was largely because of the dramatic turnaround in the U.S. economy in the latter half of the 1990s, which caused banks to relax their underwriting standards (i.e., they allowed higher loan-to-value ratios), lessening the need for gap financing.

- One of the most difficult challenges VSBFA faced in its transaction was reassigning the collateral from the RLF to the buyer. In part, this was because the original loans had been made through IDAs, so each piece of collateral had to be transferred twice (once by the intermediary and once by VSBFA). This involved

dozens of different attorneys, each using their own unique legal documents that had to be modified and agreed upon by the parties involved.

In the end, despite their notably different approaches and concerns, and despite the significant costs involved, both the Virginia and New Jersey RLFs were very satisfied with their transactions and state they would do them again if they needed additional capital for lending. Both RLFs make their loans a bit differently than they did previously. New Jersey tends to make its loans at rates closer to market than it used to. Virginia no longer makes its loans through intermediaries and uses shorter terms than it did in the past, building in balloon payments where needed. However, both organizations state that these changes would have occurred anyway and are unrelated to their securitization experience. Neither NJEDA nor VSBFA indicated that they rely heavily on servicing fees as a source of revenue.

In addition to these isolated experiments in securitization, EDA has also sponsored research to investigate the feasibility of securitizing economic development loans. Most importantly, the agency funded a project that explored the potential for making "credit enhancement" grants to fund multiyear debt service reserves or subsidized interest accounts for public infrastructure bonds issued by base reuse authorities. These credit enhancement approaches would allow the federal government to leverage its funds while limiting its potential liability to the amount of any grants provided (Reznick, 1998).[12] Subsequently, EDA has experimented with a few of these credit enhancement grants for military base reuse. However, the agency has not chosen to use federal funds for credit enhancement more broadly. EDA's view has been that the market is so poorly developed and so poorly understood that it is not yet clear how much or what kinds of credit enhancement are needed, or where the federal government has a responsible role to play in credit enhancement. Instead, EDA policy has been to encourage projects that build market experience, both on the part of RLFs and investors. By building such experience, EDA hopes to contribute to the development of a market in which RLFs can obtain the highest prices possible for their portfolios with the most efficient federal support.

CHAPTER 3

SUMMARY OF THE EDA DEMONSTRATION PROJECT

Project Goals and Design

In 1999, EDA initiated a demonstration project designed to build on the experience of others and overcome some of the identified barriers to RLF securitization by supporting a handful of real-world transactions. The specific goals of the project were to

1. increase investor familiarity with RLF portfolios as a new type of investment asset.

2. provide RLF managers information they need to

    - determine if securitization is an appropriate strategy for them;
    - minimize any discount of their loans in the market; and
    - maintain loan underwriting and servicing practices that balance investor and borrower needs.

3. help staff members of government agencies identify policies to promote successful securitization and determine what forms of oversight might be required in such markets.

To maximize the probability that real transactions would actually be completed, EDA had to overcome at least some of the barriers that had previously restricted the use of securitization. The chosen strategy was to provide grants covering participants' transaction costs (staffing, legal and rating agency fees, etc.). This effectively insured participants against any potential breakup costs. Under this approach, if a transaction collapsed, participating RLFs and/or intermediaries would not be harmed financially, because their transaction costs were reimbursed by the government. If, on the other hand, a deal were completed successfully, the share of the proceeds that would normally go to paying the transaction costs would simply flow to the RLF as increased capital for relending. Any transaction proceeds were required to be reloaned in a timely fashion in a manner consistent with the RLF's lending plan.

In May 1999, EDA issued a request for proposals (RFP) that invited organizations to submit descriptions of potential transactions they would pursue if funded. The RFP did not specify any preferred securitization approach. Nor did it require buyers and sellers to be identified in advance. However, proposers were required to:

- ensure there would be a good faith effort to complete the proposed transaction;
- describe projects that could reasonably be expected to be replicable by others;
- include a plan to guarantee competitive pricing (as part of this, there was a prohibition against using federal funds for loan guarantees or other credit enhancements designed to influence market prices);
- describe anticipated impacts on participating RLFs; and
- describe how any proceeds of the transaction would be used, ensuring that these uses would be consistent with the lending plans of participating RLFs.

Additionally, participants were required to:

- demonstrate that participating RLFs actually needed recapitalization;
- include EDA RLFs in the project (although other RLFs could participate as well);
- work with EDA to gather information needed to describe lessons learned from their experience, including information needed to determine those factors that influence the discount on loans sold; and
- perform post-transaction monitoring to determine if securitization influenced future lending and/or servicing practices.

The Participants

By late July, EDA selected four grantees from an initial pool of thirteen applicants. Final awards were made in late September. The selected participants had a wide breadth of experience, with each using a different method of securitization. In one case, the grantee was an RLF; in the other cases, the grantee was an intermediary. The grantees also tended to operate at differing geographic scales, and in different parts of the country. The following are brief descriptions of each grantee and its proposed securitization strategy:

Racine County Economic Development Corporation (RCEDC): RCEDC is a county-wide economic development agency operating an EDA-funded RLF in Racine, Wisconsin. The grantee proposed a relatively simple transaction which used its loans as collateral to back a letter of credit from local banks.

South Dakota Rural Enterprise, Inc. (SDREI): SDREI is a private nonprofit organization that makes low-interest loans to local RLFs to capitalize their loan funds. SDREI proposed to pool

loans from RLFs around the state and market them to investors nationally. Part of the project was to include a study to determine which among several alternative securitization strategies would be most appropriate for the state's RLFs.

Community Reinvestment Fund, Inc. (CRF): CRF is a nonprofit organization located in Minneapolis, Minnesota. CRF has been buying and selling community development loans in secondary markets for many years, but had not previously purchased loans from EDA RLFs. CRF proposed to buy loans from EDA RLFs nationally and use them to back bond sales. In the past, most of CRF's bond sales have been to institutional investors. CRF uses foundation funding to buy loans and warehouse them until its bonds can be sold.

Commonwealth Development Associates (CDA): CDA is a private for-profit firm based in Harvey Cedars, NJ. Like CRF, CDA proposed to pool loans from RLFs around the country and use them to back securities marketed to institutional investors nationally. However, CDA's proposal differed in several key respects. First, it does not warehouse loans while waiting for notes or bonds to be issued. Instead, it has helped RLFs to obtain necessary authorization to sell their loans in advance of an actual sale. Second, CDA intends to obtain an investment grade rating for its securities. The purpose of obtaining a rating is to make the CDA securities attractive to a much larger set of investors, many of which are constrained by regulations or internal rules regarding the types of securities they can invest in. CDA has partnered with the National Association of Development Organizations (NADO). NADO's role has been to act as a facilitator and help CDA provide outreach to the RLF community.

Once each project began, EDA continued to have contact with the grantees at several key points. For the two national intermediaries, EDA served as a liaison to the RLF community, providing CRF and CDA with a list of RLFs they could solicit for loans. EDA also published a brochure describing the demonstration project and identifying each of the grantees. While EDA offered no official endorsement of the various organizations, the fact that they received EDA grants to participate in the pilot project provided RLFs interested in securitization some comfort that the intermediaries had some familiarity with their mission. EDA also invited each grantee to make presentations at regional and other EDA-sponsored conferences. This encouraged open competition among the intermediaries seeking to buy loans, and helped RLFs to obtain better prices for their loans. Once an intermediary negotiated a tentative deal with an RLF, EDA's approval of sale of the loans, and in most cases, subordination of the government's interest in those loans, in accordance with EDA's regulations, was required.

A Summary of the Results to Date

Under the original terms of their grants, it was anticipated that grantees would complete their securitization transactions in approximately eight months.[13] None of the grantees were able to meet this deadline. In most instances, this was because they had difficulties enticing RLFs to participate. As this report was completed, after approximately 20 months, three projects (Racine County, South Dakota, and CRF) had structured and closed a transaction. In the South Dakota

case, the hesitancy of RLFs to participate forced a significant change in strategy—abandoning traditional securitization in favor of an innovative borrowing approach that made use of incentives offered under the Community Reinvestment Act. CDA has acquired tentative commitments to sell approximately $5.6 million in loans. However, the number of loans involved is not yet large enough to obtain a rating at a favorable price.

As of May 2001, the demonstration project had allowed 6 RLFs to raise approximately $3.7 million for new lending. Deals worth an additional $8.7 million had been approved and were expected to close soon, involving 8 more RLFs. Although they do not have firm

Table 3.1
Status of Transactions and Capital Raised

	Racine County	South Dakota Rural Enterprise	Community Reinvestment Fund	Commonwealth Development Associates	Total
Completed transactions	$700,000	$1.8 million	$1.2 million		$3.7 million
No. of RLFs	2	1	3		6
No. of loans	25	na	27		52
Total discount	8.0% [a]		7.0%		
Pending transactions	na		$3.1 million	$5.6 million	$8.7 million
No. of RLFs	na		6	2	8
No. of loans	na		63	34	97
Discount			8.4%	3.0%	
Reasonably anticipated	na	$8.3 million		unknown, but ongoing purchases anticipated	

[a] Discount calculated on loans as priced. RCEDC final transaction details were largely unrelated to the portfolio value. Not all the loans priced were used as collateral.

Completed: Transaction structure finalized and final dollar values agreed to; paperwork may not be completed. **Pending**: Transaction agreed to by all parties and structure settled, but final dollar values or approvals may be pending. **Reasonably Anticipated**: Transaction with high probability of completion in negotiation but somewhat speculative; dollar values estimates only.

commitments in place, SDREI expects to raise an additional $8.25 million in equity equivalent investments. CRF is continuing to buy EDA loans, and further direct lending benefits will accrue if CDA's transaction is completed. Using even the most conservative assumptions, the $900,000 spent on the demonstration appears to have leveraged several times that amount in new private capital for economic development. A large number of loans have been priced for market, even though some of them were not securitized. This has allowed the project participants to generate a significant amount of data about what affects loan pricing, procedures and documentation required, etc. Even in cases where the securitization has not proceeded exactly as planned (i.e., SDREI and CDA), a great deal has been learned and there may be very significant amounts of capital raised.

Based on the knowledge we have now, it appears the worst fears that RLFs had about securitization will not materialize. In the vast majority of cases where loans have been priced as part of a transaction, associated discounts have been modest—usually under 10%. In every case where an RLF wished to retain servicing of their loans, they have been allowed to do so. While there is a longer-term trend for RLFs to move more toward market rate lending, there is no strong evidence so far that their securitization experience has led RLFs to change their lending or servicing practices.

Perhaps more importantly, a great deal has been learned in the demonstration project regarding

- how RLFs should evaluate securitization opportunities;
- actions RLFs can take to reduce discounts;
- opportunities to reduce discounts by clever structuring of the transaction;
- factors that determine the willingness of RLFs to market their loans; and
- actions federal agencies can take to avoid interfering with the market and to promote RLF securitization.

Let us now consider those lessons more closely.

CHAPTER 4

LESSONS FOR RLFS ABOUT SELLING OR PLEDGING LOANS

To Securitize Loans or Not?

The decision of whether or not to securitize a portfolio can be complex. Securitization is not appropriate for all RLF portfolios, and RLF managers with seemingly identical portfolios may come to very different conclusions depending on their particular needs. However, experience gained in the demonstration project suggests that RLF managers do not require specialized financial backgrounds to make these decisions responsibly—provided they are given adequate information to understand their options fully (Blumfield, 2001; Reznick 2001).

Reasons to Securitize

Securitization is first and foremost a means for making the relatively fixed assets of a loan portfolio more liquid. The most obvious form of liquidity provided by securitization is the cash raised for new lending. Even with a significant discount, securitization typically increases lending capability of an RLF significantly in the short-term. This can be especially valuable where an RLF has a strategic opportunity that will be lost if it must wait for existing loans to be repaid before making new ones. Of course, there are other ways that liquidity can benefit an RLF as well. By allowing lenders to clear old loans from their books, securitization can allow RLFs to alter the composition of their lending portfolio. This can be valuable to an RLF that wishes to diversify its portfolio, increase its cash reserves, redirect lending to new areas or specific types of borrowers, or change the terms of its lending. One RLF participating in the demonstration project used securitization to clear low-interest loans from its books, allowing it to earn increased operating revenue when it reloaned its money at higher rates.

Reasons to Avoid Securitization

In the demonstration project, many RLFs indicated they were not interested in securitization because they had no need to make new loans. On the surface this may seem difficult to understand, since most distressed areas have unmet demand for additional economic development lending. However, there are many legitimate reasons why an RLF may choose not to make additional loans:

- There may not be a ready population of high-quality projects to fund. This is especially true in rural areas and small markets where quality projects may not be available at all times. It may also be true where local capacity to undertake projects is weak, where there is a shortage of local workers with the specific skills

needed for the project, or where infrastructure is substandard. In short, the area may not be "development ready."

- RLFs may lack the management and/or staff to monitor a larger portfolio of loans.

- An RLF may need to reevaluate its strategic goals and approach before making new loans.

Despite these important exceptions, we believe that most RLF managers can use occasional infusions of new capital. Indeed, the vast majority of RLFs participating in the demonstration project indicated that they needed funding immediately to make new loans. Still, even where there is high demand for lending, securitization may not be the best means for suppling the necessary capital. Most importantly, private bankers may be able to meet the demand for local development capital. Typically, RLFs have arisen in direct response to ongoing failure by private markets to provide nontraditional borrowers with capital at an affordable price. However, this changed somewhat in the boom economy of the late 1990s, as large infusions of capital into the U.S. banking system made it easier for many nontraditional borrowers to obtain capital from private sources. Even if private capital is not available, RLFs may have access to low-cost funding from foundations or other granting organizations, which also see their contributions increase in good economic times. There have also been public policies, such as the Community Reinvestment Act, that give private banks greater incentives to lend in distressed communities. Still, supply conditions can change quickly and dramatically. Of course, as the boom economy cools, we should expect increasing demand for RLF loans as private capital is less forthcoming.

Another reason why RLFs might avoid securitization is that it can deprive them of income streams that are crucial to their everyday operations.[14] In principle, an RLF can replenish this revenue by immediately relending the capital it receives upon the sale of its loans. In practice, however, this may not be possible. To offset this lost income, some experts have advocated that RLFs increase interest rates and charge higher fees for originating and servicing loans. These are possibilities, although they may conflict with RLFs' efforts to keep costs down for their borrowers. Also, many fees are one-time charges that do little to supplement ongoing revenues. In general, the RLF managers we interviewed that had experience with securitization did not describe origination and servicing fees as an important source of revenue for their organizations.

