

October 2003

COMMUNITY AND
ECONOMIC
DEVELOPMENT
LOANS

Securitization Faces
Significant Barriers



G A O

Accountability * Integrity * Reliability

Highlights of [GAO-04-21](#), a report to congressional requesters

Why GAO Did This Study

Community economic development (CED) lenders serve the credit needs of nonconventional borrowers and economically distressed areas across the nation. However, little is known about this industry, its ability to tap private sources of capital, and loan performance and volume in the industry. To provide information that would be helpful in considering the role that the federal government might play in facilitating the creation of a secondary market for CED loans, GAO was asked among other items to (1) determine the barriers to more widely securitizing CED loans and (2) identify options for overcoming these barriers and the likely implications of these options.

What GAO Found

CED lenders rely on multiple federal programs that offer grants, loans, guarantees, and other support to help fund lending activities. Some of these lenders have expressed an interest in finding alternative sources of funding, including securitizing the loans that they make. However, the volume of CED loans potentially available for securitization is not known. In addition, the community economic development industry is characterized by nonstandard underwriting, loan documentation and loan performance information, and limited mechanisms for securitizing loans. Without greater understanding of available loan volume, the capital markets have little interest in developing standards or mechanisms for securitizing CED loans.

CED lenders also face barriers to securitizing their loans. Some of these barriers are unique to CED lending, including: limited lender capacity to manage a securitized portfolio of loans; the external legal and regulatory limitations and requirements governing the use of the funds that these lenders receive; and the high cost of originating and servicing CED loans.

This report describes options that the federal government might exercise to address the identified barriers. This report also describes the implications that implementing each option might have, including the potential for increased federal costs and changes in lenders' missions. Ultimately, securitization may not be a significant alternative for CED lenders until the volume of loans available for securitization is better known and lenders are convinced of the benefits of participating.

Wall Street and Main Street Face Barriers to Securitizing Economic Development Loans



Sources: Corbis Images (left photo); GAO (right photo).

www.gao.gov/cgi-bin/getrpt?GAO-04-21.

To view the full product, including the scope and methodology, click on the link above. For more information, contact William Shear at (202) 512-4325 or shearw@gao.gov.

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Abbreviations

ARC	Appalachian Regional Commission
BRV	bankruptcy-remote vehicle
CED	Community and Economic Development
CDA	Commonwealth Development Associates
CDBG	Community Development Block Grant
CDC	Community Development Corporation
CDFI	Community Development Financial Institution
Commerce	U.S. Department of Commerce
CRF	Community Reinvestment Fund
CSBG	Community Services Block Grant
EC/EZ	Enterprise Community/Empowerment Zone grant
EDA	Economic Development Administration
EDI	Economic Development Initiative
HUD	U. S. Department of Housing and Urban Development
HHS	U. S. Department of Health and Human Services
IRP	Intermediary Relender or Intermediary Relending Program
RBEG	Rural Business Enterprise Grant
RLF	Revolving Loan Fund
SBA	U.S. Small Business Administration
SEC	U.S. Securities and Exchange Commission
Treasury	U.S. Department of the Treasury
USDA	U.S. Department of Agriculture
504 CDC	Section 504 Certified Development Companies

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United States General Accounting Office
Washington, D.C. 20548

October 17, 2003

Congressional Requesters:

Community and economic development (CED) lenders make loans to qualified businesses that are generally unable to obtain suitable financing from conventional private-sector lenders. CED lenders rely on a variety of funding sources including the federal government, but tend not to rely on securitization as a funding source.¹ If properly structured, securitization represents an option that could offer lenders increased liquidity for additional lending and offer borrowers greater availability of loanable funds.² Some of the federal programs that support CED lending have considered using securitization to provide lenders greater access to capital.

This report responds to your July 11, 2002, request for information on CED lending. Based on the potential benefits that securitization may offer lenders and borrowers, you asked us to describe the characteristics of (1) selected federally sponsored CED lenders, (2) the federal programs that sponsor them, and (3) selected existing and proposed models for securitizing CED loans. You also asked that we (4) determine the barriers to more widely securitizing CED loans, and (5) identify options for overcoming these barriers and the implications of these options.

To address the first two objectives, we reviewed studies and other documents obtained from lender trade associations, program regulations, procedures, and guidance and spoke with program and industry officials representing seven federally sponsored CED lenders we were requested to review and the federal programs that support them.³ To describe efforts to securitize CED loans, we reviewed agency and trade association documents and spoke with representatives of organizations undertaking securitization efforts. To determine the barriers to securitizing CED loans

¹Broadly, securitization is a process whereby lenders and others create pools of loans and sell to investors securities that are backed by cash flows from these loan pools—thereby replenishing funds available for lending.

²Lender liquidity is a measure of a lender's ability to meet its current financial obligations. It implies that the quality of the lender's assets are such that they can be readily converted into cash with minimal loss in market value.

³Our review does not include lenders identified as Community Development Enterprises financed through the Department of Treasury's New Markets Tax Credit because these entities were only recently established.

and potential options for overcoming them, we synthesized information from our literature search, as well as information gathered from interviews with program officials, CED lender representatives, capital market participants, researchers, and others knowledgeable about CED lending and securitization. Finally, we developed additional options the federal government might exercise for potentially overcoming identified barriers and explored the implications of these options, as well as those proposed by others. The options for overcoming the barriers often entail additional federal costs and, given the scope of this review, we were unable to determine whether the benefits would exceed the costs that could result from such efforts. Therefore, we do not endorse these options. Also, our work focused on access to capital through securitization, not through other means. We conducted our work in Washington, D.C.; Philadelphia, Pennsylvania; and Manchester, New Hampshire, between October 2002 and July 2003 in accordance with generally accepted government auditing standards.

Results in Brief

While the seven groups of CED lenders we reviewed have similar missions, available data show variation in the types of borrowers they serve, the investments they make, and how they are capitalized.⁴ However, little is known about the industry as a whole. CED lenders vary in the types of loans they make. For example, some lenders tend to focus on operating loans, while others may focus on real estate loans. Lenders are funded by federal, as well as state, local, private, and philanthropic funding sources. Federal funding sources, however, are important for all of the lenders included in our review because they provide lenders engaged in high-risk lending with low-cost funding. Data on the amounts the lenders invest in communities were not current or complete for lenders in our review. In addition, because data on lender activity are reported through multiple channels, data on the total number of lenders and the amount they invest—as a group—in communities are not available. Loan performance data were not available or current on all lenders. Finally, because of the various

⁴The seven groups of lenders reviewed are (1) Community Development Financial Institutions (CDFIs); (2) Revolving Loan Funds (RLFs); (3) Intermediary Relenders funded by the Department of Agriculture's (USDA's) Intermediary Relending Program (IRPs); (4) Community Development Corporations (CDCs); (5) Small Business Administration (SBA) 504 Certified Development Companies (504 CDCs); (6) microlenders; and (7) lenders supported by Community Development Block Grant (CDBG) entitlement and state grantees.

sources of data on CED lenders, loan performance is not consistently defined. Therefore, it is difficult to describe the performance of CED loans.

