Securitization for Social Innovation

Jump-starting Commercial Intermediation for the CDFI Industry

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Due to the socioeconomic calamities caused by the Covid-19 pandemic, the work of Community Development Financial Institutions (CDFIs) in the United States is more important than ever. Both private and public sectors are turning to CDFIs as economic first responders to help repair and restore communities in a manner that closes racial and place-based disparities. In order to accomplish that mission, CDFIs themselves need continued support and investments to increase their capacity and reach. Until now, increasing funding for the industry has meant incrementally increasing the availability of low-cost, geographically flexible debt to CDFIs. We see an opportunity for a quantum leap forward in CDFI funding: the creation of a secondary market for community development investments originated by CDFIs that creates liquidity and unlocks more lending in our underserved communities.

We believe that it is not a matter of if, but when a robust secondary market is created for the CDFI industry. This common feature of other assets such as mortgages and corporate bonds can and should be realized for CDFI assets. The Riegle Act of 1994 that established the CDFI Fund even anticipated this need and included the ability to fund entities that sought to purchase CDFIs’ assets, but this policy tool has yet to be funded. Now the moment is ripe. The CDFI sector can collectively unlock more liquidity than is currently available by utilizing commercial asset-backed structures to trade CDFI assets for cash. Such a secondary market would increase the amount of institutional capital flowing to CDFIs while simultaneously increasing the investment capacity of CDFIs beyond the current limits of their balance sheets. Moreover, recent advancements in accessing the capital markets like note and bond issuances are typically feasible only for larger CDFIs with sizable real estate-backed portfolios; this approach of purchasing assets would be able to include CDFIs regardless of their size, sophistication, or asset class focus.

This white paper is a blueprint for building a sustainable intermediary business that actualizes the opportunity at hand. In the commercial space, a thriving sector of intermediaries connects originators and investors across various asset-backed securities markets. For the CDF industry, we need an intermediary savvy with the expectations of commercial investors while also aligned with the social mission of CDFIs. The intermediary would take financial structures well known to the commercial sector and construct securities from pools of CDFI assets. Using the case study of the New York Forward Loan Fund, analyses of CDFI portfolio data, and commercial structure examples, this white paper details how the concept of CDFI commercial intermediation can become reality, and considers the obstacles to execution and how to overcome them.

The time has come for the next stage in community development financing. We seek to gather partners in this endeavor—investors, originators, and stakeholders. Together, we can open a new channel for greater volumes of private capital to flow into CDFIs across the country and ultimately into the local communities that we serve and live in.
Executive Summary

This white paper advocates for the creation of an intermediary business between community development financial institutions (CDFIs) and capital markets. This business would structure financial products backed by assets acquired from CDFIs, thus mobilizing more mainstream capital for CDFIs of all sizes and enhancing their community lending capacities in a sustainable manner.

The proposed intermediary would assist CDFI loan funds in particular and the local communities they serve in gaining access to capital through a new and currently unavailable channel for the CDFI industry: asset-backed securities. Many CDFIs face the ongoing challenge of diversifying away from traditional CDFI funding sources and tapping mainstream capital markets using, for example, bond issuances. An intermediary can lower barriers to such funding by acquiring the assets of CDFIs regardless of their sophistication or size and packaging, or securitizing, those assets in a manner suitable to different types of investors. This approach enhances CDFIs’ investing capacity more than directly lending to CDFIs, since CDFIs can originate a loan, sell it off to the intermediary, and use that recovered capital to make more loans without encumbering their balance sheets with additional debt. Moreover, the intermediary allows public and philanthropic actors to support CDFIs quickly and effectively, which has become an even more pressing need in this pandemic-stricken environment. Governments and foundations can provide funds or guarantees to support a structure that acquires significant volumes of assets from a multitude of CDFIs without those public entities having to seek out and engage directly with each individual CDFI. An intermediary business should specialize in acquiring CDFI assets and actualize the advantages of such an approach for the CDFI industry, with the guiding motive being acceleration of funding for economic development and equity in the United States.

In fact, the New York Forward Loan Fund (NYFLF) is a successful example of CDFI intermediation and asset acquisition. The NYFLF has enabled numerous private and state actors to commit tremendous funds for investing in thousands of small businesses and nonprofits across New York State through the mission-oriented work of CDFIs, a targeted scale of investment that would not have occurred but for intermediation. The NYFLF aggregated over $100 million of private capital and government guarantees to purchase small-balance loans originated by five New York-based CDFIs. The loan fund trust (the intermediary) repays its investors in a tranched structure, while allowing the CDFIs to service the acquired loans to mitigate defaults and ensure better financial and social outcomes. The key to successful intermediation of this nature is fund administration, which in the case of NYFLF is performed by Local Initiatives Support Corporation (LISC). LISC has provided the critical investor and originator services, legal and operational expertise, and IT systems that ensure smooth transfers of information and payments between all parties. NYFLF demonstrates that financially viable CDFI asset acquisition is already being implemented; the intermediary proposed herein would take this initial proof-of-concept one step further: building capital structures backed by CDFI assets and issuing them in the global capital markets, a business model this white paper coins as “commercial intermediation”.

Finally, this white paper sets forth in detail the necessary functions and capabilities of a self-sustaining intermediary to CDFIs, as well as the challenges to achieving commercial intermediation. Similar to the duties of LISC for NYFLF, the intermediary would work with investors and guarantors with various risk-return goals, source loans and investments from
CDFIs to create the asset-backed structures, and manage those structures on an ongoing basis. Utilizing analyses of CDFI asset characteristics and quality, this white paper argues that a commercial intermediary could securitize CDFI assets, i.e. pool such assets and sell securities backed by structured claims against the pools, and that the securitization of CDFI assets can simultaneously accommodate the social mission of CDFIs while competing in the marketplace for the investments of institutional investors. In addition, this white paper describes the advantages and limitations of applying two types of collateralized structures to CDFI intermediation: commercial mortgaged-backed securities and flexible asset-backed securities. Overall, this white paper seeks to outline a clear blueprint for a CDFI commercial intermediary; only the commitment and execution of a capable team is needed to take this blueprint and build the next groundbreaking institution in financing community development.
Introduction

The current moment is one of tremendous opportunity for community development financial institutions (CDFIs). A confluence of events in the capital markets, government priorities, and political discourse has created an environment in which CDFIs could mobilize an unprecedented amount of capital to benefit the communities that they serve. The idea of investing for a social purpose has been mainstreamed, and commercial investment managers have deployed or are seeking to deploy over $20 trillion into investments that are aligned with social or environmental goals; CDFIs are an ideal vehicle for this “impact investing”. In the public sector, governments are focused on accessible capital as an important tool to sustain and rebuild the small business economy in the wake of Covid-19, and are looking for ways to ensure that their considerable capital resources are deployed efficiently to businesses that need them; CDFIs are an ideal partner for these activities. Furthermore, the general public continues to demand that the benefits of the market economy be distributed more widely and equitably; CDFIs are an ideal conduit for advancing social justice through financial empowerment means. All of these factors have created an environment in which there are new and myriad opportunities for CDFIs.

However, CDFIs are simultaneously facing two great challenges. The first is immediate: the local communities that CDFIs serve are experiencing severe economic crises due to Covid-19. Small businesses and nonprofit organizations in areas historically lacking or denied capital access, particularly low-wage communities of color, represent a core constituency of CDFI borrowers, and they are facing existential threats. Despite broad market and government interest in deploying capital to support these communities, they have not been well-served by many of the relief programs that have been enacted to date. One salient reason is that enterprises in such communities require more flexible capital, underwriting approaches, and collateral standards than existing programs allow. Furthermore, while the expertise, community knowledge, and missions of CDFIs make them ideally suited to be in the forefront of supporting small businesses and communities with ample investment capital willing to back their efforts, CDFIs often face operational and financial constraints that make it difficult for them to deploy as much capital as they could, coupled with the risk that the ongoing Covid-19 pandemic leads to an exacerbation in loan defaults and distressed borrowers. Recent support from the federal government has only helped stabilize many CDFIs, rather than multiply their community lending and investment activities in a time of dire economic need.