Still another reason why an RLF may choose not to securitize its portfolio is to avoid federal regulations. When an EDA loan is sold, any new loans made from the revenue raised must be made in accordance with EDA regulations. We heard of at least one case in the demonstration project where an RLF chose not to securitize for this reason. The particular RLF had been funded as a response to the 1994 Northridge earthquake in Southern California, so new loans had to be made for disaster-related purposes. Despite ongoing need for economic development in the area, the RLF could not find enough applicants meeting the disaster criteria.

In another case, an RLF chose not to sell its loans because it feared that raising cash by securitization would make it appear too wealthy and hurt the organization's chances of receiving future grants. In yet another instance, an RLF stated that it was afraid to open its books to outsiders. Evidently, some of its earlier loans had been poorly documented. Again, it feared this could jeopardize its ability to obtain subsequent grants.

The Role of Discounts

In the past, and in this demonstration project, many RLFs have avoided securitization because they fear deep discounts that may be imposed at the time of sale. The discount in a securitization is simply the difference between the balance due on a loan or portfolio and the market price that private investors are willing to pay. Later in this chapter, we will describe how the discount is calculated. For now, we are concerned with identifying *how and when a discount should affect the decision to securitize or not to securitize.* There are two main reasons why investors may be unwilling to pay full price for loans or loan-backed securities they purchase:

- the underlying loans may be made at below-market interest rates. When investors buy a loan, or a security backed by a loan, they are essentially buying the income stream from repayment of the loan. The income received depends both on the interest rate and the length of repayment (as well as any balloon payments). If the interest rate on the loan is below what investors could earn on another investment of comparable term (e.g., a Treasury note of comparable maturity), they will not be willing to pay as much for the loan; and

- the investments may be risky because the loans are made to weak businesses, there are federal regulations on the loans, or market conditions could change. In such cases, investors will lower the price they are willing to pay in order to compensate for the likelihood their return will be lower.

Obviously, the deeper the discount, the less capital the RLF will receive to make new loans. If an RLF takes a deep discount on a sale, then relends its cash at below-market interest rates, the RLF can experience significant erosion of its capital over the longer run. However, the presence of a discount, by itself, may not be a good reason to avoid securitization. Consider the case of an RLF that charges below-market interest rates on its loans. Clearly, when the loans are repaid, the RLF will have less capital available to relend than if it had made its original loans at the market rate. This loss occurs whether the loans are subsequently sold or not. We can measure the size of this loss today by calculating the present value of the portfolio assuming the loans had been made at market rates and comparing it to the present value of the portfolio with loans made at the subsidized rate. All else being equal, this difference is precisely the discount that would be imposed by an investor at the time of sale. *In this case—where the discount is driven solely by the fact that the RLF makes low-interest loans—the discount simply represents the present value of a loss that would have been incurred anyway.* Stated another way, *if the*

RLF took its cash and reinvested it at market rates, it would have the same amount of capital available when the loans are repaid as it would if it had never securitized its portfolio. The real loss occurs because the loans are made at below-market rates—and that loss is often compounded when an RLF securitizes its portfolio, then continues to relend the new cash at below-market rates.

Lending to risky borrowers and at below-market rates are policy choices that RLF managers make. These policies have costs. The discount simply makes the cost of those policies more visible. There is no reason to avoid securitization simply because there is a discount imposed if those costs are being incurred anyway as a matter of policy. The real question is whether those policy choices are necessary to support the economic development mission of the RLF. Lending to risky borrowers is almost certainly a critical part of that mission. It has yet to be shown that lending at below-market rates is as important.

Other components of the discount are less policy-driven. If an RLF's portfolio is discounted because it is mistakenly perceived to be more risky than it really is, then the RLF will suffer a larger discount than it should—a greater loss than if it simply held the loans. So, if an RLF's portfolio is being discounted because the RLF keeps sloppy loan records or because investors are unfamiliar with RLF lending, the RLF manager should think twice before selling loans.

Evidence on Discounts from the Demonstration Project

Just how large is a typical discount? As part of the demonstration project, we examined the discounts imposed on 115 different loans from 9 different RLFs. 90 of the loans were priced by one organization and 25 by another. Not all of these loans were ultimately sold or pledged, but all went through a formal market valuation. Across the entire sample, the total outstanding balance on the loans priced was $6.4 million.[15] The market value of the loans was $5.8 million. This represents a gross discount of 9.6%. In fact, this figure is somewhat inflated, because there were a few large loans that received very large discounts (one loan was discounted by 62%). Given the skewed nature of the distribution, a more representative measure is to look at the median. This is the loan in the middle of the range—where half the loans have higher discounts and half have lower ones. For our sample, the median discount was just 6.3%. Fully two-thirds of the loans that were priced received discounts less than 10%, and several loans were actually priced above par. CDA, while it has not actually purchased any loans, estimates that at current interest rates, it will achieve a net discount of approximately 3%.

Clearly, one reason for the low discounts experienced was the fact that interest rates in the broader markets were at historically low levels. Were interest rates to increase, investors would demand higher returns and RLFs making loans at low interest rates would suffer a greater discount.

It is also likely that part of the reason for this small discount is that RLFs tended to engage in "creaming" or "cherry picking" whereby they included only their best loans. It may also be that the RLFs participating were those that tend to make loans at or near market rates. Whatever the reason, the median interest rate on loans included was somewhat higher than we might expect to find for RLFs overall—with a median around 7.5% (about 2 percentage points

Table 4.1

Eligibility Guidelines for RLFs Suggested by Intermediaries

	Commonwealth Development Associates	Community Reinvestment Fund
Minimum loan balance	$10,000	$10,000
Remaining term of loan	less than 15 years	less than 10 years
Seasoning	1 year minimum	1 year minimum
Interest rate type	fixed only	fixed only
Balloon payments	allowed	allowed
Subordinated payment position	secondary and tertiary position allowed (collateral dependent)	secondary position allowed
Borrower tenure	in business at least 2 years	tenure not specified. loans seasoned 1 year
Collateral	1st or 2nd lien on commercial real estate, machinery, personal real estate, personal guarantees	personal guarantees collateral coverage of 1:1
Debt service/ delinquencies	no more than four 30-day or 2 60-day delinquencies in past 24 months	debt service coverage of 1:1 payments current since origination of loan
Leverage ration (debt to worth)	N/A	not to exceed
Taxes and Insurance	current	current

N/A - not applicable

below prime at the time the loans were priced).[16] The loans included also had a relatively short term remaining—with a median of 5 years.

Loan Eligibility

In principle, almost any kind of loan can be securitized if the owner of the loan is willing to accept a large enough discount. During the savings and loan crisis, the RTC was able to securitize loans that few people thought had any value whatsoever. In practice, however, the vast majority of investors favor loans that are less risky than this. Table 4.1 shows the suggested standards for loans invited by CRF and CDA to participate in the demonstration project. These are not strict standards. In fact, both organizations accepted loans that failed to meet one or more of the criteria listed. However, the table does show the types of loans that each organization targeted. Both organizations had very similar views regarding the types of loans they wanted, and what they thought RLFs might provide.

Preparing a Portfolio for Securitization

Once an RLF has determined that securitization is a viable option, the RLF analysts need to inspect their portfolio records to prepare for due diligence proceedings. Incomplete or poorly maintained loan documents can result in a larger discount, may increase transactions costs, and can slow a transaction. Most potential buyers of RLF portfolios will require very similar documentation. Common records critical for due diligence are described in Table 4.2.

Identifying Potential Investors

For RLFs trying to use their loan assets to raise capital, it is the investor that ultimately determines the value of their portfolios and the conditions imposed on any transaction. The universe of potential investors varies tremendously with the capitalization approach taken. For a collateralized borrowing, lenders will typically include local banks and foundations. In cases where securities are issued, RLFs will often sell or pledge their loans through an intermediary, but the ultimate market will be investors interested in the loans as a payment stream. Below, we consider some of the primary investors of importance to RLFs, as well as their concerns, tolerance for risk, and investment capacity.

Table 4.2

Documents Required for Due Diligence

Information Required (applies to each loan included in transaction unless stated otherwise)	CDA	CRF
Basic borrower information: contact information, purpose of the business, legal structure of the borrower, etc.	✓	✓
Loan origination and closing documents: loan agreement, repayment schedule, warranties, purpose of the loan, evidence of fee payments, checklist for servicing system, etc.	✓	✓
All recorded mortgages, notes, liens, deeds of trust, pledge agreements, security agreements, etc, endorsed by seller where applicable	✓	✓
Record of payment history: including original and outstanding balance; term/maturity; history of delinquencies, writeoffs, & debt restructuring	✓	✓
Evidence of title insurance and insurance on collateral, with annual certifications	✓	✓
Description of statutory/regulatory issues imposed by RLF funders, as well as any history of compliance problems or issues	✓	✓
Attorney letter verifying the adequacy of loan documents	✓	✓
Borrowers' current financial statements	✓	3 yrs.
UCC-11 search documents to perfect security interest of the seller	✓	✓
Financial statements of the RLF	✓	
Portfolio summary for the RLF, describing the balances, delinquency history, foreclosures/writeoff history, etc, of all loans in the portfolio (not just those loans being sold).	✓	✓

Banks

Local banks are an obvious source of capital for RLFs. Lending is their business, and they tend to have a vested interest in local economic performance. Consequently, local bankers are usually sympathetic to what economic developers are trying to achieve. Indeed, it is extremely common for bankers to be represented on the governing boards of RLFs in the communities they serve. In the Racine County case, and in the New Jersey Economic Development Authority case described in Chapter 2, economic development agencies successfully used their loan portfolios as collateral to establish credit with local banks.

Banks are also subject to CRA. Under CRA, federal banking regulators are required to examine a bank's record of meeting the credit needs of its community and consider this record when considering applications by the bank to merge, acquire other operations, relocate, etc. With the banking industry's wave of mergers and acquisitions over the past decade, a handful of banks have made large economic and community development investments explicitly to earn CRA credit. Banks investing for CRA credit bring tremendous resources to the market for RLF-backed securities, and may be willing to accept higher credit risk than other institutional investors. Interestingly, in the Racine County case, one local bank actually withdrew its participation in RCEDC's collateralized borrowing shortly after it was acquired by a larger operation. This suggests that CRA credit may not be enough to offset the loss of local control over lending decisions that often accompanies merger activity. In the South Dakota case, SDREI was able to use a financial instrument known as an "equity equivalent investment" to obtain very low-cost capital in return for exceptionally favorable CRA treatment for investors.

Institutional Investors

Institutional investors include banks, insurance companies, universities, mutual funds, pension funds, and other organizations that routinely reinvest deposits for profit. This segment of the market accounts for the overwhelming majority of demand for mortgage and other asset-backed securities. It also represents a huge potential market for RLF loan-backed securities. Institutional investors are investing other people's money and have fiduciary responsibilities to protect those deposits. As a result, they are typically conservative, placing a high priority on preservation of capital, liquidity, and income stability. Reznick (1998) points out that many of these investors prefer securities with maturities less than ten years.

In the course of the demonstration project, it became clear that there are different categories of institutional investors, and that even the financial experts involved in securitization may disagree on precisely what an institutional investor is. Some experts insist that institutional investors are those institutions and organizations that will only purchase highly rated securities in order to minimize risk. These institutional investors also typically favor relatively large investments in highly standardized assets that allow them reduce transaction costs to help offset the relatively low rates of return characteristic of their conservative investments. Other experts suggest that institutional investors may include banks seeking CRA credit, as well as pension

funds and other for-profit investors that do not necessarily seek the highest level of return when their investments support some important public purpose, such as economic development.

We know of no case to date in which economic development loans have been used to back a rated security. This is primarily because obtaining a rating at a reasonable cost still requires that a relatively large number of loans be included in the transaction, so that the rating agencies can perform reliable statistical analyses necessary to rate the securities. In the demonstration project, only CDA proposed to obtain a rating. CRF considered obtaining a rating for its securities, but determined this was not cost effective for the size of transaction it intended to undertake.

Private Individuals

Individual investors are a diverse group. Some individual investors seek higher rates of return and are less risk-averse than typical institutional investors. These individuals represent a major source of demand for below investment grade ("junk") bonds that are relatively risky but pay high yields. A markedly different, and growing, group of individual investors have targeted "socially responsible" investments such as environmentally sensitive or labor-friendly companies, and investments in community and economic development. Often, these investors are willing to accept lower rates of return in order to support their chosen causes.[17] Overall, individual investors almost always engage in smaller transactions than their institutional counterparts. Unfortunately, attracting large numbers of private individuals into this market may require that securities be marketed through public offerings. In past securitizations, including the transactions proposed and undertaken in this demonstration project, securities have not been sold in this fashion because it entails much more oversight by the Securities and Exchange Commission.

Foundations and Charitable Institutions

Led by large foundations such as Ford, McArthur, Casey, and Mott, a growing number of charitable institutions have sought to stretch their available funds by making "program-related investments" (PRIs). Initially structured as loans or loan guarantees to organizations, PRIs have taken on new sophistication in recent years, including investment in asset-backed securities. As a result, the line between PRI, and institutional investing has become blurred. As investors, charitable institutions may be willing to accept higher levels of risk and/or lower returns than institutional investors in order to promote the causes they are supporting (Baxter, 1999). Relative to the scale of investment possible from profit-maximizing investors, foundations represent a tiny part of the market. However, they have become very proficient at leveraging their limited dollars. In the case of CRF, for instance, foundation investors not only buy the loan-backed securities that CRF issues; they also provide CRF with working capital to warehouse loans while the organization acquires loans and seeks out buyers. In some instances, foundations and charitable institutions may be able to make investments that are large enough to "tip the scale" and make a transaction possible that was not feasible without their intervention.

