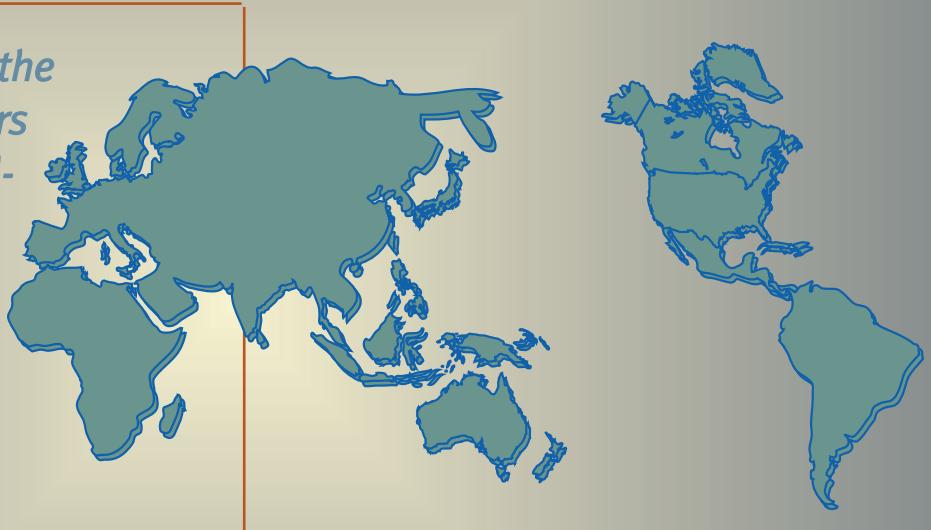


# UNBLOCKING OBSTACLES TO CAPITAL MARKETS FOR COMMUNITY DEVELOPMENT LENDERS

*Improving access to the capital markets occurs by enhancing the collaborative vision of practitioners, Wall Streeters and philanthropists*



Where access is a direct function of adopting market standards, increasing scale, through pooling and converting operations from portfolio to a capital markets asset management model.

"The breadth and attitude of our vision for today's potential or tomorrow's dream will profoundly influence what we see at this moment." —(Author unknown)



by Gregory M. Stanton  
Director, Capital Markets Access Program  
and the Wall Street Without Walls Initiative

June 2003

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## Executive Summary

This paper examines the persistent obstacles, gaps and barriers to the capital markets, that prevent a freer flow of capital to needy communities. The supply of capital from the community development finance industry is currently provided by a host of mission-driven financial intermediaries. These include Community Loan Funds, Community Development Corporations (CDCs), Revolving Loan Funds (RLFs), Community Development Credit Unions (CDCUs) and Micro-lending Financial Intermediaries (MFIs).<sup>1</sup> Collectively we will refer to them as Community Development Financial Institutions (CDFIs).

These CDFIs finance various community assets such as single and multifamily affordable housing, small business loans, consumer loans and community facilities. Yet, the increasing demand for capital cannot be met by the current supply of traditional philanthropic, government, concessionary rate, and other sources of capital.

While there have been a few CDFIs successful in achieving limited access to financing from institutional investors, according to Kevin Smith, Vice President of the Fannie Mae Foundation, "...there is an inadequate flow of capital into the Community Development Finance System to fulfill the supply needs for affordable housing and build healthy, vibrant communities nationwide."<sup>2</sup> This is the major challenge to practitioners facing current and potential future declines in grant and concessionary-rate capital from philanthropy and government.

Our examination of major obstacles, such as the scale of lending or documentation of loans, joins other important current research and pilot projects, that are dedicated to finding solutions to the capital shortage affecting most depressed communities, minority businesses and aging community economic development infrastructure. The premise of this paper is that sustained capital markets access is a function of increased scale, standardization of practices, documents and processes and improved management skills.

This paper is divided into three sections:

**Section I. Problem Areas and Obstacles to the Capital Markets.** This section reviews some of the problem areas and systemic blockages to the capital markets that may be caused both by inadequate infrastructure within CDFIs, such as data collection and information systems, and the fact that many CDFIs have not adopted certain market standards, such as standard underwriting processes.

**Section II. The Capital Access Landscape.** This section highlights the current capital markets business model for small business loan securitization, Rule 144A private placement activity<sup>3</sup>, and secondary market activity as applied to the community development finance industry's efforts to improve its access to the capital markets.

**Section III. Vision and Innovation: Steps to Improve Capital Markets Access.** This section examines the possible improvements, new ideas and innovations that may be helpful in improving capital markets access for the community development finance industry. Community development lenders and Wall Street professionals need to work together to solve the capital access problem. In so doing, they will identify and build strong pathways into the flows of institutional capital for community development projects. Success in closing the "capital gap" will be based on the success of CDFIs accessing mainstream markets through achieving scale and piggybacking with other CDFIs (as issuers) and using the market's customary structures. These collaborative efforts must meet and pass institutional investor's due diligence tests and appetite for various security types. Successfully accessing capital markets will require that CDFIs: 1) Quantify liquidity needs and market size; 2) Accurately document asset performance; 3) Design innovations necessary to isolate perceived and actual risks related to Community Economic Development (CED) investments; and 4) Utilize incentives such as the New Markets Tax Credit to appeal to institutional investors.

<sup>1</sup> Community Development Financial Institutions include all of the following: Community Development Financial Institutions; Revolving Loan Funds; Community Development Corporations, called CDCs; and Community Development Credit Unions.

<sup>2</sup> Fannie Mae Foundation "Expand Capital to Communities." A presentation by Kevin Smith, Washington, D.C., September 26, 2002.

<sup>3</sup> Definition of Rule 144A for Private Placements. Excerpt from the *CPA Online Journal 2001*. "The principal objective of Rule 144A is to increase the efficiency and liquidity of the U.S. market for equity and debt securities issued in private placements by allowing large institutional investors to trade restricted securities more freely without subjecting the companies to the SEC registration and disclosure process."

The innovations that we discuss here include:

- Creating community development financial guarantees and financial wraps custom-tailored for CED products, but shaped by generic investment grade institutional investor demand. This may include the use of “dead” or underused government assets, such as the assets of Housing and Urban Development (HUD) auctions to provide additional collateral to raise CED transaction credit quality and reduce the financial guarantee and transaction costs.
- Employing relevant financial engineering to develop financial products that use the New Markets Tax Credit.
- Modernizing the CDFI’s approach to financing and asset management—from the Portfolio Method of Financing (PMF) to a Capital Markets Financing (CMF) method of asset management. The CMF method originates, packages and sells assets to increase capital and liquidity, rather than just originating assets and managing them through maturity. We realize that many community development lenders will want to maintain a portion of their loans in portfolio. This may make sense for certain types of loans or a certain percentage of the overall portfolio. We also realize that many lenders are reluctant, for good reason, to sell their loans at a discount. We are cognizant of these issues, and our innovations will take these concerns into account.

This paper invites *bold action* from practitioners and finance professionals in finding common ground and methods to efficiently finance pools of non-conforming assets. Bold action calls for substantively improving systems of tracking and servicing assets, finding more cost-effective means of credit enhancement, and adopting standards that are accepted by capital markets. Bold action requires debate and analysis on how to gain capital access by communities. Bold action must address an increasing capital gap and make it a priority on the national agenda.

How we view obstacles to capital access and what we do to overcome them—now—profoundly influences society. We must investigate how to integrate the loans originated by community development lenders into capital markets instruments. There are many ideas and innovations being discussed in the field. The Capital Markets Access Program (CMA)<sup>4</sup> has organized and is part of a team of institutions and individuals that is working to promote innovation in the field.

<sup>4</sup> The author, G.M. Stanton is Director of the Capital Markets Access Program, a foundation-funded program to improve access by nonprofit organizations to the capital markets. Started in 1998.

## Credit Insurance

## Assignment of Government Collateral

## Capital Markets Asset Management

Four innovations currently being pursued include:

1. Establishing a Financial Guarantee Corporation or capability to provide a financial guarantee by credit enhancing or wrapping CED transactions to investment grade credit quality.
2. Establishing a CED financial Product Task Force for high net worth individuals and institutional investors.
3. Developing a peer-to-peer lending capacity for CDFIs in the form of a mini-Federal Reserve System.
4. Establishing a Capital Markets intensive training program alongside the Federal Reserve Bank’s Community Affairs Programs.

## Introduction and Background

**C**ommunity Development Financial Institutions (CDFIs) capitalize themselves through a mixture of public, private, and philanthropic investments and contributions. Unlike many “conventional” financial institutions, most CDFIs do not re-capitalize themselves by packaging and selling their loan portfolios on a secondary market. It is not clear how many CDFI loans could potentially be sold on a secondary market. It is also unclear to what extent there is a desire on the part of CDFIs to sell their loans and thus obtain additional capital, or to what extent CDFIs are experiencing capital liquidity problems.

The Department of Treasury’s Community Development Financial Institutions Fund suspects that the capital liquidity issues are serious enough to create a demand for a secondary CDFI market. The Fund also hypothesizes that the current secondary market (to the extent that one exists) is inadequate to meet this demand. Yet, a definite and positive relationship between access and standardization almost certainly exists: A correlation exists between integrity of the data collection process, market acceptable servicing procedures, and the level of institutional investment interest in CED assets.

### Obstacles, Barriers & Gaps.

By analyzing the obstacles over which practitioners and CED professionals have some control, this article highlights the required changes in systems, processes, infrastructure and knowledge that positively and substantially affect the potential of CDFIs to increase their access to capital.

A “capital gap” occurs when organizations can no longer finance their CED assets from their usual and customary funding sources. To bridge the gap, practitioners are challenged to identify and attract other consistent sources of capital, addressing their target area’s capital needs. Only through a collaboration of practitioners, philanthropists, social investors<sup>5</sup> and capital markets financiers, all motivated to bridge a large and increasing “capital gap,” will a solution be found. The work these groups do together in thoughtful collaboration will result in debt instruments that will bring large institutional investors into the CED finance marketplace.

What is needed is a radical shift from “the tried and true” in the way CDFIs obtain investment financing—a transition from the older portfolio financing model to a dynamic capital markets model.

### Capital Markets Access for CDFIs, CDCs and RLFs as a function of scale, standardization and management (Theoretical model)

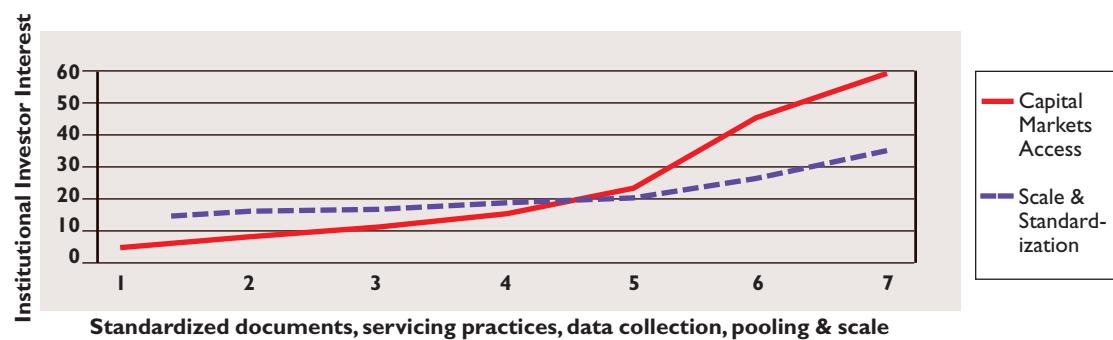


Figure 1

<sup>5</sup> Social investors are defined by their interest in both the social and financial returns of an investment or concerned about the “double bottom line.”