The second challenge for CDFIs is longer-term but just as critical: the need to diversify their capital base. The single largest capital source for CDFIs is loans from banks, which are driven by the requirements of the Community Reinvestment Act (CRA) to invest in certain lower-wage areas of the US. Consequently, CRA-motivated funding has geographic limitations, as well as being subject to changes in regulations, bank capital requirements, and other factors exogenous to CDFIs. Indeed, the CDFI industry is likely to be impacted by the recent rulemaking by the Office of the Comptroller of the Currency (OCC) that drastically changes implementation of the CRA and goes into effect in October of 2020. Many industry participants worry that this change will reduce the stringency of the mandate for banks to invest in the granular, mission-oriented lending that CDFIs specialize in. Notwithstanding such changes, continued dominance of CRA motivated lending in CDFI capital means that the CDFI industry’s ability to grow will remain tied to banks’ CRA requirements. CDFIs have made significant progress in responding to this challenge, in particular through bond and note issuances, but such programs have limitations. CDFIs need to develop a much broader array of funding mechanisms to both secure their capital base and make it possible for them to attract capital from a broader set of sources.
However, CDFIs face obstacles when attracting capital markets actors to directly fund their community investments. Two issues come to the forefront: collateral and perceived risk. As a result of many CDFIs lending to small businesses, nonprofits, and community development entities, many CDFI investments are unsecured or secured by collateral that is more difficult to appraise and/or not generating revenue. For example, CDFI funding plays a crucial role in financing recreation facilities, small business expansions, childcare centers, and a variety of other highly need-specific projects. This lack of measurable collateral poses limitations when seeking investors to directly fund such projects, since sufficient collateral cannot be proffered to satisfy investors’ loan-to-value requirements. Likewise, the CDFI industry’s primary raison d’être is to extend financial services where traditional institutions do not. CDFIs are charged with intentional lending to disinvested, low-wage, and minority communities at low cost and free from predatory practices. Consequently, their investments are perceived as riskier because of the uncertain economic conditions of such places. Therefore, CDFIs may find it difficult to create a fluid market that attracts institutional investors to offer capital for CDFI assets because of the nature and perception of those assets.

The New York Forward Loan Fund (NYFLF) offers an exciting model that will help CDFIs address both the immediate economic crisis and long-term capital base challenges. The NYFLF is a coordinated response to the Covid-19 pandemic involving the State of New York, banks, foundations and other mission-oriented investors, and five CDFIs with significant lending operations in New York State. In just a few weeks, the NYFLF raised $100 million for the deployment of thousands of low-rate, small-balance loans to small businesses and nonprofits; as of this writing, the five originating CDFIs already identified enough qualifying loans to fully exhaust NYFLF’s capital. The NYFLF’s funding mechanism and loan product could be replicated across the country to help address the near-term challenge of rapidly investing in disinvested communities.
Moreover, launching funds similar in structure to the NYFLF would not only enable numerous public and private actors to fund en masse targeted small business loans to help combat the immediate economic hardship, but could also help increase the conventional capital markets’ acceptance of small-balance, uncollateralized loans for working capital, a product in high demand from small enterprises but perceived as risky by institutional investors. The managers of those funds would work in conjunction with CDFIs to acquire CDFI-originated loans, sell investment-grade securities backed by pools of those loans, and use the sale proceeds to continue the cycle. While the economic viability of the NYFLF depends on its significant state subsidies, its funding nevertheless proves that sufficient loss reserves can take the place of collateral to attract return-seeking private investors, thus addressing the under-collateralization problem. Indeed, if the NYFLF structure is managed properly and replicated sufficiently, the success may serve to jump-start acceptance of securities formed from such smaller, impact-oriented loans by the capital markets, just as the distressed loan pools assembled by the Resolution Trust Corporation after the Savings and Loan Crisis jump-started the commercial mortgage-backed securities market in the early 1990s.5

The NYFLF model has the potential to address the longer-term challenge of diversifying CDFI capital sources, by providing the proof-of-concept and impetus for a CDFI financial intermediation business that remains relevant beyond the current economic recession. If CDFIs can successfully build on their experience with the NYFLF and other similar funds to implement additional features such as ratings, more sophisticated trancheing, and securitization, they have the potential to unlock a highly attractive avenue to more capital that can support all CDFIs—not just the largest or most sophisticated. In order to do this, the CDFI industry needs to develop its own set of financial intermediaries— institutions that are skilled in raising, understanding and administering complex capital structures and also have the credibility and mission orientation to be trusted partners with local CDFIs and communities. LISC, as administrator of the NYFLF, is developing the skills, relationships and capacities to be an effective intermediary and unlock this capital—and further replications of the NYFLF structure can serve the industry by allowing LISC and other managing CDFIs to develop those capacities even more, to the point at which they can effectively use them to channel large-scale commercial capital. The remainder of this white paper will discuss the role and implications for CDFI loan funds in particular, as opposed to other types of CDFIs such as banks, credit unions, and venture capital funds.
The New York Forward Loan Fund: An Initial Proof-of-Concept

The New York Forward Loan Fund is a $104 million loan fund that finances loans to small businesses and nonprofits in New York State that have been negatively affected by the Covid-19 pandemic. It is a central part of Governor Cuomo’s economic response to the pandemic. Small businesses with less than 20 employees and annual revenues below $3 million, small landlords with less than 50 units that rent to lower-income tenants, and nonprofits are eligible for the loans, which are intended to be used to fund the borrowers’ up-front expenses to comply with New York’s reopening plan, such as build-out expenses required to comply with social distancing guidelines. The maximum loan amount is $100,000, and the projected average loan size is $36,000. The loans have a 3% interest rate (2% for nonprofits) and fully amortize over their 5-year term (with a one-year interest only period); they are prepayable at any time. The loans do not require collateral, but must be personally guaranteed by each owner of more than 20 percent of the business.

This type of lending—uncollateralized lending in relatively small amounts to small, often neighborhood-oriented businesses—was in very short supply even before Covid-19; it is especially inaccessible to businesses in low-wage, under-resourced communities. Consulting firm Next Street has estimated an $87 billion deficit in available financing for small businesses in the United States. A broad expansion of small-business lending to meet this need would have significant social benefits. Small businesses have accounted for 64% of job creation over the last fifteen years and are an important contributor to building community wealth. Even successful small businesses are vulnerable to short-term operational or economic shocks; for businesses experiencing such shocks, access to capital could be the difference between long-term growth and insolvency.

However, despite the strong need for more of this type of lending, lenders of all types—and mission-oriented lenders in particular—have struggled to meet that need. One reason is cost-efficiency: small balance loans tailored to unique borrower needs do not scale well. Origination
fees are smaller due to the loan amounts, but costs of origination and servicing remain relatively fixed, because of the nuanced diversity of borrowers. Another reason is that small business loans have a high perceived default and loss risk. Wholesale capital providers have not widely accepted these loans as sound investments, and rating agencies have rarely rated asset pools comprised of them. As a result, significant public support and financial guarantees were required to attract private capital to the NYFLF—but, as described below, its successful deployment and management may help attract more private capital to small business lending in the future.

The capitalization of the NYFLF is made up of three primary parts: an A-Class tranche provided by banks, a B-Class tranche provided by foundations and impact investors, and a guarantee provided by New York State for loan loss reserves. The $88 million A-Class is senior to the B-Class within the structure, meaning that principal and interest payments as well as payments from the guarantee fund go first to the A-Class investors until they are fully repaid, and only then do payments start to flow to the B-Class investors. The B-Class and the guarantee together provide the A-Class investors with 30% subordination. The A-Class investors earn a fixed interest rate of 2%, while the $17 million B-Class debt bears 0% interest and is protected by 16% subordination. The $20 million state guarantee is unfunded until needed, at which point funds are deposited into the reserve account.

This tranched structure—in which different investor groups have different seniority levels, concomitant risk exposures, and return levels—is similar to many structures that exist in the commercial financial markets. Furthermore, the A-Class tranche’s 1.65% spread is higher than the spreads on senior tranches of commercial pooled loan structures. For example, the most-senior tranches of recent commercial mortgage-backed securities (CMBS) issuances, which typically have 20% subordination, have priced in the range of 1.15–1.20% over five-year swaps. However, since the NYFLF is comprised of unsecured small business loans, institutional investors would likely not have even considered investing without the presence of significant guarantees. The NYFLF is also different from commercial tranched structures because the highest-risk tranches do not receive any return; in a typical commercial offering, the less subordination a tranche has, the higher its interest rate. Nevertheless, the NYFLF’s tranched structure overall is similar to structures that are familiar to credit investors.

Furthermore, the NYFLF’s investment process and administration are a strong model for future capital-raising mechanisms for CDFIs. Rather than making loans itself, the NYFLF purchases loans originated by a group of five CDFIs with lending operations in different parts of New York State. These CDFIs focus on originating loans and working with borrowers, and investors invest in a single entity with centralized investor relations, reporting and cash management functions. Furthermore, because the CDFIs sell the loans to the NYFLF almost immediately after closing, their capacity to make these loans is not limited by the capital remaining on their balance sheets after closing and funding the loans. Two mission-driven lenders acting as key partners keep the structure together: LISC as trust administrator and master servicer, and Calvert Impact Capital as arranger. These partners arranged the key participants and raised the requisite capital (with significant input and participation from New York State). Without the robust intermediation function of those two organizations, the structure simply could not work. While capital raising is an important function of intermediaries, and the tranched structure of NYFLF is more complex than a typical CDFI capital raise, the element that holds the most promise to change CDFIs’ capital raising options in the future is LISC’s development and implementation of the infrastructure and practices necessary to administer and service a $100 million fund that purchases thousands of loans. That technical execution by LISC is critical behind-the-scenes work. The expertise that LISC is developing in buying, servicing and administering a large pool
of assets originated by other CDFIs will make it possible for LISC—or another similarly prepared CDFI—to take the next step and launch a commercial intermediation function: an independent, self-sustaining enterprise that raises capital for both itself and other CDFIs through the issuance of sophisticated capital structures.