How Your Portfolio is Valued

Before an RLF can pledge or sell its loans, it must have each loan assigned a market value. In this demonstration project, all RLF loans were valued using very similar methods. To an investor, a loan's value lies in the future stream of payments it generates. However, when a loan is traded or pledged, we must express the value of that future payment stream in today's dollars. The standard method for making such valuations is to calculate the "present value" of the payment stream. This is familiar language to many readers, but for those who do not have an intuitive feel for what it means, let me explain it briefly. The present value of a future payment is simply the amount of cash held today that is required to generate a given payment in the future at some assumed interest rate. Thus, for instance, if current interest rates are 8% annually, and you are guaranteed a payment of $108 a year from now, the present value of that investment is $100. However, if interest rates were to rise to, say 10%, the present value of that $108 would decline to $98. Why is this? Because you could generate the same payment with just $98 invested over the same period at the higher rate. Imagine someone was buying the right to that future payment from you. They would not pay $100 when they could generate the same payment themselves simply by investing $98 of their own money at current rates. Stated in terms of a loan portfolio, if your money is locked into 8% loans and interest rates subsequently rose, your portfolio would be worth less because a potential buyer could earn the same return with a smaller investment. To compensate the buyer for that loss, the portfolio would normally receive a 2% discount on the sale.

Present value calculations are easily done with any standard spreadsheet program. We simply need to know the cash flow from each loan at each period in the future. The interest rate assumed is equal to the current rate of return that investors could earn on their investment. This is referred to as the "discount rate" and is not to be confused with the "discount" imposed on the portfolio. In our example, the discount imposed on the loan was 2% when the discount rate was 10%. Likewise, a present value calculation will always involve a discount rate, but it may not involve a discount. Consider a portfolio where all loans are made at market interest rates. If we ignore transaction costs and risk for the moment, this portfolio would have a discount rate set equal to the current rate of return on capital, but it would have zero discount (because the investor could not earn more by reinvesting his/her cash elsewhere). It is important to note that, in cases where the loans in a portfolio are made at interest rates above current market rates, RLFs may be able to sell their loans at a premium above their face value.

Factors Affecting the Discount Rate

The discount rate is critical, because it determines the price of the loan. Typically, the discount rate is initially set equal to the current yield on Treasury notes with a comparable maturity date. Thus, if the loan to be sold matures in 5 years and has a single payment due at maturity, the analysts will compare it to a 5-year Treasury note. It does not matter whether it is a new 5-year loan or a 10-year loan that has been seasoned for 5 years. The Treasury yield is the largest single component of the discount rate. In general, different analysts will use identical

yields to set the basic discount rate for any given portfolio. Bonds with longer maturities usually pay higher yields to compensate investors for the fact that their capital is locked into relatively fixed investments. Similarly, loans with longer maturities will suffer a greater discount to compensate investors for the fact that their money is unavailable to make other investments. In the event that interest rates rise, the investor will miss out on an opportunity to earn a higher rate of return.[18] This is often referred to as "interest rate risk."

There is more to calculating the discount rate, however, than just determining the proper Treasury yield to use. Virtually any analyst will adjust this base Treasury rate by some "spread." The spread is an adjustment (increase) in the discount rate used to compensate for additional risk and uncertainty. Common types of risk considered in pricing a portfolio are summarized in Table 4.3. Because attitudes toward risk vary from one investor to another, different investors may apply different spreads to the same portfolio. The spread is also heavily affected by the discretionary lending policies of an RLF. Finally, the way in which securities to be sold are structured will determine the price demanded by investors, and consequently the price that can be paid to loan sellers. Let us consider some of the specific items that can affect the spread portion of the discount rate.

First and foremost, there is always some adjustment for credit risk—the risk a borrower will default or be delinquent on payments. To achieve their economic development goals, RLFs routinely underwrite loans using risky practices:

- they loan to individuals with poor or nonexistent credit histories;
- they loan to startup businesses;
- they take a subordinate position with respect to repayment and collateral;
- they accept collateral that is hard to value or less reliable than traditional standards;
- they tend to make loans in a restricted geographic area, so any regional recession can affect repayment on the entire portfolio; and [19]
- they make loans that include balloon payments;

The discount rate may also be adjusted for two specific kinds of interest rate risk. The first, known as "prepayment risk" applies when a borrower prepays a loan. In this case, investors lose the future interest generated from the loan. In theory, they can restore this revenue by immediately reinvesting the cash from the payoff. However, if interest rates have fallen since the initial loans were made, investors will be forced to reinvest at a lower rate of return. The problem is compounded by the fact that borrowers are most likely to prepay their loans when

interest rates are low—refinancing their loans at a lower rate. When interest rates are high, borrowers paying lower rates have little incentive to prepay. Consequently, creditors are likely to find themselves with cash on hand when the return on capital is low and vice-versa.

The second form of interest rate risk that applies is found where an intermediary purchases loans in advance of issuing a security—warehousing loans while it assembles a pool and finds buyers. In this case, the buyer of the loans is subject to a loss if interest rates rise,

Table 4.3

Types of Risk Affecting the Discount Rate

Credit Risk	The risk associated with potential delinquency or default on the part of the borrower, or bankruptcy on the part of the securities.
Issuer Risk	The risk to an investor that the issuer of a security will go bankrupt, with the creditors subsequently trying to make claims on the securities.
Interest Rate Risk	The risk associated with changing interest rates. When investors purchase a loan or a bond backed by a loan, their money is unavailable to make other investments. Consequently, if the loans they purchase are made at fixed rates, they risk missing more profitable opportunities if rates increase. This risk may be reflected both in the spread and in the higher rates paid on Treasury notes with longer maturities.
Prepayment Risk	A special kind of interest rate risk. If a borrower pays off a loan early, it denies interest income to the owner of the loan. In principle, the investor could take that cash and reinvest it immediately to compensate for the loss. However, there is a risk that s/he will be forced to invest it at a lower rate, and the investor will almost certainly incur costs associated with the transaction.
Warehouse Risk	Another form of interest rate risk, in which an intermediary bears the risk that interest rates will increase while they are assembling a pool of loans to securitize.
Regulatory Risk	When investors buy loans from government-funded RLFs, those loans are usually subject to a variety of regulations. In the event a borrower fails to comply with those rules, the investor may have to recall the loan early or pay some penalty, etc.

because the value of the portfolio declines. In fact, CRF faced exactly this situation in the demonstration project. It purchased its loans at one price, only to have interest rates subsequently

rise before it could market its security. When CRF did go to sell its security, investors that had not previously agreed to a price were either unwilling to pay the high price CRF expected originally or they expected to earn a higher yield.

Yet another source of risk is government regulation. When government programs capitalize RLFs, they impose regulations on the grantees and the borrowers to ensure that public funds are used in a fashion consistent with the sponsoring program. These rules can raise risks and costs to investors. For instance, if a borrower breaks a regulation and the federal government requires the purchaser to recall that loan, there will be transaction costs and potential interest losses associated with that action. From the investor's viewpoint, recall of a loan has the same effect as a default. Other government policies may make it more difficult to foreclose on troubled borrowers. In each case, if investors believe that these regulations threaten the integrity of the portfolio's revenue stream, this will be reflected in the spread. Particular regulations of importance to federally funded RLFs are described more fully in Chapter 6.

The spread above Treasury yields can also reflect uncertainty on the part of investors. In cases in which investors cannot completely assess the risk associated with making a particular investment, their normal inclination is to be conservative and discount its value. In present value calculations, this conservative behavior is equivalent to increasing the discount rate by some amount to overcompensate for risk. Unfortunately, the vast majority of institutional investors are largely unfamiliar with RLF loans as an asset class. They are not familiar with the types of lending undertaken by RLFs, or the performance characteristics of those loans or the securities backed by them. Furthermore, there are no standardized, known, and accepted tracking systems in place to help investors evaluate the credit worthiness of RLF loans. This uncertainty is increased by the fact that some RLFs have poorly maintained records. In general, investors and intermediaries will not buy loans where records are incomplete.

Once the spread is calculated, a final contributor to the discount rate is transaction costs. In some cases, transaction costs are compensated through fees; in other cases they affect the discount. Transaction costs can include such things as legal and consultant's fees, filing fees, salaries and overhead devoted to assembling loans, and due diligence. Many transactions costs are relatively fixed, in that they do not vary much with the size of the transaction. As a result, the contribution of transaction fees to the discount is likely to be much less for large transactions than for small ones. In all the demonstration cases, EDA partially subsidized the transaction costs through the grant. Some increase in the discount should be expected in future transactions unless compensated for by lower interest rates, other cost savings, or risk reduction. None of the grantees have provided accounting that is detailed enough to identify all their transaction costs. RCEDC faced legal fees above $30,000 for its relatively small collateralized borrowing. On the other hand, CRF estimated that removal of the EDA subsidy on future transactions would be likely to add less than 50 basis points (one-half of one percent) to the total discount imposed on any portfolio.

Most of the information we have provided on the discount rate, and on the spread in particular, is highly theoretical. We know these things can and do affect discounts, but how did the numbers actually play out in the demonstration project? We do not really know. The CRF transaction, which accounted for the vast majority of all loan valuations considered, used a single spread figure of 2.5% used for every loan. Consequently, differences in risk among individual loans did not affect the discount. By design, the only real variation in discount rates resulted from the interest rates charged on the loans and the term of the loans remaining when they were sold. Although CRF used a fixed spread in the demonstration project, its normal policy is to adjust the discount for credit risk in loans greater than $50,000. Based on its due diligence investigation, CRF rates each loan based on the following criteria:

- liquidity ratio (assets/liabilities);
- duration of positive cash flow;
- debt service coverage ratio (monthly cash flow/debt service);
- degree of collateral coverage (collateral/outstanding debt);
- credit and payment history; and
- the presence of any government guarantees.

The Use of Pricing Models and Credit Scoring

In secondary markets for residential mortgages and other highly standardized assets, transaction costs associated with pricing loans for sale have been greatly reduced by use of specialized pricing models and credit scoring. These statistically-based models allow analysts to calculate a price or assign a risk rating to a loan quickly using a few key pieces of information about the borrower. This alleviates the need for a great deal of labor-intensive investigation of individual loan files. SBA uses credit scoring in its loan program. As investors have gained experience and trust in these models, it has become a marketing advantage to have a portfolio priced with them. CDA uses a small business model developed by Fair-Isaac & Company.

There are several possible drawbacks with credit scoring and related techniques. It is difficult to know just how serious these are in any given case. Nonetheless, in relatively small markets with highly varied underwriting practices, borrowers, and collateral, it may be difficult to draw valid statistical conclusions based on the data available. Also, in markets where there is rapid structural or technological change, it may not be statistically valid to draw conclusions about the future based on past trends. Finally, these models tend to be proprietary and closely guarded by their developers. This makes them something of a “black box,” that is not open to

scientific scrutiny. Indeed, in March 2000, Fannie Mae announced it would stop using the Fair-Isaac model precisely because the model's structure and methods are not public.

Beyond Pricing

For RLFs trying to raise capital for new lending, the price they receive for their loans is obviously a critical consideration. However, it is not the only issue that RLFs selling or pledging their loans need to consider beforehand. Even if there is no security sale anticipated, the RLF's management still needs to consider issues such as whether the cash raised will be available when needed, how loan servicing will be conducted, and whether there are continuing legal obligations imposed on the borrowers. In the case where an RLF's loans will ultimately be used to back a security sale, the issues are even more complex. All of these issues have the potential to affect the price an RLF receives for its loans.

Market Intermediaries

As economic development finance has become more sophisticated, a growing diversity of financial intermediaries has become increasingly important to RLFs. Initially, this consisted mainly of nonprofit groups and foundations that funded local loan funds using grants. More recently, intermediaries have become significant buyers of economic development loans. In fact, it is probably safe to say that an RLF wishing to securitize its portfolio today is most likely to do so by selling or pledging its loans to an intermediary. CDA, CRF and SDREI all began the demonstration project intending to serve as intermediaries that would buy loans from RLFs and remarket them. SDREI changed its mind because RLFs in South Dakota were not willing to sell loans. CRF was successful at buying RLF loans and using them to back securities, and is continuing to buy loans after the project. CDA has not yet closed its transaction, but is continuing to pool loans toward the ultimate goal of issuing a security with an investment grade rating.

To date, intermediaries have tended to act something like general contractors, performing a wide variety of jobs and bringing in outside expertise as needed. As markets become more developed, it is likely these intermediaries will become more specialized in different parts of the securitization process. For the present discussion, we will act as if there is a single intermediary for a transaction. Roles commonly filled by intermediaries include the following:

- Serving as pool assemblers ("conduits"). Given the small portfolio size of most RLFs, pooling of loans is critical to helping RLFs obtain the best possible price for their loans. Pooling can increase geographic and sectoral diversity in the loan pool, helping to protect downstream investors from losses due to an economic downturn in any single region or industry. Pooling can also help ensure that loans in the pool have a variety of maturity dates. Finally, pooling helps RLFs to spread fixed transaction costs over a larger base. In some cases, such as with CRF, an intermediary with sufficiently deep pockets can buy loans as they become

available, warehousing them until enough loans are acquired to structure a security sale.

- Providing RLFs with financial market expertise that their own staff may lack. Intermediaries can help the RLF work with investment bankers to develop marketing strategies, identify potential investors, and organize and prepare their portfolio for resale. Where the loans will ultimately be used to back a security sale, intermediaries can help to structure the securities in a way that provides RLFs the best return on their loans. Intermediaries may also help to prepare offering statements and obtain credit ratings for the portfolio being securitized.

- Setting up the trust used to distribute revenues to bondholders. Usually a commercial bank will serve as trustee.

- Serving as master servicer to ensure that payments are collected and distributed to investors in a timely fashion.

RLF operators need to remember that an intermediary is just that—a middleman—it is the downstream buyers that ultimately determine the price paid an RLF for its loans and the conditions imposed on sale.

"Warehousing" vs. "Forward Commitment"

One of the major differences between CRF's approach and CDA's proposed approach is the timing of their transactions. CRF operates by buying loans and then "warehousing" them until it can pool enough loans to issue new notes. RLFs are immediately paid for their loans. CRF uses lines of credit from banks and credit reserves from foundations to acquire the loans. These are repaid from the proceeds of the securities sale. In contrast, CDA does not actually transfer the loans until the security is ready to sell. Originally, CDA had intended to use forward commitments that would require RLFs to commit to sell their loans at some future date under agreed conditions. As the project evolved, the forward commitment was dropped. Now CDA works with RLFs to obtain advance authorization from government funders, the RLF's Board of Directors, and any other necessary signatories.

Aside from the issue of when the RLF receives its cash, the main difference between these approaches is who bears the risk of changing interest rates between the time a deal is agreed to and when an investor is found. In a period of rising interest rates, a pool assembler that warehouses loans will typically bear the cost of declining portfolio values caused by interest rate hikes. In the case of a forward commitment, such as that used by CDA, the cost of this interest rate change would be borne by the RLF when it sold its loans. Conversely, if there were a decrease in rates, the RLF selling to a warehouse would earn less than if it had sold by forward commitment.