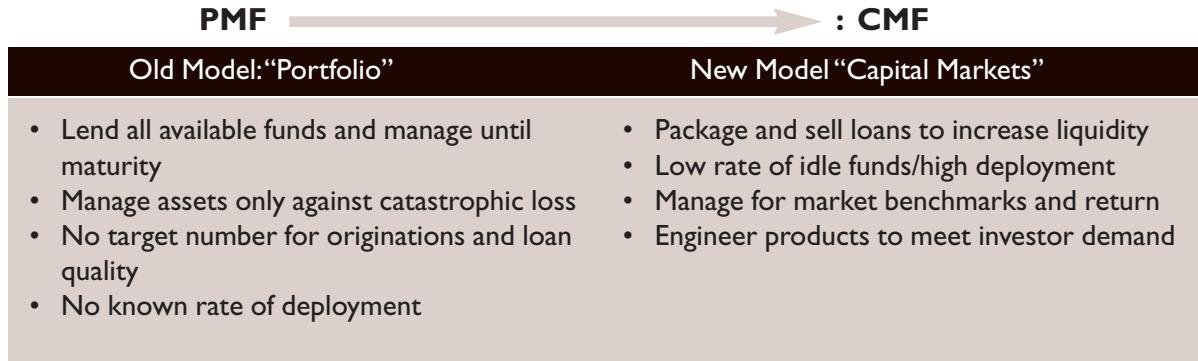


Figure 2

While the method of financing called “securitization” has been bandied about quite liberally, the reality is that any large-scale loan securitization either in the public or private capital markets remain out of reach for the majority of CDFIs at present. Yet, the process of monetizing loan portfolios, or portfolios of well-documented assets, and packaging them as investment-grade private placements, including 144A private placements, either from individual issuers or as a pooled group of loans from multi-issuers, remains a viable and strategic financing mechanism.

Just as it has already proved to be a major source of financing in the for-profit financial services market that provides small business loans to average and higher risk borrowers, this process has proved to be a sizable source

of liquidity to some of the larger CDFIs. Examples of successful applications of the Capital Markets Funding process of economic development loans in the community development sector are the Community Reinvestment Fund (CRF) of Minneapolis, Minnesota, and Self Help Inc. of Durham, North Carolina.<sup>6</sup> They demonstrate that applying capital market based methods, financial engineering, loan servicing and performance tracking techniques in no way compromise an organization's mission and service to its communities.

With these thoughts in mind, we need to analyze the problem areas, review the capital market landscape and environment, and devise meaningful and innovative solutions to community investment problems.

<sup>6</sup> The Community Reinvestment Fund of Minneapolis, Minnesota has underwritten over \$250 million in economic development loans. Self Help of Durham, North Carolina has underwritten over \$1.5 billion in mortgages for low-income communities. Both organizations have been largely responsible for attracting a number of institutional investors to invest in their community and economic development. These firms include: Prudential Securities, Washington Mutual, Wells Fargo, MetLife, Mennonite Pension Fund and Equitable Insurance. Their role, as well as many other CDFIs, have been instrumental in growing this marketplace and has been the inspiration for bringing their clients' mission to Wall Street and getting it financed.

## Section I. Problem Areas and Obstacles to the Capital Markets

Over the last twelve months, this author has been listening to community economic development and capital markets finance professionals across the country talk about the major problem areas and obstacles that CDFIs encounter trying to find alternative sources of capital. Those discussions have led to an identification of the problems involved in adopting a capital markets model for CDFIs.

### Major Obstacles:

1. *Lack of Knowledge.* There is a lack of knowledge among CDFIs about capital markets mechanisms and underlying requirements.
2. *Concern about Cost.* CDFIs are rightfully concerned that selling loans on a secondary market will require them to take discounts on their loans. That is, they are concerned that they will lose money when they sell their loans. Most CDFIs cannot afford to do this.
3. *Lack of Market Data.* For any emerging asset class to gain credibility in the capital markets, it must have a historical and reliable performance database of five years. This allows investors to analyze the assets over time to determine trends and projected risk. A minimum of at least a three-year period is required for most rating agencies and investors to get comfortable with average performance, worst-case scenarios, and likely returns. With the exception of the Small Business Administration's (SBA's) database and several third-party data tracking indices on the performance of small business loans, the CDFI industry has no body of data that has been uniformly collected, is highly reliable, and is accurate for capital market investors to analyze risk and performance.
4. *Lack of Incentives.* There is a dearth of incentives to establish loan production goals, that attempt to in-

crease loan volume and improve quality based on a comprehensive system of awards for grants and Program Related Investments (PRIs).<sup>7</sup> Today, CDFIs do not have the ability to quantify demand or their need for liquidity.

5. *Continued Use of Unsophisticated Portfolio Valuation Models.* Currently, CDFIs do not price adequately to earn sufficient spread income for long-term viability without additional grant funding. CDFIs may not price their loans to the risk assumed. Below-market rate loans with insufficient spread, along with the cost of technical assistance, require many CDFIs to raise substantial operating income from grants and donations. This is a large issue within the field. Many CDFIs knowingly subsidize the cost of their technical assistance services because their customers cannot afford to pay the full cost of that assistance. The provision of assistance also helps create loan demand from the targeted groups and individuals. This, in itself, is not an obstacle to accessing mainstream capital markets for CDFI loans, but many CDFIs are unable to project growth in lending due to limitations in raising the operating capital needed to subsidize the lending.
6. *No Incentive to Pool.* There is little or no regional aggregation for financing assets. CDFIs are not organized to participate as part of pool loan originators, nor are they organized as part of a cooperative network of loan sellers or issuers.
7. *CDFIs Do Not Farm Out Specialized Services.* Unlike many traditional lenders, CDFIs do not breakdown and quantify the profitability of each part of the underwriting process and farm out specialized functions to more cost-efficient vendors.

<sup>7</sup> Program Related Investments are a type of grant or loan provided by foundations which usually have more flexible terms, conditions and lower rates than conventional loans.

## Current Efforts—Not Enough

While the CDFI industry participants and trade associations have recently undertaken research initiatives to gather financial data about the credit quality of the CDFIs as financial service entities, and a new research effort will look at individual CDFIs and their portfolios of assets, the current and historical performance of their loans—none provides standard data tracking processes.

However well intentioned and costly these research projects have been to date, they have not resulted in reliable or complete information sufficient for investors. And because there is no accuracy or completeness of CDFI loan demand data and market research, the net result is that can be no factual conclusions drawn or representations made as to *what the market size and market potential really is*. In this information void, the industry is unable to answer standard market questions that the capital markets ask of any asset class, especially new, emerging markets or non-traditional assets classes.

### “Yes,” “No” and “Not Sure”

- “Does the CDFI industry have a liquidity problem?”
- “Are CDFIs meeting their area’s demand for capital?”
- “Are CDFIs sufficiently meeting the capital needs of their communities?”

The responses to these questions vary depending on who you ask. Some say “Yes”—there are many problems accessing the markets. Some say “No”—there is no problem, nor is there a need that they are not already filling. Some policymakers from the CDFI industry claim that there is no need for liquidity or liquidity vehicles that can’t already be provided from the local banks. Industry spokespersons are unsure about capital needs—some say that there is an \$8 billion capital need; some have ventured \$25 billion. In contrast, the Milken Institute, which tracks capital to low-income communities and minority business trade associations, says that the CDFI industry is not even touching the tip of the iceberg in meeting the demand of minority businesses in these communities.

**No sense of real market loan demand by target area.  
No reliable forecasting capabilities.**

## Problem No. 1: Failure to Adopt Market Standards

The Community Development Financial Institution’s single most problematic area for capital markets access is its inability to communicate its financial asset’s performance on the same terms and conditions that are used by mainstream institutional investors. Moreover, the CDFIs have failed to adopt the universally accepted capital markets standards for underwriting documents, data collection processes and reliable performance tracking.

More CDFIs need to adopt the for-profit disciplines, practices, standards and techniques for lending. These disciplines include:

- Credible data collection systems and market intelligence.
- Reliable loan performance tracking tools.
- Market acceptable servicing software and practices.
- Valuation methods to price portfolios of loan.
- Underwriting, risk assessment and risk mitigation methods.
- Servicing systems, practices and procedures.
- Acceptable collections and back-up service requirements.
- Packaging and distributing to institutional investors.
- Compliance with regulatory and securities laws.

**Employ scientific methods to determine demand**

## Problem No. 2: Market Size and Loan Demand is Unknown

The market for community development loans has not been accurately quantified on a national, regional or local basis. CDFIs have not used reliable market research tools to accurately determine their potential market share.

### Recent Attempts to Define the Market

Over the past several years, there have been several significant research efforts sponsored by foundations or trade associations to map the market and determine the current and future size of the CDFI market.

The research and innovation efforts identified in Appendix A are substantive and very valuable. Yet none of these efforts has quantified factual loan demand, loan performance, market share, market penetration and market forecast data. The field needs to utilize the techniques, predictive marketing tools and professional firms who specialize in these disciplines—specifically determining loan demand and market share. But there will be extensive market research expenses in determining demand. Collecting adequate data will require resources from corporations and local governments as well as philanthropy.

### Market Forecasting

When reliable market demand is collected and analyzed, then the CDFI fund, other government funders such as the Economic Development Administration and the foundations can allocate their grants based on greatest potential, demand, impact and need.

Several other good examples of information gathering and collection that CDFIs may imitate or replicate include:

1. *The Borrower Sentiment Index*: A Federal Reserve's "Survey of Lenders" identifies whether loan demand is rising or falling, measuring expectations of whether terms or rates will ease or tighten and measuring borrower sentiment from potential small business borrowers as to whether they believe whether it will be harder or easier to obtain a loan.
2. *Small Business Survey by Business Week*. *Business Week Magazine* employs a series of small business surveys of borrowers and lenders to obtain a market sense of demand and issue concerns.
3. *Consulting Firms*. The increasing sophistication of financial product marketing has helped in perfecting market intelligence gathering tools, techniques and feedback. Firms such as McKinsey, Booz Allen Hamilton, Bain Consulting, the Business Loan Group, BCG, or Wells Fargo, Bank of America, J.P Morgan Chase and Washington Mutual all have produced a number of applicable forecasting processes and models.
4. *American Bankers Association Customer Satisfaction Seminar*: Banks have to use market demand diagnostic tools. The American Bankers Association publications describe a number of tools that aid member bankers in effective market research and marketing techniques to reach the small business: "Who and where is my customer base?" "How do I maintain or better service my customers?" "What is the future total demand for my products in my target area?" "How can I define my target customer base more precisely and profitably?"

