CDFI Bond: *Opportunity of a Decade*

By Cathy Dolan

Transformational Potential

There is a new game-changing program available for community development financial institutions (CDFIs). The CDFI Bond Guarantee Program offers CDFIs up to $1 billion of affordable, long term, government guaranteed debt financing per year, through 2014, to promote community and economic development in our nation's low-income, low-wealth, and other disadvantaged communities. It significantly improves CDFIs' access to capital, offering financing terms that make sense for CDFIs and the communities they serve and helping CDFIs meet substantial unmet capital demand in target communities. At the same time, it has the potential to transform the way CDFIs capitalize themselves, improving sustainability and financial stability.

Quite frankly, the CDFI Bond Guarantee Program could forever alter the landscape and future of the industry. For that reason alone, we need to make sure it works well for CDFIs and the communities they serve.

What is the CDFI Bond Guarantee Program?

The purpose of the CDFI Bond Guarantee Program is to create a new CDFI investment vehicle for community and economic development purposes. Passed as part of the Small Business Jobs Act of 2010, it is intended to support CDFIs' role as economic engines of growth in the nation's disadvantaged markets.

Select features of the CDFI Bond Guarantee Program include:

- $3 billion in bond guarantee authority through 2014 with minimum bond size of $100 million;
- CDFIs will be able to issue taxable bonds with terms up to 30 years;
- The Federal Government Guarantee ensures repayment of verifiable losses of principal, interest, and call premium, if any, on bonds and notes;

- The Program is being administered by the CDFI Fund at the U.S. Department of the Treasury;
- The Federal Financing Bank will buy 100 percent of bonds and notes issued to simplify execution and minimize cost and pricing;
- Participating CDFIs will be required to establish a risk share pool of three percent of the bond or note amount;
- Proceeds can be used by CDFIs to finance or refinance activity that meets the community and economic development definition of the Riegle Act (the enabling legislation for the CDFI Fund).

The CDFI Fund states that the program rules will be issued in the fall of 2011 and bonds are poised to be issued by the spring of 2012. The Program provides up to $3 billion of total financing before it sunsets in September, 2014, unless reauthorized.

Why is the CDFI Bond Guarantee Program so important now?

The timing for this new program couldn't be more opportune. With unemployment rates above nine percent and slowing GDP growth, economic recovery has been disappointingly weak. Low growth prospects lead to corporate hesitation to invest in new ventures and hire new workers. However, with interest rates at historic lows, it's an ideal time to borrow and invest for the future. In fact, recent monetary policy decisions have pushed long term rates even lower; as of September 25, 2011, 30-year treasuries are below three percent. This may be a "once in a lifetime" opportunity to lock in 30 year debt at rates this low. Once economic activity ignites, capital will become more expensive and more difficult to raise. There is no better time than now to give CDFIs access to $1 billion per year of up to 30 year debt, at rates similar to government securities.

Why CDFIs?

CDFIs have a long history of financing and meeting the needs of entities and individuals that lack access to the mainstream financial system. But as the boundaries of the mainstream financial system contract, the need for CDFIs to fill the gap increases. Indeed, while there are reports that corporate cash levels are at record highs, the capital tills of small businesses and entrepreneurs are empty. Large companies are reticent to invest in new initiatives, and banks' tightened credit standards have constrained small business and consumer lending. While policy makers and regulators work hard to make capital more freely available, in order to spark job creation and economic growth, the only thing growing is cash accounts. Lending and investment, particularly in underserved markets, remain low.

CDFIs, which are positioned to address these issues, report increasing demand for credit in their markets, partly in response to declining bank lending. According to The Opportunity Finance Network (OFN) 2011 2nd Quarter CDFI Market Conditions Report (a publication based on quarterly surveys of CDFIs), 54 percent of respondents reported an increase in the number of financing applications received year-over-year and 55 percent reported an increase in loan originations.[1] Among survey respondents, 25 percent reported that they are capital-constrained and could have made more loans in the second quarter of 2011 if financing capital had been available. To meet estimated demand in the next 12 months, the respondents reported they would need an additional $880 million in capital.

The respondents made these estimates assuming they were limited to the type of debt financing currently available to CDFIs, which is generally less than 10 years in term and priced based on market spreads over treasury securities or LIBOR. In March 2011, OFN expanded the scope of this survey to gauge broader market demand for CDFI Bond-type financing—up to 30 years in term and priced at a small spread over treasury securities. The responses indicated an overwhelming confidence in CDFIs' ability to absorb $1 billion per year to meet the needs of community businesses and individuals in low-income, low-wealth and otherwise disadvantaged markets.

What is the critical path to success?