While the NYFLF is a compelling program addressing a real need in the wake of a crisis, its structural elements are not novel. There are other examples of institutional and impact investors working together to invest directly in CDFI-originated assets rather than simply lending to CDFIs themselves, such as the New York City Acquisition Fund or the Golden State Acquisition Fund. These funds utilized significant funding from respective state agencies to provide the first-loss capital, thus enabling far more leverage of the originating lenders’ capital and achieving more impact than the lenders could have achieved alone. Other companies have pooled small business loans at scale and issued securities to institutional investors. One salient example is Newtek Business Services’ $119 million rated securitization of SBA 7(a) unguaranteed portions in 2019, its 10th issuance to date. Yet, the NYFLF is unique in that it accomplishes three elements at once: large-scale acquisition for a traditionally risky class of uncollateralized assets, a tranched repayment structure with market-level returns for senior investors, and the CDFI mission of servicing borrowers for social returns. These elements together are the requisite pillars for implementing commercial intermediation and securitization to serve the broader CDFI industry and its wide variety of assets.
Launching Commercial Intermediation for CDFIs

Financial intermediation is the practice of matching capital owners with capital users, and a set of businesses and other institutions that specialize in providing matching services has evolved over the years. Indeed, the presence of robust financial intermediation is recognized as one of the hallmarks of an efficient economy. While intermediaries exist for the CDFI industry, they act primarily to aggregate capital in order to lower CDFI’s cost of debt and increase accessibility of funding. Intermediation directly between individual CDFIs and institutional capital for the exchange of assets with liquidity is not yet widely available.

Building that type of commercial intermediation into a sustainable, industry-wide enterprise poses challenges. The intermediary business needs to achieve a high level of trust with capital owners and users, applying the gamut of comprehensive social and financial data analytics and customer service. The business also needs to offer standardized products to capital owners, but those products cannot be so standardized that it deprives capital users of the flexibility they need to close investments. Finally, the business needs industry-grade technical skills in a host of different functions related to fund management and investor/originator relations. The remainder of this section will first explain the potential benefits of applying commercial intermediation to the CDFI industry, then discuss the challenges and solutions to executing on the idea.

Commercial Intermediation Potential for CDFIs

The CDFI industry stands to benefit greatly from an intermediary business that taps into the capital markets directly through the issuance of securities structures well-suited to CDFI assets and business models. This form of intermediation would lower the barrier to wholesale capital, increase liquidity, and facilitate public sector support. Moreover, this business would be a fundamental value-add over existing intermediary entities and liquidity facilities for the CDFI industry because by acquiring assets from CDFIs directly, it increases liquidity and lending capacity without increasing indebtedness, while the existing solution paradigm is to continually lower the cost of debt for CDFIs, without necessarily reducing their need for debt.

1 Bank Dependence and Limitation of Bond Issuances

Although CDFIs currently obtain their capital from a diverse array of sources, they face a severe concentration risk in bank funding. LISC’s 2017 white paper provides a detailed overview of the historical evolution of the CDFI investor base, which is comprised of banks and other financial institutions, foundations, religious institutions, individuals, and the federal government. Currently, the single largest source of capital for CDFIs is banks, which provide nearly twice as much capital as the second-largest capital source, and banks’ loans to CDFIs are largely driven by CRA regulatory requirements. Since the CRA only applies to select areas of the country, CRA-motivated funding contributes to imposing geographic limits on CDFI activity. CDFIs’ dependence on bank capital also means CDFIs are at risk of significant reductions in funding if there are amendments to the CRA or changes in its interpretation, as evinced by the CDFI industry’s negative reactions to the OCC’s recent rulemaking on the CRA.
In response to the problems with excessive reliance on CRA-motivated funding, CDFIs have been seeking to develop and expand new financing sources. One notable approach is accessing the conventional debt market through rated bond and note issuances. Eleven of the largest CDFIs have been rated by Standard & Poor’s with all of them achieving investment-grade ratings; subsequently, nine have issued bonds or notes that have been bought by conventional institutional and retail accounts at spreads comparable to similarly-rated corporates. CDFIs issued bonds and notes in order to strengthen and diversify their own balance sheets by refinancing shorter-term, sometimes variable-rate debt from banks with the longer-term notes at lower fixed rates. In addition to their ability to lower the cost of capital for CDFIs that have issued them, these rated notes have been important because they have shown that it is possible for CDFIs to raise capital at scale on favorable terms from conventional investors that do not have a regulatory motivation. These issuances have educated bond investors about the CDFI sector and the types of loans that CDFIs make—and they have also shown underwriters and other third parties that they can be rewarded financially if they work with CDFIs to help them access the conventional capital markets.

However, rated bond and note issuances also have significant limitations for the CDFI industry. Rated issuances can be inaccessible to many CDFIs, with the barriers more difficult to overcome the less resources and sophistication a CDFI has. The financial gains from a successful issuance would need to justify the significant costs, which include legal counsel, underwriting, and regulatory compliance. Moreover, the gains are only meaningful when the bond or note issuance is made at significant scale, which may be out of reach for many smaller CDFI’s abilities and balance sheets. In addition, an issuing CDFI must maintain certain leverage ratios in order to receive and maintain favorable ratings, as is the case with Standard & Poor’s ratings. To meet such ratio limits, CDFIs may need to restrict their lending activity past a certain point in the absence of additional equity capital. Besides, nonprofit CDFIs are not permitted to raise equity capital from third parties except in the form of grants or donations, hence the existence and necessity of deeply subordinated equity equivalent (EQ2) loans in the CDFI industry. Even if bonds or notes lower the cost of capital for a CDFI, difficulties in obtaining equity to maintain leverage may negate the overall advantage of an issuance. Thus, rated issuances are sensible for only the well-capitalized actors in the CDFI industry and do not necessarily expand the lending capacity of CDFIs that do issue them.

An intermediary business would help CDFIs rely less on CRA funding by taking a different approach: acquiring CDFI loans based on their characteristics, irrespective of the originating CDFI’s size or sophistication. Instead of adding to CDFI indebtedness to make the loans, the business pays cash sourced from the capital markets, thus avoiding the problem of increasing leverage. Likewise, only the intermediary needs to have the sophistication and resources to interact with investors and the capital markets, thus negating the need for each CDFI to have the same. The NYFLF demonstrates that intermediated model—several of the CDFIs selected to originate loans for the NYFLF each have total assets of less than $100 million, making them too small for a rated bond issuance. However, they still benefit from attractively priced wholesale capital by selling loans into the NYFLF’s structure, which has pooled the capital together from various sources.

2 Liquidity and Capital Efficiency

Intermediated structures could also function to increase the liquidity and capital efficiency of CDFIs by helping them “recycle capital”. In the case of the NYFLF, CDFIs that would normally be limited by their ability to raise net assets are now able to originate new loans without
encumbering their capital. When the NYFLF buys the loan, the originating CDFI recovers the capital used to originate that loan, net of a small ownership share for risk retention. The CDFI can then use the proceeds to make a new loan, either for sale to the NYFLF or to be held on its balance sheet. Through this arrangement, the CDFI now has the option of choosing whether to keep a loan in its portfolio or to sell it to continue originating; the CDFI has a ready channel to liquidity and is not limited to receiving the coupons of its loans until maturity or refinance. Most commercial intermediated structures require some level of risk retention by the loan originator or intermediary, but that requirement tends to be fairly small; in the case of NYFLF, the risk retention rate is 5% for its CDFI originators. Therefore, CDFIs can execute more lending activity with a given amount of intermediated capital than with the same amount of direct debt, since only a small risk retention portion of the originated loan, and not the full balance, remains on the balance sheets.

This approach contrasts with the various existing mechanisms to bring wholesale capital to CDFIs. The Federal Home Loan Banks, CDFI Bond Guarantee Program, Federal Reserve Funding and Liquidity Facilities, and other similar programs all share a common goal: increasing the availability of capital and lowering the rates on borrowed funds for community lenders. Through various combinations of intermediary entities and government support, such programs achieve a lower cost of borrowing for CDFIs that would otherwise face a much higher cost or be denied credit due to their financial position, perceived risk, or portfolio characteristics. These programs play a vital role for the CDFI industry, but all of them require CDFIs to be taking on borrowed funds. Such funds may not be applicable for institutions that have exhausted their capacity for debt, whether by having reduced their cost of capital to the ideal level and/or reached maximum leverage. On the contrary, the proposed intermediary business would not lend to CDFIs in exchange for payments, but instead pay CDFIs cash in exchange for assets. Moreover, pooling those assets into tranched securities of varied risk levels achieves the same outcome as the programs above: attracting wholesale capital investment into intermediary entities or products, rather than directly into individual CDFIs.