The federal programs that support CED lenders have similar missions—to improve economic conditions in communities considered to be distressed or underserved. However, the type of federal support they provide and the targeted lending criteria they use differ. These programs also differ in terms of the number and type of lenders they support and awards made. In fiscal years 1998—2002 these federal programs provided billions to support CED lending in the form of grants, loans, loan guarantees, and equity investments. However, federal funding for some of these programs has declined in recent years. Some programs use securitization, or have considered using securitization, to help lenders in accessing capital markets to maintain or expand lending activity. Finally, these programs collect and maintain data to oversee lender’s activities using various methods and have different reporting requirements.

The five existing and three proposed securitization models that we reviewed illustrate a variety of structures to securitize small business and CED loans and vary in the amount of CED loans that they securitize.⁵ Each of the existing and proposed models varies in terms of the types of loans pooled and the method for pooling the loans. All of the models we reviewed utilize or propose differing forms of credit enhancements, funded by the federal government, participating lenders, or others to limit credit risk to investors.⁶ Accordingly, each of the models distributes the risks and benefits associated with securitization differently among participants—borrowers, lenders, poolers, investors, and government(s). The structure of these models can affect participants’ willingness to engage in securitization and cost incurred by the federal government.

⁵The five existing models include those for securitizing SBA 504 program loans, unguaranteed SBA 7(a) loans, guaranteed SBA 7(a) loans, and HUD Section 108 guaranteed loans, and the securitization model used by the Community Reinvestment Fund—a nonprofit secondary market maker for CED-based lenders nationwide. We also reviewed three models proposed by various sources—Commonwealth Development Associates’ (CDA) model proposed under the EDA 2001 securitization demonstration, HUD’s proposed CDBG /Section 108 model, and Capital Access Group’s proposed Capital Access Program securitization model.

⁶A credit enhancement is a payment support feature that covers defaults and losses up to a specific amount, thereby reducing investor need for loan-specific information. It acts to increase the likelihood that investors will receive interest and principal payments in the event that full payment is not received on the underlying loans.

We identified six key barriers to securitization, all of which keep lenders from working with capital markets.

- First, borrower demand is not known across targeted markets, and CED lenders generally lack incentives—both market-based and federally driven—to participate in securitization. As a result, the volume of loans that could be securitized is not well understood.
- Second, many CED lenders lack the capacity to securitize their loans. For instance, their reliance on small, less-diversified portfolios that require intensive servicing results in higher per loan costs. Also many lenders do not have financial information—such as their cost to originate and service these loans and the expected income from these loans—that is needed to assess whether securitization is a viable option. Nor can they readily obtain the staffing resources or skills needed to expand lending activity that might be required when securitizing their loans.
- Third, external requirements—statutory or programmatic—attached to funding sources may directly or indirectly inhibit the securitization of loans.
- Fourth, CED lenders believe that selling their below-market-rate loans would require them to absorb too high a discount to benefit from a securitization.
- Fifth, lack of lender standardization and performance information impedes securitization by increasing the cost of securitizing these loans.
- Finally, mechanisms available to support securitization for CED loans, such as information links between capital markets and lenders and loan pool assemblers, are limited in number and capacity.

We identified a range of options the federal government could use to address each of the barriers to securitization. Undertaking any of these options could have important implications in terms of cost to the federal government, mission of CED lenders, and lender and program management. For instance, to address lack of lender participation, incentives could be built into existing federal programs for lenders who are willing and capable of securitizing their loans. However, such incentives might require federal funds, and the extent to which this might result in sufficient loan volume to make securitization viable is not clear. To

improve lender capacity, the government could allow for set-asides within existing programs for training and technical assistance to lenders designed to help lenders improve portfolio management, staff skills, and their financial information. This option, however, might reduce the funds available to support lending. The government could also remove program restrictions that inhibit or prohibit securitization such as restrictions on the use of loan repayments, which could affect lender missions. To improve standardization and performance information, the government could provide incentives for lenders and capital market participants to develop a useful level of standardization and performance information tailored to CED loans—which could lower the cost of underwriting loans, but could also result in lenders moving away from target markets. Such incentives could include funding set-asides, changes in program award selection criteria, or even increased program funding to those lenders—all of which may entail added program costs that should be assessed. Improved information on lending activity and loan performance could also help managers make better program decisions. To overcome the limited mechanisms to securitize CED loans, the federal government could provide a variety of different credit enhancements that would improve the investment quality of these securities and minimize standardization requirements for lenders, but which might also have a negative financial impact on the federal budget.

While we do describe the likely implications of many of the options we identified, we did not measure the extent to which each may affect lenders' mission, federal costs, program oversight, and other potential implications. Likewise, we did not determine whether the benefits would exceed the costs that could result from such efforts. We, therefore, did not endorse these options, and this report contains no recommendations. The information we present provides a framework for understanding the challenges, benefits, and costs of securitization. Based on our findings and this framework, the final section in this letter presents some observations on the nature of barriers CED lenders face in securitizing loans.

We provided a draft of this report to the U.S. Department of Agriculture (USDA); U.S. Department of Commerce (Commerce); U.S. Department of Housing and Urban Development (HUD); U.S. Department of Treasury (Treasury); U.S. Small Business Administration (SBA); U.S. Department of Health and Human Services (HHS); and the Appalachian Regional Commission (ARC). Officials in all agencies provided technical comments that we incorporated into the report, where appropriate. The technical comments from HHS were from officials in HHS's Administration for

Children and Families. Generally the agencies did not indicate whether they agreed or disagreed with the report's findings.