The members of the CDFI industry, through its sponsors and underwriters, have not hired or caused their grantees to hire demonstrably qualified firms from the capital markets, banking industry and marketing consulting firms that are recognized specialists who know how to identify, qualify and forecast market demand by geographic, mission, designated market area or zip code.

### Failure to adopt market standards

### Problem No. 3. No Systematic Method for Pooling Assets for Economies of Scale.

Most community development lenders operate in their own universe and are not part of an integrated system that connects them to others in the same target area or regionally to raise capital as one of multiple issuers working with the broker/dealer community in structuring and selling loans to bring liquidity into their respective markets.

When a number of CDFIs are clustered in the same area, there may be a number of redundant costs and expenses. If the expenses for financial services administration and loan origination are shared and redundant services eliminated, the impact of grant dollars would be greatly enhanced. Yet, it seems that each nonprofit financial intermediary does not see itself as part of an organic whole, but as a separate and unique entity.

The pooling concept is not new to CDFI practitioners. Yet, there are few opportunities to participate in scale initiatives that either reduce their transaction costs or their operating expenses. The beneficial effects of pooling need to be quantified and offered to the CDFIs.

### Problem No. 4. No Incentives to Bring Together Wall Street, Practitioners and Philanthropy

### Stakeholder, funders and investors are not currently motivated to cooperate

The CDFI industry, through the CDFI Fund, that is leading practitioners and trade associations has not developed any incentives for bracket capital market firms to commit some financial, as well as organizational resources to help in researching, analyzing and tinkering with this emerging asset group. To do this requires that this industry not be viewed as 3000 separate, distinct and disconnected little lending companies. Rather, it should be viewed as a cohesive and networked group of loan originators and potential issuers with a quantified, current and future demand for capital. For Wall Street to invest its expertise, they have to see this marketplace as more than a series of individual transactions.

The CDFI industry needs to see itself as a connected network of loan originators with common issues and problems. They need to collectively quantify current and future demand for capital and to develop common data collection systems. CDFIs can be served by the existing system of investment banking. Existing regional and national investment banking firms have the qualifications, expertise and regulatory infrastructure necessary to help groups of CDFIs raise capital in the institutional markets.

### No Social Capital Markets: It's All One Market

A number of practitioners and trade associations in the CDFI field have presented another view: the need to build up a hybrid capital market—a “Social Capital Market” which runs outside of or parallel to the commonly accepted capital markets systems, forces and disciplines—even advocating having its own rating system, risk assessment measures, data and servicing procedures. While these ideas may seem attractive, all emerging markets assets are part of the capital markets and must pass through the portals and disciplines of the financial markets that operate to isolate and package risk for defined institutional investors.

### Conclusion: Summary of Problem Areas

The main reason why CDFI access to mainstream capital markets is so limited is due to a systemic failure of the CDFI industry to apply and custom-tailor the capital markets model.<sup>8</sup> CDFIs need to conform their processes of originating, servicing, tracking, packaging, structuring, placing and distributing their loans to institutional investors as a security or private placement. The prime movers—the CDFI Fund, the Economic Development Administration (EDA) and foundations providing Program Related Investments and operating support to these CDFIs could be more aggressive in requesting that Wall Street firms teach their grantees about the systems and processes necessary to package these loans and sell them to institutional investors. Grantors have not

required that their grantees learn directly from the capital markets makers nor apply the required accounting and serving systems, data collections processes and use of standardized underwriting documents.

When each CDFI makes up its own loan documents and establishes its own servicing criteria and definitions for default and delinquencies, then these assets cannot be measured, pooled or financed as a group of similar type assets. The capital markets require that pools of assets have some uniformity and accurately reflect the asset’s performance in order to be predictable. The capital markets system reinforces and rewards those whose data and performance can demonstrate timely payment of principal and interest. The more accurate, standardized and reliable the data, the better the pricing that is offered by sellers (issuers) as well as investors.

### Applying What Works in the For-Profit Capital Markets

To solve the problems of access requires that practitioners and capital markets professionals apply what works in the capital markets and custom-tailor them for the uniqueness of CED assets and processes. Applying capital markets processes, structures and forms of credit enhancement to CED financial products will help the CDFI industry meet its mission-related financing needs. Without a fresh perspective, the CED field could be locked into practices of the past that limit its scope, impact and, in some instances, relevancy and sustainability.

<sup>8</sup> See the Capital Markets Model for application to nonprofit organizations..

## Section II. The Capital Access Landscape: The Challenges Facing the CDFI/CED Finance Field

The size and scope of the CED market has been thoughtfully described by Charles Tansey, Senior Policy Director for the Neighborhood Reinvestment Fund and leader of the Capital Access task force of the Financial Innovations Roundtable sponsored by Southern New Hampshire University's School of Community Economic Development.

The rapidly changing institutional CED landscape includes approximately 600 community development financial institutions (CDFIs) certified by the CDFI Fund, 6,400 federal credit unions (FCUs), of which 200 have a low-income designation given by the National Credit Union Administration (NCUA), 500 EDA grantees as revolving loan funds, 350 United States Department of Agriculture (IRP) borrowers, 300 SBA 504 lenders and 140 micro-lending organizations... Over the past decade the community and economic development field ("CED Field") has benefited from major advances in the efforts to expand access to capital. New public and private sector entities, new concepts, mechanisms and products, new and expanded public sector programs, greater awareness of the Community Reinvestment Act, greater visibility of the CED field and greater commitments on the part of the for-profit as well as the non-profit sectors have contributed to a dramatic expansion of capital availability.<sup>9</sup>

There are a number of challenges currently facing the CDFI sector as it seeks to expand and scale-up its lending activities. These challenges include:

1 **Pricing:** Previously those entities, that attempted to buy portfolios of loans from CDFIs either did not know how to value the portfolio appropriately or the buyers were overcompensated for their risk. Historically, the discount offered to price the loan portfolio was very deep (price too low) and it didn't make economic sense for CDFIs to sell their loans and lose net asset value. The challenge is to develop a more exact pricing model that better reflects the asset value

in the portfolio and the real default and delinquency histories.

2. **Lack of Document Standardization** alienates institutional investors and increases transaction costs. Many CDFIs use various types of loan underwriting documents that differ from the generally accepted loan documents of conventional lenders. The field needs to use standard loan documentation.
3. **No Mechanism for Achieving Scale.** CDFIs generate small loan portfolios that are difficult to sell. The CDFIs that want to access the capital markets need an ongoing mechanism to increase scale through pooling. This may include cooperatives, super regional Community Development Entities (CDEs), or an origination system that reflects the capital markets with specialists in each part of the origination, pricing, packaging and selling functions rather than just each organization standing by itself.
4. **Market and Management Expertise.** CDFIs have varying credit training skills and risk assessment capabilities. There is no across-the-board minimum competence standard.
5. **Unequal Access to Bridge Funds.** Many CDFIs do not have the funds to close on loans at hand and could use a short-term facility that allows them to complete loans in a timely manner. Some CDFIs have excess liquidity, while others have a significant need for 30-, 60-, or 90-day short-term capital. There is no short-term capital capability similar to the Federal Reserve's discount window to supply short-term bridge capital. By arranging a peer-to-peer CDFI short-term lending process, the CDFIs would achieve a higher deployment rate of limited funds being put to use in their target areas.

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<sup>9</sup> "Mini-Federal Reserve System" proposal by Financial Innovations Working Group, Charles Tansey, Neighborhood Reinvestment Fund.

## So Where Do the Various Actors Stand?

The CDFI Fund has made it a priority to find answers to questions about market demand, liquidity or need for supporting a secondary market. The CDFI Fund, in conjunction with Abt Associates of Cambridge, Massachusetts, the Economic Development Assistance Consortium (EDAC), and Community Reinvestment Fund (CRF) are embarking on a major research and survey effort to find relevant CDFI member's interest and need for capital markets access. Abt *et al* shall assess the feasibility of creating and/or enhancing a sustainable secondary market for loan/investment portfolios of CDFIs. The research looks to answer the following questions posed by the CDFI fund:<sup>10</sup>

1. Is there actual or potential demand for the sale and purchase of CDFI loans/investments?
2. If so, what types of loans/investments lend themselves to being sold?
3. Are there particular types of CDFI loans/investments that could not be sold on a secondary market?
4. Assuming that there is some mutual unmet demand (on the part of both CDFI sellers and potential buyers) for a secondary market for CDFI portfolios, why has that demand not been met?"
5. What informational, financial, legal or other barriers hamper the development of such a market?
6. What benefits would the establishment/enhancement of a secondary market have for CDFIs?
7. To what extent would such a market address/alleviate capital liquidity issues in the industry?
8. Which CDFIs or types of CDFIs could/would benefit most from a secondary market?
9. What are the potential conflicts (if any) between the financial incentives of a secondary market and the social/economic/charitable motivations underlying many of the CDFI loans/investments?

Assuming that a secondary market for CDFI portfolios could be viable and sustainable, continued research with the CDFI field would look toward answering the following questions:<sup>11</sup>

1. Who are the potential purchasers of CDFI loans?
2. What marketing efforts would be required to build/expand the demand for these products?
3. Is there an ideal/minimum volume and/or amount of loans that must be included in any secondary

market sale transaction in order for that transaction to be appealing/successful?

4. What legal/regulatory changes would be required (if any) to establish such a secondary market?
5. What financial incentives (credit enhancements, guarantees, etc.) would be necessary to make the sale of CDFI portfolios appealing/viable?
6. How much capital would be required to establish/enhance such a secondary market?
7. What non-financial resources (education, publicity, etc.) would be necessary?
8. Who could/would take the lead role in building the secondary market?
9. Who would regulate the market?
10. Who would be responsible for servicing the loans/investments sold on the market?
11. How would the secondary market ensure that it remained focused on community development?
12. What role, if any, could/should the CDFI Fund play in creating/enhancing the secondary market?

The government's response through the CDFI Fund has been to fund research to not only determine the magnitude of current and future loan demand, but more importantly, to determine what elements are necessary to develop and credit enhance products for a secondary market. The results of the research efforts should be available in 2003.<sup>12</sup>

## Foundations' Response

Some foundations have been motivated to rethink their grant allocations based upon impact and sustainability. Yet rarely do foundations reward the more successful CDFIs because funding is not based upon performance realized, but rather performance hoped for. This is a point of concern for some CDFI grantees; their success seems to provide a disincentive for furthering a foundation's grant-making commitment to them.

Some foundations such as the Ford, Rockefeller, F.B. Heron, W.K Kellogg, MacArthur and Fannie Mae Foundations have developed the field's overall knowledge base in Community and Economic Development Finance. They have individually and occasionally jointly discussed or funded pilot programs and research that will help CDFIs achieve financial autonomy. They are currently exploring how they may guide their grantees towards adopting a dynamic capital markets model.

