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Capital Markets for Community Development Lenders: Questions & Answers

by Michael Swack
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How is this type of lending different from what conventional banks do?

In the 1970s and 1980s, banks began packaging and selling their residential mortgage loans to a secondary market, in a process known as securitization. Banks no longer had to fund each loan through their deposits. Instead, they could sell their loans to investors and use the revenue to fund more loans. The birth of securitization allowed banks to originate more loans, generate more revenue off the fees from the originations, and sell off their risk of holding fixed rate loans in their portfolios. With all of these benefits, this process of originating loans and selling them, called capital markets lending, is now the standard for banks. Today, securitization accounts for trillions of dollars of transactions.

So, banks are involved in capital markets lending, not portfolio lending. Let’s take a step back.

What exactly are capital markets?

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

Aren’t there also primary and secondary capital markets—what’s the difference?

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

After the securities are issued, they are sold to the public in the secondary capital market. Secondary markets are where securities are traded. The vast majority of financial transactions that occur through stock exchanges, bond markets, futures markets, or other mechanisms all happen in the secondary market.
This seems a little abstract. Can you give an example of how this works?

Sure. Let’s take a look at the residential mortgage system in the United States. This system is made up of a primary market and a secondary market. In the primary mortgage market, funds are provided directly to the new homeowner, who in turn issues a security to his bank—his mortgage.

The secondary market is the market where this mortgage loan can be bought and sold by investors. The bank that made the loan in the primary market wants to sell the mortgage and use the money to originate more loans. Because the mortgage is backed by the homeowner’s real estate, it is an attractive security for investors. In most cases, one of the two largest secondary mortgage market institutions—the Federal National Mortgage Association or the Federal Home Loan Mortgage Corporation—will buy the mortgage from the bank. “Fannie Mae” or “Freddie Mac,” as they are commonly known, then bundles the loan with others to form a large pool of similar mortgages. Fannie Mae and Freddie Mac then sell mortgage-backed securities to public investors in order to finance their future purchases.

You mean, my mortgage with my local bank is being traded by investors around the country?

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

O.K. I think I understand these primary and secondary capital markets. But aren’t CDCs and CDFIs already involved in them?

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

That seems to work in my community, so what’s the problem?

Well, foundations and government have limited funds. You probably have noticed this. You may also have noticed that there is still demand for capital in your community. People want to buy homes and start businesses. Organizations want to develop housing and community facilities. CDFIs are mostly portfolio lenders. And, while they have become good at assessing risk and managing healthy portfolios, they are limited by the amount of money they receive in grants and donations. They cannot fill all of their lending needs. Many CDFIs could expand their lending and better serve their communities if they complemented their portfolio lending with some capital markets lending. After all, there’s a lot of money out there in the capital markets—and we could use it.

Remind me what you mean by capital markets lending.

A CDFI involved in capital market lending would employ methods, such as securitization, that would distribute its loans among a range of investors, instead of holding all of the loans in its portfolio. By selling their loans on the secondary market, CDFIs can increase their liquidity.

We want Wall Street to buy our loans. What’s the hitch? What do we have to do to get them to buy? Discount our loans?

No, not necessarily. Sure, investors will want to pay less than the face value of a loan if they think the loan won’t perform. But CDFI loans perform and yield good returns. CDFIs simply have to demonstrate this success in a way that investors will understand.

How can CDFIs do that?

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

**Performance Data**

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

**Standardization**

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

The CDFI industry does not currently have any specific standards for these practices. However, trade associations of CDFIs like the National Community Capital Association are becoming larger and more sophisticated. They have begun to promote operating practices among their members that enhance the industry’s ability to meet the capital markets’ standards. It is the first step toward standardizing CDFI processes and procedures.

**Volume**

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

**Pricing**

The capital markets need products that are priced properly to risk and offer an attractive return. Can CDFI loan products offer a rate of return that would satisfy the market? The first response might be “no.” But, in fact, several CDFI portfolios are offering competitive rates of return. Not all CDFI products will meet the pricing criteria, but many can and do. CDFIs must identify and market these products.

**Credit Enhancements**

To make CDFI products more attractive, investors may want certain credit enhancements. Credit enhancements, such as insurance or letters of credit, are tools that make loans less risky to investors by ensuring that regular payments will be received. CDFIs could leverage some of their
government and foundation money as credit enhancements in, perhaps, a better use of these funds.

Where should we start? How can CDFIs break into the capital markets?
Let’s look at two of these barriers:

**Volume**
To achieve larger volume, CDFIs can and have created cooperative mechanisms where a number of CDFIs pool their loans and sell them to an institutional investor similar to Fannie Mae. By enticing an investor with large volume and low risk resulting from the geographic dispersion of the loans, pooling can be a cost-effective way for smaller CDFIs to increase their liquidity.³

**Credit Enhancements**
A common tool used to promote the sale of loans is financial guarantee insurance. This insurance ensures that payments are made to investors who buy pools of loans. CDFIs could negotiate a financial guarantee through an established insurance company and provide a credit enhancement on a pool of community development loans. The enhancement would help the pool achieve a good rating from one of the rating agencies, which would signal that the pool was a sound investment.⁴ The favorably rated security could now more easily be sold in the financial markets, where many insurance companies and mutual funds buy only highly rated securities.

This all sounds good, but I still have concerns. For example, I have developed and maintained close working relationships with my borrowers. Won’t I lose this when I sell my loans?
Not at all. In most instances, you will continue to directly service your own loans. You will need to maintain a close relationship with your borrowers, providing them technical assistance and monitoring their performance, in order to ensure a healthy return to your investors.

O.K. But won’t I have to adjust my portfolio to meet the specific “appetite” of the market, as opposed to the needs of the borrowers and communities I serve?
Not necessarily. Many CDFIs will continue to do portfolio lending even if they are able to sell some of their loans. That is, they will still have loans that meet certain unique needs or circumstances and require the CDFI to service and hold the loan to maturity. In fact, a CDFI might have many of these. But, many community development lenders have developed certain pre-packaged loan products, such as housing or facility loans. These loans are underwritten in a consistent way and are “standard” within the CDFI’s own portfolio. These are the types of loans that would best be packaged and sold to investors in the capital markets.

Will institutional investors really buy CDFI loans? Has anyone actually done anything yet?
Yes, it can work, and it has. For example, both the Community Reinvestment Fund (CRF) of Minneapolis, Minnesota, and Self-Help of Durham, North Carolina, have successfully accessed capital markets and are providing increased liquidity to the community development field. To attract institutional investors, CRF began pooling and underwriting loans that had been originated by a range of smaller community development lenders around the country. They have amassed over $300 million worth of loans and sold them to the secondary markets, bringing in capital for these small lenders. Self-Help developed and marketed a standard home mortgage product to attract investors and has underwritten over $1.5 billion in these mortgages for low-income communities. Both organizations’ efforts have attracted a number of institutional investors to invest in these community development projects, including Prudential Securities, MetLife, and Equitable Insurance.

It sounds like this might work! Where can I find additional information?
The Financial Innovations Roundtable at Southern New Hampshire University’s School of Community Economic Development is working on these issues and developing concrete ways for CDFIs to access capital markets. If you would like to learn more about current and future innovations, visit the Financial Innovations Roundtable’s web site at www.finir.org. If you are interested in participating directly in our ongoing initiatives, please contact me, Michael Swack, at m.swack@snhu.edu.

End Notes
1 Securitization protects banks from interest rate volatility, reducing risk. Before securitization, banks would make a loan at 6% for 30 years. Several years later, they might suffer a loss, paying their depositors more than 6% if interest rates went up.
4 Ibid.

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