Background

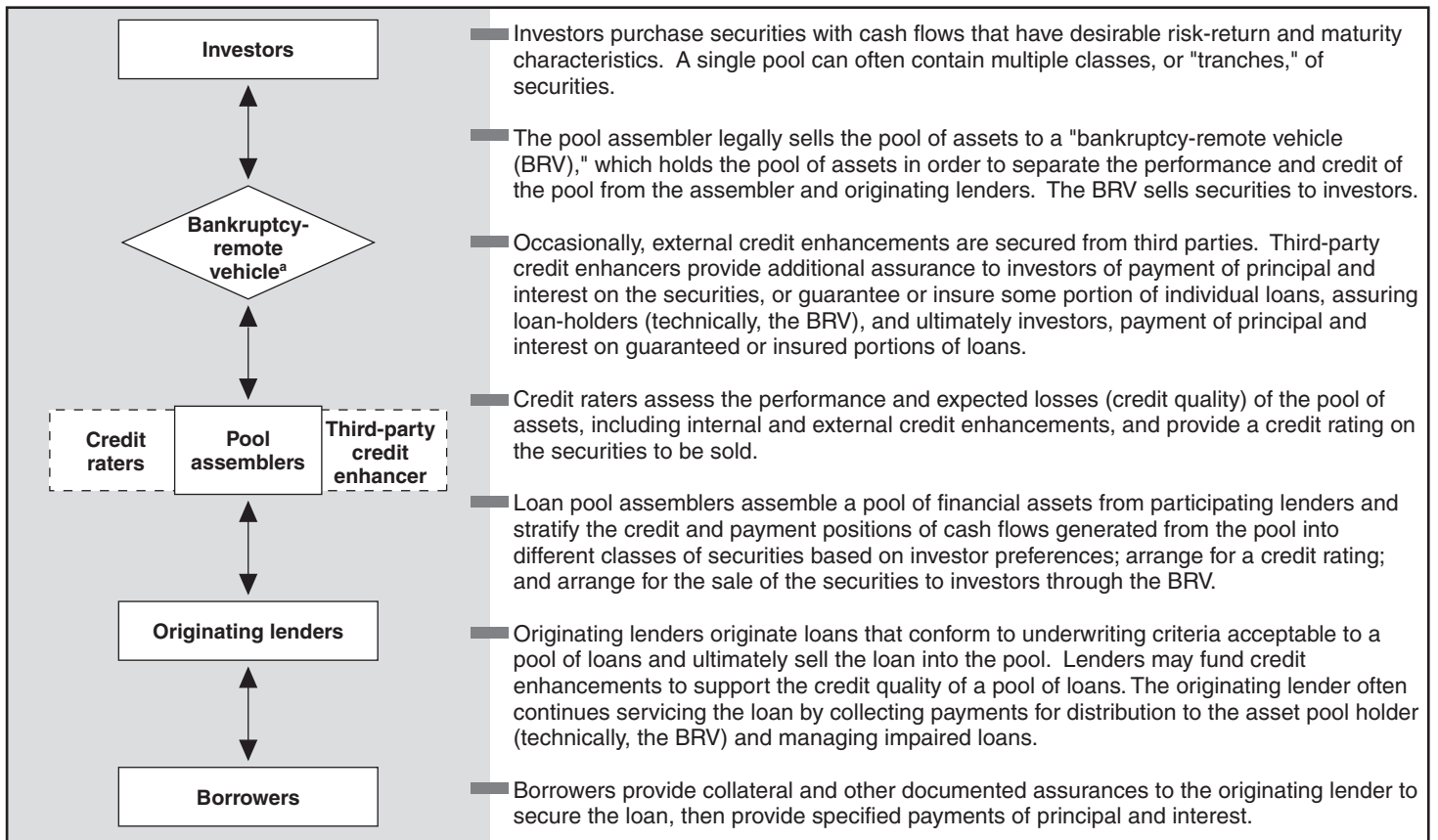
The federal government funds CED lending through a variety of mechanisms, including grants, loans, loan guarantees, and tax expenditures. Many government officials, academics, CED lenders, and nonprofits have recognized the value of identifying ways to maximize the impact of CED dollars. These efforts have resulted in alternative mechanisms CED lenders can use to access private, rather than governmental, funding for CED purposes. For example, CED lenders have worked with local banks by providing subordinate financing.⁷ Lenders have also received equity-like investments from banks. In addition, lenders have sold CED loans to replenish loan funds. Many have studied securitization of CED loans as a potential option to access additional private capital.

Securitization is a process that packages relatively illiquid individual financial assets, such as loans, leases, or receivables with common features, and converts them into interest-bearing, asset-backed securities with characteristics marketable to capital market investors.⁸ As outlined in figure 1, the participants in securitization—borrowers, originating lenders, pool assemblers, credit raters, investors, and sometimes third-party credit enhancers—each assume specific roles during the transaction. Additionally, each of these participants derives specific benefits from the transaction. For example, borrowers gain access to loanable funds with favorable terms—such as longer payment terms and fixed rates—that may otherwise be unavailable. Securitization offers originating lenders a tool to improve their risk and balance sheet management, as well as potential new fee or income streams and the ability to put existing capital to other purposes. Securitization also allows the cash flows from pools of assets to be structured to match the appetites of investors; thus, investors can diversify with access to new securities that satisfy their maturity, risk, and return preferences.

⁷In the case of a loan default, providers of subordinate financing have a claim to borrower assets that is junior, or secondary, to the claims of the provider of the senior financing.

⁸Anand K. Bhattacharya and Frank J. Fabozzi, ed., *Asset-Backed Securities*, (New Hope, Pennsylvania: Frank J. Fabozzi Associates, 1996).

Figure 1: Role of Participants in a Common Securitization Model



Source: GAO.

^aAlso known as a special purpose vehicle, a bankruptcy-remote vehicle is established to legally purchase the financial assets for the purposes of removing the assets from the credit risk associated with asset originators or the pool assembler.

The degree to which participants receive these benefits depends largely on how well, or efficiently, the markets for securitized assets are functioning. With better current and historical performance data on financial assets, capital markets can more easily profile the risk of a pool of similar assets. This risk can be divided and sold to investors who are willing to purchase it at an acceptable risk-adjusted return (investor-required yield). As the markets for particular securitized assets grow more voluminous and liquid, and the performance of securitized assets as well as the risks associated with securitization become better understood, investor-required yields on particular asset-backed securities can decline. Additionally, the

transaction costs of securitizing assets can also decline as the assets become better understood. Declining investor-required yields and transaction costs can lower the cost of financing for originating lenders and ultimately borrowers. Conversely, with inadequate performance data, and low volumes of similar financial assets, these benefits may not sufficiently materialize for securitization to be a viable financing arrangement for originating lenders and borrowers.

Home mortgages are the most well-established securitization market in the United States. Private conduits, such as commercial banks, and governmentally sponsored conduits such as the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac), have combined to securitize trillions of dollars of home mortgages over the past three decades. According to the Federal Reserve, as of the end of 2002, there were over \$3 trillion dollars of securitized home mortgages outstanding. With visible and voluminous demand for home mortgage financings evident in the late 1960s and early 1970s, Congress restructured Fannie Mae and created Freddie Mac and the Government National Mortgage Association (Ginnie Mae) to provide secondary market outlets for home mortgage lenders using private capital.⁹ Ginnie Mae pioneered the securitization of the Federal Housing Administration and the Veteran's Administration home mortgages—which already had standard underwriting and documentation guidelines, robust secondary markets, and benefited from federal guarantees—in 1970. Freddie Mac, and later Fannie Mae, did the same for nonfederally guaranteed mortgages, developing uniform guidelines for mortgage underwriting and documentation, and educating a diverse set of mortgage lenders nationwide about the benefits of securitization.

In addition to home mortgages, financial assets such as commercial mortgages, consumer credit receivables, and even small business and CED loans have been securitized.¹⁰ Today, outstanding securitized commercial mortgage and consumer credit receivable volume ranges in the hundreds of

⁹Congress established and chartered Fannie Mae and Freddie Mac as government-sponsored, privately owned and operated corporations to enhance the availability of mortgage credit across the nation during both good and bad economic times. Congress established Ginnie Mae as a government-owned corporation within HUD responsible for activities including guaranteeing mortgage-backed securities backed primarily by cash flows from Federal Housing Administration and Department of Veterans Affairs mortgages.