<sup>10</sup> "Feasibility Analysis—Secondary Market and Recommendations for Establishing/Enhancing It." Direct quotes of questions included in RFP by CDFI Fund 9/13/02.

<sup>11</sup> Direct quotation of questions from Request #RFQ 01-F064 dated 9/13/01 from the CDFI Fund.

<sup>12</sup> Source: Tony Brown, Fred Cooper and staff of CDFI Fund.

### **Capital Market's Response**

Wall Street firms in general have not provided much research effort to the CED field, although several firms such as Bear Stearns, Jackson Securities and MONY Advest have reached out across the aisle to determine how they might participate with the CDFIs in this emerging marketplace. The major capital markets firms with their structured finance and development finance groups have developed many financial products that address and fund just about every type of asset class (e.g., mortgages, loans, receivables, intellectual rights, contracts, and payment streams, etc.) that appears in the CED portfolio. For even the most unique nonconforming assets originated by financial intermediaries, there is already a financial instrument that has successfully raised capital from institutional investors by for-profit issuers. There is no need to invent anything new—the financial product templates already exist. They simply need to be custom-tailored to the unique repayment characteristics, cash flow and asset type of nonprofit organizations assets.

### **Financial Innovations Roundtable (FIR) Response.**

The Roundtable organizers<sup>13</sup> wanted to make sure that the CED field had a complete and working knowledge of current practices and standards required of any issuer that attempts to access the institutional capital markets. The primary reason for bringing this group together was to frame possible strategies and establish task forces that would help to dramatically increase CDFI liquidity in this sector (*if liquidity needs were warranted and loan demand was not being met*) in addition

to current sources of foundation and government grants and CRA—driven investments. The roundtables provided a clear overview of the *required standards, credit quality, data collection, servicing and reporting procedures* that are practiced and followed by all for-profit issuers (sellers of small business loans) and which must be embraced by all potential issuers from the financial services sector regardless of whether the entity is for-profit or not-for-profit.

The Financial Innovations Roundtable task force concluded with the following recommendations:

1. ***Build Nothing New.*** In order to successfully access the institutional capital markets in any size and of any consequence, the Roundtable participants advised the CDFI field to build nothing “new” nor invest in the high cost of building investment banking infrastructures for underwriting and distribution of securities.” The finance professionals advocated that the practitioners apply the best and required practices from the for-profit issuer capital markets model and systems that would be sufficient to satisfy the due diligence and risk mitigation needs of institutional investors.
2. ***Important Next Steps:*** The most important steps for CDFIs’ improved capital access are:
  - Identify and quantify real market-based loan demand.
  - Standardize documents with grantor involvement.
  - Provide market acceptable data and performance tracking.
  - Incentivize loan origination and loan quality.
  - Coordinate pooling and issuer cooperatives among regional CDFIs.
  - Establish a standards oversight committee.

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<sup>13</sup> Securitization Roundtable, U.S. Chamber of Commerce, March 15, 2002 in Washington, D.C. and May 3, 2002, Manchester, NH, sessions sponsored by the Financial Innovations Roundtable, a program of the School of Community Economic Development at Southern New Hampshire University. See [www.finir.org](http://www.finir.org).

## Accessing Capital Markets: Next Steps

### First Step—Need for Organizational Audit and Review.

The Wall Street participants agreed that unless the capital markets were approached on the terms and conditions that they were accustomed to, there was very little chance of creating a sizable or efficient way to finance a growing amount of CDFI's Bankable Financial Assets.

An FIR speaker, Ms. Robin Gordon of the Deloitte & Touche's Global Markets Securitization Strategies Team

#### **Next Steps**

- **A CDFI audit**
- **Incentives for increasing loans and quality**
- **Form a market committee**
- **Cooperation**

provided an overview of the standards terms and conditions and processes that the capital markets was accustomed to. She presented all of the critical elements that any CDFI needs to possess, manage or master in order to be an issuer in the market. These basic elements include:

Data-Collection, Performance-Tracking, Back-Office Systems, Servicing Credit Quality, Collection Systems, Troubleshooting, Loan Pricing, Deal Structuring and Standardization Requirements.

Ms. Gordon suggested that each CDFI should perform an audit on its readiness to be an issuer by completing an "Infrastructure Assessment" on its abilities and capacity to sell its loans in the capital markets. The audit reviews the following critical functional areas:

- A review of the CDFI's management, policies & procedures.
- A review the technology systems for maintaining data integrity and reporting.
- A review of the appropriate internal accounting and audit controls.
- An evaluation of all potential "bombs" or weak links in the organization.
- A review of underwriting and origination practices.

### Second Step—Develop Incentives

Based on the result of the audit, the grantors, in conjunction with practitioners, would look at what area of the loan underwriting business would need improvement and change. Further, they would look at what guidelines or incentives they would be able to provide for their grantees to...

- adopt market-based underwriting standards and controls,
- adopt incentives for loan origination to increase the number of loans per target area,
- adopt incentives for the practitioners to improve loan credit quality, and
- adopt incentives for market-based systems and servicing practices.

### Third Step—Form the Committee to Advance Market Standards

Similar to the way in which the Federal Reserve uses its "moral suasion" to guide its member banks in maintaining banking disciplines, so too foundations can provide a similar guidance to grantees in fostering financial autonomy over time. The role of "philanthropic" moral suasion by the leading foundations in community development funding could play a significant role in guiding grantees' adoption of standards and embracing the disciplines necessary for meeting the demands of institutional investors. A committee comprised of foundations and CDFI practitioners could be established by the grantor community to organize voluntary guidelines for the standardization procedures and advance market standards. This group should include CDFI practitioners and trade organizations as well as leading CED funders such as:

1. MacArthur Foundation
2. CDFI Fund
3. F.B. Heron Foundation
4. Fannie Mae Foundation
5. W.K. Kellogg Foundation
6. Ford Foundation
7. Rockefeller Foundation
8. Economic Development Administration
9. Calvert Foundation

#### **Fourth Step—Cooperation.**

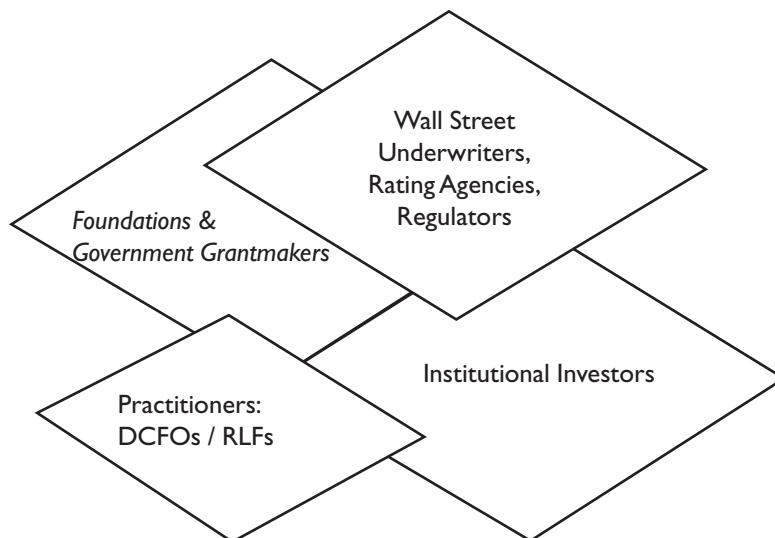
In order to advance the vision of across-the-board capital access for the CDFI industry, it will require resources and active participation from the CDFI Fund, EDA, HUD, USDA, contributing Wall Street firms, and foundations *working together*. This level of cooperation has not been experienced before and, while difficult to achieve among highly independent groups and organizations is considered the single most important factor in achieving consistency, standardization and universality. By collaborating as issuers, the CDFI industry may also be able to achieve scale. If funders collaborated as cooperating stakeholders, they would be instrumental in collectively identifying the lab work, experimentation and pilot projects that would help this field address the needs for a secondary market, systemic changes to the origination, valuation and distribution processes for the underwriting of CED assets.

The cooperation of Wall Street with foundations and practitioners would also find more effective ways of credit enhancing CED products or increasing the

deployment of capital among CDFIs across the country. The CED field could possibly develop super-regional CDEs to use excess new market tax credits or partner with other CDEs or establish regional pooling mechanisms for aggregating loans sufficient for a CED private placement.

There are several important areas in which the foundations, financial firms and practitioners could work together, the most important being that they need to plan and execute pilot programs to improve access by standardization, credit enhancement, pooling and creating scale and establishing basic competencies.

Thoughtful input from interviews, roundtables, focus groups and think-tank sessions highlight the need for leaders in the field to be innovative, collaborative and creative problem-solvers in order to increase the supply of capital to meet expanded demand as well as determining the suitability of current infrastructure. The transformation of the CDFI process from a portfolio to a capital markets asset management model requires a change in the methods of doing business.



*Figure 3. Cooperating Stakeholders*

### Section III. Vision and Innovation—Steps to Improve Capital Markets Access

This section identifies and describes nine innovations that would improve capital access for community development lenders. The chart below identifies the nine innovations and is followed by a brief description of each of them.

<p><b>I. Create a Community Development Financial Guarantee Corporation.</b></p> <ul style="list-style-type: none"> <li>– Establish a financial guarantee capability designed to credit enhance pools of CDFI loans issued as investment grade “A” or better with private placements. Develop from existing capacity, programs and resources, that are already available.</li> </ul>	<p><b>2. Develop a Training Institute to train CDFI lenders in capital markets practices.</b></p> <ul style="list-style-type: none"> <li>– Establish a training program, with the Federal Reserve banks as partners, to teach CDFIs credit policies, standards, and procedures.</li> </ul>	<p><b>3. Establish a CDFI Mini-Federal Reserve System for short-term liquidity.</b></p> <ul style="list-style-type: none"> <li>– Establish a CDFI peer-to-peer short-term lending capacity through a custodian Federal Bank and supported by foundation credit backstop for 30-,60-, 90-, or 120-day loans to peer CDFIs.</li> </ul>
<p><b>4. Create a Pooling Mechanism for CDFI Loans.</b></p> <ul style="list-style-type: none"> <li>– Establish a cooperative or aggregating vehicle that brings together several CDFIs as separate issuers into a larger pool of multi-issuers which would sell or collateralize a private placement in exchange for liquidity at a negotiated rate.</li> </ul>	<p><b>5. Establish a Production Index &amp; Accounting Methods.</b></p> <ul style="list-style-type: none"> <li>– Establish a production index for foundations to measure rates of deployment and the number and quality of loans originated by CDFIs per year.</li> <li>– Design, with practitioners in conjunction with national accounting firm(s), accounting software to measure cost and efficiency of administering lending functions.</li> </ul>	<p><b>6. Improve Asset Management.</b></p> <ul style="list-style-type: none"> <li>– Use “dead” or auctionable assets from HUD, USDA, or SBA as part of a revolving collateral pool.</li> <li>– Establish a CDFI Loan Marketplace on the Internet where practitioners can go to determine pricing on their portfolio or potential market interest or potential pooling with other CDFIs as issuers.</li> </ul>
<p><b>7. Establish a Financial Product Task Force.</b></p> <ul style="list-style-type: none"> <li>– Maximize Tax Credit Sources by providing investor input into developing equity-type securities that include the New Markets Tax Credit (NMTC) so that there is market acceptance upfront from the three investor groups: Banks, corporates/institutions and High Net Worth Investors.</li> </ul>	<p><b>8. Create a Standardization Oversight Committee.</b></p> <ul style="list-style-type: none"> <li>– Establish a committee to be comprised of senior members of foundations, CDFI practitioners, securities firms, and others to adopt standards around data collection, underwriting standards, documentation etc. Eventually, make these standards one of the conditions necessary for future grants.</li> </ul>	<p><b>9. Create a Community Development Asset Exchange—NMTC Barter System.</b></p> <ul style="list-style-type: none"> <li>– Develop an exchange program similar to the asset barter systems to replicate those elements that attract corporate investors to the NMTC in exchange for donated/depreciated assets.</li> </ul>

## Innovation #1. Community Development Financial Guarantee Corporation

**Objective:** To design a business model for a financial guarantee company that would wrap and credit enhance pools of loans from CDFIs so that they could be issued as investment grade to institutional investors such as pension funds and insurance companies which invest in private placements (144A private placements). Community development lenders need a credit guarantee vehicle that can shorten the distance between the lenders and the capital markets.