On the surface, this suggests that, in a period of increasing rates, RLFs should seek out intermediaries that use warehousing, and vice-versa in periods of falling rates. In reality, the case is far more complicated and makes such "gaming" of the system highly problematic. First of all, any intermediary that uses warehousing is likely to build this interest rate risk into its spread when it prices the RLF loans it is buying. Second, there are likely to be transaction costs associated with warehousing loans. We might expect that, all else being equal, the intermediary buying loans at the time the security is issued would be able to pay a higher price for the RLF loans it buys. On the other hand, RLFs presumably are undertaking securitization because they need to make loans immediately, so waiting to receive their cash may entail a significant opportunity cost. Furthermore, risk-averse RLFs may prefer to use warehousing because interest rates are hard to predict. Overall, the differences in prices paid to RLFs by intermediaries are likely to be caused by many things—of which the timing of their transaction is only one small part. In general, interest rate risk will increase with the time required to complete the transaction.

Ratings

To date, no security backed by RLF loans has received an investment grade rating. CDA has tried to obtain one, but thus far has been unable to pool the number of loans required to do so at reasonable cost. As the market becomes more developed, the volume of loan sales should increase to the point where obtaining a rating is cost-effective. Because ratings are familiar to and trusted by investors, they can vastly expand the market for any security—particularly those securities that can be designated as investment grade. For this reason alone, it is important to understand what it really means to obtain a rating.

Rating agencies provide information to investors to help them determine the likelihood they will be paid principal and interest in a timely fashion, as described in the security offering. The resulting ratings are critical for setting the prices received by sellers and the yields that must be paid to investors for different bond offerings. Rating agencies are typically paid by the issuer of the bond. By having the rating completed up front, investors do not need to research the credit quality of the individual loans used to back the security. All they need to know are the standards for each credit rating category and the payment characteristics of the bond. To obtain an investment grade rating required by most institutional investors, a security must demonstrate a very high probability of being repaid fully and in a timely fashion even under the harshest economic conditions.

In rating a security, the rating agency looks at the historical performance of the pool from which the loan is taken, and the characteristics of individual loans (age, type of loan, etc.) that may affect their repayment. The agency also considers the underwriting practices of the originator and loan servicing characteristics. To obtain a high investment grade rating, timely repayment must be essentially guaranteed, even during the most severe recession. Geographic diversity of the loan pool is considered to determine if repayment is contingent on strong economic performance in any single area. As an example, in rating mortgage-backed securities, Fitch Investment estimates hypothetical losses based on a recession comparable to the Texas real

estate crash of the 1980s (Baron, 1998). If the pool is geographically isolated, economic forecasts for the region during the repayment period may be germane. The rating agency estimates the maximum loss possible to the investor in the event of such a worst-case scenario, and requires the issuer to provide protection for the investor in the form of insurance, a reserve pool, residual and mezzanine securities or other loss protection or credit enhancement. Because most institutional investors are restricted to buying investment-grade securities, a credit rating is central to establishing a robust secondary market for RLFs.

Loan Servicing

In every securitization, it is necessary to decide who will service the loans after they are sold and what standards they will use. Investors generally require very high standards for servicing. Indeed, it is normal to have both a master servicers and backup servicer to ensure seamless payments to investors in the event the master servicer goes bankrupt. Most (but not all) RLFs wish to maintain servicing of their loans so they can protect and work with troubled borrowers. In both the CRF and CDA securitization efforts, RLFs were allowed to retain servicing of their loans by having the master servicer contract servicing back to the RLF. CRF pays the RLF a small fee for servicing. To protect investors, CRF serves as master servicer and retains the right to replace the RLF as servicer if they fail to perform their duties associated with collecting payments, monitoring collateral, etc. CRF also has a specialized Loan Servicing Agreement that spells out the rights and obligations of CRF and the RLF servicer. The proposed CDA approach is very similar, but the master servicer would be chosen by the pool assembler.

In cases where the RLF retains servicing, there are significant issues that need to be agreed upon by the buyer and the RLF. Among others, these include

- a list of loan files to be maintained;
- a description of who collects loan payments and how those payments are to be distributed;
- description of any fees to be collected and/or distributed;
- provisions for inspecting collateral;
- provisions handling delinquencies and defaults, including claims on collateral;
- provisions for handling probate, bankruptcy, etc. of borrowers;
- requirements for monthly, quarterly, or annual reports; and
- provisions for terminating a servicer in the event of nonperformance in collecting and distributing payments, maintaining collateral, etc.

Of course, these are only representative issues to think about and RLFs should obtain qualified legal advice in all such matters.

In some instances, buyers will wish to take over servicing of the loans they purchase, both because they can earn fees for servicing and because it allows them to exercise more control in the event of delinquency or default. Other RLF operators may prefer to let someone else do their servicing. In Chapter 2, for instance, VSBFA did not believe it had adequate staff to service both its existing loans and the new loans it anticipated making after securitization. In cases where servicing is transferred to the investor or buyer of the loans, RLFs may wish to retain the right to substitute another loan into the portfolio in the event a borrower is delinquent or threatened with foreclosure. In this case, it is also advisable to require that the servicer notify the RLF before initiating foreclosure proceedings, so that the RLF has time to substitute a loan before proceedings are started.

Credit Enhancement

Credit enhancement generally refers to any of a variety of interventions to reduce risk to investors below what it would be otherwise. Credit enhancement can be done at many different stages—as early as when a loan is underwritten or as late as when any securities are actually put up for sale. The most common example of credit enhancement is a federal loan guarantee. By guaranteeing repayment in the event that a borrower defaults, the federal government significantly reduces risk to lenders—and to any subsequent purchaser of the loan. Similarly, governments may guarantee bond payments to investors with any of a variety of full faith and credit guarantees or pledges.

In many instances, these options will not be available and the RLF will have to bear some cost of credit enhancement, usually by diverting cash from the proceeds of the transaction or by locking up assets in an illiquid form.[20] Some common types of credit enhancement and their costs are described below:[21]

- Recourse: One of the more common approaches to protect investors against losses is for an RLF to guarantee that it will repurchase or replace any nonperforming loans it has sold or pledged with other loans from its portfolio. Recourse may be either mandatory or voluntary. This also provides the RLF a means to intervene when foreclosure is threatened against a borrower. The main drawback to this approach is that the RLF must retain enough unpledged loans in its portfolio to satisfy investors that they will not be forced to absorb any loss.

- Overcollateralization: Another alternative to large discounts is to overcollateralize any line of credit or bonds sold. In both the New Jersey EDA example and the Racine County borrowing, the RLF was required to pledge its new loans as well as the original portfolio to the bank as collateral for its line of credit. In each

instance, this resulted in collateral worth several times the amount borrowed. As with recourse, the cost to this approach is that the additional loans pledged as collateral cannot subsequently be sold to raise new cash. The exact level of overcollateralization must be negotiated with investors.

- Reserve Pools: The RLF can dedicate a pool of funds to guarantee repayment in the event of delinquency or default by a borrower. Typically, this will be funded out of the cash raised from the loan or bond sale. In the NJEDA case, for example, the RLF was required to set aside 30% of proceeds of its bond sale. RCEDC was also required to fund a 30% reserve pool on its collateralized borrowing. In the CRF case, a reserve pool was set up for each security class that was replenished as necessary by the monthly payment stream from the securitized loans. In the event of widespread delinquency, payments to residual securities are interrupted to ensure the reserve pool on senior securities is replenished. In the CDA case, a relatively small reserve pool is proposed for delinquency or default. Large reserve pools can significantly deplete the capital available for immediate lending. However, assuming no major losses, the required size of the reserve pool should normally decline as loans or bonds are paid off, until it ultimately reverts to the RLF or bond issuer when repayment is complete. RLFs should also determine if they are entitled to use the interest earned on any reserve pools.

- Letters of Credit (LOC): Letters of credit allow a bond issuer essentially to "rent" the credit rating of a bank or other financial institution. Under a direct-pay LOC, the bank pays investors each period and is repaid by the RLF or intermediary issuing the bonds by drawing on the LOC. Different types of LOCs may specify different approaches to settling investor claims in the event of default or delinquency by the issuer. Most often, the bank will accelerate payment or recall the bonds. In return for using its credit rating, the issuer pays the bank an ongoing fee (Reznick, 1998). This approach was used in the NJEDA case described in Chapter 2.

- Credit Enhancement Grants: Reznick (1998) suggests that government agencies could provide grants explicitly for credit enhancement. A county government could, for instance, set aside some portion of its deposits as a reserve pool to enhance the rating of bonds sold by an RLF. Very much along these lines, HUD recently announced a $10 million pilot program whereby applicants could receive grants up to $1 million to fund loan loss reserves for securitization.[22]

- Multi-Tiered Bond Structures: A final means of credit enhancement is to use multiple tiers of bonds where payments on one class of securities can be diverted to another in the event of a shortfall. Both CRF and CDA use this approach. This can be thought of as a waterfall where monthly loan repayments are placed in a single pool. Payments then flow out of that pool, cascading from one security

class (tranche) to the next in a prescribed priority. In the event payments are insufficient to pay all investors, it is the downstream bondholders who are not paid. This effectively credit enhances the upstream investors. While there can be any number of bond classes included in such a security, a typical structure for RLF loan-backed securities might have four classes—senior, junior, mezzanine, and residual. By channeling payments to the senior securities in the event of a shortfall, these securities may be able to earn a higher rating—and pay a lower yield. Normally, each lower tier would be forced to pay a higher yield to attract investors. The highest tier securities normally appeal to the most risk-averse investors (e.g., institutional investors) while the subordinated tiers are bought by investors willing to bear more risk in return for a higher yield (perhaps individuals or foundations). Often the most subordinate tiers are held by the RLF or intermediary issuing the bonds. This bottom tier security acts very much like a reserve pool. In the CRF case, the intermediary issuing the notes held both the mezzanine and the residual securities.

Regulatory Issues

In most cases, federal or other government bodies funding RLFs maintain a legal interest in loans originated by the fund. Before these loans can be sold, that governmental interest must be released or subordinated. In the demonstration project, this was accomplished by requiring EDA approval of all loan sales. When approval was granted, EDA Headquarters provides the RLF with a letter releasing or subordinating EDA's interest in the loan (see Chapter 6). EDA release or subordination is contingent on two conditions.

First, any new loans made from the proceeds of the transaction must be reloaned in accordance with EDA rules and the RLF's lending plan. This effectively transfers EDA's interest from the old loans to any new loans made.[23] It also means that RLFs must relend a large percentage of their sale proceeds within a prescribed time period. In cases where the RLF's existing lending plan interferes with the ability of the RLF to securitize its portfolio or reloan its funds quickly after a transaction, EDA can expedite changes to the plan.

Second, any federal regulations originally placed on the borrowers and enforced by the RLF travel with the loan. For instance, EDA rules specify that if a borrower leaves the distressed area where they were located when the loan was made, the RLF must recall the loan. In the event of a sale, this regulation would remain in effect, but the designated servicer would assume enforcement responsibility. There are a variety of other regulations that apply to borrowers from federal RLFs, including Davis-Bacon wage standards, various antidiscrimination clauses, etc.

A special type of regulatory issue arises in cases of tribal RLFs. Although Tribes are sovereign entities, the U.S. government holds a trustee responsibility over tribal lands. In the past, this has made it difficult for tribes to borrow from banks, which could not be certain that their claims on collateral would be honored in the event of default. Even if the claims were

honored, foreclosure could be tied up for long periods by the need to obtain approval from the Bureau of Indian Affairs (BIA) and other relevant government agencies. To remedy this, many market-oriented tribes have created Uniform Commercial Codes and foreclosure and eviction statutes that make it easier for them to deal with private banks and investors.

As a result of the demonstration project, CRF negotiated a transaction with the Hoopa Valley Tribal Government in California.[24] In this case, BIA approval was needed because the loan was for a public facility located on trust land. To facilitate the deal, the RLF involved was rechartered to make it a tribal enterprise distinct from tribal government. Both the Tribe and the tribal enterprise had to provide limited waivers of sovereign immunity to allow the transaction to go forward.

CHAPTER 5

LESSONS FOR INVESTORS

As a relatively new asset class, securities backed by economic development loans are unfamiliar to most investors. Furthermore, the social mission of RLFs to encourage local economic development often causes them to make loans and manage their portfolios very differently than if they were lending for profit. Together, these features could cause uncertainty on the part of investors regarding how to value RLF loans. In this chapter, we describe key features of these loans with the goal of lessening this uncertainty.

Revolving loan funds for economic development are locally-managed pools of capital used primarily for small business lending. Most often, they have received their initial capitalization from some governmental source, nonprofit organization, and/or foundation. Pioneered by EDA and later by HUD in the 1970s, RLFs today are operated by organizations at every geographic level, and may target borrowers as different as industrial tenants in municipally-led brownfield redevelopments and women-owned microenterprises. Some funds provide capital for construction or purchase of a business, while others focus on provision of working capital. Today, some RLFs (but not EDA's) even provide equity capital, although we will focus on debt financing here. There is no single trade organization or industry association that represents these lenders or collects data on their operations. These funds are unregulated by the federal banking system and subject largely to local control, although funders usually place regulations on how the funds may be used.

The varied and fragmented nature of the RLF industry makes it difficult to identify the entire universe of RLFs, much less to characterize the industry's financial practices and economic health statistically. What these RLFs do have in common is that they provide capital to inexperienced or nontraditional borrowers that have difficulty borrowing from private banks. Some RLFs even require that borrowers be rejected by one or more local banks before they are eligible for funding to ensure that RLF funds do not compete with private sector lending. The specific barrier to the borrower may be a lack of credit history, low or sporadic income to support debt repayment, or small transaction size. These borrowers may also rely on unconventional collateral and/or personal repayment guarantees.

In the case of EDA RLFs, lending is specifically targeted at areas of the United States exhibiting low income, high unemployment, adverse structural economic change, or economic distress brought about by specific events such as natural disasters and military base closings. EDA requires its RLFs to match any grant it provides with local funding, the exact amount of which depends in part on the severity of distress locally. This leverages federal dollars, gives the local community a strong stake in the performance of the fund, and encourages private sector involvement in economic development activities. The specific projects funded will depend on local needs and opportunities. EDA RLFs develop a lending plan that describes investment

targets and connects them to broader economic development goals of the region. EDA requires that, once established, its RLFs keep 75% of their funds loaned out at any given time.