Indeed, even the legislation that established the US Department of Treasury’s CDFI Fund contains provisions for generating more liquidity for the CDFI sector through secondary market activity. Section 113 of the 1994 Riegle Community Development and Regulatory Improvement Act authorizes the CDFI Fund to provide up to $5 million in grant or loan funds to an organization that will in turn use that capital to purchase loans from CDFIs. The awardee need not be a CDFI, but the loans it purchases must be purchased from CDFIs – and the CDFIs must in turn use any sale proceeds for community development purposes.24 In practice, an awardee could utilize those funds effectively by having it form part or all of a loan-loss reserve that helps leverage much larger amounts of private sector capital. The availability of such funds would promote the existence of a secondary market with multiple intermediaries at work. However, Congress has yet to set aside appropriations for this liquidity program, and is unlikely to in the near future. CDFI industry members have been focused in their lobbying on fully funding the CDFI Financial/Technical Assistance Programs; gathering support from either side to stand up an entirely new program faces difficulties. In addition, the language of Section 113 contains restrictions on receiving funding from the CDFI Fund, while also being too vague on the community development use mandate. Both issues present significant obstacles to supporting and funding this liquidity program. However, this lack of direct federal support for liquidity does not mean that the industry’s need has not continued to grow; in recent years there has been growing pressure on the Federal Reserve to establish a long-term liquidity facility for CDFIs. Therefore, in the absence of government funding, it is all the more necessary for industry leaders to help launch and operate commercial intermediaries. If this intermediation can demonstrate success, Congress may see a clear demand for more liquidity and a proven channel through which to provide it.
Successful intermediation can also serve to increase the range of investors willing to provide liquidity to the CDFI industry, albeit indirectly. In order to issue tranched securities from CDFI loans, the intermediary will need to assemble and present the loan pools in a manner that enables investors, the ultimate purchasers of the securities, to underwrite those loan pools as an asset class. The ability to underwrite the assembled loans as a singular asset class with known characteristics will allow fund managers and other institutional investors who were unwilling to invest in any individual CDFI or CDFI-originated asset to become comfortable with senior tranches that spread the risk across numerous, similar loans. Meanwhile, philanthropic and impact investors searching for social returns can purchase the junior tranches of the same loan pools and benefit from the large aggregation of investments originated by institutions with verifiable social mission. With this tranched structure, the intermediary can cast a broader net in finding both financial- and social-return seekers to invest in the same set of assets. In addition, when certain types of loans gain acceptance as an asset class, it also becomes successively easier to assemble another pool of those loans (in potentially larger volumes than before) and issue another round of securities. This manner of execution is more efficient than standing up a new program or intermediary each time to achieve the same effect of funding CDFI assets. The intermediary business has great potential to scale up, using the same infrastructure and resources to issue larger volume securitizations, provided that the supply and demand can keep up.

3 Facilitating Direct, Low-Cost Government Support

Intermediated structures can be particularly valuable in times of crisis when governments seek to extend support to community financing. As with the NYFLF, the public sector can work with an intermediary to raise a capital structure with the support of government guarantees, and swiftly establish multiple funding channels to numerous CDFIs. Indeed, the CDFI industry and their local communities would benefit from an ongoing guarantee facility established by public sector entities to back certain types of CDFI lending, which could expand and contract in size of guarantees according to time and need. In the absence of such a facility, a commercial intermediary instead could provide an easy avenue for the public sector to support targeted investments by providing funds or guarantees to securitized structures.

There is strong precedent for this type of collaboration—in the US, all levels of government participate in the financial market at a significant scale, often through partnerships with financial intermediaries. These partnerships allow public entities to achieve their aims not by directly spending from their capital or operating budgets but by using unfunded guarantees (or even implicit guarantees) to attract private capital to finance the activities the public entities desire on favorable terms. Governments are generally understood to be strong creditors, and the US federal government cannot go bankrupt. Moreover, in times of economic crisis, public entities can bolster investor confidence and activity by increasing the size of its existing guarantees to pools of assets that investors have already funded.

One well-known example of this collaboration is found in the residential mortgage market, which has been supported by the federal government for decades as part of public policy to encourage homeownership. In 1938, the US Congress established Fannie Mae, and in 1970, its competitor Freddie Mac (collectively known as the Government-Sponsored Enterprises, or “GSEs”). These independent, privately owned GSEs have supported the residential mortgage market through a wide array of intermediation activities. Their most important form of support is guaranteeing the repayment of securitizations of mortgages that fit certain criteria. This guarantee is widely understood to be backed by the federal government (although no law or contract states this backing), and consequently induces investors to make capital available
Intermediated guarantees of this type are attractive public policy tools to governments because they have a low cash cost (and sometimes even generate revenue). Guarantees are also flexible—if the government entity’s policy goals change, they can vary the terms or size of the guarantee to reflect the changed goals. Other examples of government-guaranteed intermediation relevant to the CDFI industry include the CDFI Bond Program, which has raised over $1.7 billion in bonds to date, and the Credit Enhancement for Charter School Facilities Program, which has provided $394 million in grants towards leveraging private sector funds for charter schools. Building an intermediation infrastructure for CDFIs, especially in the context of public-private partnerships like the NYFLF, will create a reliable channel whereby governments can guarantee products created by CDFI intermediaries—either in times of crisis or even as ongoing public policy.

Overcoming Obstacles to Commercial Intermediation

In order to access the benefits of commercial intermediation, CDFIs must surmount two major obstacles. The first obstacle is underwriting CDFI loans and investments to create asset pools. CDFIs, as mission-oriented institutions seeking to address racial and social inequalities, make investments that vary greatly across borrower and product types, contain various credit enhancements and concessions, and have collateral distributed among the diverse communities served by CDFIs. On the other hand, traditional investors seek relatively uniform asset pools with demonstrated risk-return characteristics; thus, the challenge is to construct such pools from the diversity of CDFI assets. The second obstacle is making this business model work simultaneously for all parties involved. For example, originating CDFIs need sufficient incentive to participate by selling their loans; borrowers need continued servicing and assistance. Different investor types will have unique expectations for reporting, compliance and overall investor relations, in addition to their desired rates of return. These two obstacles together represent a significant, but not insurmountable, challenge to launching a successful CDFI intermediary business.

Preliminary analyses of CDFI assets and conversations with financial markets participants suggest that the first obstacle can be readily overcome. Across the broad spectrum of CDFI assets, there are groups of assets sharing common characteristics and at meaningful volume to underwrite on an aggregated basis. Moreover, while CDFI investments may be perceived as riskier overall from a commercial risk-return perspective, CDFIs have managed to keep delinquencies, losses, and credit performance at levels comparable to the market since the 2008 financial crisis, all the while earning competitive spreads. Such trends are counterintuitive, given that CDFIs seek and lend to borrowers operating in disinvested and low-wage neighborhoods. Indeed, that track record is a testament to the ability of CDFIs to work closely with their borrowers to ensure yields for the lender and success for the borrower. These factors imply that the challenge lies in assembling and structuring the assets according to sound credit criteria, rather than in the nature and creditworthiness of the assets themselves.

Funds like the NYFLF are demonstrating how to overcome the second obstacle: bringing together capital market actors and CDFIs while addressing each of their needs. With respect to originators’ economic incentives, the intermediary can negotiate fees and compensation that make participation a sensible complement to originators’ existing business models.
There are also legal options in the form of sub-servicing contracts that address the critical need for mission-oriented servicing by allowing the CDFI originator to continue servicing their loans. Finally, the unique compliance and reporting needs of originators and investors require operational expertise and investments in fund servicing infrastructure, which the participating CDFIs and LISC as fund administrator are gaining as part of the NYFLF execution. The above set of issues is not exhaustive, but captures several concerns in executing commercial intermediation models for CDFIs.

1  |  Forming Viable Pools of CDFI Assets for Securitization

Initial reviews of CDFI industry data suggest that pools of CDFI assets can be formed at sufficient scale with acceptable risk-return characteristics, if the intermediary business focuses on certain loan types and maintains a well-defined “credit box”. In addition, lack of collateral to meet investor requirements can be addressed with guarantees and/or first-loss capital. The following analyses of CDFI loan data below discuss the characteristics and technicalities of a feasible asset pool for securitization, with the aim of providing realistic guidance for an actual issuance.