**Rationale:** It is very difficult to get a pool of loans packaged and of interest to institutional investors without either high loan loss reserves, substantial first loss guarantees, subordinated tranches or over-collateralization. The Community Development (CD) Financial Guarantee Corporation would be an “A-Rated financial guarantee insurance company dedicated exclusively to the community development sector to credit enhance loans as an investment grade private placement. The financial guarantee insurance industry was founded in the early 1970’s and can be best described by the following Standard & Poor’s commentary:

Financial guarantee insurance...is the oldest rating enhancement mechanism for providing third-party support or security for the guaranteed payment of principal and interest...has been driven by several factors...(including) upgrading through the insurance mechanism an eco-

nomically attractive proposition for both the issuer and insurer....From the investors' standpoint, the added comfort and liquidity that the insured rating provides appears well worth the slight reduction in yield. (S&P's Public Fin. Criteria 2000)

The proposed mono-line company will have a primary business objective to issue A-rated financial guarantee insurance policies to enhance the credit (and subsequent credit ratings quality) of securities and obligations issued by qualified community development institutions. The financial guaranty insurance company will be funded by equity from socially motivated capital (SMC) and foundations in the amount that the rating agencies would deem necessary to provide a single A credit quality wrap. For example a CD Financial Guarantee Corp. with an equity capitalization of \$2million would allow this entity to credit enhance \$50 to \$75 million in loans that have been put together as a security or debt instrument. In Figure 4, a group of sellers (issuers) sell their loans to a trust that is credit enhanced. A rating agency would assign a rating either to the guarantor company or to the pool of loans as a debt security. Either way, the sellers benefit from a higher credit quality (actual or perceived) and a broader base of potential institutional investors.

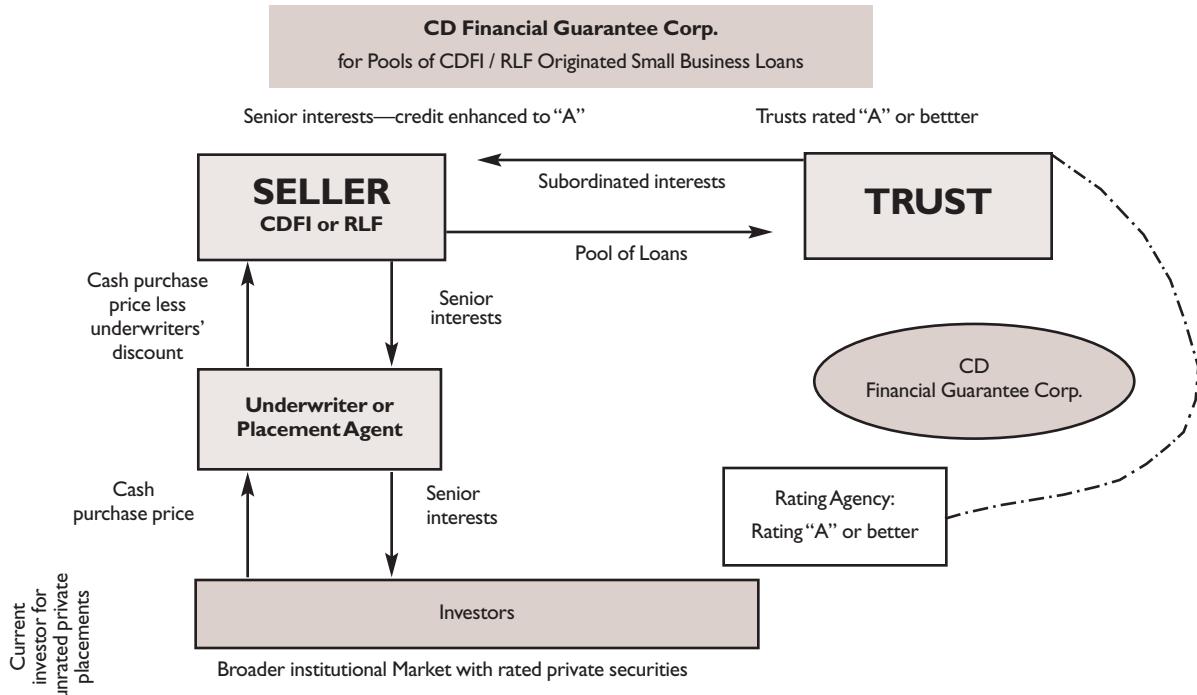


Figure 4. Schematic of Community Development Financial Guarantee Corporation.

## Innovation #2. Develop a Training Institute for Community Development Lenders

**Concept:** For the CDFI system to expand its capacity to help low-income communities overcome critical financing gaps, it must begin to develop new ways of organizing its work, serving its customers and interacting with and leveraging the resources of mainstream capital markets. Knowledge of the capital markets needs to be understood and mastered if seeking capital from institutional investors. This is a prerequisite in terms of due diligence, quality of historical data and acceptable management practices. The CDFI system and its pipeline to larger and more consistent sources of capital by way of institutional investors are being limited by CDFI infrastructure constraints, methods and practices of doing business, and a reluctance to adapt to capital market standards.

**Rationale:** The various capital markets initiatives cannot be fully implemented without a technically proficient CDFI industry. A capital markets training program for practitioners will achieve this goal through a partnership with the Federal Reserve System and deploying seasoned CDFI, capital markets and credit experts to serve as institute faculty. While there are various types of technical assistance offered by trade associations and consulting firms, the banking and capital market industry through its standard credit, pricing and risk assessment programs are best equipped to teach each member of the CDFI industry the necessary steps to issue investments as practiced in the for-profit sector. The following chart illustrates a proposed training program.

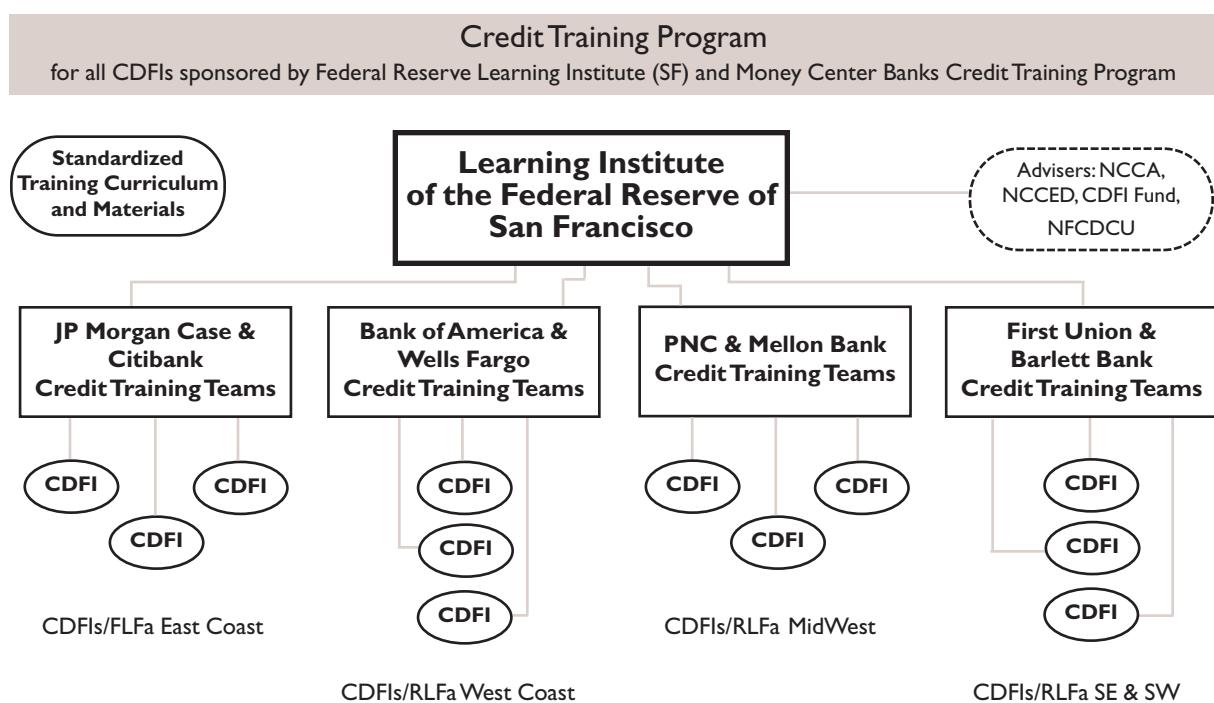


Figure 5. Credit Training Program

## Innovation #3. Mini-Federal Reserve System for Short-Term Liquidity

**Concept:** The proposed “Mini-Fed” would help increase the rate of deployment of grantor funds to needy borrowers in the CDFI system. It calls for the establishment of a vehicle for short term liquidity among CDFIs that would allow for increased loan closings, accelerated capital deployments rates and achieving higher levels of across-the-board impact. The CDFI Mini-Federal Reserve System is the equivalent of a discount window—a liquidity vehicle for CDFIs to cover capital needs for short-term liquidity (i.e. 30-, 60-, 90-, 120- or 180-day funding needs). This system would increase the Rate of Funds Deployment throughout the system, a measure for foundations and grantors to track the impact of loans and grants. This would be the basis of a Deployment INDEX. The Mini-Federal Reserve concept is essentially a CDFI peer-to-peer short-term lending program. CDFIs with excess short-term capital, which they normally deposit in their local banks, will provide a CDFI borrower with the needed funds.

**Rationale:** This mechanism allows advances against investments and allows the CDFI to close on potential loans at hand. The peer lender would be providing a peer borrower with needed funds based not on the borrower's CDFI credit, *per se*, but on the quality of the proposed “take out funding” or the letters of intent or commitment from borrowing CDFI's expected source of repayment. This Mini-Fed lending capacity would be offered through a custodian trustee money center bank. The due diligence for the CDFI lenders could be provided by an industry participant (such as the Calvert Foundation which already provides this function to foundations and investors). Currently there is no national liquidity vehicle to move excess capital to areas with shortage of capital within the CDFI or RLF industry the same way that the Federal Reserve or the central Credit Union or the FHLB provides it members.