¹⁰Consumer credit receivables include assets such as auto loans and credit card receivables.

billions of dollars. However, despite favorable regulatory treatment, lending institutions have securitized less than \$6.2 billion of nonfederally guaranteed small business loans from 1994 through 2001.¹¹ During this same time frame, lending institutions securitized approximately \$22 billion of SBA-guaranteed small business loans.¹² As a rough point of comparison, in June 2001 commercial banks held an estimated \$450 billion in outstanding small business loans.¹³ In a previous report, we attributed the lack of securitized small business loans to the wide variety of small business loan products, difficulty communicating the performance of small business loans sufficiently and cost-effectively to capital markets, and sporadic visible financial benefits for originating lenders and investors to securitize these loans.¹⁴

CED Lenders Share Similar Missions, but Markets Targeted and Loan Information Vary

The seven types of federally sponsored CED lenders reviewed have similar missions: to service the credit needs of small businesses and others that generally cannot access funding otherwise or are located in communities that are considered underserved. However, these lenders differ in the types of borrowers they serve, the types of loans they make, and their sources of funding. Also, the total number of lenders and the amount they invest in communities are not known. Finally, the performance of CED loans is difficult to describe because consistent performance data are not available for all lenders in our review.

¹¹Congress passed the Riegle Community Development and Regulatory Improvement Act (Riegle Act) in 1994 to remove several legal and regulatory impediments to small business and commercial mortgage securitizations, including favorable regulatory capital treatment for depository institutions, and preemption of state securities registration and investment restrictions. This data is from the Federal Reserve Board and includes pools of nonguaranteed portions of SBA 7(a) loans and pools of other non-federally guaranteed loans.

¹²Federal Reserve Board. Includes pools of guaranteed portions of SBA 7(a) loans.

¹³Federal Reserve Board. The board notes that their 1998 Survey of Small Business Finance indicates that commercial bank small business loans outstanding represents roughly 65 percent of all small business lending.

¹⁴U.S. General Accounting Office, *Small Business Administration: Size of the SBA 7(a) Secondary Markets Is Driven by Benefits Provided*, [GAO/GGD-99-64](#) (Washington, D.C.: May 26, 1999).

Lenders Have Similar Missions in Financing Underserved Markets

All of the lenders we reviewed have similar missions to service CED credit needs in low- and moderate-income communities or borrowers that are considered to be underserved. Borrowers served by CED lenders are perceived by traditional sectors as high risks—that is, they have difficulty accessing credit either because they have poor or nonexistent credit histories, insufficient collateral, or are start-up businesses with no track record. Some lenders also help borrowers gain access to capital from conventional sources (for example, banks) by providing a portion of what the business needs and agreeing to let the bank recoup its losses first from the business' collateral in the event of default.

CED lenders employ several strategies to meet their missions. For instance, they work extensively with their borrowers and target loans rejected by banks. According to lenders with whom we talked and studies we reviewed, lenders must work extensively with their borrowers, providing loan servicing and technical assistance to help borrowers make consistent loan payments and sound business decisions to ensure their survival. In addition, lenders also devote more time to their borrowers than that required for conventional loans to help borrowers qualify for CED loans.

Lenders Target a Range of Borrowers and Products and Receive Funding from Various Sources

While overall missions of CED lenders we reviewed are similar, they differ somewhat in terms of the types of borrowers they serve, products they offer, and the targeted location of their investments. The lenders may support a range of borrowers, from poverty-level to moderate-income. Many of the lenders focus on start-up businesses. Some lenders have more specific targets. For example, microlenders serve businesses with five or fewer employees and capital of \$25,000 or less. Lenders may offer loans for working capital, equipment, or real estate; however, some concentrate more on one type of loan than others. For example, 504 Certified Development Companies focus on commercial real estate and equipment loans, while microlenders concentrate on working capital and equipment loans. Some lenders service specific geographic areas. For instance, ARC Business Development Revolving Loan Fund lenders service borrowers in the Appalachian region.

As shown in table 1, lenders receive funding from various sources including federal, state, local, private, and philanthropic sources of capital as well as earned income. According to lenders, trade association representatives and studies we reviewed, federal funding sources are important because

they provide low-cost capital for high-risk loans they finance. In addition, federal funding makes up a significant portion of the capital available to some lenders. We also found that the source of federal funding for these lenders varies. For instance, federal funding for CDFIs comes from the U.S. Department of Treasury. In addition, some CDFIs—particularly those that finance microloans, and that are also classified as CDCs—also receive funding from HUD, SBA, Commerce, USDA, and HHS.

Finally, lenders generate income from interest earned and administrative fees they charge borrowers for services and loans. According to lenders and other research, lenders rely on these earned-income sources to cover their operating costs. Earned income also is important to many lenders because other funding sources do not allow lenders to use a portion of the funding to cover operating costs.

Table 1: Sources of Lender Funding

	Nonfederal sources					Federal sources						
	State	Local	Private	Earned Income	Other ^a	Treasury	Commerce	HUD	USDA	SBA	HHS	ARC
Community Development Financial Institutions (CDFI)	X	X	X	X	X	X	X	X	X	X	X	
Microlenders	X	X	X	X	X	X				X	X	
Community Development Corporations (CDC)	X	X	X		X	X	X	X	X	X	X	
Revolving Loan Fund lenders (RLF) ^b	X	X	X	X	X		X	X	X	X	X	X
Intermediary Relenders (IRP)	X	X	X	X					X			
504 Certified Development Companies (504 CDC)			X	X	X					X		
Lenders supported by HUD's Section 108 and CDBG programs ^c				X				X				

Sources: Lender trade associations and federal programs.

^aOther includes individual investors, philanthropic investors, and utilities.

^bIncludes EDA- and ARC-sponsored RLFs. However, RLFs may receive funding from multiple federal sources.

^cHUD Section 108 and CDBG lenders are local government agencies or nonprofit intermediaries.

Total Number of CED Loans and Amount of CED Lending Are Not Known

Data on the number and amount of CED loans invested in communities are not current or complete for all lenders targeted by our review. For example, data on the number and amount of loans these lenders make are sometimes only collected for a sample of lenders. Data on the number and amount of loans for microlenders were collected in September 2000, but cover only 308 of the 554 identified microlenders. Similarly, the most recent reporting time frame for 504 CDC data is fiscal year 2001 but covers about 272 lenders. Data on the amount and number of CDFI loans covers 389 of the 800–1000 CDFIs identified. The latest survey on Community Development Corporation lenders was completed in 1997 and indicated that there were an estimated 3,600 CDCs nationwide—as many as 776

reported making CED loans.¹⁵ Data on loan numbers and amounts for IRPs cover only 29 out of the 400 IRPs identified by the trade association that represents them.¹⁶ Data are reported on 422 Department of Commerce RLFs and 1,012 lenders supported by Section 108 and CDBG programs. However, the total universe of these lender types is unknown.¹⁷

In addition, it is impossible to aggregate available data to determine the total number of CED lenders and the number or dollar volume of loans they make because some lenders may be counted in more than one lender group. For instance, as indicated previously, both microlenders and CDCs may also be CDFIs. Many lender types can be supported by HUD's Section 108 and CDBG grant programs. Given the data limitations, the total volume of loans and dollars invested in communities through CED lending is also unknown.