Overview of Underwriting and Servicing Practices

While underwriting practices vary widely with the precise goals of each fund, a fairly typical RLF might concentrate on gap lending to make up the difference between the amount a borrower can obtain from private banks and the amount needed to complete a project. Such gap financing is usually made subordinate to the private loan, and may be made at a lower interest rate. In a 1987 evaluation of EDA RLFs, Mt. Auburn Associates found that loans were typically made at about three percentage points below the prime rate (Mt. Auburn Associates, 1987). A decade later, a similar evaluation of EDA RLFs created for defense conversion found lending was typically about 2 percentage points below prime (Burchell, 1997). Borrowing from an RLF can provide local small businesses with needed funding while helping them to establish a strong credit history with local banks. It is common for RLF loans to be made with variable interest rates, often with a cap. Balloon payments are also common. RLFs also tend to service loans differently than profit-driven lenders. They routinely work closely with troubled borrowers, often restructuring payments to prevent default and foreclosure.

In recent years, the common RLF practice of charging below-market interest rates has come under criticism from a growing number of financial and economic development experts. The basic question asked today is whether nontraditional borrowers actually need below-market interest rates and favorable terms, or whether they simply need access to capital denied them by the private market. Opponents of low rates and favorable terms argue that these practices are either wasting public funds by supporting businesses that are not fundamentally viable, or stealing business from banks by offering subsidized rates that banks cannot match. Proponents of favorable terms traditionally argued that many small businesses could survive if only given the chance to get established—an opportunity that is denied them by banks applying market rates and lending rules. In general, there has been some tendency to move more toward market rates and terms. However, many RLF managers continue to argue that below-market rates should be included in broader incentive packages designed to keep businesses in or attract them to economically distressed areas.

Risk Characteristics of RLF Loans

By design, economic development lending is more risky than typical bank lending. As a matter of policy, RLFs target risky borrowers and engage in practices that raise risk to the lender. When these practices were initially adopted, few if any RLF managers anticipated they would ever be transferring that risk to a third party via securitization or collateralized borrowing. Partly due to the fragmented and localized nature of the industry, there are very few systematic studies of RLF performance or even industry-wide descriptions of the types of loans made. However, what we know is summarized below.

Credit Risk

Recapping the material provided in Chapter 3, there are a variety of common RLF practices that raise credit risk to investors in securities backed by these loans. These include:

- Making loans to borrowers with limited credit history.
- Lending to startup firms and small borrowers (who demonstrate statistically higher failure rates than established and large firms).
- Taking a subordinate position with respect to repayment and collateral.
- Accepting collateral that is hard to value or less reliable than conventional standards.
- Making loans in a restricted geographic area, so any regional recession can affect repayment across the entire portfolio.
- making loans that include balloon payments.

Despite these practices, most evidence is that loan losses are only slightly higher for RLFs than for private lenders. Table 5.1 summarizes key studies that have been done on RLF performance. Unfortunately, these studies do not use consistent definitions, and it is not always clear precisely what is being measured. The studies also look at very different groups of RLFs. Nonetheless, the overall picture is one in which default rates are typically between 5% and 8%. For studies done since 1990, default rates are most frequently under 8%. Still, there are wide differences among funds. In its Ohio analysis, CFED found delinquency rates that varied from 0 to over 50%, with default rates ranging from 0% to 65%. Nearly half the funds older than 2 years had default rates below 6%. CFED also found that these rates tended to be lower for microenterprise funds, and that there was little difference in defaults between funds that received funding from a single agency and those with funding from multiple agencies.

Of the studies shown, most do not calculate true loss rates, because they exclude recoveries of collateral. The exception is the report by Lipson (2000) of the National Community Capital Association (NCCA). Each year, NCCA collects data from its membership, which includes nongovernmental RLFs. Their loss rates average between 4% and 8%. CDA reported loss rates that were significantly lower in the demonstration project (Reznick, 2001). To be sure, these loss rates are higher than for private banks. Nonetheless, we should not expect loss rates similar to private banks if RLFs are actually targeting risky borrowers. Indeed, extremely low loss rates would likely indicate that RLFs are making loans to borrowers that could qualify for bank loans.[25]

Table 5.1

Research Findings on RLF Delinquencies, Defaults, and Losses

Author	Year	Populations Studied	Key Findings
Mt. Auburn Associates	1987	EDA RLFs	default rate of 9.6% on fixed asset loans
			default rate of 19.1% on working capital loans
Levere, Clones, and Marcoux (CFED)	1997	290 federally-funded RLFs (excludes HUD loans)	median default rate of 5.7%
		81 Ohio RLFs	combined delinquency & default rate of 6.3%
NADO	1999	52 rural RLFs	default rate of 2% 42% of RLFs had no defaults
Lipson (NCCA)	2000	20 business and microenterprise CDFIs with assets under $2 million	cumulative loss rate of 7.6% 90-day delinquency rate of 9.4%
		17 business and microenterprise CDFIs with assets between $2 million and $6 million	cumulative loss rate of 4.7% 90-day delinquency rate of 2.6%
		15 business and microenterprise CDFIs with assets greater than $6 million	cumulative loss rate of 5.7% 90-day delinquency rate of 6.0%

If we look more specifically at underwriting practices affecting credit risk, Reznick (2001) found that, among the RLF loans he has examined, there is a strong tendency to overcollateralize, with a collateral-to-loan ratio of about 1.5:1. On the other hand, RLFs also tend to have few, if any loss reserves. The CFED study of Ohio RLFs found just 14% of funds with any loss reserve. On a dollar basis, this represented less than a 4% reserve for loans outstanding. NCCA's study of small business and microenterprise CDFIs (those with assets less than $2 million) found average loss reserves of 12%, declining to 8% for large funds (those with assets greater than $6 million). The exact size of reserves can be heavily influenced by federal

regulations of programs used to establish each fund. Some microenterprise funds, for example, are required to establish loss reserves. The USDA IRP program, which provides loans to RLFs, requires its RLFs to retain reserves of 15% to ensure that these loans are repaid. In contrast, EDA RLFs are funded by grants. To make sure that the largest amount of federal funding possible goes directly to lending, EDA does not allow cash reserves—permitting only non-cash reserves to be used for accounting purposes.

Interest Rate and Prepayment Risk

Of course, the level of interest rate risk inherent in securities backed by economic development loans depends largely on macroeconomic conditions and how the securities are structured. In general, economic development loans tend to have short- to medium-term maturities. Taken as a group, the loans examined as part of this demonstration project carried a median maturity of 10 years, and had 7.5 years remaining on them at the time each portfolio was priced. Unfortunately, we do not have any reliable information on prepayment. To the extent that these borrowers have low incomes and tend to receive below-market interest rates, we should expect relatively low prepayment rates.

Issuer Risk

Because RLFs tend to be very small organizations, they will typically need to sell or pledge their loans to some form of pooling intermediary to engage in transactions of a meaningful size. The immature nature of this market also means that there are very few intermediaries currently serving this function. This has not, however, led the emergence of a dominant intermediary such as Fannie Mae in housing. The two organizations that pursued conventional securitization in this project, CDA and CRF, both designed (or intend to design) their security offerings to use bankruptcy-remote special purpose vehicles in order to protect investors from any collapse on the part of the bond issuer. To the best of my knowledge, this is the first time such a structure has been used in markets for securities backed by economic development loans.

Credit Enhancement

To date, the primary form of credit enhancement used in RLF securitization has been overcollateralization, as shown in the New Jersey and Virginia transactions. The Racine County collateralized borrowing was also heavily overcollateralized. The use of reserve funds has also been extensive, with both the New Jersey and Racine County collateralized borrowings having a reserve fund equal to 30% of the value of the notes outstanding. RCEDC reports that this overcollateralization at the portfolio level is necessary to offset undercollateralization at the loan level. To date, the CRFs Twelfth Series and CDA's proposed securities are the first known use of multi-tranche structures for RLF loan-backed securities. In contrast to earlier deals, none of the transactions in the demonstration project included mandatory recourse or swapping of loans at the request of the bondholders. Voluntary recourse at the request of the RLF was included.

Despite the widespread activity of the federal government in this field, the use of governmental guarantees either on the notes themselves or on the underlying loans has been rare—being restricted mainly to SBA loans.

The Supply of Loans for Securitization

Without question, the biggest barrier to undertaking successful securitization in the EDA demonstration project was the hesitancy of RLFs to sell or pledge their loans. Of the three grantees that intended to use securitization, only CRF was able to complete a transaction before this report went to press. In the South Dakota case, RLF hesitancy and the availability of lower cost capital caused securitization to be discarded as an option. Low RLF participation has also been a major barrier in CDA's effort to obtain a rating, since the rating agencies required something on the order of 300 loans to be included in a transaction in order to guarantee the statistical validity of their credit analysis.

Why have RLFs been so hesitant to participate? As part of their final reports to EDA, CDA and CRF each tried to answer this question. CDA surveyed 110 RLFs that subscribe to NADO's Economic Development Finance Service (EDFS). The lack of interest in securitization is exemplified by the fact that CDA received only 12 replies to its survey. Of these, 11 saw securitization as a useful recapitalization tool. The top reasons given for not participating were that the RLF did not need capital at this time and that the RLF would prefer to wait and see how others did before participating. This view was supported by the CRF research. The most frequent reason RLFs gave CRF for not selling their loans was that they did not need additional capital at this time. Indeed, the only RLFs that sold loans to CRF were those that needed immediate funding.[26]

The fact that so many RLFs say they do not need additional capital warrants further examination. Clearly there is continuing need for new investment in the distressed areas where EDA's RLFs operate. RLF managers are a diverse lot. In some cases, it is certainly possible that RLF managers are not working hard enough to make new loans, or that they are using a perceived lack of lending opportunity as an excuse to avoid securitization. However, there are also several good reasons why RLFs may hesitate to make new loans, even where there is a demand for capital. Some of these were described in Chapter 3. An RLF may, for instance lack the day-to-day operational resources to expand their lending. It takes a very large increase in servicing income and loan origination fees to enable hiring of new staff.

RLFs may also have difficulty making loans for macroeconomic reasons. RLFs are traditionally lenders of last resort. However, in the strong economy of the late 1990s, traditional banks with large amounts of cash were scrambling to find borrowers. As a result, these banks began to lend to individuals and businesses they never would have considered previously. In this situation, if RLFs were to avoid competing with banks, they could only make new loans by targeting even riskier borrowers. It also becomes more expensive to work with less sophisticated and/or riskier borrowers. At some point, RLF managers simply have to stop making loans if they

are to manage public funds prudently and avoid potentially large losses.[27] Of course, as macroeconomic conditions change, private sector banks will tighten their lending standards again. When this happens, RLFs should find they have greater need for new capital and may be more open to securitization. It is important to note that current public policy may interfere with managers' good sense here, if regulations force RLFs to continue making new loans without regard for business cycles or the quality of borrowers available.

Another reason why RLFs avoid securitization is their lingering fear of discounts. In some instances, these fears may be irrational, because these losses result from making low interest loans and will eventually be realized anyway. Again, however, the timing of these losses may be important. First, if there is an immediate shortage of lending opportunities for these RLFs—as many have indicated—then they could not recoup their discount by relending at higher rates. Second, and more speculatively, many RLF managers may have believed that while these losses occur they could, given sufficient time, be offset by new grants. Selling or pledging the loans makes the loss immediate. If there are no grants immediately available to make up the difference due to the discount, it indeed represents a loss to the RLF that might not have occurred otherwise.

Other reasons given by the grantees for low RLF participation include:

- reluctance of RLFs to open their files to outsiders;
- difficulties convincing the RLFs' Boards of Directors that securitization is a responsible approach to asset management;
- fear that the RLF will appear too wealthy after a transaction, hurting its chances to obtain federal grants;
- government rules that specify how new funding may be used; and
- in at least one case, RLF participation was further constrained by governmental policy, when the U.S. Department of Agriculture refused to allow interested IRP RLFs to participate in the EDA project.

Potential CRA Benefits

In the end, the market for securities backed by economic development loans will succeed or fail based on the fundamental soundness of those investments. However, there are additional incentives that are important for investors to consider. Especially important among these is the possibility of regulated financial institutions receiving CRA credit. There are several important issues when collateralizing or securitizing economic development loans for CRA credit.

The first issue is whether investments in loan-backed securities can earn CRA credit at all. Anyone seeking CRA credit from an investment in development loan-backed securities should obtain qualified legal advice. Roughly speaking, however, CRA requires that investments must support one or more of the following activities:

- affordable housing, community services, or permanent jobs for low-or-moderate income individuals;
- equity or debt financing of small businesses;
- area revitalization or stabilization; or
- other activities, services or facilities that primarily promote the public welfare—in conformity with the provisions of 12 C.F.R. Part 24.

In the demonstration project, SDREI and CRF both included statements in their legal documents to verify that all proceeds of their transaction would go toward these purposes, and that each intermediary would support the claims of any investors for CRA credit to the extent possible. There are several different interpretive letters from the Department of the Treasury and Interagency Questions and Answers (Q & As) that bear on the question of receiving credit for investing in securities backed by development loans.

- Interagency Q & A Section 23 (Scope of Test) speaks to the issue of making indirect investments through a fund rather than investing directly.[28] Generally CRA does not differentiate between "direct" and "indirect" investments. However, investors may not receive additional credit for investing loans they originated and already receive CRA credit for (since that would constitute double-counting).
- An interpretive letter dated September 9, 1996 speaks directly to investment in EDA RLFs, noting that such investments may earn credit, but that the RLF in question did not specify that its lending is for qualified small business purposes, for the creation of permanent jobs for low and moderate income individuals, or for qualified community development loans.

There is an additional complication in obtaining CRA credit where securities being offered are backed by a geographically diverse loan pool. CRA is, after all, intended to promote reinvestment in a bank's home community. Consequently, there has been some question whether bonds backed by national loan pools can be given credit, since those investments may or may not affect local redevelopment in the bank's assessment area. According to an interpretive letter dated September 11, 1997, investment in

> a broader statewide or regional area that includes the institution's assessment area(s) will receive consideration for the investment, provided the institution has adequately addressed the community development needs of its assessment area(s).[29]

What is less clear is whether the entire investment of such an investor is counted, even if the bank's own assessment area represents a small part of the overall loan pool. Is some form of pro-rating system used? If so, exactly how is this accomplished?