Note the crossing of loans through a money center bank, using existing capabilities and capacity rather than building anything new.

### “MINI-FED” SHORT-TERM LIQUIDITY CAPACITY FOR CDFIS

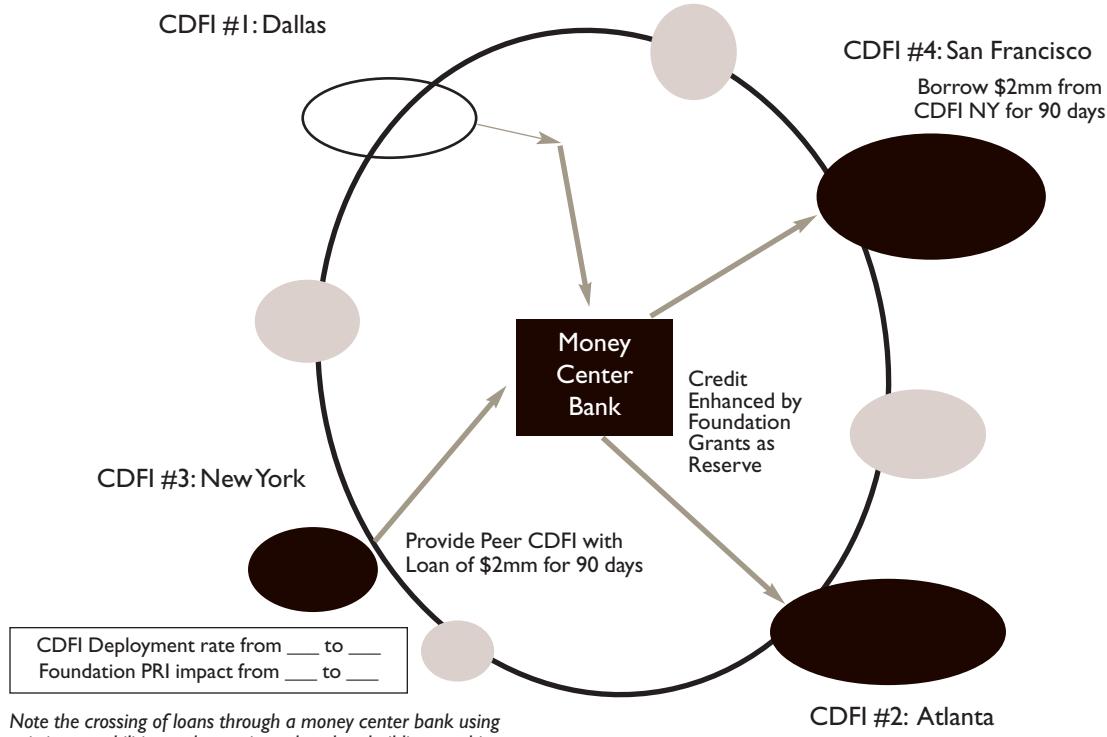


Figure 6.—A Concept of a Mini-Federal Reserve System

## Innovation #4. Pooling Mechanism for CDFI Loans

**Concept:** Pooling is a very cost-effective way for smaller CDFIs with small portfolios of loans who may only need to borrow infrequently. Pooling can reduce transactions and issuance costs. There are several reasons why pooling can be economical for multiple CDFIs:

- Borrowing costs are spread over a larger base, so the cost per dollar borrowed is less.
- Rating agencies are willing to rate a pool's debt, and bond insurers are willing to consider insuring a pool issue, even though the pool includes CDFIs, which are not rated or ratable.
- Default risk is lower due to the diversification of credit risk and from a geographic dispersion of risk.
- Diversification results from having many borrowers instead of a single CDFI with loans concentrated in one census area or cluster of zip codes.

**Rationale:** In addition to pooling loans among groups formed as issuers or “loan sellers,” regional organizations could be formed to service those entities that are linked or networked with other CDFIs that have qualified for Community Development Entity (CDE) status and

received an allocation of New Markets Tax Credits (NMTC). CDFI-NMTC recipients may want some mechanism to join other CDEs together in monetizing their NMTCs for their projects or access to other CDE’s projects that may provide them with an opportunity to use their NMTC allocation to raise capital for their target area. A Super Regional CDE may be able to aggregate tax credits and transactions or to broker or join CDEs together in selling their NMTC. These Super Regional CDEs may mirror the way in which the CDFIs have already organized themselves into geographic areas, such as the West, Midwest, and East Coast.

There are many economic benefits and infrastructure cost savings when a regional or collaborative pooling effort is established among several CDFIs and RLFs. A hypothetical example is provided in Figure 7. With the assistance of Wall Street Without Walls, an actual pooling initiative began in 2002 with 15+ CDFIs in the Southern states mostly in rural low-income areas. These CDFIs have portfolios of loans and want to learn about options for monetizing those loans.

### EXAMPLE OF SEVERAL REGIONAL CDFIs POOLING ASSETS

(for illustrative purposes only)

		POOLING GROUP I		No. of Loans	Total	\$ (Loans)
State	City	CDFI / RLF				
CA	Sacramento	Rural Comm.Assist. Corp	1	6	\$1,500,000	
KY	Kentucky	Federation of Appalachian Housing	1	14	\$3,200,000	
MI	Battle Creek	Neighborhoods Inc of Battle Creek	1	5	\$1,800,000	
MT	Montana	Montana Community Dv. Corp.	1	4	\$1,530,000	
		POOLING GROUP 2		Total	29	\$8,030,000
NC	Durham	Self-Help Inc.	2	20	\$9,500,000	
MA	Boston	Boston Community Capital	2	12	\$5,000,000	
IL	Chicago	Illinois Facilities Fund	2	14	\$4,600,000	
ME	Bath	Coastal Enterprises	2	9	\$2,500,000	
		POOLING GROUP 3		Total	55	\$21,600,000
NH	Concord	New Hampshire com. Loan Fund	3	9	\$2,500,000	
NJ	Newark	New Jersey Com. Loan Fund	3	7	\$6,000,000	
VT	Montpelier	Vermont Com. Loan Fund	3	6	\$1,200,000	
CT	New Haven	Greater New Haven Com. Loan Fund	3	8	\$800,000	
		Total			30	\$10,500,000

Figure 7. An example of pooling assets

## Innovation #5. A Production Index and Accounting Methods

### **Production Index—A Proposed Measurement Tool**

There is no national index by which the CDFI Fund or the EDA measures each CDFI's loan production and quality against an objective benchmark. The result of an Index and measurement against an Index would be to establish a system of rewards or incentives to motivate grantees to maintain loan quality control and adherence to agreed upon and accepted loan origination standards. Of the 500 CDFIs and 300 RLFs, only a small percentage (15-20%) originate greater than 20 loans per year. Too many CDFIs originate far too few loans to be effective.

### **Incentives for Quality Loan Origination**

There is no organized method for measuring and rewarding strong, quality loan origination. Foundations and the EDA, concerned about getting maximum social or mission utility from their grant dollars, should look at grantee deployment rates, the percentage of grant capital that is actually loaned or deployed to targeted borrowers, and determine the total number of loans and quality of loans that a grantee is underwriting in their portfolio.

With the CDFI Fund's recent geographic organization into three territories—East, Midwest and West—there should be a national grid of CDFIs that assesses loan activity by state, by market, by census tract, by zip code and by grant dollars provided. This information would be most helpful to the Fund and to foundations to determine the geographic reach and penetration into the most distressed areas. It is also a service measure—the effective rate of CDFIs and RLFs meeting demand in targeted geographic areas. An annual review of total loan activity and a master grid of loans by service areas will help leaders in the industry develop an informed perspective on possible measures that could increase the social and economic impact and the effective delivery of financial services.

This may include: 1) Combining functions of CDFIs/RLFs to achieve economies of scale, 2) Advocating for certain CDFI mergers, acquisitions or combinations of capabilities with other financial intermediaries, 3) Tracking loan volume and credit quality by region to detect trends or information that would be helpful to adjust lending practices or retool loan products, 4) Providing grantors with a timely audit on effective and non-effective CDFIs and RLFs, which CDFIs and RLFs need greater assistance, and those CDFIs that may need to be closed down, expanded or retooled in order to yield a higher level of impact.

Standard cost accounting software needs to be developed that identifies, separates and quantifies the two major costs of issuing a CDFI loan: 1) the cost for origination and delivery of financial services, and 2) the cost for providing technical assistance (TA), business plans and the mission-oriented value added to the community and the borrowers.

This standard cost accounting software could be developed with input from the major accounting firms, an oversight group established by the philanthropic community (perhaps through the Council of Foundations), the experience from small business loan issuers (e.g. Business Loan Express, The Money Store, Lending Tree.com) and the nonprofit financial intermediaries such as the CDFIs and RLFs. The overwhelming goal is to develop an efficiency-checking mechanism that helps determine the cost for administering loans versus the cost of providing TA to borrowers.

### **Technical Assistance Costs versus Standard Loan Administration Costs**

There is currently no way to measure how much the technical assistance costs versus the standard loan administration costs in the development of a CDFI loan portfolio. Much-needed technical assistance provides help to potential borrowers and absorbs a lot of either the operating overhead costs or the spread income realized. The nature of the CDFI lending business requires lenders to provide these specialized TA services and to work with their borrowers. By doing so, the capital is used to help stimulate growing companies and job creation. There is no apples-to-apples comparison between a strong credit, a bank borrower and a CDFI borrower. The costs for underwriting the loans on an "all in" basis is much higher for the CDFI. However, it would be extremely helpful to know the TA costs and the administration costs. These comparisons would provide insight into operational efficiency. Either way, accounting for the full costs of a CDFI loan (TA vs. Administration) empowers management and philanthropy to make more informed decisions on cost improvement and realizing greater returns per grant dollar.

*Improves Pricing.* Even though the relative costs of originating and administering loans to a CDFI's target market are much higher than an average financial services company, CDFIs equipped with more precise cost information will be better able to price its loans.

## Innovation #6. Improved Asset Management

**Concept:** Use U.S. Government “Dead” or “Auctionable” assets for collateral in Community Development Loan Pool Transactions.

**Rationale:** To advance a program for monetizing “dead” or auctionable assets by HUD, USDA, SBA, etc., to be used as a central collateral guarantee initiative using excess or auctionable assets as collateral for a specific transaction. The results would be higher credit quality transactions that consequently open CD organizations up to a broader institutional marketplace of investors who are only able to buy investment-grade rated debt securities. Often, if a transaction had additional collateral behind it, it could mean the difference in

a much higher credit quality rated vs. unrated security, or could substantially reduce the transaction costs associated with financing a certain community project.