Loan Performance Data Are Limited, but Attempts Have Been Made to Improve Data

Loan performance data, including data on loan delinquencies, defaults, and loss rates were not available, complete or defined consistently for both ongoing and one-time data collection efforts (see figure 2).¹⁸ For example, loan performance data are not available for CDCs at all. The CDFI Fund and other ongoing sources of data on CDFIs do not track default rates at all. Conversely, ongoing data collection on IRPs covers defaults and

¹⁵The National Congress for Community Economic Development, a trade association for Community Development Corporations conducts a survey on these lenders. The next survey is not scheduled for completion until 2004.

¹⁶While data on the number and amount of loans made by IRPs are limited, USDA, which currently funds 400 IRPs is drafting a new template to be used by IRPs requiring lenders to provide more detail on their lending activity.

¹⁷Data on the total number of RLFs and HUD-supported lenders are unavailable. RLFs do not have a central organization that maintains data on the RLF industry as a whole. While an attempt to collect RLF data was made by the Corporation for Enterprise Development in 1997, it was not successful because reliable data were not available at that time on many of the RLFs. Also, RLFs funded by HUD's CDBG program were excluded from the count. HUD's recent attempt to identify its grantees using Section 108 and CDBG dollars for CED lending resulted in the identification of 1,012 state and local entitlement grantees. However, because these grantees make direct loans to businesses and to nonprofit intermediaries (such as RLF lenders), identified grantees do not represent the universe of the lenders supported by the programs.

¹⁸Delinquency refers to a situation where an entity falls behind agreed payment dates in making payments. Defaults occur when the lender no longer believes that the business will make payments. Losses are the monetary losses to the loan holder in the event of borrower default, less any monetary value recovered from the liquidation of loan collateral.

delinquencies, but only at an aggregate level—not at a loan level. In fact, only EDA, SBA, and ARC collect loan-level performance information on an ongoing basis (for the RLF, 504 CDC, Microlenders, and ARC/RLF programs).

Figure 2: Business and CED Loan Performance Measures Collected about Each Lender Type

Lenders			Performance measure status				
Data collection efforts	Number of lenders reported	Total estimated number of lenders	Defaults	Delinquencies	Losses	Recovery	Unpaid principal balances
One-time data collection efforts							
RLFs (EDA RLFs Rutgers University) ^a	422	546	●	●	●	○	○
Lenders supported by HUD's Section 108 and CDBG programs ^b	51	unknown ^c	●	●	○	○	○
Community Development financial institutions (ABT Survey) ^{d,e}	54	800-1,000	○	●	○	●	○
Ongoing data collection efforts							
Community Development financial institutions (CDFI data project) ^{f,g}	389	800-1,000	○	◐	◐	◐	○
Microlenders ^h	174	554	●	●	○	○	○
RLFs (EDA Commerce) ^{i,j}	450	546	●	●	●	○	○
RLFs (ARC) ^k	35	35	○	●	●	○	●
IRP ^l	29	400	◐	◐	○	○	○
504 Certified Development Companies ^m	270	270	●	●	●	●	●
Community Development Corporations ⁿ	Up to 776	3,600	○	○	○	○	○

Legend

- Data collected at the loan level
- ◐ Data collected at the aggregate level
- Data are not collected

Sources: Reports maintained by lender trade associations and federal programs.

^aRutgers University, "EDA RLFs—Performance Evaluation," 2002. These data do not include non-EDA RLFs.

^bUrban Institute, "Public-Sector Loans to Private-Sector Businesses: An Assessment of HUD-Supported Local Economic Development Lending Activities," 2003.

^cWhile the total number of lenders is not known, loans covered by the 51 lenders in the Urban Institute Study account for over 50 percent of third-party lending for CED loans made, and up to 58 percent and

at least 96 percent respectively, of third-party CED loan dollars tracked in HUD's CDBG and Section 108 state and local entitlement programs. Therefore, coverage is fairly high.

^dAbt Associates, Inc., "CDFI Fund Secondary Market Survey of CDFIs," 2002.

^eAbt surveyed 108 CDFIs but received only 54 responses from the survey on loan-level performance data. In addition, all measurements were not reported on all loans. For instance, recovery amounts are available on fewer than 2 percent of the loans. Measurements for delinquencies reported 30 days past due are available on 44 percent of the loans included.

^fCorporation for Enterprise Development, CDFI Data Project FY 2001.

^gThe latest CDFI Data Project survey indicates all respondents surveyed did not report on each data point requested. Therefore, these measures are available on only 389 of all 512 CDFIs surveyed. CFED also disclosed that they could not guarantee the reliability of the data.

^hSBA quarterly reports for the 174 microlenders participating in SBA's microloan program; and Aspen Institute, "Directory of U.S. Microenterprise Programs," 2002, for the estimated number of microlenders, totaling 554.

ⁱEDA program data as of May 2003.

^jData are collected but are maintained in hard copy at various regional offices and, therefore, not useable.

^kARC program data as of February 2003.

^lNational Association of Development Organizations Biennial Survey data as of March 2003.

^mSBA 504 program data 2003.

ⁿNational Congress for Community and Economic Development 1999 Census.

EDA and HUD recently completed one-time studies on RLF lenders, lenders funded by Section 108 and CDBG, respectively, that included analysis of loan-level performance data (see figure 2). In addition, the CDFI fund has received and consolidated loan-level data as part of its ongoing Secondary Market Feasibility Study. We attempted to obtain summary data from these sources on the dollar amount and number of loans in default in order to estimate a cumulative default rate for each program. Although CDFI Fund does not collect default data, they recently began collecting loan-level data and tracked information on loan write-offs. We, therefore, attempted to obtain CDFI write-off data as a proxy for default measures. However, we found that loan-level data from the CDFI Fund lacked data on the timing of write-offs. This information was requested from the lenders in the study's survey; however, only 10 percent of the reported loans included the date of write-off. Without knowing the timing of defaults, it is not possible to account for differences in default rates attributed to the age of a loan. According to data provided by Rutgers University, non-real estate, loans made by EDA/RLFs between 1988—1995

have, on a weighted average basis, a 4-year cumulative default rate of 4 percent.¹⁹ The ultimate default rate cannot be calculated until loans have had an opportunity to reach maturity. Comparable data on HUD loans were not available at the time of this report.

Where loan performance measures did exist in aggregate form, they were defined inconsistently across lenders. For instance, delinquencies for IRPs are defined as loans up to 90 days past the due date, whereas delinquencies are defined for CDFIs as failure to make a payment as early as 31 days and up to 90 days or more past the due date. Defaults for EDA RLFs are defined as 60 days past due, but not written off; whereas, the defaults for lenders supported by HUD's Section 108 and CDBG programs are defined as more than 90 days delinquent with no further payments expected.