CDFI INVESTMENT CHARACTERISTICS  Since the total balance of a commercial issuance is large relative to individual asset size, the questions arise of “which loans to aggregate, and is there sufficient supply?” Opportunity Finance Network (OFN), the CDFI industry association, conducts annual surveys of its members across a wide range of measures. Figure 1 from the survey data demonstrates that the assets of CDFI loan funds are diverse, but remain concentrated in four primary sector types: housing to organizations, community services, commercial real estate, and business. Loans in those four sectors comprise over $5.9 billion in outstanding balance as of 2018 year end. Moreover, Figure 2 shows that the largest average loan sizes are found in the housing to organization, community services, and commercial real estate sectors. Consequently, if the viable issuance deal size is around $250–300 million, then the issuer would need to collect slightly over 400 of such loans assuming an average loan size of $600,000 (whereas more loans are needed if sourced from sectors with lower average investment sizes). These two data findings together point toward the initial working assumption that aggregating loans from the aforementioned three loan types will scale most efficiently.

* See table below for definitions of sector types.
† Fiscal year 2018 is the most recent edition of OFN’s member survey.

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**FIGURE 1.**

OFN Loan Funds—
Value of Loans
& Investments Outstanding by Sector, 2018

- Housing to Organization
- Community Services
- Commercial Real Estate
- Business
- Housing to Individual
- Microenterprise
- Other

Source: Opportunity Finance Network
Focusing on housing to organization, community services, and commercial real estate loans comes at the obvious exclusion of the business sector loans. This sector contains the small business and nonprofit loans that are the focus of Covid-19 economic recovery efforts. For a successful first commercial securitization however, they may not be the most feasible candidates relative to the other peer sectors. First, their smaller average balance means that more loans need to be aggregated to reach the viable total asset volume. Once strict credit criteria are applied, the pool of qualifying loans may be insufficiently small, since CDFI business loans tend to be unsecured and/or without collateral, exhibit higher default and delinquency rates on average, and have shorter durations. However, that situation assumes the acquisition of only existing loans rather than originating new ones using the funds from issuance. Certainly, a paramount goal of CDFI commercial securitization is the inclusion of such business loans in the provision of mainstream capital, and the NYFLF is providing strong momentum for doing so. Thus, the workaround is likely similar to the NYFLF’s model: support the origination of new small enterprise loans along the criteria demanded by a feasible securitization, and then acquire those newly originated loans into the asset pools.

Once the asset pool is formed, another important question arises: “how will it perform?” This performance is anticipated by using CDFI cohort data as rough proxies for the performance
OFN categorizes its members into different cohorts based on the primary financing products they offer. Since the data do not track delinquency and write-off rates for each loan type across all CDFIs, instead the average delinquency rate reported by the Commercial Real Estate cohort, for example, can serve as a proxy for the true delinquency rate of CDFI commercial real estate loans in general. Moreover, the same measure for either FDIC institutions or CMBS issuances provides a useful reference point when presented alongside the OFN trends. When this method is applied to the three sectors most promising for securitization, the trends show a promising picture.

**DELIQUENCIES** Investors use delinquency rates as an easily accessible and high-frequency indicator for loan performance. The 90-day delinquency rates of the selected CDFI cohorts show trends comparable to those of the FDIC institutional average. As Figure 4 demonstrates, 90-day delinquency rates for every sector stayed mostly below the FDIC average in the selected time period. Likewise, in Figure 5 the 30-day delinquency rate of the sector cohorts remained below that of CMBS issuances, from 2010 onwards. When compared to each other, the commercial real estate cohort tends to have slightly higher delinquency rates than housing to organization or community service cohorts, while also showing the most variability.
Likewise, trends in the net charge-off rate show a favorable picture. Net charge-offs or net loan losses are reported after default, foreclosure, and liquidation and are net of any recovered assets. This indicator provides a definite measure of the realized losses of a particular asset pool, and thus is another critical measure for investors. Figure 6 shows that the net charge-off rate of each cohort track relatively close to the FDIC institution average within the last several years. Likewise, the peaks for each cohort after the 2008 financial crisis are never exceedingly high, indicating that CDFI portfolios were not overly vulnerable to the economic recession.

Similarly, LISC conducted analyses of its own portfolio performance data and found that cumulative loss rates on its loans were well below those for commercial originations from the same periods. Specifically, LISC originations from the several years prior to the financial crisis exhibited significantly lower cumulative loss rates than conduit CMBS originated in the same years, with the average loss rate for LISC loans from 2005 to 2008 being approximately 4% while the average loss rate for CMBS loans exceeded 11% in the same years. It must be noted that CDFIs are exempt from the safety and soundness exam required by the Federal Reserve Board, allowing them to engage in more proactive asset management and loan amending rather than resorting to write-offs. Consequently, many delinquencies are prevented from becoming defaults, and many late loans are amended and worked out to prevent delinquencies. Nevertheless, these trends in delinquencies and net charge-offs attest to two complementary aspects of CDFIs: CDFI investments overall are not necessarily riskier than those of traditional institutions, and CDFIs ensure strong portfolio performance through the provision of active servicing and technical assistance.

Moreover, CDFI assets also bear the potential of strong investment returns, especially when grouped in asset pools to further reduce risk for senior investors. The interest rate spreads in Figure 7 were calculated by subtracting the cost of funds from the weighted average interest rate on loans for each respective sector cohort. The resulting trends show clear differences between the cohorts, with community services tending to have a more consistent and larger spread on average than its peers. The spreads were also compared to historical yields on Moody’s Seasoned Baa Corporate Bonds relative to the yield on 10-year Treasury Constant Maturity, the former being an investment bond that acts as an index of the
performance of all bonds given a “Baa” rating by Moody’s Investors Service. Figure 7 clearly demonstrates that the spreads for the selected CDFI assets were comparable to those of investment-grade corporate bonds over the past decade, with the community services and commercial real estate sector loans in fact showing greater yields than the Baa corporate bonds for almost all of the years analyzed. For additional reference, prior to the Covid-19 pandemic, loans in new CMBS pools had an average spread to the treasury rate of less than 2%. Meanwhile, spreads for the selected CDFI loans consistently averaged above 2%. These favorable credit spreads on CDFI loans indicate that a pool of such loans could be structured such that the senior-most tranches are paying competitive returns to their investors.

**COLLATERALIZATION**  The collateral backing the loan pool is also critical to securitization. Amassing that collateral, however, may pose a challenge when it comes to CDFI assets beyond traditional commercial or residential real estate-related investments. Since data on the rate of collateralization for CDFI loans are not readily available, it is difficult to anticipate how much collateral will be available for a given amount of CDFI loans. However, if the intermediary business focuses on the three sectors mentioned above, loans in those sectors tend to have senior secured positions on real estate. Using LISC’s portfolio as one reference point, 76% of commercial/industrial, 71% of community facility/economic development, and 77% of housing rental loans have a first-lien position on collateral. Overall, low collateralization does not have to be an inhibitor to pooled acquisition and can be addressed initially with first-loss capital and/or unfunded guarantees and then subsequently with abundant and extensive loan performance data.

The NYFLF and other examples demonstrate that a loan pool with little to no collateral is still palatable for commercial investors—those seeking market-rate, risk-adjusted returns—if there is sufficient loss-reserve protecting their repayments. A balance can be struck through the structuring process: if there is insufficient collateral, the desired level of protection can be achieved by filling the gap with first-loss capital or unfunded guarantees sourced from social return-seeking investors. For example, several microfinance institutions have issued successful securitizations of their loan portfolios with the help of credit enhancement

‡ As of June, 30 2020. Source: LISC outstanding portfolio data
from social investors. In 2006, ProCredit Bank Bulgaria securitized over $61 million of its microfinance loans to entrepreneurs. Such loans tend to be unsecured and uncollateralized, but highly diversified and relatively homogenous with respect to amount and terms. The European Investment Bank and KfW, the German development agency, provided the guarantees necessary to complete the funding structure. In the NYFLF, the capital structure utilized both unfunded guarantees from New York State agencies as well as Class-B notes from foundations and impact investors that effectively function as first-loss capital by providing significant subordination to the Class-A notes and yielding a 0% coupon.

First-loss capital and guarantees help investors become comfortable with investing in uncollateralized assets because they replace the function of collateral. Yet collateral is only necessary in the case of default; its liquidation covers payments owed to investors. Both collateral and guarantees do not have inherent value to investors, but only serve as protection when repayment is uncertain and loan loss levels unpredictable. Hence, investors and rating agencies focus on the lack of collateral for small business loans because that asset class in general has insufficient track record data on repayments and defaults to underwrite such loans without collateral coverage (with the exception of government-guaranteed loans such as SBA 7(a) loans that are mandated to report data). Therefore, if an asset class could demonstrate low, predictable rates of default, it is reasonable that investors would accept the absence of collateral, and that is precisely what has happened with several types of uncollateralized asset classes.