Currently, there is a vast (\$10 billion annually) portfolio of assets auctioned off by the U.S. government (see [www.Fedsales.gov](http://www.Fedsales.gov)). If a small amount of these assets could be set aside and pledged on a revolving basis (i.e. replenished every 24-26 months) as a credit enhancement or additional collateral for about 2-5% of the total value of a community development financing (i.e., \$50mm-\$100mm) could leverage \$2 billion in CD transactions.

### Utilizing Government “Dead” Assets as Credit Enhancement or additional collateral to CDFI loan pool securities received from HUD, IRS, SBA, US Treas., USDA

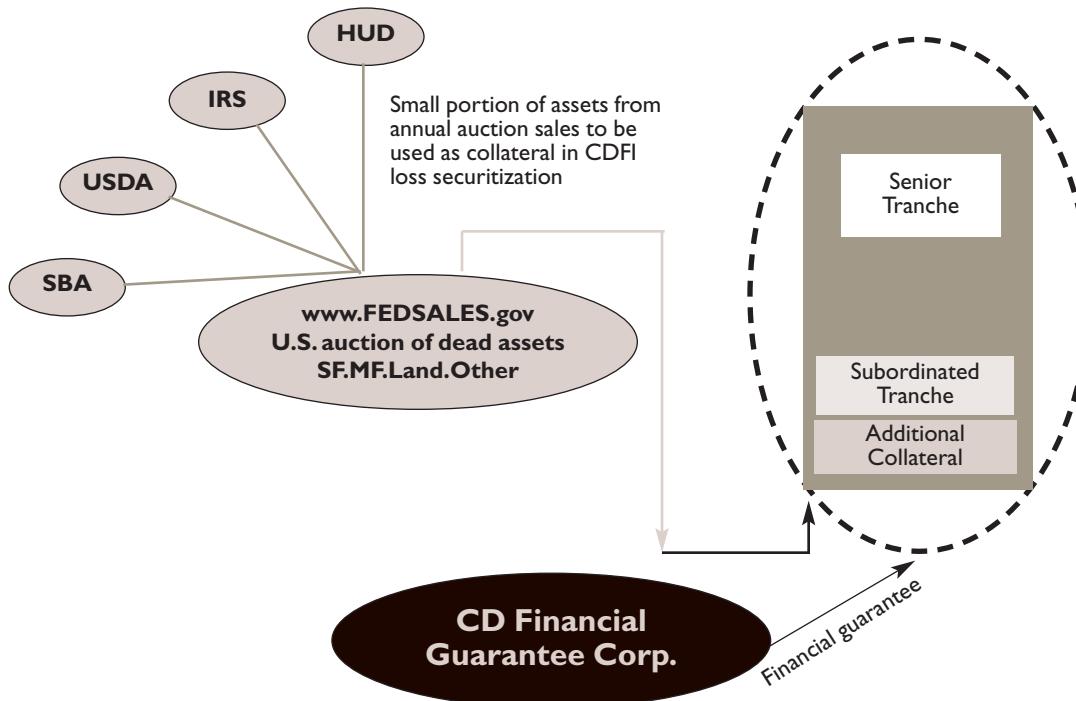


Figure 8. Using Government Assets as Credit Enhancement

## Innovation #7. Develop a Financial Product Task Force

**Concept:** Over the next seven years, \$15 billion in New Markets Tax Credit investments will be made by private investors. While the NMTC is perceived as a “shallow” credit, many investors, particularly those who were used to substantial tax credits from the low-income housing tax credit, have initially demurred from embracing the NMTC because there is too much risk for too little tax credit. Within the CDFI industry and at the CDFI fund level, there still needs to be discussions with groups of potential investors such as CRA-driven banks, taxable insurance and corporate investors with an interest in minimizing tax liabilities, and high net worth individuals (HNW) whose tax planning and trust planning could use tax credits as part of their overall estate planning. Each of these potential target groups has unique investment horizons and investment parameters so a “one product fits all” approach would not work in attracting these investors. A financial product task force could examine a number of potential opportunities for the NMTC.

### Investors & Financial Engineers

For the NMTC to be a success and gain investor interest, the CDFI industry should be spending as much time educating the practitioners, as well as the street investors, on designing possible equity products with input directly from the investors and financial engineers.<sup>14</sup> The industry should team up with a representative group of financial engineers, financial product developers from the major bracket firms, private banking groups and treasury and trust sides of the large commercial banks to help them decipher the specific investors’ needs and develop securities that meet their needs.

There are many opportunities to employ new financing and develop new tools for the field, including:

- Preferred Equity
- Cumulative Preferred Equity
- Pay-In-Kind Cumulative Preferred Equity
- Convertibles (equity converts to debt, or debt converts to equity)
- Exchangeable—Redeemable Preferred
- Participation Certificates
- Index-based Equity<sup>15</sup>

<sup>14</sup> “Financial Engineers” is a term used by Wall Street firms to describe structured finance professionals, or sophisticated financial debt and equity product developers and designers.

<sup>15</sup> Index-based equity: We also suggest several ideas for the NMTC administration group to consider—a vehicle to buy out a failed QEI or CDE by an existing CDE or an indemnity or insurance product that protects investors from recapture. As it relates to the recapture issue, since the CDE over a seven-year period may cease to qualify as a CDE or the CDE redeems the investment or the QEI fails substantially all the requirements and because investors have no control over these aspects and could be seriously impacted due to recaptured tax credits—both on their previous accounting statements and on their exposure, we suggest that the CDFI Fund consider setting up a “buyer” of last resort or where then-existing CDE will buy the “failed” CDE in order to keep its QEI status. While the funding for this acquisition and purchase is to be determined, there should be a cure period or a CDE in place as a “white knight” to protect against CDE failure and recapture. The loss of potential investors far outweighs the cost of this capacity. As it relates to an indemnity bond or insurance product that protects investors from recapture, the insurance industry is very creative when designing instruments to hedge or effect risk. While recapture is not a catastrophic risk, it would seem that the probabilities and potential risks might be sufficiently quantifiable that several leading insurance companies may be interested in developing a product that addresses this investor risk.

### Market-Based Product Development

Include Wall Street financial engineers, applied structured finance and financial product and private banking product developers into the NMTC discussion. Involve these groups in developing possible mechanisms to attract investors in raising Tier 1 capital for the CDFI industry as a whole. An example of this process may include the following:

Assemble tax attorneys, think tank innovators, and the three types of potential investors: *Private Bankers* (e.g., JP Morgan, US Trust, Bessemer, Northern Trust for high net worth investors), *Fund developers* and markets for the Socially Motivated Capital Funds (e.g., Calvert, Trillium, Domeni) and *Structured Finance Financial Product Developers*, e.g., Solomon Smith Barney, MONY, and CSFB). Supply them with the direction and the resources to develop marketable financial products. In turn, these products should stimulate investment from CRA driven banks, private institutional investors, corporations, socially motivated institutions and individual investors.

**Develop Investment Incentives** to corporate investors employing the NMTC by raising Tier 1 capital through a Community Development Auction eBay-like system for Tax Credits (see Innovation #9).

**Develop Financial Products** that can use NMTC and deferred capital gains liabilities in a product tailored for high net worth investor’s estate and trust planning.

**Pay-in-kind Preferred Stock as Capital Gain Offset** to NMTC investment. With the New Markets Tax Credit, an equity investor in a qualified investment receives a total tax credit of 39 % over the seven years (Yr 1-Yr 7 (5%, 5%, 5%, 6%, 6%, 6%, 6%) yet the initial basis of the equity’s value is reduced by the cumulative amount. Therefore, the equity investment presents a capital gains tax liability at the end of the seven years. Since this capital gains tax would reduce the overall return to the investor, it reduces an already “shallow” tax credit further. If investors balk at these projected returns, perhaps the CDEs, in conjunction with financial engineers, can use an already existing equity product, the PIK (Pay-in-Kind) Preferred Stock, that would be custom-tailored to the market risk, the investor type, and the realities of the NMTC and design a financial product that would overcome the capital gains tax in Year Seven.

A PIK Preferred Stock each year offers investors a current coupon from a preferred stock that pays in cash and additional stock equal to or sufficient to offset or pay for the investors' capital gains tax in Year Seven. An example of PIK Preferred: Assume the investor pays \$100 and receives 100 shares at \$1.00 with a PIK Preferred coupon of 6% that pays 6% to investors in cash and also pays them with additional stock each year, phased in over the investment period of seven years (usually nonvoting or financial shares).

This additional stock's total value would equal or be sufficient to cover the assumed capital gains liability at the end of seven years. On a cumulative basis at the end of the seven years, the investors would be looking at their total yield of 6% coupon per year plus the tax credit of 5% or 6% per year or 11% or 12 % return, with the problems of capital gains being neutralized by PIK Preferred additional stock.

	<b>Year 1</b>	<b>Year 2</b>	<b>Year 3</b>	<b>Year 4</b>	<b>Year 5</b>	<b>Year 6</b>	<b>Year 7</b>	<b>Cum</b>
Stock Basis 100	95	90	85	79	73	67	61	61
Tax Credit	5%	5%	5%	6%	6%	6%	6%	39%
Cap Gains		100 -	61	= 39 x	tax rate	(38%)	= \$11	\$11
PIK 6% Coupon	\$6	\$5.70	\$5.40	\$5.10	\$4.74	\$4.38	\$4.02	\$35.34
PIK Add'l shares	1	3	3	5	5	5	5	27

Figure 9. Example of PIK Preferred with 100 shares of stock

## Innovation #8. Standardization Oversight Committee

**Concept:** Establish a committee to be comprised of senior members of foundations, CDFI practitioners and securities firms to adopt standards around data collection, underwriting standards, documentation of loans and performance of loan portfolios. Gradually make adherence to these standards one of the conditions nec-

essary for future grant support.

*Establish the Gold Star System.* Foundations can set up a gold star program for those CDFIs that integrate the above standards and disciplines. Additional PRI monies could be committed to those entities making the effort to integrate or mainstream into the capital markets.

## Innovation #9. Community Development Asset Exchange: NMTC Barter System

*Assets in Exchange for Cash/in Exchange for Tax Credits.* As mentioned in innovation #7, there are a number of creative possibilities in utilizing the New Markets Tax Credit. The barter and exchange industry has provided a number of successful models of corporations using excess inventory as a currency to purchase benefits such as tax credits. The model described below has not been tested, but is in the process of development.

*Community Development Auction:* Assets for Tax Credits. This auction program can succeed when the proceeds of the auction are donated by the corporation/donor to the CDE in exchange for NMTC for some agreed-upon value. This Community Development Auction/eBay concept is simple. It includes an auction mechanism that converts Corporate Assets to Cash and subsequently exchanges the cash for tax credits at some agreed-upon formula. The corporation is essentially using the cash proceeds from their assets or products auctioned off as a donation to a CDE with allocated tax credits in exchange for NMTC at some agreed-upon dollar-for-tax-credit basis.