As with the Lenders They Serve, Federal Programs Share Similar Missions, but Differ in How They Operate

We reviewed 11 federal programs that fund the seven CED lenders included in our study. These programs are administered by EDA, Treasury, HUD, USDA, SBA, ARC, and HHS.²⁰ The programs have a similar purpose in that each was established to improve economic conditions in communities considered distressed or underserved. However, the programs differed in how they achieved their purposes and the size and level of activity. Some programs in our review have experienced budget reductions. We also found that several programs have considered securitization as an option to increase access to capital. Finally, few programs regularly collect information on the performance of lenders and the loans they make. Consequently, little information is known about the dollar volume or number of loans that some of these federal programs have funded to support CED lending in communities across the country.

¹⁹These data should be viewed carefully. Data on loan performance are derived from semiannual reports prepared by RLFs. According to EDA officials, use of RLF grant money may not be covered by RLF audits. We did not assess the reliability of these data.

²⁰HHS also administers the Community and Economic Development Discretionary Grant Program. According to HHS officials, beginning in 2000, these grants may be used for funding RLFs. In 2002, HHS made fewer than 10 grants to RLFs under this program.

Federal Programs Have Similar Purpose but Different Requirements and Forms of Support

The 11 programs we reviewed were established to improve economic conditions in distressed or underserved communities. However, the programs differed in the form of federal assistance offered to CED lenders, and the targeting of assistance to specific geographic areas, borrowers, or businesses.

As noted in table 2, 6 of the 11 programs in our review helped fund CED lending through grants only; one program used loans only; two used loan guarantees only; one used a combination of loans and loan guarantees; and another used a combination of grants, loans and equity investments. The programs provide lenders with funds that may be loaned to borrowers and the proceeds from repayments on the loans may be used to make additional loans for community and economic development.²¹ All but one of the programs allowed lenders to establish their own rates and terms.²² In general, programs required that lenders' applications include a discussion of how they planned to use the funds, which might include lenders' targeting criteria for borrowers, interest rates, and terms. Finally, all but the 504 CDC program receive some level of government subsidy.

²¹For the 504 CDC program, loan repayments go directly to investors and are, therefore, unavailable for relending.

²²SBA sets the interest rate on 504 CDC loans.

Table 2: Federal Programs and Type of Assistance Provided to CED Lenders

	Federal program	Loan	Grant	Loan guarantee
1	Intermediary Relending Program (IRP)	X		
2	Rural Business Enterprise Grant (RBEG)		X	
3	Economic Adjustment Assistance Program (EDA RLF)		X	
4	Business Development Program Revolving Loan Fund (ARC RLF) ^a		X	
5	Community Development Block Grant (CDBG)		X	
6	Section 108 loan guarantee			X
7	Community Services Block Grant (CSBG)		X	
8	Empowerment Zone/Enterprise Community Grant (EZ/EC)		X	
9	Financial Assistance component of CDFI Fund ^b	X	X	
10	504 Certified Development Company (504 CDC)			X
11	Microloan Direct and Loan Guarantee programs	X		X

Source: Federal program documents.

^aARC is authorized to make loan guarantees but has not used this authority in the last 13 years.

^bAlso offers equity investments, deposits, and credit union shares.

- The seven grant programs we reviewed permit grantees to use funds for operating RLFs, as well as for other economic development activity—for example, acquisition or development of land, or provision of public water and sewer facilities.²³
- Two loan programs—USDA’s IRP, and SBA’s Microloan program—offer lenders loans with low rates and relatively long repayment terms. For

²³HHS’s CSBG and EZ/EC programs are among these. According to HHS officials, Illinois is the only state that uses HHS CSBG funds for the purpose of economic development activities such as establishing RLFs.

example, IRPs receive loans at 1 percent interest to be repaid within 30 years. The low cost of the federal loan could enable the lender to pass on low loan payments to borrowers. SBA's Microloan program makes loans to lenders that lenders then use to make microloans to eligible borrowers. Lenders may receive loans of up to \$750,000 to be repaid within 10 years. Each lender is limited to a maximum of \$3.5 million outstanding at any one time. SBA looks to the lending intermediary to pay its loans in full, regardless of the payment history of individual borrowers. Borrowers, unable to obtain credit from a traditional lending institution, also benefit from the technical assistance to improve their business' chance of success.²⁴

- The three loan guarantee programs—HUD's Section 108 and SBA's 504 Certified Development Company (504 CDC) and Microloan programs—offset all or a part of the credit risk of loans by providing participating lenders with a loan guarantee on all or part of the loan payments in the event of a borrower default. In the Section 108 program, the principal security for the loan guarantee is a pledge by the applicant community or the state (for nonentitlement communities) of its current and future CDBG funds. Under the 504 CDC program, SBA guarantees loans made by 504 CDCs at market interest rates to be paid over 10 or 20 years.²⁵ The 504 CDCs provide small businesses with fixed-rate, long-term loans, primarily for buildings, land, equipment, and machinery (not to exceed 40 percent of the total project cost). A private lender must provide at least 50 percent of the project cost. According to SBA officials, the lenders benefit from SBA's guarantee because they are in a first lien position, which lessens their credit risk. Under the Microloan program, SBA guarantees loans that are made to intermediaries by private sector lenders.
- Finally, the Financial Assistance component of the CDFI Fund offers grants, loans, and equity investments to CDFI lenders. However, lenders

²⁴SBA's Microloan program allows grant funds to be used only for technical assistance and training of microborrowers and potential microborrowers. According to SBA officials, such technical assistance is sometimes viewed as a substitute for collateral and is intended to help ensure repayment of Microloans.

²⁵The 504 CDC makes its loans with proceeds from a guaranteed debenture. Loan payments owed to the 504 CDC match the payments the 504 CDC owe investors under the debenture. If the borrower defaults, SBA buys the debenture back from the investors. Lenders must reimburse SBA for 10% of the loss it incurs in connection with the 504 CDC's default on the debenture.

must obtain nonfederal matching funds in a form and value similar to the CDFI Fund's award. For instance, a lender receiving a grant award from the CDFI Fund must match the award dollar for dollar with other grant money. Likewise, lenders receiving loan and equity awards must match the loan dollar for dollar with other loan and equity money.