Numerous securitizations demonstrate that asset classes without inherent collateral can gain commercial acceptance with the accumulation of detailed data. In the case of federal student loans, the federal government previously guaranteed loans through the Federal Family Education Loan Program by subsidizing and reinsuring loans made through the program. However, despite the program’s termination in 2010, the market for student loan-backed notes continued to thrive, with recent issuances totaling billions of dollars. Likewise, credit card
debt-backed securities have proliferated, due to the explosion of credit users and concomitant growth in performance data. Securitizations of the unguaranteed portions of SBA 7(a) loans have also gained acceptance, thanks to the SBA data collection and reporting requirements along with a robust secondary market. Recent examples of such issuances include Hana Financial and Newtek Business Services issuing millions of dollars in volume. In the impact investing space, Funding Circle, a UK-based small business lending platform, executed seven securitizations of its loans totaling over $1 billion and did so without significant governmental or philanthropic guarantees. Funding Circle was able to achieve this repeated success because of their extensive database on the performance of their multi-billion-dollar portfolio and their proprietary technology to capture and track that data. With sufficient performance data, CDFI assets without collateral have potential to gain commercial acceptance as well, and the CDFI industry has already been building up that data internally, as shown above. In the first securitization of CDFI assets, presenting loan performance data representative of the asset pool will be critical to gaining the confidence of investors. With repeated securitizations, that data can continue to build and be publicly disseminated to the institutional investing market, allowing CDFI assets to further gain acceptance as a dependable, low-risk asset class.

**INVESTMENT PRODUCT TYPE** CDFIs provide a wide array of investment products to address the varied financial needs of community borrowers, ranging from pre-development loans to permanent loans to lines of credit. From that variety, the intermediary will need to choose certain product types with representative features suitable for the securities and their prospective investors. In general, an ideal loan for securitization purposes is fixed-term and fully drawn. Those features enable the forecast of a predictable cash flow, which is necessary irrespective of loan purpose or industry sector in order to guarantee that the loan pool repays as anticipated. Thus, whether the asset is a small business equipment loan or multi-million permanent financing for real estate development, it can be readily pooled and securitized if the asset ensures fixed cash flows for a definite period. Consequently, this preference may exclude products like lines of credit and construction financing for which the outstanding balance can fluctuate or the terms can change with certain project milestones.

Among the various features of a loan, the term warrants special attention. The average term of the loan pool will determine the schedule of repayments and the types of investors that the issuance is able to attract. Some investors may require more seasoned loans, or loans with demonstrated repayment history. In addition, rating agencies also tend to discount early-stage financing. On the other hand, investors can be comfortable with shorter-term loans if a revolving period and proper procedures and policies are in place. The revolving period in particular enables the inclusion of loans with shorter terms, such as mini-perm loans or other bridge financing, by permitting the redeployment of principal repayments over a period of two to five years. Without a revolving period, such redeployment is typically not allowed. Thus, some investors may see as an advantage the ability to collect repayments quickly and deploy funds across a greater and more diversified pool of assets. The intermediary’s decision for the loan pool’s average term and representative product type will depend on the type of structure it wants to construct and investors it seeks to target.

Ultimately, the intermediary business will need to define a “credit box” – a set of criteria for loan acquisition. For each issuance, the credit box defines the loan type(s) to be acquired, desired maturities and balances, thresholds for measures such as loan-to-value and yield, and much more. A strict credit box creates a homogenous asset pool that is more easily evaluated at the asset-class level, but it may disqualify many CDFI assets due to their aforementioned variability. The solution is to construct the financing structure that fits the characteristics of the asset pool, whether by creating more tranches, securing more unfunded guarantees, or including a revolving period. Section IV discusses the processes of structuring and issuing in greater detail.
Addressing Needs of Originators, Borrowers, and Investors.

Even if CDFI asset pools viable for commercial securitization are able to be formed, there are still a variety of specific concerns and needs for the parties involved in executing an actual securitization issuance. For originators, the economic incentive to sell off loans into the structure must outweigh that of keeping the loans. In addition, the ability to fulfill the mission of achieving desired socioeconomic outcomes must remain intact for CDFIs and their borrowers alike. For investors, they each come with their particular set of reporting and compliance needs, along with tailored insights into asset performance as requested. Within the NYFLF, LISC addresses each party’s needs through its professional fund management staff and systems. Using NYFLF and LISC as a case study, the following section discusses the solutions implemented to address these multi-faceted concerns.

**ORIGINATOR ECONOMIC INCENTIVE**  The intermediary business can provide several options to ensure an economic incentive for CDFI originators to participate by selling loans into the structure.

1. Share of gross profits from closing of issuance
2. Retain interest-only strip of loans
3. Origination fees
4. Servicing rights and fees

The NYFLF partner CDFIs receive origination fees at closing and ongoing servicing fees. They also contributed their own capital into the structure for risk retention (approximately 5% of total invested capital), and ideally will earn a yield from principal and interest. In general, a combination of the options above can not only create sufficient incentives but potential returns as well for a participating originator. Moreover, this business model of acquiring CDFI assets is targeted at those CDFIs seeking to increase their lending volume and turnover within their given balance sheet limits and thus enhance their social impact. The primary goal of this model is not to produce financial returns for originators in excess of their current revenue models; instead the objective is to open a new avenue for increasing originations and capital deployment, and consequently enlarge the social impact in the communities served by the CDFI industry.

The proposed intermediary model offers the most value-add to CDFIs in two categories. The first category is CDFIs that need to increase their liquidity. Such lenders may find a marketplace to sell their well-performing assets not only useful but indispensable, especially if covenant compliance or employee retention are at stake due to economic downturns. Moreover, as the pandemic-induced recession in the US continues to deepen, even financially strong CDFIs may seek immediate cash over future interest income. The second category is CDFIs with fee income-oriented business models. For example, according to 2018 OFN member data, housing to organization sector CDFIs earned 63% of their earned income from portfolio interest and 10% from fee income, while commercial real estate sector CDFIs earned 34% and 32% of their earned income from portfolio interest and fee income, respectively. Although CDFIs in both sectors focus on funding real estate-related projects, the data demonstrate that their revenue models are constructed quite differently. The ability to sell off loans (that meet the intermediary’s credit box) may enhance CDFIs with fee income-orientation by allowing more capital turnover and originations. Despite the financial incentives from participation mentioned above, originators may still be reluctant to sell off their stable, low-risk, cash-flowing loans. If this reluctance happens to be widespread, then the intermediary business may run into

§ Buying loans at a premium to par is not listed as an option above, because doing so introduces additional prepayment risk into the structure.
asset quality issues in assembling the loan pool. However, the business can focus on targeting participants from the aforementioned categories willing to trade their qualifying assets for cash, in addition to appealing to the broader industry as an alternative source of liquidity for weathering the current economic recession and political uncertainty.

MISSION-ORIENTED SERVICING OF BORROWERS  CDFIs offer a critical value-add to community financing through hands-on servicing and technical assistance. This servicing-dependent model of social impact presents a challenge and opportunity for the commercial securitization of CDFI assets. The challenge is that borrowers may continue to need servicing and work-outs after their loan has been sold into a structure. Once the ownership of the loan is held with the intermediary, the question of servicing responsibility arises. However, the opportunity is that originating CDFIs can still remain actively involved with their loans while not having to retain them on their balance sheets through the use of subservicing agreements. Subservicing agreements allow the investor-facing fund manager to be the designated “master servicer” and delegate the actual duties of servicing to “sub-servicers”. Each loan in the asset pool can carry its own subservicing agreement. While working hands-on with the borrower, the sub-servicer is compensated through servicing fees, which help align incentives toward strong loan performance. Applying this arrangement to CDFI securitization, the originating CDFIs are the sub-servicer to their own loans, utilizing their local community expertise and borrower relationships, while the intermediary business as master servicer claims responsibility for the pool of loans as a whole and interacts primarily with investors and originators, the domain of its expertise. Indeed, NYFLF utilizes this arrangement to great effect, with originator CDFIs as sub-servicers and LISC as master servicer.

In the case of delinquency or default, the intermediary also has the ability to employ a “special servicer” to help manage the troubled loans in question. The special servicer is designated at closing of the issuance and is granted considerable discretion on how to work out loans in distress. They can extend and modify loans in any manner they see fit, and can decide whether and how to enforce remedies if a loan defaults. This broad discretion is bounded by guidelines set forth in a document called a Pooling and Servicing Agreement (PSA) that is filed at the issuance of the securitization. For a securitization with CDFI assets, the issuing intermediary could write in an authorization for the special servicer to prioritize social mission in making servicing decisions; for example, Fannie Mae and Freddie Mac have provisions to this effect in their PSAs. If a participating CDFI originator prefers to service its loans, then the sub-servicing agreement is also able to delegate authority accordingly. An alternative to that arrangement is including a provision that allows third-party originators to buy back their loans out of the securitization to service them. Overall, an asset-backed structure can be highly flexible with respect to servicing distressed assets, and legal agreements can be written to codify the importance of serving borrowers and their respective communities in a just and equitable manner. Thus, there is wide scope for the intermediary to take different approaches that address all parties’ interests and concerns.