A special issue of CRA credit applies to the equity equivalent investment as undertaken in the South Dakota case. In an interpretive letter dated June 27, 1996, the Comptroller of the Currency determined that the investor may be entitled to credit, not only for its original investment, *but also for a pro rata share of any additional funds leveraged.* This allows investors to earn more in CRA credit than they invest.

One interesting questioning that emerges with respect to CRA credit for securitization has to do with broader trends in CRA investing. Some experts report that, as rules have been relaxed to allow a greater breadth of investments to qualify, banks no longer have to make the extremely low return or deeply subordinated investments that they once did to qualify. If this trend continues, investing in relatively high return RLF-backed securities could prove very competitive with other types of potential CRA investments.

Tax-Exempt Status of Bonds

Despite the fact that states are widely involved in economic development lending either as RLFs or as intermediaries that fund RLFs, the bonds issued by these organizations are generally not tax-exempt. This is because the proceeds of these transactions benefit private firms (the private borrowers). While they could be qualified as "qualified private activities," this would apply against the total cap for such activities allowed each state by the federal government.

CHAPTER 6

LESSONS FOR GOVERNMENT AGENCIES

Some of the most important lessons learned in the EDA demonstration project have been for government agency staff wishing to encourage securitization. Securitization can be a very powerful tool for government agencies involved in economic development, because it provides a new means to bring the private sector back into funding development projects. Even where private capital markets are unwilling to make direct loans to RLF customers at acceptable terms, those same investors may be willing to fund RLFs through securitization, providing adequate loss protection and/or credit enhancement is included. However, very few investors will be willing to risk their capital unless government funders release or fully subordinate their interest in any loans to be securitized. Federal accounting rules ensure that subordinating the government's interest is not trivial. Furthermore, most government agencies want to ensure their funds will be used in specific ways designed to fulfill their public mission. In some cases, this will mean having specific rules and regulations remain in effect after the transaction. We will describe these issues more fully below, focusing on the federal role, although many of the lessons learned should apply to state governments and regional authorities as well.

Subordinating the Public's Interest in Securitized Loans

The need for government to subordinate its interest in any loans to be securitized is straightforward. If investors' claims for repayment are encumbered by any sort of prior government claim in the event of delinquency or default, it makes any deal far less attractive. Depending on the particular investors and the specific nature of the risk involved, investors will either not show any interest in the loans, they will require a larger discount on sale, or they will demand a higher yield from securities purchased. In EDA's case, this was addressed by a simple letter to the intermediary whereby EDA subordinated the federal interest in the loans. Generally, EDA releases its interest in the case of a sale, and fully subordinates it in the case where loans remain the property of the RLF.

EDA reserved its right to disapprove of any deal where public interests were compromised. For instance, if an RLF wanted to securitize its portfolio, but had large reserves of cash, the agency would block a sale. EDA would also stop a deal if a particular RLF had shown signs of gross mismanagement or was the subject of an audit investigation. The need to subordinate the public interest in any loans provides government an opportunity to take a close look at each transaction, collect data for tracking securitization's impacts on the RLFs involved, stop any deals that are undesirable, and impose specific conditions on transactions as may be needed. As a matter of policy, EDA chose not to interfere with the transactions any more than was absolutely necessary. The agency did not, for instance, block transactions simply because of

the discount or other purely financial aspects of the transaction. With few exceptions, EDA approved all requests presented to the agency. In a few cases, approval was withheld temporarily because incomplete or conflicting information had been submitted. In one case, EDA's approval process identified a situation in which an RLF and a buyer were prepared to undertake a transaction in which they did not actually have authority to do so, because there was a co-grantee involved that had not been consulted.

At least as important as the act of subordinating interest in a loan is that this action be taken swiftly. Delays lower the value of the transaction to investors and RLFs alike, as the loans are paid down, decreasing the value of the transaction. As we saw in the HUD cases described in Chapter 2, this can kill a deal if the value of the portfolio becomes too small to make securitization worthwhile. Furthermore, delays almost always raise transaction costs as prices have to be recalculated with changing market conditions, and as lawyers and other specialized professionals monitoring the transaction continue to accrue costs.

In EDA's case, the decision to subordinate the federal interest required coordination between our regional offices and headquarters. Normally, EDA's regional offices make all operational decisions regarding RLFs in their areas. However, the fact that this was a demonstration project meant that there was a strong national interest in learning as much as possible from each transaction, so some headquarters involvement was clearly needed. Furthermore, for an intermediary trying to assemble a pool of loans nationally, having to negotiate separately with each regional office could be problematic. After consultation among EDA management at headquarters and in the regions, the process eventually agreed upon was to have the approval process centered in headquarters, but with regional participation. Without exception, it was the regional office participants that had the specific knowledge of each RLF required to make informed decisions about whether the government should subordinate its interest. When one of the grantees wanted to proceed with a transaction, they would contact EDA's Economic Adjustment Division (EAD) in Washington D.C. Typically, this meant submitting a list of loans to be sold by an RLF, along with supporting documentation for the transaction. EAD would then assemble a panel with representatives from their office, the appropriate regional office, and the headquarters Research and National Technical Assistance Division. EAD would distribute copies of documents required to assess the transaction and convene a conference call shortly thereafter. Once all parties agreed to a transaction, EAD would prepare the documents releasing the federal interest and submit them for approval by the appropriate EDA official(s). In most cases, approval was obtained in less than three working days, although there were cases where it took longer to draft the language of the letter. EDA now has several standardized letters that are used for this purpose, but it is still necessary, on occasion, to negotiate specific language with the RLF or intermediary acting on their behalf.

Reuse of Securitization Proceeds

In order to ensure that its funds are applied to new lending as quickly as possible, EDA rules require that RLFs funded by the agency loan their funds out according to a strict schedule:

- within 18 months of its grant, the RLF must loan 50% of its funds;
- within two years, it must loan 80% of its funds; and
- within three years it must loan 100% of its funds.
- After that, the RLF must operate the fund so that 75% or more of its funds are loaned at all times.

For securitization, EDA treats the proceeds of a transaction as if it were a new capitalization grant. This effectively transfers the federal interest from the loans being securitized to any new loans that are made. In principle, this means that RLFs must lend out their proceeds according to the schedule described above. For the purposes of the demonstration project, EDA wished to minimize any potential barriers to RLF participation. Accordingly, the agency waived the 18-month and two-year milestones for relending proceeds, but maintained the three-year full lending requirement. In practice, the RLFs participating all reported that they needed the funds immediately, so it does not appear the regulations were a barrier. However, there were RLFs that reported they were interested in securitization, but did not need capital immediately. This suggests that waiving the three-year lending deadline might have increased participation by a small amount. We simply do not know. The agency made an informed policy decision not to waive the relending requirement entirely in order to facilitate securitization; securitization is deemed to be a means to allow new lending, not an end in itself.

EDA also has rules regarding how RLF grants can be used. Many of these are mandated by Congress. To enforce these rules, but encourage flexibility in how the rules are applied to the needs of each community, EDA requires each RLF it funds to develop a lending plan that specifies how it will use its funds. These plans are also required to be consistent with the community's Comprehensive Economic Development Strategy (a prerequisite to obtaining EDA funding). EDA must approve the lending plan of each RLF. Part of the review for this approval is to ensure the plan meets all federal regulations. Again, EDA has chosen to treat securitization proceeds like an RLF grant. Specifically, the agency requires that any proceeds be reused consistent with the RLF's federally approved lending plan. This is not unique to the demonstration project, having been included in earlier securitizations as well.

Several important and unanticipated questions about the reuse of securitization proceeds have arisen in the course of the demonstration project. To date, these have appeared as largely hypothetical issues, so EDA (and to the best of our knowledge, other agencies) have not formulated policies to respond. We present them here so others may be aware of them:

- Can the proceeds of a loan sale be applied toward the matching requirement on a subsequent grant application? EDA requires localities seeking RLF funding to provide a local match. The question here is whether an RLF can apply funds obtained under a securitization toward that match.

- Relatedly, can an RLF treat the discount it receives on a loan sale as a matching contribution?

- How long do funds initiated from a federal grant continue to maintain their "federal character?" EDA requires federal grant funds to be tracked indefinitely. However, such identification of funds becomes very difficult where an RLF does repeated securitizations, where RLFs obtain funding from nonfederal sources as well (which EDA requires them to do), or where nonfederal funds are used for credit enhancement.

Protecting Borrowers

In the vast majority of cases, RLFs are very careful to ensure their borrowers are protected. However, government agencies may wish to examine how borrowers are protected before subordinating the public interest in a loan. In approving transactions that predated the demonstration project, EDA typically required RLFs to include a repurchase option in their loan sales in the event a borrower whose loan was sold fell into default. EDA did not impose such requirements on loan sales made under the demonstration project. In most cases, the participating RLFs already had a clause in their sale agreement that allowed them to repurchase or substitute a loan in place of a borrower subject to foreclosure. Often the RLF also retained servicing of the loans.

Regulatory Issues

Virtually all federally-funded RLFs are subject to a variety of federal regulations, although they differ from one agency to another. The most obvious regulations applying to RLFs are those that control the kind of activities they can fund. For EDA, these regulations do not pose a special problem for securitization because federal rules are generally included in the lending plan approval. Requiring that any new funds be used consistent with this lending plan assures that most, if not all regulations affecting the RLF will be met.

Regulations applying to borrowers are more problematic for securitization, because they may raise risk to investors or require the servicer of the loans to incur monitoring costs they would not otherwise bear. This is because the current practice by EDA and other agencies has been to require that all federal regulations on borrowers travel with the loan. Table 6.1 lists some of the common regulations that may apply. There are also agency specific regulations, as well as state and local laws. To give an example, if a borrower whose loan has been sold subsequently

moves out of the distressed area served by the RLF that originated the loan, the new owner of the loan is required to recall the loan.

Table 6.1

Representative Federal Regulations Affecting EDA RLF Borrowers

Law/Regulation Topic	Citation	Purpose
Anti-Kickback Act	40U.S.C. 276(c) 18 U.S.C. 874	To ensure that parties entering into contracts with the federal government do not make or receive payments to receive those contracts
Civil Rights Act of 1964, Title VI	42 U.S.C. 4002, et seq. 15 CFR Part 8.	Prohibits exclusion from federal programs/assistance on grounds of race, color, or national origin
Contract Work Hours and Safety Standards Act	40 U.S.C. 327-333	Sets overtime rates for laborers and mechanics on federally-funded projects
Davis Bacon Act (Fair Wages)	40 U.S.C. 276a-276a-5; 42 U.S.C. 3222	To ensure that government contractors and grantees (including RLF borrowers) pay locally prevailing wages
Executive Order on Protection of Wetlands	Executive Order 11990 (May 24, 1977)	To ensure that federally funded activities do not result in unnecessary destruction of wetlands
Executive Order on Environmental Justice in Minority and Low-Income Populations	Executive Order 12898 (February 11, 1994)	To address disproportionately high and adverse human health or environmental effects of federal programs and activities in minority and low-income neighborhoods
Flood Hazard Insurance	42 U.S.C. 4002, et seq. P.L 97-348 (16 U.S.C. 3501, et seq.)	while not generally regulated as banks, RLFs may be required to have their borrowers purchase flood insurance.
Freedom of Information Act	15 CFR Part 4	to ensure public access to government records (including some nonproprietary RLF documents)
Inspector General Audits	Agency-specific	Most agencies will stipulate that the Inspector General responsible for their agency has authority to audit the accounts of RLFs and their borrowers

Source: EDA Regulations, 13CFR, Chapter III

The Use of Federal Funds for Credit Enhancement

Reznick (1998) and others have pointed out that the federal government could leverage its available funding tremendously if, instead of recapitalizing existing RLFs directly, it funded credit enhancement of loans to be securitized. The federal government has long used credit enhancement in the form of guarantees for student, home, and other loans—many of which are subsequently securitized. There have been far fewer efforts to fund credit enhancement for RLFs. HUD's recent pilot program to fund loss reserves for its Section 108 Economic Development Initiative loans is a notable exception (see Chapter 2).

Without question, funding loss reserves or other forms of credit enhancement could make securitization easier to achieve and vastly leverage federal funds. This loss protection could allow securities backed by economic development loans to pay much lower yields and allow new types of loans to be securitized that would never reach the market otherwise. Still, to many observers, credit enhancement for loans from federally sponsored RLFs seems like a double subsidy, because the government would be subsidizing the sale of loans that have already been subsidized using government funds. The real question here should be, how many total federal dollars does it take to created a given level of lending? Since it only takes a small amount of added loss protection to make bonds more attractive, credit enhancement should be many times more efficient than simply using that same amount of capital as a direct capitalization of an RLF for lending.

CHAPTER 7

CASE STUDIES

In the prior chapters we have presented the lessons learned from the cumulative experience of the four projects funded by EDA under its demonstration. This chapter presents a more focused look at each of the projects. For each case, we describe

- the portfolio(s) being securitized or collateralized;
- the basic details of the transaction, including how is was structured and carried out, who the investors were, etc.;
- any discount that was imposed on the participating RLF(s); and
- any documents developed to facilitate the transaction. (In most instances, these documents may be obtained from the grantees.)

Collateralized Borrowing by a Single RLF: Racine County Economic Development Corporation

As described throughout this report, many RLF managers have been unwilling to securitize their portfolios where a significant discount is involved. For these RLFs, collateralized borrowing has provided the most attractive means to generate new capital from their existing loan assets. EDA included one collateralized borrowing in the demonstration project specifically to learn more about the benefits and costs of this approach relative to conventional securitization. Racine County Economic Development Corporation (RCEDC) is a relatively small local economic development agency like many others throughout the United States. Prior to the EDA project, RCEDC had discussed the possibility of pledging its portfolio for a line of credit (LOC) with local banks. However, RCEDC had not decided the exact approach to take. Initially, they proposed to have two separate LOCs, one with a consortium of local banks and one with the County of Racine—each worth approximately $400,000. The main unanswered question with regard to the structure of the deal was how the county would fund their LOC (direct expenditure, bond issue, etc.). Part of the EDA grant was used to hire a consultant to assess the various county financing options.