The programs also varied in whether and how they target geographic areas, borrowers, or businesses. Table 3 illustrates the range of geographic areas targeted by the programs in our review. For example, both USDA programs target rural areas, the ARC program targets Appalachia, and other programs target eligible areas that they define as economically distressed.²⁶ Similarly, table 3 shows that many of the programs we reviewed require that eligible borrowers create jobs or otherwise improve economic conditions in the areas that the borrower's business or project will impact.²⁷ Likewise, some programs have established target eligibility criteria for borrowers that include credit qualifications. For example, in EDA's Economic Adjustment Assistance Program, borrowers are not eligible unless they are unable to obtain a loan with acceptable terms and conditions from a traditional lending institution. Finally, some programs limit eligibility to specific types of borrowers. For instance, SBA's Microloan program requires that borrowers be small, for-profit businesses.²⁸

²⁶Appalachia includes all of West Virginia and parts of 12 other states: Alabama, Georgia, Kentucky, Maryland, Mississippi, New York, North Carolina, Ohio, Pennsylvania, South Carolina, Tennessee, and Virginia. The term "economically distressed" is defined differently among programs. For instance, EDA defines economically distressed as urban or rural communities that are experiencing high unemployment, low per capita income, and other conditions, including sudden economic dislocations due to industrial restructuring and relocations or natural disasters. Other programs may use different terminology to indicate targeted economically distressed areas.

²⁷ARC's Business Development program allows borrowers to be located outside of the Appalachian region; however, the business or project to be funded must provide jobs or other economic benefits within the region.

²⁸A borrower may also use Microloan proceeds to establish a nonprofit child care business.

Table 3: Summary of Programs and Their Target Market Criteria

Federal program	Targeting criteria			Borrower credit	Types of entities supported
	Geographic areas	Low income populations	Job creation and preservation		
Intermediary Relending Program (USDA IRP)	X		X	X	Start-up, expansion of existing businesses
Rural Business Enterprise Grant (USDA RBEG)	X		X		Start-up, expansion of existing businesses
Economic Adjustment Assistance Revolving Loan Fund (EDA RLF)	X		X	X	Start-up, expansion of existing businesses
Business Development Revolving Loan Fund (ARC RLF)	X	X	X	X	Start-up, expansion of existing businesses
Community Development Block Grant (CDBG)		X			Various for-profit or nonprofit businesses
Section 108 Loan Guarantee		X			Various for-profit or nonprofit businesses
Community Services Block Grant (CSBG)		X	X ^a		Start-up, expansion of existing businesses
Enterprise Community/Empowerment Zone Grant (EZ/EC)	X	X	X		Various
Financial Assistance component of CDFI Fund	X	X			Various
504 Certified Development Company (504 CDC)	X		X	X	Small, for-profit businesses
Microloan Direct and Loan Guarantee programs	X	X		X	Small, for-profit businesses

Sources: Federal program documents and Catalog of Federal Domestic Assistance.

^aIllinois CSBG program requires borrowers to hire at least one new full-time equivalent CSBG eligible employee for each \$20,000, or any portion thereof, of CSBG monies borrowed.

Federal Programs Differ in Size, Level of Activity

In general, as shown in table 4, programs ended fiscal years 1998—2003 with lower funding levels than they began. In the most recent three years, the Section 108 and 504 CDC loan guarantee programs, which securitize CED loans, have required less funding than most other CED programs. In these years, the 504 CDC had no appropriations because the present value of the estimated cash inflows from fees and recoveries equaled the estimated cash outflows from claims. Table 4 illustrates the levels of appropriations for those programs where data were available for fiscal years 1998—2003.

Table 4: Appropriations for CED Lending Have Declined in Selected Federal Programs (Fiscal Years 1998–2003)

Dollars in millions

Federal program	1998	1999	2000	2001	2002	2003 (estimate)
EDA—RLF Grant ^a	\$29.9	\$34.6	\$34.6	\$49.5	\$40.9	40.6
Treasury—CDFI (FA) ^b	43.0	75.8	66.8	47.1	34.3	31.8
HUD—Section 108 Loan Guarantee ^c	9.0	10.0	29.0	29.0	14.0	6.0
SBA—504 CDC Loan Guarantee ^c	166.0	34.0	5.0	0	0	0
USDA—IRP Loan	17.0	17.0	17.0	19.0	13.0	20.0
SBA—Microloan Direct Loan ^d	0	2.0	2.0	3.0	1.0	4.0

Sources: Federal Budget Appendixes for 1998 through 2004 and federal agency data.

Note: Six programs were unable to provide information on the dollar amount of annual appropriations used to capitalize CED lenders. HUD CDBG (State-Administered and Entitlement Cities) and HHS EZ/EC programs do not allocate appropriations by type of activity (that is CED lending) funded. The USDA RBEG program does not receive an earmark in appropriations for RLF spending. RBEG recipients may use the funds for a variety of purposes, including capitalization of an RLF. Appropriations for the HHS CSBG program were not included because, as noted elsewhere in this section, according to HHS officials, Illinois is the only state known to use CSBG funds for CED lending purposes. ARC receives one appropriation to support all administrative and programmatic activity. Hence, there is no budget specifically for the Business Development Revolving Loan Fund program. The appropriation is allocated amongst the 13 states, and the commission decides to approve the funding for individual plans submitted by states based upon how the proposed project meets the agency's mission strategy.

^aOnly includes funds for RLFs that help communities adjust to sudden and severe economic dislocation (SSED/RLF), and long term economic deterioration (LTED/RLF). Does not include grant funds used for defense and disaster assistance. Appropriated funds for these other types of economic adjustment grants varies from year-to-year and has declined in recent years.

^bIncludes grants, loans, and equity investments made from the CDFI Fund.

^cAppropriations for loan and loan guarantee programs are based on assumptions regarding the performance of the loans. The ultimate cost to the government could be higher or lower if actual loan performance differs from these assumptions.

^dAppropriations for the SBA Microloan loan guarantees were zero for all fiscal years 1998–2002 and the 2003 estimate, except in fiscal year 2000, when SBA did not report the budget authority for the program. However, fiscal year 2000 outlays for the SBA Microloan loan guarantees were \$1 million.

The federal programs we reviewed also differed in the number of lenders participating in the program, ranging from as few as 35 lenders in ARC's Business Development program, to as many as 546 in EDA's Economic Adjustment Assistance RLF program. Most of the programs were able to provide information on the number of lenders and the number and dollar volume of program awards—whether loans or grants—made to CED lenders. HUD CDBG and HHS EZ/EC and CED programs were the only

exceptions. The two loan guarantee programs, 504 CDC and Section 108, issue notes that are sold to investors. The volume of loan guarantee commitments is noted in table 5. We found that there was a great deal of variation in the level of program activity between these programs.

Table 5: Number of Lenders and Dollar Volume of Federal Support (Fiscal Years 1998–2002)^a

Federal program (agency)	FY 1998–2002 ^b	
	Number of lenders supported	Dollar volume of support (in millions)
Intermediary Relending Program (USDA)	273	\$167.5
Rural Business Enterprise Grant (USDA)	364	45.6
Economic Adjustment Assistance (EDA) ^c	546	24.4
Business development program (ARC)	35	33.7
Section 108 loan guarantee (HUD) ^d	N/A	1,800.7
Community Services Block Grant (CSBG-Illinois)	38	49.0
Financial Assistance (FA) component of CDFI Fund (Treasury) ^e	N/A	267.0
504 CDC program (SBA)	272	11,524.0
Microloan program Direct Loans (SBA) ^f	174	111.2

Source: Federal agency data.

