

# Bridging the Information Gap between Capital Markets Investors and CDFIs

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**T**he problem of efficiently matching buyer and seller is both ancient and ubiquitous. It is, of course, the source of the concepts of brokerage and intermediation. The situation in which sellers are small, traditional and local and buyers large, sophisticated, and national or, indeed, global, is an especially difficult one to get right—especially from the perspective of the sellers. But it is also the situation in which modern technology may be most useful.<sup>1</sup>

This ancient dilemma resembles the problem of connecting the CDFI industry to the capital markets. The vast majority of CDFIs are small and local, and, to the extent anything can be traditional in an industry barely twenty-five years old, traditional in the sense that they are structured as vertically integrated portfolio lenders heavily reliant on low-cost funding. The capital markets are huge, efficient, market-based, and global. Even the most sophisticated CDFIs find them difficult and often frustrating to access.

The disconnect exists on a number of levels, including scale, structure, and systems. But as important as these items are, the lack of understanding by potential buyers and sellers of each others' needs may be a bigger barrier. In other words—and this was repeated many times during the September 2006, Secondary Markets Conference sponsored jointly by the Federal Reserve Bank of San Francisco and the Federal Reserve Board of Governors—information asymmetry may be at least as much a barrier as scale, structure, and systems.

## **Understanding the Motivation of CRA Investors: A Typology**

One way to bridge community development loan products to the investor community is to develop a better understanding of what motivates investors. Dan Letendre, director of Merrill Lynch Community Development Company, asserted that while the conventional capital markets, including the structured finance markets, may not be quite ready for CDFIs, capital markets investors with obligations under the Community Reinvestment Act (including, perhaps, some in industries attempting to avoid such obligations) are ready to deal. But it is critical that CDFIs understand what those investors want and that they do not all want the same thing. Moreover, even the same bank or other type of investor may want different things at different times, potentially even in different parts of the organization.

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<sup>1</sup> For a fascinating example of technology overcoming ancient barriers to sellers finding efficient markets, see "Information Technology to the Poor," in C. K. Prahalad, *The Fortune at the Bottom of the Pyramid*, Wharton School Publishing (2006).

Letendre posited a typology of three types of CRA-motivated investors: (1) volume investors, (2) innovators, and (3) yield shoppers.

CRA volume investors are organizations that know they will need loans beyond their own production on their books for their next CRA exam. These investors are in general looking to purchase high volumes of relatively short-term, low-risk, easily understood loans. Bigger is better; \$10 million is about the smallest transaction they are willing to do. They are most interested in working with organizations that can assure them of a steady stream of such loans year after year. The good news is that these investors tend not to be particularly yield sensitive, although, as with all capital markets investors, the loans must at least fully cover the investors' cost of funds, including transaction costs.

Innovator investors are at the other end of the CRA spectrum. These investors have in general satisfied their CRA volume expectations, but they are looking for that added "plus" of "innovative, complex, and flexible" to impress both examiners and the public. Like volume investors, innovators tend to be relatively insensitive to yield. They are also interested in nonstandard transactions, and frequently they have an appetite for somewhat higher-risk transactions. The bad news here is that these investors are willing to buy only relatively small volumes. And, as with all CRA investors (but especially this group), location matters. Although consolidation in the banking industry has made it relatively easier to meet the geographic targets of the largest institutions, even they have greater needs in some markets than in others, and for regional and smaller institutions location is an even greater issue.

Between volume and innovator investors are yield shoppers. These investors view community development lending as a business. They want volume, and they care about the fees and yields they earn. They are interested in usage. If they are willing to provide a \$10 million line of credit, the goal is to make sure the line is fully drawn down and remains outstanding over a long period. To keep transaction costs down, these investors are most interested in establishing structures, such as lines of credit, that can be created once and used for high volumes over an extended period.

Faced with this spectrum of investor needs, Letendre argued that at least the largest CDFIs should be able to find a market for much of their product. Doing so may require structuring transactions, including being willing to engage in swaps to turn fixed-rate CDFI paper into the floating-rate paper many investors want, and also a willingness to hold on to a subordinate piece of a transaction, or to structure a pool into tranches. But when a high-quality, strong, and productive CDFI finally becomes equity constrained, Letendre argued, the market will be there for the easiest-to-understand, least risky loans that were made at market rate.