To determine how large an LOC could be obtained from the bank syndicate, RCEDC hired an independent firm, Valuation Research, Inc. (VRI) to appraise two portfolios—one with

Table 7.1

Racine County Economic Development Corporation
Summary of Loans Pledged

Racine County RLF	
Description	small business lending
No. of Loans	22
Original Loan Value (median)	$64,655
Original Term (median)	5 yrs.
Interest Rate (median)	7.0%
Term Remaining (median)	2.5 yrs.
Balance	$1,227,733
Market Value	$1,084,135
Discount from Face Value	11.7%

Source: Valuation Research Corporation, 2000

twenty-two active loans and a second with three loans. Only the first portfolio was collateralized. Summary data for the portfolio is included in Table 7.1. The fund consisted of small business loans with a total outstanding balance of $1,227,733. VRI valued the RLF at $1,084,135, for a total discount of 11.7%. This figure is somewhat misleading, because the portfolio includes a few large loans with very high discounts. The median discount of 5.9% is more representative of individual loans in the portfolio. The relatively low discount imposed on the majority of loans is primarily due to the fact that these loans carry a high interest rate and short maturity compared to many RLF loans. The average interest rate charged on the loans is 7.0%; the median term remaining is 2.5 years. RCEDC also manages a second portfolio of three loans valued as well, but these were not included as collateral.

During the course of the project, RCEDC was able to enlist more financial support from local banks than had been expected. As a result, RCEDC established a single $1 million revolving LOC with the banks—eliminating the need for a county LOC. Each bank contributed a minimum of $100,000, with no bank contributing more than 20% of the total. The Bank of Elmwood serves as lead bank for the syndicate. Repayment of the LOC is made using the income stream from new and existing loans. The interest rate charged by the banks on the LOC is 5%

(Table 7.2). RCEDC will relend those funds at 6%. The one percentage point spread is used to fund RCEDC administrative costs and to help cover any loan losses. Repayments on interest are to be made quarterly, with repayments on capital being made annually.[30]

Table 7.2

Transaction Summary
Racine County Economic Development Corporation

Capital Raised	$700,000
Interest Rates	borrowing at 5% relending at 6%
Backed By	$1.1 million loan portfolio
Credit Enhancement	1) 30% reserve pool on $1 million line of credit 2) overcollateralization by $84,135 in current loans and up to $700,000 of future loans
Discount	11.7%
CRA Credit	equal to pro rata share of new lending by the RLF
Documents Used	Security and Collateral Agency Agreement Revolving Credit Agreement

There are also several forms of credit enhancement built into the transaction. First, the portfolio used as collateral actually was valued at approximately $84,000 higher than the line of credit, representing a small overcollateralization. Second, the RLF may never draw more than 70% of the total credit line, effectively providing additional overcollateralization of 30%. Finally, all future loans are pledged as collateral as well, representing a potential additional overcollateralization of $700,000. Assuming the RLF loans the full amount that it can borrow, it will have nearly three dollars in loss protection (collateral plus reserve pool) for every dollar borrowed.[31] This degree of credit enhancement is much larger than that seen in other projects funded under the demonstration, but not larger than that required by other securitized borrowings we have seen. Indeed, these terms are very similar to those contained in the New Jersey financing. In theory, this overcollateralization deprives the RLF of capital it could have used to

make additional loans.[32] It cannot, for instance, loan out the $300,000 in the reserve pool; nor can it securitize or collateralize the loans it makes from the transaction proceeds to borrow further. On the other hand, the income from new loans made should still be enough to ensure positive growth and cash flow to the RLF. Given this, the RLF's management views the severe overcollateralization as a cost they must endure in the short run, but expects that banks will reduce their collateral requirements in future transactions once the RLF establishes itself as a safe borrower. RCEDC management also notes that some of this collateralization at the portfolio level was necessary to make up for the fact that individual loans tend to be undercollateralized. By pledging the income stream from its loans rather than selling the loans outright, RCEDC retains full control over servicing its loans. Although the syndicate of banks could have chosen to impose strict and specific standards for underwriting and servicing on future loans to be made, it has chosen not to. Interestingly, this borrowing has led to new loans being underwritten at lower interest rates than what the RLF had previously been charging (6% on new loans vs. 7% on existing loans).

The transaction costs on the collateralized borrowing were much higher than RCEDC expected. Legal fees alone were more than $30,000, even though RCEDC only had to deal with a single set of attorneys because the consortium of banks chose a single bank (the Bank of Elmwood) to act on their behalf. Without publicly available examples to draw on, the participants were operating in uncharted territory regarding the types of agreements that had to be negotiated. Another challenge RCEDC identified was that, in the year and a half it took to finalize a deal, several of the banks were acquired by larger banks centered elsewhere. In most cases, these newer operations were less interested in supporting RCEDC's efforts. This meant that RCEDC had to start over, convincing a new management team that the project was worthwhile.

Equity Equivalent Investing: South Dakota Rural Enterprise, Inc.

South Dakota Rural Enterprise Inc. (SDREI) is a private nonprofit intermediary that makes loans to capitalize rural RLFs throughout the state. Initially, SDREI's proposal to EDA considered two possible vehicles for securitizing loans in the state. The first model was a collateralized borrowing, whereby RLFs would pledge loans as collateral to SDREI. The intermediary would then borrow funds from banks and lend it back to the RLF. The second model SDREI considered was the direct sale of loans to SDREI, with SDREI discounting loans to a smaller degree than would the private market. Alternatively, the sales could have been directly to outside investors, with some sort of subsidy to the RLFs (presumably from SDREI or government).

After significant analysis, SDREI rejected both collateralized borrowing and securitization as strategies for recapitalization. There were three main reasons for this. First, RLFs in the state indicated they would not participate in any program that required them to absorb a significant discount. Because most RLFs in the state make their loans at below-market rates, SDREI would have had to provide the RLFs a large subsidy in order to obtain significant participation. Second

and equally important, current economic and political conditions have made less-expensive sources of recapitalization available. Third, and related, it is not in the interest of either SDREI or the RLFs to offer collateral when uncollateralized financing is available.

Given this turn of events, SDREI and EDA negotiated a modification to the project that allowed SDREI to explore an alternative source of RLF recapitalization known as "equity equivalent investment" (EQ2). EQ2 is not securitization in the classic sense, but it does have considerable potential as a source of RLF capital. Developed by the National Community Capital Association (NCCA) and Citibank in a project supported by the Ford Foundation, EQ2 is an unsecured, low-interest, deeply subordinated bank loan to a community lender in return for very favorable CRA treatment (Park, 2000). EQ2 loans have several unique features:

- the borrower only makes interest payments until the loan is due;
- the loans have a rolling term;
- the loans are subordinated to the RLF's other lenders and are not collateralized;
- for accounting purposes, the lender treats the loan as an investment while the borrower treats it as subordinated debt;
- the lender has no right to accelerate repayment of the loan unless the RLF ceases its normal lending operations; and
- the interest rate on the loan is not tied to the cash flow into the RLF. In the NCCA demonstration project, interest was set at 250 basis points (2.5 percentage points) below the rate on a ten-year Treasury note, with a fixed rate over the first 10 years of the loan.

Because EQ2 loans have an indefinite term and are unsecured, they act much like an equity investment (hence the "equity equivalent"). In the legal documents, investors are referred to as investing in notes, rather than making a long-term loan to SDREI. Investors were solicited using a private placement offering document. EQ2 is attractive to banks because they can claim highly leveraged CRA lending or investment credit in proportion to their share of the RLF's equity. Lehr (1997:4) describes the situation, using a community development financial institution (CDFI) as an example:

> Assuming a nonprofit CDFI has equity of $2 million, $1 million in the form of permanent capital and $1 million in equity equivalents provided by a commercial bank, the bank's portion of the CDFI's equity is 50%. Now assume the CDFI uses this $2 million to borrow $8 million in senior debt. With its $10 million capital under management, the CDFI makes $7 million in community development loans

over a two-year period. In this example, the bank is entitled to claim its pro rata share of loans originated, 50% or $3.5 million. Its $1 million investment results in $3.5 million of lending credit over two years.

To date, SDREI has approximately $1.75 million in EQ2 commitments under which investors will lend SDREI funds at 3% (Table 7.3). SDREI will then relend the funds to RLFs at 5%. Subject to certain performance criteria, the initial term of the loan is 10 years, renewable yearly thereafter. In addition to CRA credit, it is anticipated that participating banks will receive a 15% rebate from the Department of the Treasury as a grant under its Bank Enterprise Award (BEA) program. Any nonprofit RLF promoting community investment can use EQ2 investments. However the BEAs are available only to CDFI's certified by the Treasury Department.

Table 7.3

Transaction Summary South Dakota Rural Enterprise, Inc.

Capital raised	$1.75 million
Backed by	unsecured
Interest Rates	borrow at 3% relend at 5%
Credit Enhancement	N/A, loans not pledged or sold
Discount	N/A
Servicing	retained by RLFs
CRA credit	1) highly leverage investment or lending credit 2) possible 15% rebate from Bank Enterprise Award

N/A - not applicable

Clearly, obtaining unsecured loans with an indefinite maturity date is a tremendous benefit to cash-starved RLFs. However, there are three points to make about EQ2. First, it is very new, and rules on EQ2 investing are still evolving. Second, while the EQ2 investment can be renewed indefinitely, investors can call their debt in after the initial term expires. This means that an issuer of the EQ2 "notes" should structure its assets in such a way that it could begin repayment if

required to do so as the initial term expires. Third, and perhaps most important, EQ2 is attractive to banks today due to a specific set of conditions:

- the economic boom of the 1990s resulted in a huge influx of deposits with a relatively scarce supply of investment/lending outlets;
- CRA requires banks to demonstrate a commitment to local investment in order to obtain regulatory approval for significant restructuring; and
- the banking industry has been undergoing rapid consolidation, requiring frequent regulatory approval.

If any of these conditions change, the attractiveness of EQ2 investment could change dramatically relative to other investment opportunities available.

Securitization by a National Intermediary: Community Reinvestment Fund, Inc.

Created in 1988, Community Reinvestment Fund, Inc. (CRF) is the country's most established buyer and seller of economic and community development loans. Most of CRF's transactions consist of buying whole loans, although it also buys participation in loans (owning a fraction of the loan), and makes advance commitments to purchase loans when they are made.[33] Once CRF purchases a loan, it is held until the organization acquires enough additional loans to back a sizable security. Alternatively, CRF has served as a broker of loans sold directly to a single institutional investor. Operating as a nonprofit organization, CRF borrows working capital from foundations and has also obtained a warehouse line of credit from a commercial bank to support its loan purchases until a security sale can replenish its cash. The fact that CRF warehouses loans has two important implications. First, it means that RLFs selling loans to CRF can sell when it is most opportune for them, receiving cash at the time of sale. Second, it means that CRF is exposed to warehouse risk from changing interest rates between the time it buys a loan and the time it issues its security. The degree of this risk increases with the time required to complete its transactions.

In general, CRF requires that loans be seasoned at least one year (except for advance commitments) (Table 7.4). It also prefers to acquire loans greater than $10,000. The loan sales are non-recourse, meaning that the seller is not required to buy the loan back in the event of default or delinquency (although the RLF may substitute other loans in their place if it wishes to protect the borrowers). CRF enters a "Qualified Seller Agreement" with the RLF that establishes the authority of the seller to market its loans, the eligibility of loans to be sold, and the general

procedures for pricing the loans and closing the transaction.[34] This agreement remains in effect after the transaction and can be used by the RLF in subsequent sales. A second document, the "Loan Purchase Agreement," sets the actual purchase price and obligations of buyers and sellers. This document is unique to each transaction. At the time of sale, CRF requires sellers to make a variety of warranties confirming that they have full authority to make a sale and testifying to the

Table 7.4

Community Reinvestment Fund
Summary of Loans Purchased

	Loans included in 12th Series Security	Loans Purchased or Committed for Purchase Thereafter
Description	3 RLFs	6 RLFs
No. of Loans	27	63
Original Loan Value (median)	$50,000	$60,000
Original Term (median)	5.5 yrs.	10.0 yrs.
Interest Rate (median)	8.50%	7.25%
Term Remaining (median)	6.0 yrs.	6.8 yrs.
Balance	$1,323,433	3,400,002
Market Value	$1,230,845	3,104,975
Discount from Face Value (entire portfolio)	7.0%	8.7%

accuracy of the loan documentation. CRF may require the RLF to repurchase a loan in the event these warranties are violated. In some cases, CRF also uses foundation funds to provide additional loss protection for investors by establishing reserve pools.

In pricing the loans it purchased under the demonstration project, CRF used a 2.5% spread above the yield paid to Treasury notes of similar duration. At the time this paper was prepared, CRF had priced 90 EDA loans from 9 different RLFs. Only 27 of these loan sales had actually been securitized. These securitized loans had an outstanding balance of approximately

Table 7.5

Structure for Community Reinvestment Fund Twelfth Series Notes

Note Component	Amount	Yield	Description
Senior (Class A)	$7.6 million	8.8%[a]	First payment position. Noteholders have first claim on all interest and principal generated by the underlying development loans.
Junior (Class B)	$3.5 million	6.25%	Subordinated to senior notes. Payments to the junior note holders shall be interrupted in the even of significant defaults in the underlying development loans.
Subordinated	$0.6 million	9.15%	Held by CRF, may be sold. Subordinate to senior & junior notes. Interest payments on the subordinated notes shall be interrupted in the event of significant defaults in the underlying development loans. The default hurdle is lower than for the junior notes No principal is paid until senior and junior notes are fully paid off.
Residual	$2.9 million	N/A	Held by CRF. Only paid when all notes are paid. CRF is prohibited from selling its residual interest.

[a] The senior notes were split into two classes paying different yields. Because CRF is a nonprofit corporation, it occasionally obtains investments from foundations that carry below-market interest rates. In this transaction, the John D. and Catherine T. MacArthur Foundation purchased $1.0 million in Class A-2 notes that carried a 5% coupon.
N/A - not applicable

$1.32 million. CRF paid approximately $1.23 million for the loans, representing a cumulative discount of 7.0%.[35] For individual loans, there was significant variation in the discount. The largest single discount for a loan was 22%. On the other hand, several loans actually sold slightly above par, because the loans carried interest rates above current market rates. The median discount was just 3.2%, in large part because the loans carried a relatively high median interest rate of 8.5%. CRF also charges certain fees in its transactions. For the EDA project, these included a 2% transaction fee and $20 setup fee. CRF offers sellers the option of continuing to service their loans or transferring the servicing of the loans to CRF. In the demonstration project, only one RLF chose to have CRF service its loans. Where the RLF continues to service the loans, CRF and the RLF enter a loan servicing agreement that sets out the responsibilities of each

Table 7.6

Transaction Summary
Twelfth Series Notes
Community Reinvestment Fund.