To give an example, we will use, for illustrative purposes only, Apple Computer Corp. and Self Help, Inc., of Durham, NC: Assume that Apple Computer has \$10 million worth of computers in a warehouse in Chicago that have not been selling well or that is excess inventory. Apple may have fully or partially depreciated these assets, but they are willing to have these assets in this warehouse auctioned to the public by an auction group,

such as Bid4Assets.com. Apple pledges that the cash proceeds from the auction will be a donation to the CDE, Self Help in Durham, NC. Self Help has been allocated tax credits and they are going to use \$X million on a project. The Apple Computers are sold at auction and realize \$4 million in cash. That cash is held in the custodian fiduciary E-deposit which facilitates the exchange of cash to Self Help in exchange for \$ dollar value of tax credits. This process has few transactional costs: Bid4Assets.com and E-Deposit.

In his recent book, *The Rise of the Creative Class*, Richard Florida reminds us that the need for creative problem solving:

Creative problem solving is multidimensional and comes in many mutually reinforcing forms . . . thus creativity has come to be the most highly prized commodity in our economy, and that commodity is people. . . . People who [are creative] are required sometimes to think on their own. They apply or combine standard approaches in unique ways to fit the situation, exercise a great deal of judgment, perhaps try something radically new from time to time.<sup>16</sup>

In mentioning just a few of these promising initiatives, we are reminded of the simple yet compelling wisdom about the need for innovation from Karl Stauber, President of the Northwest Area Foundation:

Nations, communities and firms that prosper, constantly invest in creating a new competitive advantage rather than protecting old advantage.

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<sup>16</sup> *The Rise of the Creative Class*. Florida, Richard, excerpt from *The Washington Monthly* ([www.washingtonmonthly.com/features/2001/0205\\_florida.html](http://www.washingtonmonthly.com/features/2001/0205_florida.html)).

**Community Development Auction Process**  
**\*CD eBay A Donation in Exchange for NMTC Tax Credits Schematic**

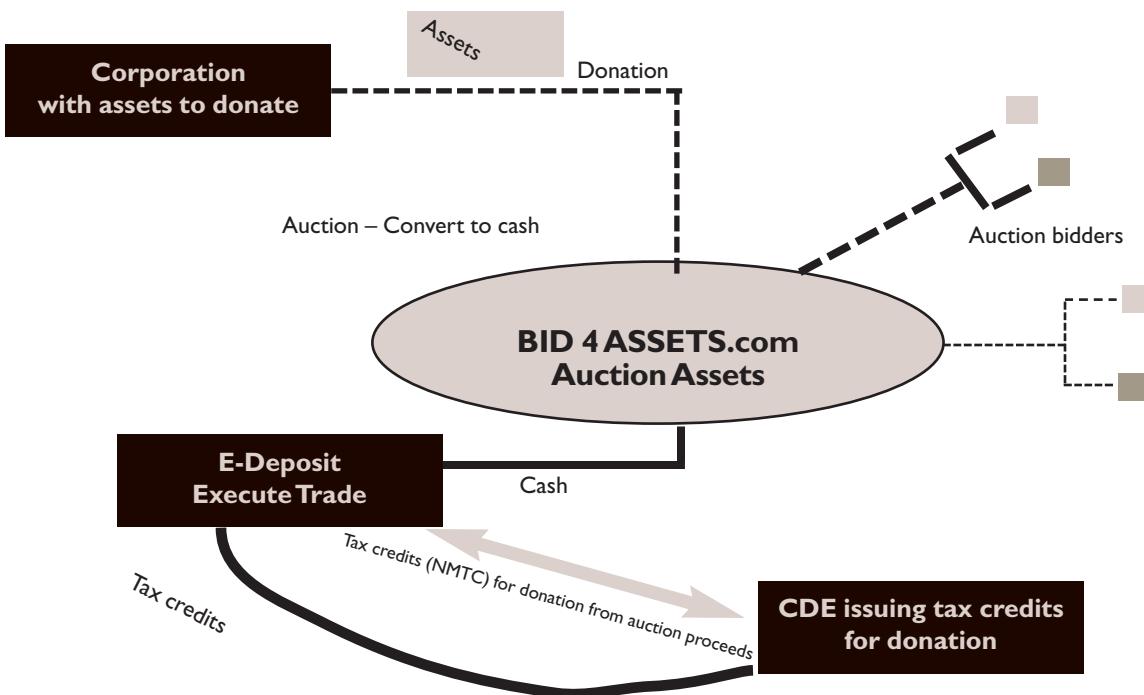


Figure 10. A Community Development Auction Process

## Appendix A—The Visionaries and Innovators

The following organizations and groups are creating new competitive advantages for the community development finance field. They are innovators—providing new methods and practices for improved capital markets access.

1. The foundations: Ford, F.B. Heron, Rockefeller, W.K. Kellogg, MacArthur and Fannie Mae's funding efforts in community development finance research and field reports to develop community-based institutions that leverage philanthropic capital, investment capital, knowledge and skills.
2. The documentation and skills provided in technical assistance and training programs offered to community development organizations throughout the U.S. by The Enterprise Foundation and LISC.
3. The works of the Ford Foundation's intensive research efforts on CDFI capacity under the direction of Frank DiGiovanni, including valuable CDFI industry mapping and identifying the current landscape through Brody, Weiser & Burns "Loan Policy Shape of the New CDFI."
4. CDFI Fund's "New Markets Tax Credit Program" and the leadership of Tony Brown and Fred Cooper.
5. F.B. Heron's advancement of Social Investment and the direction by Sharon King and Luther Ragin in establishing a foundation's perspective in greater portfolio commitment and management practices applied to mission investing.
6. The advancement and professionalization of the CDFI field through the efforts of NCCA, offering a full range of research, advocacy and product development including co-designing the EQ2 and internet training and the leadership of Mark Pinsky CEO, and Kathleen Stearns, CFO.
7. The MacArthur Foundation's significantly expanded PRI program under Jonathan Fanton, Gregory Ratliff, and Debra Schwartz.<sup>17</sup>
8. The Rockefeller Foundation's Enhanced *Working Communities Program* under the direction of Darren Walker and Betsy Biemann.
9. Calvert's SEA Corp and Community Investment Notes under the direction of Shari Berenbach.
10. The pioneering work of Boston Community Capital under the leadership of Dick Jones and Elyse Cherry

and their in-depth study of exit strategies for the community development venture community.

11. The W.K. Kellogg Foundation's *Funders Effectiveness Fair* under the direction of Thomas Reis, and the Fannie Mae Foundation's expanded informational website, KnowledgePlex under the direction of Peter Beard.
12. The law firm of Mayer, Brown & Platt in developing and offering an open platform about securitization in *Securitization.net*.
13. Pre-eminent research by the Fannie Mae Foundation's James Carr on Predatory Lending in America, and the Communities of Capital Program led by Kevin Smith.
14. The research work by Bear Stearns Managing Director Joseph Stark in mainstreaming the NMTC to institutional investor parameters and needs.
15. The significant consulting and publication works of:
  - Marc Weiss at the Economic Development Assistance Consortium (EDAC).
  - John Weiser of Brody & Weiser for his work "Conversations with Disbelievers."
  - Daniel Leibsohn's, "Case Studies Community Development Finance."
  - Dr. Glenn Yago, Betsy Zeidman and Paul Pryde for their pioneering work in minority capital access at the Milken Institute and the "Democratization of Capital" initiative.
  - Isaac Megbolugbe<sup>18</sup> "The New Architecture," a white paper and in-depth analysis of community development finance.
16. BridgeSpan Consulting's work in identifying the capital gaps, for nonprofit organizations funded by the Ford and Heron foundations.
17. The EDA pilot securitization program for Revolving Loan Funds led by EDA's David Witschi and researched by H. Robinson, at Rutgers University.
18. The extensive work by Paul Bradley of the New Hampshire Community Loan Fund in advancing methods to finance manufactured housing parks as cooperatives throughout the State of New Hampshire.
19. The Financial Innovations Roundtable at the School of Community Economic Development, Southern New Hampshire University, and the

<sup>17</sup> Oliver Wyman Report Vol 1 (3) ERisk "The Case for Loan Pooling."

<sup>18</sup> "The New Architecture," Isaac Megbolugbe, Fannie Mae Foundation (to be requested directly from the Fannie Mae Foundation).

- efforts of Dr. Michael Swack, Chair of the FIR.
- 20. The innovation forums of the Federal Reserve Bank Community Affairs offices.
  - 21. The Capital Access Roundtable of the Financial Innovations Roundtable, under the leadership of Charles Tansey and his work on the Financial Guarantee Corp. and the Mini Federal Reserve.
  - 22. The Brookings Institute Capital Xchange articles on increasing capacity in the CDFI sector by several leaders in their field including:
    - Michael Barr, The Brookings Institution Center on Urban and Metropolitan Policy, "Access to Financial Services in the 21st Century: Five Opportunities for the Bush Administration and the 107th Congress" June 2001
    - Nancy Andrews, The Low Income Housing Fund, "Equity with a Twist: The Changing Capital Needs of the Community Development Field" April 2001
- Mark Pinsky, NCCA, "Taking Stock: CDFIs Look Ahead After 25 Years of Community Development Finance" April 2001
  - Kirsten Moy, Aspen Institute and Alan Okagaki, Consultant "Changing Capital Markets and Their Implications for Community Development Finance" July 2001
  - Charles D. Tansey, "Community Development Credit Unions: An Emerging Player In Low Income Communities" September 2001
  - Jeremy Nowak, The Reinvestment Fund, "Civic Lesson: How CDFIs Can Apply Market Realities To Poverty Alleviation" March 2001

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**Gregory Stanton** is the director of the Capital Markets Access Program (CMA) and the Wall Street Without Walls Initiative funded by W.K. Kellogg, Rockefeller, Fannie Mae, F.B. Heron and Atlantic Foundations. CMA is a specialized financial technical assistance program provided to nonprofit organizations with medium to large economic development initiatives seeking access to the capital markets, in the form of debt and other forms of structured finance. CMA provides assistance in attracting alternative sources of market rate and capital markets funding for nonprofit organizations (NPOs) assets, businesses and programs owned or operated by nonprofit economic and community development organizations. The work and role of CMA is to help NPOs leverage their current grant income, growing

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**UNBLOCKING OBSTACLES TO CAPITAL MARKETS FOR COMMUNITY DEVELOPMENT LENDERS** by **Gregory M. Stanton** . . . examines the persistent obstacles, gaps and barriers to the capital markets, which prevents a freer flow of capital to needy communities. The supply of capital from the community development finance industry is currently provided by a host of mission-driven financial intermediaries. These include Community Loan Funds, Community Development Corporations, (CDCs), Revolving Loan Funds (RLFs), Community Development Credit Unions, (CDCUs) and Micro-lending Financial Intermediaries (MFIs) Collectively we will refer to them as CDFIs.

Our examination of major obstacles, such as scale of lending or documentation of loans, joins other important current research and pilot projects, which are dedicated to finding solutions to the capital shortage into affecting most depressed communities, minority businesses and aging community economic development infrastructure. The premise of this paper is that sustained capital markets access is a function of increased scale, standardization of practices, documents and processes and improved management skills.