What will make the CDFI Bond Guarantee Program a success? And how do we ensure CDFIs derive maximum advantage from the Program and dramatically impact communities in need? There are many important principles that will lead to a successful bond program, including performance and outcome based evaluation and efficient and affordable participation among CDFIs, but most critical are the following objectives:

1. The need for flexibility to accommodate the variety of financial structures that CDFIs use to serve low-income, low-wealth communities

One of the CDFI industry's strengths is its diversity of products and practices. In order to adequately meet the needs of their underserved communities, CDFIs need to be flexible and responsive to the unique factors that affect those businesses outside the mainstream financial system. That means the program can't be cookie cutter or one-size-fits-all in nature.

To that end, eligible uses need to include all financing sectors, including housing, small businesses, community facilities, retail and commercial real estate development in distressed markets, and personal financial credit products targeted at disadvantaged populations.

Moreover, the terms of the bond need to accommodate the way CDFIs provide capital to their targeted markets. CDFIs offer term financing, lines of credit, construction loans, secondary capital investments, and revolving lines of credit, and the program should accommodate all these types of financing products.

2. Financing via the CDFI Bond Guarantee Program is used and controlled by CDFIs with a proven track record of mission based financing.

The prospect of a new government-guaranteed debt program could attract the attention of entities that fashion themselves as community development lenders, but who lack the mission-based orientation and track record of responsible financing that the CDFI industry has long stood for and upheld. This program should be reserved only for those entities that have a proven record of responsible financing, with a strong mission of creating access to responsible and affordable financial services for disadvantaged and underserved communities. This program should not be available to CDFIs in name only.

3. Underwriting based on CDFI's assessment of risk

Program risk criteria and issuer selection should be based on the CDFI industry's performance track record, not on that of the mainstream financial services industry. There will be a temptation to look to mainstream financial service providers and programs to assess the overall program risk and individual bond applications because this is a new program to a largely unregulated sector, and Treasury (CDFI Fund) has few precedents to guide it. However, the CDFI industry has thrived for the past thirty years precisely because non-CDFI regulated institutions and for-profit finance companies operate so differently.

The markets served by CDFIs are unique and, by definition, outside the mainstream. CDFIs understand how to underwrite and manage the risk of businesses, individuals, and community projects in underserved markets because they are close and responsive to their borrowers, willing and able to provide technical assistance when necessary, and flexible enough to work with borrowers when difficulties arise. This high-quality track record is evidenced by OFN's Inside the Membership Report, which shows a weighted average cumulative net charge-off rate of 1.4 percent and weighted average delinquency of more than 30 days of 9.2 percent, as of year-end 2009.[1] As of the second quarter of 2011, problem loans seem to be in decline, as OFN's Market Conditions Report shows that members' rate of delinquency of more than 30 days had improved to 6.5 percent.

This performance track-record is indicative of CDFIs' unique ability to underwrite and manage risk. When assessing the risk of the CDFI Bond Guarantee Program and designing underwriting criteria for use in the selection of bond applicants, it will be critical for the CDFI Fund to use CDFIs' track record and not that of the mainstream financial services sector.

Conclusion

The CDFI Bond Guarantee Program is meant to encourage the creation of a new type of security that would provide access to responsible financing for disadvantaged communities at meaningful volumes, affordable cost, and long terms. If successful, this program could dramatically improve access to capital, recapitalize CDFI balance sheets (improving profitability and financial stability) and help banks and other mainstream financial institutions increase their financing in partnership with CDFIs for the benefit of low-income and low-wealth communities. This could lead to important increases in the number of jobs created and retained, the supply of quality affordable housing, and access to vital community facilities and services. In short, the CDFI Bond Guarantee Program would give CDFIs access to a reliable supply of capital with a term and cost structure that has never before been available.

As our economy struggles to regain footing, CDFIs have a vital role to play as engines of growth and the CDFI Bond can help make it happen. As Federal Reserve Chairman Bernanke recently said, "Providing responsible credit for individuals and small business through community development financial institutions can stimulate economic activity that generates local tax revenues."[2]

The imperative is clear. The CDFI Bond Guarantee Program needs to become a reality as soon as possible so CDFIs can increase financing to under-served markets and contribute to job creation and economic growth. OFN encourages all those interested in the program to join the CDFI Bond Alliance, which will actively shape the discussion on the design and implementation of the CDFI Bond on behalf of CDFIs for the full lifecycle of the program—from initial rule promulgation, through bond issuance, and ultimately to encourage reauthorization. For more information, visit http://opportunityfinance.net/financing/ CI