Capital Raised[a]	$1.23 million
Backed by	$1.32 million in loans from 3 RLFs
Credit Enhancement	1) tiered structure of notes 2) reserve pools for upper tier securities 3) limited recourse (RLF must replace defaulted loans if warranties are voided, but not for default)
Discount	7.0%
Servicing	may be retained by RLFs at their discretion they earn servicing fee
CRA Credit	CRF supports claims by investors for credit
Documents Used	Qualified Seller Agreement Loan Purchase Agreement Loan Servicing Agreement Private Placement Memorandum

[a] Includes only EDA portion of larger offering worth $14.4 million.

party. In the event that an RLF fails to service its loans responsibly, CRF may take over servicing the loans. For the EDA project, CRF is charging borrowers a servicing fee of .375% of the outstanding loan balance; .25% is paid to the RLF doing the servicing and the remainder is retained by CRF as master servicer.

In January 2001, CRF completed the sale of its 12th Series securities (Table 7.5). These securities were backed by approximately $14.4 million of development loans it has purchased from RLFs nationally, including the EDA loans described above. Some of the other loans include federally guaranteed loans. The offering was an unrated private placement. The securities were structured using a 3-tranche structure with a residual. Payments from the loan portfolio are collected by a bankruptcy-remote corporation set up expressly for that purpose, then paid to each tier in order—with senior obligations paid first, then junior, subordinated, and residual notes, respectively. This structure allows CRF to raise more capital from a given portfolio, because investors in the lower-tier securities are willing to accept greater risk in return for a higher yield. These investors subordinate their claim for payments to investors that are highly risk averse—enhancing the credit of the upper-tier securities because they receive payment only after the higher-level obligations are paid. In the CRF transaction, this did not play out quite as we would expect, because the riskier junior securities actually paid a lower yield than some of the senior notes. This anomaly occurred because yields were negotiated with different buyers at different points in time during a period of rising interest rates. The price for the junior notes was locked in earlier, but one of the senior securities was not priced until interest rates had risen significantly.

The repayment risk for the senior and junior notes is further diminished because CRF has established a reserve account for each tier that can be drawn against in the event of a payment shortfall (Table 7.6). CRF has chosen to hold the subordinate and residual tier notes themselves, although they can sell their subordinated notes later, as the risk to the higher-level investors diminishes over time. These notes could, for instance, be sold to foundations engaged in program-related investment or to risk-tolerant private investors seeking a higher yield. Each month, interest payments are paid first, with scheduled payments to principal made afterwards. No principal payments are made on the subordinate notes until the senior and junior note holders have been paid off completely.

To the extent that debt securities sold in secondary markets help recapitalize economic development RLFs, buyers of these notes are supporting economic development lending. Accordingly, the Treasury Department has shown willingness to give CRA credit for CRF securities. As part of its marketing effort, CRF helps investors document their claims for CRA credit from investing in its securities.

CRF identified a number of special legal challenges in executing its transaction. Most of these are described elsewhere, including issues related to loan sales on tribal trust lands and SEC exemption from registration. There was also one issue that applies somewhat uniquely to CRF. As a nonprofit organization, CRF is exempt from income tax on the proceeds of its security sales.

However, transfers from one nonprofit to another are generally taxable. To solve this, CRF operates as a "supporting organization" under the Internal Revenue Code. As such, it can only buy loans from nonprofits or units of government making loans supporting its economic development mission. This also affects the particular documents it uses.

Securitization by a National Intermediary Using a Rated Security: Commonwealth Development Associates

Commonwealth Development Associates, Inc. (CDA) is a private financial consulting firm based in Harvey Cedars, NJ, and headed by Scott Reznick, a practicing attorney and former professor at Rutgers University Law School. Partnering with CDA is the National Association of Development Organizations (NADO). NADO is a trade organization representing many EDA Economic Development Districts and RLF operators, especially in rural areas of the country. As this paper was being prepared, CDA had not yet completed its transaction. However, it had obtained authorization to sell loans from two large RLFs holding approximately $5.6 million in marketable loans. Like CRF, CDA acts as an intermediary that pools loans for the RLFs and uses them to back securities that are marketed nationally. The two most visible differences between CDA's and CRF's approaches are that: (1) CDA does not buy loans in advance and warehouse them; and (2) CDA intends to sell an investment-grade rated security.

Much of the CDA/NADO project has been devoted to extensive outreach. As part of this outreach program, CDA and NADO have used NADO's access to the community of RLF operators to

- advertise EDA's demonstration project in NADO's *Economic Development Digest,* a newsletter with several thousand subscribers;
- post CDA's *Securitization Manual* on NADO's Web site; and
- e-mail NADO members and members of similar organizations about the project and securitization more broadly.

CDA has also had extensive contacts with rating agencies, investment bankers, and loan servicers to educate them about the project and about RLF loans as potential investments.

Rather than buying loans in advance, CDA's approach is to encourage RLFs that have loans to sell to obtain advance permission from their Board and from any government grantors to sell loans when an attractive deal can be put together. CDA also offers to help RLFs scrub their loan files to prepare them for due diligence. CDA provides RLFs that are interested in securitizing their loans with an estimate of the price they could receive if the loans were sold today. The final price is not established until the securities are sold. Because it does not warehouse loans, CDA does not have to build any protection against interest rate increases into its

spread. All else being equal, this should allow it to offer a better price for their loans. Of course, the RLF bears the risk of any rate increases prior to the time the securities are priced.

CDA intends to use a multi-tiered, bankruptcy-remote structure for its securities (Table 7.7). CDA also intends to have its securities rated, with sufficient loss protection so that its upper-tier security can earn an investment-grade rating. This should attract a much broader array of institutional investors than have purchased RLF loan-backed securities in the past. Depending on the details of how a security is offered, obtaining a rating can be expensive. To help reduce its overall costs, CDA intends to price its loans with a credit scoring model from Fair-Isaac & Company. This can help reduce transaction costs and burden on RLF staff, since it is requires less information than performing a detailed review of each loan file. It can also help RLFs keep their loan files private, because credit scoring uses relatively little data from loan files. Credit scoring is also respected by the rating agencies and can help reduce uncertainty surrounding the valuation of the loans that underlie the security. Both of these features of credit scoring ultimately benefit the RLF, because they reduce the discount imposed on the RLF's portfolio at the time of sale.

Table 7.7

(Proposed) Transaction Summary
Commonwealth Development Associates

Capital raised[a]	$5.4 million (tentative)
Backed by	$5.6 million (tentative)
Credit Enhancement	1) tiered structure of notes 2) voluntary recourse for default or delinquency 3) single reserve fund
Discount	3% (tentative)
Servicing	may be retained by RLFs at their discretion they earn servicing fee
CRA Credit	CDA supports claims by investors for credit
Documents Used	Loan Sale Agreement Loan Servicing Agreement Private Placement Memorandum

[a] Includes only EDA portion of larger offering worth $14.4 million.

CDA intends to hire a master servicer, but allow for servicing to be contracted back to the RLFs if they wish. CDA's transaction also allows for voluntary repurchase or replacement of loans by an RLF.

CONCLUSION

In less than two years, the securitization demonstration project has raised more than $3.7 million in new private-sector capital for economic development lending in distressed areas, with an additional $8.7 million in sales pending. Perhaps more important, the experience of the very diverse set of grantees makes clear that securitization can be carried out in such a way as to address the serious concerns of RLF operators.

- Loan sales can be made with very modest discounts (two-thirds of the participating RLFs experienced discounts of less than 10%).

- At the levels of discount typically experienced, most RLFs find they can still generate healthy growth in their revolving fund.

- RLFs can retain servicing of their loans, or pass on servicing to someone else, depending on their needs.

- RLFs can further protect their borrowers by including voluntary recourse provisions that allow them to substitute loans in the event of foreclosure.

- RLF pricing can be done in ways that RLFs need not open their detailed loan files to outside scrutiny.

The usefulness of securitization to RLFs is likely to increase even further as the volume of loan sales increases.

- As it becomes possible to sell loans at any time, it will be easier for RLFs to adopt asset management techniques that allow them to sell loans only when they have ready borrowers—to protect their operating income by guaranteeing they can quickly relend the proceeds of securitization.

- Discounts will decline further as investors become more comfortable with buying RLF loan-backed securities and as competition increases.

- Transaction costs will decline as standardized documents and procedures are developed.

- Specialized intermediaries should emerge to increase competition.

At the current time, it appears that the biggest obstacle to expanding the use of securitization to meet RLF needs lies on the supply side of the market. Each of the demonstration participants that attempted to buy or pool loans found it difficult to find RLFs willing to sell.

While recognizing that demand for RLF loans may be suppressed somewhat right now due to the fortunate economic times the nation has experienced, it seems unlikely that this is the only explanation. Each of the demonstration project grantees reported that significant numbers of RLF operators and their boards of directors remain skeptical of securitization. For that matter, so do many officials in EDA and other federal agencies. Many RLF operators may also be trapped by their past practices, because their loans carry low interest rates that would subject them to large discounts.

The experience gained in the demonstration project raises important new questions.

- What forms of continuing outreach can help RLFs to determine if securitization is right for them?
- Would securitization be more viable if the federal government worked with RLFs and the financial community to develop standardized documents?
- Are subsidized interest rates central to the economic development mission of RLFs operating in distressed areas?
- If subsidized rates are important, should the federal government reimburse RLFs for the cost of those subsidies?
- If not, should the federal government encourage or require RLFs to lend at interest rates that are closer to market rates?
- Should the federal government require RLFs to attempt securitization before they can qualify for recapitalization grants?

EDA and other federal agencies that fund RLFs will have to consider these questions carefully as it becomes increasingly difficult to fund RLF recapitalization using grants. In the meantime, a growing number of RLF operators are using securitization to generate new lending capital from their portfolios. EDA is continuing to support these innovative approaches as one way to increase the impact of federal funds in the communities we serve. Operators of EDA RLFs may securitize their loans at any time; obtaining EDA approval is fast and simple using the procedures developed under this demonstration. RLF operators are invited to contact any of the demonstration participants using the contact information listed on the following page.

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NOTES

1. Most notably, CFED excluded RLFs funded by HUD's Community Development Block Grant (CDBG) funds, even though these funds represent a huge source of capital for RLFs nationally. Some unofficial estimates put the dollars in RLFs nationwide as high as several billion.

2. The ability of an RLF to retain cash may be constrained by rules placed on the RLF by government agencies or foundations that capitalized the fund initially. EDA, for instance, requires that RLFs operate their funds so as to have 75% or more of their funds loaned out at all times.

3. According to the survey conducted as part of the research, the average rehabilitation loan on single family homes carried an interest rate of 3.11% and term of 12.8 years; for multifamily homes, the interest rates was 2.35%, with a term of 8 years (Dommel, 1995: 8). According to Malone (1992), the average EDA RLF loan as of March 1991 carried an average interest rate of 7.6% and term of 7.75 years.

4. Details of case from Richardson (1996).

5. Both HUD and EDA have provided funding to JEDA. EDA loans were not included in this transaction, however.

6. Details of case from Richardson (1996).

7. In contrast to this direct-pay LOC, a "standby LOC" would have payments being made by the RLF, with the bank backing those payments.

8. In several cases, the grant was made to support a specific loan, with the requirement that the repayments on the loan be used to establish a revolving fund.

9. Figures provided by Cathleen Surface, Executive Director of VSBFA, March 2001.

10. One result of this was that VSBFA had an inordinately large percentage of poorly performing loans left in its portfolio after the sale.

11. In retrospect, VSBFA indicated that they had received positive comments from borrowers about the quality of Cargill's servicing practices.

12. The author, Scott Reznick, is also President of Commonwealth Development Associates (CDA), one of the demonstration project grantees.

13. The projects started October 1, 1999. The anticipated closing for transactions was August 15, 2000.

14. Most federal agencies allow some portfolio revenue to be used for overhead and operational expenses. EDA allows interest income, but not repayments of principal to be used for these purposes (EDA RLF Standard Terms and Condition, 1998, E. Financial Requirements, 05-06).

15. We have pooled these loans for our analysis in order to protect the anonymity of individual borrowers.

16. This was 1 to 1.5 percentage points above the yield on 5-year fixed maturity Treasury notes.

17. In many cases, "socially responsible" mutual funds and other investments have been able to earn returns comparable to or better than the market as a whole.

18. Of course, interest rates could also fall, in which case the investor would receive a windfall. For the purposes of pricing their loans, the relationship between risk and price is asymmetrical. Investors only consider the down side.

19. Interestingly, Reznick (2001) finds that RLF collateral coverage ratios at the loan level are often higher than commercial standards.

20. To provide an example of why these options might not be available, most states do not allow full faith and credit guarantees to be provided on bonds where the revenue goes to fund private businesses (Reznick, 1998).

21. Adapted largely from Reznick (1998).

22. See *Federal Register*. June 30, 2000. U.S. Department of Housing and Urban Development, Economic Development Initiative, Community Empowerment Fund.

23. In the case of Racine County, EDA also subordinated its rights on any new loans from the RLF, because these were also pledged as collateral. However, at such time that the line of credit expired, EDA's interest in these loans was to be fully restored.

24. The time to settle the legal issues involved precluded this transaction from being included as part of CRF's Twelfth Series Notes. However, it is expected to be included in a new note offering in 2001.

25. Similarly, we might expect an increase in loss rates if interest rates and terms are shifted more toward market standards.

26. CRF reports that all but one of the RLFs they bought loans from were able to relend their proceeds immediately, and that the remaining one anticipated being able to make new loans quickly.

27. Also remember that in the Virginia case, the RLF that was willing to accept a large discount in order to securitize its portfolio subsequently found it could not easily relend its funds.

28. http://www.ffiec.gov/cra/qa/sect23.htm Retrieved April 12, 2001.

29. http://www.ffiec.gov/cra/qa/letter_19970911.htm Retrieved April 12, 2001.

30. There are no charges (except minor administrative fees) unless the RLF draws on the LOC.

31. This includes $2.1 million dollars in collateral loans and reserve funding for a borrowing of $700,000.

32. This assumes the RLF could actually find acceptable borrowers for any additional cash provided.

33. CRF has other services as well, but most of these do not apply to the EDA project.

34. As a nonprofit organization, CRF also requires that proceeds of loan sales go to socially beneficial purposes.

35. In fact, these numbers differ slightly from the final figures at closing, because some loan payments were made between the time the loan sales were approved and the final closing date.