INVESTOR AND ORIGINATOR RELATIONS  Finally, the intermediary business will need to give guidance to originators and assurance to investors. As fund manager for the NYFLF, LISC performs an entire suite of services in order to meet those needs, listed in the table below and categorized by originator or investor relations. The tasks enumerated below represent the minimum set of services that an intermediary business would have to perform in the lead-up, closing, and ongoing management of a commercial securitization.
### Originator Relations

<table>
<thead>
<tr>
<th>Originator Relations</th>
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<tbody>
<tr>
<td>Loan Eligibility Criteria</td>
<td>Promulgate and enforce set of eligibility criteria, i.e. the “credit box”; adjust to meet issuance and social impact needs</td>
</tr>
<tr>
<td>Borrower Intake Protocol &amp; Platform</td>
<td>Maintain streamlined platform for borrower processing and screening; allocate leads to participating originators</td>
</tr>
<tr>
<td>Loan &amp; Reporting Documents</td>
<td>Develop and issue suite of standardized loan and reporting documents</td>
</tr>
<tr>
<td>Loan Acquisition</td>
<td>Establish standard process for recurring loan acquisitions from originators; manage financial and legal concerns</td>
</tr>
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</table>

### Investor Relations

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<tr>
<th>Investor Relations</th>
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<tbody>
<tr>
<td>Underwriting Support</td>
<td>Assist investors in evaluating loan pools, conducting due diligence, and structuring investment; resolve legal, tax, and regulatory compliance matters</td>
</tr>
<tr>
<td>Capital Call Management</td>
<td>Maintain seamless and protected systems of accounts for receiving investor capital on regular basis to fund loan acquisitions</td>
</tr>
<tr>
<td>Payments Distribution System</td>
<td>Distribute principal and interest payments to investors according to payment waterfall in timely and precise manner</td>
</tr>
<tr>
<td>Reporting Packages</td>
<td>Deliver tailored reporting packages detailing loan performance, ESG outcomes, forecasts, and any other necessary information</td>
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PHOTO CREDIT: FRAN DWIGHT
Structuring Commercial Intermediation

As described in the previous section, LISC’s experience with managing the NYFLF is an example of CDFIs acquiring the systems and techniques prerequisite to commercial intermediation. The next step is for an organization like LISC to utilize its fund management capability and form an intermediary business that securitizes CDFI assets. However, this business would not have to create securities products from scratch for the CDFI industry, nor deviate from what the capital markets are familiar with. This section discusses two capital structures well-established in the commercial capital markets that could feasibly be adapted to facilitate investment into CDFI assets: CMBS and flexible securitization.

Commercial Mortgage-Backed Securitization

**DESCRIPTION:** Commercial mortgage-backed securitization utilizes off-balance-sheet financing vehicles for mortgages secured by commercial properties (including multi-family complexes). An issuer gathers a large stock of commercial mortgages in an off-balance sheet vehicle known as a Real Estate Mortgage Investment Conduit (REMIC) either by originating the loans itself through its lending business or buying them from other lenders. The REMIC then issues bonds secured by the pool of loans, in an amount equal to the total principal balance of the loans—fully repaying the capital the issuer invested to assemble the pool, plus a profit margin.

The bonds are tranched, with increasing risk corresponding to increasing interest rate as demonstrated in the diagram above. The vast majority of the bonds in any CMBS deal are rated by rating agencies—in a typical deal, only the most junior class (comprising less than 5% of the total principal) is unrated. The most senior tranche (usually comprising ~70% of the bonds) is rated AAA. The issuer then sells the bonds to various buyers, mostly specialized fixed income funds. AAA bonds are typically bought by long-only institutional fixed-income funds, whereas hedge funds or other levered investment vehicles are the typical buyers of bonds with lower ratings (sometimes called “mezzanine bonds”). AAA bonds have decent secondary market liquidity, while mezzanine bonds are considerably more illiquid.
The most junior tranches of bonds (usually ~10% of the deal) are known as the “B-piece.” These bonds have no coupon—they are paid the residual income after the interest is paid on all other bonds. In effect, they are the equity in the structure. Specialized investors called B-piece buyers play a very important role in the CMBS industry. Issuers typically consult them from the very earliest stages of assembling a CMBS pool to make sure they are comfortable with the loans being assembled, and issuers usually do not go to market with the other bonds in the structure before obtaining sufficient commitment for the B-pieces. B-piece buyers also have significant power over how the loans in the pool are serviced during their terms, because they have the right to appoint the special servicer for the pool—the entity that is responsible for dealing with borrowers on problem loans, restructuring those loans or foreclosing on them and maximizing recovery.

CMBS issuance is a flow business. Issuers make profit from selling the total amount of the bonds at a premium—typically 10%—to the aggregate par value of the loans that the REMIC owns. So, issuers increase their profits by increasing throughput: if the issuer’s profit is 5% of the gross value of the pool, their goal is to assemble their pools and sell the associated bonds as quickly as possible so they can earn that 5% as many times as possible in a given time period and maximize the return on the balance sheet capacity that they need to use to hold the loans before the bonds are sold. Third-party commercial mortgage originators who sell their loans to CMBS issuers make money in several ways: origination fees, servicing fees (if they play a part in servicing the loans), and, typically, participation in a share of the issuer’s profits from selling the bonds at a premium to the face value of the underlying loans.

The bulk of the loans included in CMBS securitizations are much larger than the typical CDFI loan; their average size is about $10 million, and the average CMBS pool has a total balance of roughly $1 billion. However, there is a thriving, albeit less liquid, small-balance CMBS loan market, in which loans under $1 million are common. The typical deal in this market has a total aggregate size of $200–$300 million. Spreads tend to be slightly higher for these securitizations than for those with larger loans.

**Market Size:** CMBS issuance has been roughly $100 billion per year for the last several years; small balance issuance has been roughly $2 billion per year.

**Cost of Capital:** CMBS is a well-established financing structure and thus offers a low cost of capital to originators. The AAA tranche of new CMBS issuances during the week of June 17, 2020 was priced at 121 basis points over swaps, on average; the AAA tranche typically has roughly 20% subordination. Small-balance CMBS are typically priced at a slight premium to the market average.

**Potential CDFI Application:** A mission-focused commercial intermediary for CDFIs could issue CMBS securitizations, either on its own or partnering with a bank. The underlying collateral for the securitizations would be CDFI-originated loans. Like the NYFLF’s investor composition, the B-piece buyers in a CDFI issuance could be government agencies, foundations, philanthropic actors, and impact investors. Such investors would significantly lower the cost of capital as they are willing to accept lower spreads relative to their repayment risk exposure, in exchange for the social returns. The intermediary itself, or the CDFI parent-entity if that is the case, could also be a B-piece buyer. The intermediary would likely act as servicer for the loans (either on its own or by collaborating with the originating CDFIs through a sub-servicing agreement). Originating CDFIs could participate in the economics of the loans they originate by being allocated a portion of the excess interest earned on the loans.
ADVANTAGES:

■ **Large, Developed Market.** The CMBS market has existed for over 30 years and has become widely accepted by investors. A CDFI issuance that has most of the features of traditional CMBS will have a head start over less traditional structures in gaining market acceptance.

■ **Low-Cost Capital.** With AAA-rated spreads well below 150 basis points even in a crisis environment, CMBS—even small balance CMBS—is a low-cost financing solution.

■ **Potential to Improve Capital Efficiency.** The CMBS structure creates an opportunity for smaller CDFIs to increase their origination reach without increasing net assets, by selling qualifying loans to a CMBS issuer and using the proceeds to make new loans. The structure also has significant flexibility to allow CDFIs to retain a portion of their originated loans if they so choose.

DRAWBACKS:

■ **Only Appropriate for Subset of CDFI Loans.** Because a CMBS pool needs to be fixed at the time of issuance, the structure is not appropriate for loans that require significant future fundings, e.g., loans to finance predevelopment, construction or rehabilitation expenses. Furthermore, CMBS investors typically insist that the underlying collateral for loans be cash-flowing properties and are uncomfortable with less well-established collateral types such as charter schools. However, preliminary conversations with underwriters suggest that other structures that CDFIs often employ, such as leveraged loans into New Markets Tax Credit structures, might be a good fit for CMBS securitization.