Cathy Dolan *is Chief Operating Officer of Opportunity Finance Network (OFN), the leading network of private financial institutions that creates growth that is good for communities, investors, individuals, and the economy.*

Endnotes

6. Although economists would typically view the wages paid to a job as the best summary measure of the job's skill requirements, lay readers may take some assurance that wages as a skill measure are highly correlated with logical alternatives, such as education and experience. Moreover, the ranking of occupational skills based on either wage or educational levels is quite stable over time. Thus, the conclusions here are not sensitive to the skill measure (wages, education-experience) nor the choice of base year for skill ranking (here, 1980).
7. The reason for using a different data source and time period for this figure from the prior figure is that the Census data have large enough sample sizes to be useful for the occupation level exercise, but they are less than ideal for measuring hourly wages. I use the May/ORG data for hourly wages, which are a superior source.
8. Goos, M., Manning, A., & Salomons, A. (2009). Job Polarization in Europe. *American Economic Review,* 99 (2): 58-63. The choice of time period reflects the availability of consistent data (unavailable prior to 1993). The ranking of occupations by skill level is invariant across countries, as necessitated by data limitations. The authors report, however, that the ranking of occupations by wage level is highly correlated across EU countries.
9. Autor, D., Levy, F., & Murnane, R. (2003). The Skill Content of Recent Technological Change: An Empirical Exploration. *The Quarterly Economic Journal,* 118 (4): 1279-1333.
10. Adjusting for inflation using the Personal Consumption Expenditure deflator, the real minimum wage in constant 2008 dollars was $7.50 in 1979, $5.29 in 1989, $6.41 in 1999, and $5.47 in 2006, and $6.53 in 2009. Thus, the real federal minimum wage declined dramatically between 1979 and 1989. It fluctuated modestly in real terms until 2006, when it rose sharply over three years.
11. Hamermesh, D. (2001). Changing Inequality for Workplace Amenities. *Quarterly Journal of Economics* 114 (4): 1085-1123. Pierce, B. (2001). Compensation Inequality. *Quarterly Journal of Economics* 116 (3): 1493-1525. Pierce, V. (2008). "Recent Trends in Compensation Inequality." Working Paper (Bureau of Labor Statistics).
12. Pierce, "Compensation Inequality," Pierce, "Recent Trends in Compensation Inequality."
13. Notably, the college completion rate for this group was higher in 1990 (29 percent) than in 2008 or 2008 (24 percent and 27 percent).

CDFI Bond: Opportunity of a Decade

1. Opportunity Finance Network, Market Conditions Reports available online at http://www.opportunityfinance.net/store/categories.asp?cID=29
2. Speech by Chairman Ben Bernanke on April 29, 2011 at the Federal Reserve Community Affairs Research Conference in Arlington, Virginia. http://www.federalreserve.gov/newsevents/speech/bernanke20110429a.htm

Building Literacy Skills and Transforming Lives

1. ProLiteracy. The Impact of Literacy: Basic Facts about Literacy. http://www.proliteracy.org/page.aspx?pid=345
2. National Center for Education Statistics. (2003). National Assessment of Adult Literacy: A First Look at the Literacy of America's Adults in the 21st Century. http://nces.ed.gov/naal/pdf/2006470.pdf
3. Kirsch, I., Jungeblut, A., Jenkins, L., & Kolstad, Al. (2002). "Adult Literacy in America: A First Look at the Findings of the National Adult Literacy Survey." National Center for Education Statistics. http://nces.ed.gov/pubs93/93275.pdf
4. Pro Literacy. See note 1.
5. National Institutes of Health. (October 25, 2010). Improving Mothers' Literacy Skills May Be Best Way to Boost Children's Achievement. http://www.nichd.nih.gov/news/releases/102510-reading-family-income.cfm
6. Center on an Aging Society. Low Health Literacy Skills Increase Annual Health Care Expenditures by $73 Billion. Georgetown University. http://ihcrp.georgetown.edu/agingsociety/pubhtml/healthlit.html
7. California Health Literacy Initiative. Low Literacy, High Risk: The Hidden Challenge Facing Health Care in California. http://cahealthliteracy.org/pdffiles/allfourpageshealthlitreport.pdf
8. Ibid.
9. Community Health Improvement Partners. When Words Get in the Way: A Collaborative Plan to Address Health Literacy in San Diego County. http://www.literacysandiego.org/pdf/HealthLiteracyReport_FINAL.pdf
10. Creticos, P., Schultz, J., Beeler, A., Ball, E. (2006). The Integration of Immigrants in the Workplace. The Institute for Work and the Economy.
11. UNESCO Literacy Strategy. http://www.unesco.org/new/en/education/themes/education-building-blocks/literacy/strategy/