Securitization is not an all-or-nothing situation. Like financial institutions hundreds of times their size, CDFIs will do best if they can execute a variety of strategies, including selling an existing portfolio of seasoned loans, originating for sale, and recognizing that the most complex and difficult transactions they do to meet the needs of their customers will most likely have to be held on their balance sheets.

## Other Investors, Other Needs

The concept of “know your investor’s needs” applies to philanthropic investors as well as to capital markets buyers. More foundations are beginning to do Program Related Investments (PRIs) and others are starting to look at Mission-Related Investments (MRIs).<sup>2</sup> Here, too, understanding investors’ needs is critical to being able to access these investments.

For foundation investors, the critical issue is program: What is the foundation’s mission, what is it attempting to accomplish, and, for many, where? For example, Christa Velasquez, director of social investments for the Annie E. Casey Foundation, said that her organization focuses on children and families, and it is interested in very specific geographic locations. It is a waste of everyone’s time to attempt to interest the Casey Foundation in small business loans, especially outside its target geographies. The implication is that, even among the foundations that do community development investing, it is important not to assume that because one foundation is interested in a transaction or a portfolio, the others will be also.

Socially responsible investors are similar, according to Bruce Sorensen of Piper Jaffray. Some are interested in specific types of products, such as health clinics or charter schools, and many have specific geographic interests. Understanding those needs, and matching the CDFI’s product and sales pitch to them, is critical to obtaining the investment.

## How Can We Improve CDFI Access to Investors?

Conference participants reached four major recommendations about how better to match CDFI and investors:

- Establish some sort of dynamic information exchange. Conference participants had many ideas, ranging from establishing a MySpace-type network, to creating a “deal clearinghouse,” to “speed dating” sessions among CDFIs and investors. Enacting such ideas would better enable the buyers (including socially motivated investors) and sellers to find each other. The critical element of this recommendation was that the information needed to be dynamic and up to date. Participants did not discuss issues such as requirements for access (of both potential buyers and sellers), which would need to be part of the development of such a system.
- Improve the financial capacity of the most capital-markets-ready CDFIs. This idea has multiple dimensions, including understanding and meeting the special needs (such as warehouse lines, hedging) of organizations that are moving to significantly higher volumes, and to originating loans with the intention of selling them; understanding the needs of the markets and how to structure transactions to be attractive to investors; and having the vocabulary and contacts to be able to access the

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<sup>2</sup>Program Related Investments (PRIs) are transactions with concessionary terms that are made out of a foundation’s program budget and count against the foundation’s annual distribution requirements. Mission-Related Investments (MRIs) are part of a foundation’s investment portfolio, and, while they further the foundation’s mission, they are market-rate investments.

markets and make the best deals from the perspective of the CDFI. Potentially the CDFI Fund could make special, matched grants to high-performing CDFIs for this purpose, which would enhance the ability of those institutions not only to increase scale but also to serve as aggregators for smaller institutions.

- Find the successor to the equity-equivalent investment, or EQ2. The EQ2, a deeply subordinated loan, usually at below-market rates, with a flexible maturity date, has been important to many CDFIs, but it has become virtually extinct. One conference participant characterized EQ2s as “private equity at risk-free rates,” not, in general, an attractive instrument. Mary Tingerthal of the Community Reinvestment Fund, however, said that the rate was not the important element for many CDFIs, but rather the deep subordination. Subordinated debt that was treated as equity by other lenders would help CDFIs leverage their funds dramatically. Would it be possible to develop a market-rate EQ2, perhaps as an MRI?
- Consider development of mechanisms, such as some sort of insurance or wrap product or an industrywide interest-swap mechanism, that would make the CDFI-investor relationship more like that of other sellers into the capital markets, rather than a series of special needs and “story” investments.

## Conclusion

It is not surprising that CDFIs and capital markets investors have trouble finding each other and creating an efficient market. But there are willing buyers and willing sellers. Helping each understand the needs of the other in a dynamic and efficient manner could significantly improve results for both sides.

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