■ **Requires Longer-Term Loans.** CMBS investors typically seek to make longer-term investments; typical CMBS bonds have a maturity of at least five and often ten years. Thus, the loans that make up the structures need to have similar maturities. Many CDFI loans are bridge loans with shorter terms, which are not a good fit for this structure.
Flexible Securitization

**DESCRIPTION:** As described above, CMBS is a well-established, well-understood structure that has significantly reduced the cost of capital for commercial mortgage lending over the last 30 years. However, the structure has relatively narrow loan criteria and fixes the loan pool at time of issuance. In response, intermediaries have developed structures that combine the tranched structure and low cost of capital of a traditional CMBS deal with features that provide more flexibility to fit issuer and originator business models. For example, these structures may contain features that allow intermediaries to exchange loans in and out of the structure, use proceeds from prepaid loans to buy new loans rather than immediately repaying them to investors, or permit loans with future fundings to be included in the structure. The trade-off for this flexibility is a slightly higher cost of capital and lower liquidity than CMBS, as well as some covenants and other investor protections, but this trade-off certainly gives issuers the ability to finance a much wider range of loans.

Flexible securitization structures are similar to CMBS in that an issuer assembles a pool of loans and sells tranched interests in the pool; the tranches are often (but not always) rated by rating agencies. The differences begin to come into play after the pool has been assembled and the interests have been sold. The issuer—who is almost always the servicer as well and retains the junior 10% of the structure—has a “revolving period”, or a period of time during which they can manage the composition of the pool of loans actively. They can sell loans in the pool and use the proceeds to buy new loans; they can remove loans from the pool as long as they replace them with assets of equivalent value, and they can use a portion of principal repayments to buy new loans into the pool. If an originator wishes to regain control of a loan that they have sold into the pool (for example to make a modification that is outside the servicing standard), they can trade it for another loan. Furthermore, these repurchase features allows the structure to accommodate shorter-term loans, as the issuer can use the proceeds when they pay off to buy another short-term loan. This less-rigid cash management structure also enables flexible securitization structures to accommodate loans with some level of future fundings (although traditional construction loans in which the bulk of the funding is held back are still unsuitable). Finally, the active management already built into the structure may make investors more comfortable with a mission-oriented servicer.

One example transaction, Toorak Mortgage Trust 2019-2, illustrates some of the features of this structure. This issuance was a $350 million flexible securitization made up of “fix-and-flip” loans, i.e. loans made to small single-family home investors who specialize in buying homes, renovating them and then selling them. These loans are typically short-term and often pay off well before maturity, as the borrowers typically seek to implement their business plan in as short of a time as possible. The issuer, Toorak Capital Partners, did not originate the loans; instead Toorak assembled the loan pool for this securitization by buying loans from originators, who sold the loans at par but retained a portion of the interest payments on the loans they originated as compensation.

**MARKET SIZE:** Recent annual issuance for flexible securitizations is about $1.5–$2 billion per year.

**COST OF CAPITAL:** The cost of capital is higher for flexible securitizations than for CMBS, but it is still accretive—the total cost of capital is roughly 4–5% for the 90% of the structure that is typically sold.
POTENTIAL CDFI APPLICATION: The intermediary business could gather a wider range of CDFI assets beyond commercial mortgages if constructing flexible securitizations, in turn expanding the number of CDFIs that could feasibly partner with the business in sale and origination. As the issuer, the intermediary’s duties would expand to include collateral management in addition to assembling the pool and servicing. In this case, the business would retain the most junior portion of the securitization—likely the most junior 10% of the total transaction’s value.

ADVANTAGES:

■ **Well-Suited to Range of Assets.** As described above, flexible securitizations can include many loans that would not be good candidates for CMBS securitization. In particular, they are good fits for shorter-term loans to finance rehabilitations or renovations, or short-term bridge loans—which are staples of many CDFI balance sheets. There may also be room for flexible securitizations to include a small component of subordinated loans or other special assets.

■ **More Servicing Flexibility.** Flexible securitizations, by giving originators the ability to buy loans out of the structure or replace them with other loans, give them an easy way to regain control of loans that require significant modification or restructuring beyond the scope of the servicing standard, if they wish. Furthermore, the more active management inherent in the structure (and the more significant issuer risk retention) means that investors in these securitizations are more comfortable with the idea that the issuer will be taking an active role in managing the pool, which may make them more open to accepting CDFIs’ mission-oriented servicing practices.

DRAWBACKS:

■ **Price and Leverage Level.** The flexibility of these structures comes at a cost: investors demand higher returns from these structures, so they provide less attractive financing in terms of both rate and leverage level. This is especially true for securitizations that are not rated, such as the Toorak securitization. However, as these structures become more common and investors gain comfort with the underlying collateral, there is scope for pricing and leverage to improve.

■ **Smaller, More Exposed Market.** The flexible securitization market is much smaller than the CMBS market, with a much lower annual issuance volume. The result is that it is more exposed to shocks. For example, while CMBS issuance slowed down during March and April of 2020 due to the Covid-19 pandemic, issuance of flexible securitizations ground to a halt. The result is that issuers’ risk of being “hung”—having accumulated assets for a securitization and being unable to find investors—is higher for a flexible securitization than for a CMBS issuance.
Recommendations and Conclusion

This white paper makes three recommendations for CDFI leaders to move toward achieving scaled, sustainable commercial intermediation for their industry. First, leaders with intermediation experience should develop a concrete framework for servicing securitized loans in a manner consistent with social mission and transparent to all parties. Second, those leaders should commit the resources to execute a CDFI asset-backed security issuance, following the blueprint laid out in the sections above. Last, leaders should strive to bring capital for the small-balance, unsecured loans that serve small businesses and nonprofits by collecting and disseminating the loan performance data necessary to underwrite such loans as an asset class.

1 | Develop Framework for Mission-Serving Securitization

CDFI industry leaders should work to devise a detailed framework for the relationship between loan originator and commercial intermediaries. Any intermediated structure that incorporates CDFI loans will need a servicing standard that makes it clear to investors that servicing decisions will be made with the CDFIs’ social mission in mind—but is also acceptable to investors. Both originating CDFIs and the issuer would also need policies and procedures to implement the standard that are transparent to all parties, so that investors understand how mission-oriented servicing works in practice. For example, Fannie Mae and Freddie Mac’s servicing practices make it explicit to investors in their securitizations that their mission of supporting homeownership is taken into account when making servicing decisions. Prospective intermediary enterprises for the CDFI industry will need to develop a framework that both allows for servicing decisions to be made in a way that satisfies all parties and spreads the financial benefits of intermediation fairly.

2 | Issue Intermediated Structures

At the same time, industry leaders should begin laying the groundwork to issue a CDFI asset-backed securitization. Given their lower cost and size requirement, a CMBS-style or flexible securitization are the most appropriate structures to consider for an initial issuance; a $250–300 million total deal size would be both in line with commercial issuances and realistic given the market size of CDFI assets. Next steps to execution are not limited to the following: determining the appropriate credit box; having discussions with underwriters, attorneys and other necessary third parties; building relationships with issuing CDFIs that would be prospective sellers of loans into the structure. Discussions with market participants suggest that an inaugural issuance that closes within twelve months of initiation is feasible.

3 | Accelerate Small Enterprise Loan Intermediation

As CDFIs manage an increasing number of Covid-19 relief funds for supporting small enterprises, industry leaders and fund managers should gather the data and develop practices to make it possible for small business lending to be underwritten as an asset class. Currently, the risk-return characteristics of this type of lending are not well understood due to its limited track record; building a robust data set is thus key to attracting more capital to this type of lending. Specifically, fund managers need to track delinquencies, losses, and prepayments, in addition to collecting detailed data about the resolution of defaulted loans (even if originating CDFIs are managing the recovery process). After relief funds are deployed and have enough operating history to establish a track record, the managing CDFIs should bring in new investors, in order
to utilize the existing structures and sustain the stream of capital to small enterprises. In addition to collecting underwriting data, CDFI leaders should test refinements to the operational structure of the NYFLF and similar funds that would help attract capital from a broader range of private institutional sources. In particular, there are opportunities to make the overall process more efficient and reduce fixed costs, so that originators can charge lower fees and still be appropriately compensated.

The entire CDFI industry is faced with an exciting opportunity to both address the near-term needs of the communities they serve and begin the process of expanding their capital bases and their ability to fulfill their missions in the medium- and long-term. The sophisticated financial intermediation techniques that have helped the conventional finance industry expand significantly are within the reach of CDFIs—and the imperative to respond to the current crisis gives CDFIs an opportunity to build the skills and infrastructure necessary to grasp them. By working to adapt their Covid-19 response work to broader capital markets considerations, CDFI leaders can emerge from this crisis well-positioned to build a lasting commercial intermediation business, which would have the potential to revolutionize CDFI practices and greatly expand access to capital for the businesses and nonprofits that CDFIs serve.
Endnotes


14 Riegle Community Development and Regulatory Improvement Act of 1994, H.R. 3474, 103rd Congress. (1994)