Note: N/A data is not available.

^aFederal support may consist of grants, loans, loan guarantee commitments, and other investments. For loans and loan guarantees, the amount shown is the face value of the loan.

^bBusiness development program (ARC) covers FY 1977 through February 14, 2003, and the Illinois CSBG program covers FY 1984–2002.

^cData on the number of lenders supported by EDA's Economic Adjustment Assistance program covers the period 1975-2002, and includes Disaster Assistance and Defense RLFs. However, dollar volume amounts cover the period noted in the table (1998-2002), and reflect grants made to SSED and LTED RLFs only.

^dA Section 108 grantee may reloan the proceeds of a loan guarantee to fund loans to a third-party borrower either directly or through a nonprofit intermediary (i.e., a RLF or CDC).

^eCDFI's Financial Assistance includes core and intermediary component programs. These amounts include grants, loans, deposits, and equity investments.

^fAmounts for SBA's Microloan program include support for direct loans only, not loan guarantees.

Several Programs Have Considered Securitization

Several of the programs in our review have studied or are presently undertaking securitization efforts. For example, Treasury's CDFI Fund recently commissioned a survey of its CDFIs to study the feasibility of developing the secondary market for loans made by its members. In 1999, EDA initiated a demonstration project that provided financial assistance to support RLFs wishing to securitize a portion of their loan portfolio. The pilot resulted in three RLFs successfully securitizing or selling loans. In addition to the Section 108 loans HUD currently securitizes, HUD sponsored a study to collect extensive information on the loans made by its CDBG and Section 108 awardees to third-party businesses and nonprofit organizations, in part to assess the potential for creating a secondary market for these loans. Other programs have made some efforts to determine the feasibility of securitizing loans made by their lenders. In 1999, the ARC program removed language from its guidance allowing its RLFs to sell their loans. Officials noted that grantees were uninterested in securitization for several reasons, including grantees' easy access to additional capital through the ARC grants. After a successful sale of IRP loans made in Colorado, in November 1999, USDA piloted a first attempt to sell IRP loans nationally. According to USDA officials, the pilot generated little interest because of the strict requirements for lender participation. To date, USDA has not established formal regulations to support securitization. SBA securitizes 504 CDC loans. Finally, our review also found that some programs have prohibitive or inhibitive program requirements governing the use of the funds that limit lenders' ability to securitize their loans. We address this issue in more detail later in the report.

Federal Programs Vary in Efforts to Collect and Maintain Information on Lender Activity and Loan Performance

The programs differed in the type of information they collected on lender activity, the performance of lenders' loan portfolios, and how the information was maintained. Information that lenders were required to report also varied widely. For example, the CDFI Fund requires lenders to report on the amount, number, and type of loans that CDFI lenders make. In contrast SBA's Microloan program required information on account activity supported by bank statements, as well as an account of the status of each loan in the portfolio. Other items that some programs required lenders to report included the financial condition of the lender and impact information—such as the number of jobs created and retained.

In addition, the frequency of reporting required by lenders differed by program. Three programs—USDA's IRP, RBEG and SBA's Microloan—

required that lenders submit quarterly reports; two programs—EDA RLF²⁹ and ARC’s Business Development—required semiannual reports; and six—504 CDC, CDBG, EZ/EC, CSBG, CDFI, and Section 108—required annual reports.

Further, our review found that regardless of how data are collected, there is little information about the volume of lending activity supported by and loan performance of some of the programs in our review. Programs in EDA, ARC, and Treasury required that lenders provide ongoing information on the loans in their portfolios, often including the loan amount, term, interest rate, and losses.³⁰ However, as mentioned earlier, they are not consistently defined, and do not all contain information at the loan-level. Further, four of the programs in HUD, EDA and Treasury only recently began collecting loan-level information because they undertook one-time, loan-level data collection efforts.³¹

Finally, these programs differed in whether they maintained performance information on paper or in a database and whether the files were kept in a central location or office. Only programs in Treasury maintained lender and loan information in a database, and only programs in ARC and Treasury maintained annual report information on lenders and their loans in a central location.³²

²⁹However, grantees can graduate to annual reporting upon consent of the agency.

³⁰The only exception to this is the CSBG program. According to HHS officials, Illinois is the only state in the country that uses CSBG funds for economic development lending purposes. The program has 38 local Community Action Agencies operating RLFs. The program administrator told us that he is intimately familiar with the lenders and their loan portfolios. As indicated in figure 2, performance data for CDFIs is currently collected at the aggregate level. However, Treasury has recently proposed that CDFIs report performance information annually at the loan level.

³¹In providing comments on the report, HUD officials informed us that while they do not get information on loan performance data targeted in our report, HUD’s Integrated Disbursement and Information System includes information on the type of assistance provided and the terms of assistance including interest rates and amortization periods.

³²The Illinois CSBG program also maintains data on lender activity in a database in a central office. We were unable to document the extent to which SBA maintains data on loans made by lenders supported in its 504 CDC program and Microloan programs.

Selected Securitization Models for Small Business and CED Loans Have Similarities and Differences

We reviewed five existing and three proposed securitization models designed to provide greater access to capital for small business and CED lenders. Each of the eight models exhibit similarities and differences in terms of (1) the types of lenders and borrowers served, (2) the types of loans pooled and methods for pooling, (3) the distribution of financial benefits and risks among participants, and (4) their outstanding securitized volumes. Less is known about the proposed securitization models since they do not currently engage in market transactions.

Types of Lenders and Borrowers Served Vary

As shown in table 6, these models serve, or would serve, private, nonprofit, and governmental lenders. For example, the two models securitizing SBA's 7(a) guaranteed and unguaranteed loans serve mostly depository lenders such as commercial banks and some nondepository lenders such as finance companies. The SBA 504 program serves only private nonprofit corporations called CDCs, while the existing and proposed Section 108 models serve or would serve CDBG-funded state and local governments and development agencies. The Community Reinvestment Fund (CRF) may serve nonprofit, for-profit, and governmental community development lenders eligible to sell loans. Similarly, the proposed CDA model would serve those lenders eligible to sell loans.

Table 6 also shows a wide variety of borrowers served by these models. For example, the SBA 504 model finances small businesses who have qualified for conventional loans backed by commercial real estate loans with senior bank participation, whereas the CRF model has provided financing to businesses ranging from start-up microenterprises to marginal for-profit and nonprofit borrowers. While all models generally loan to for-profit businesses, some are restricted to small businesses (SBA models) and others may also serve nonprofit borrowers (CRF and Capital Access models).

Table 6: Securitization Models and Lenders and Borrowers Involved

Model	Lenders	Borrowers
SBA 504 Program guaranteed	Certified Development Companies	For-profit small businesses that have qualified for conventional loans
SBA 7(a) guaranteed	Commercial banks, credit unions, small business lending companies and other nonbank lenders	For-profit small businesses that have demonstrated they could not obtain financing without the 7(a) program
SBA 7(a) unguaranteed	Commercial banks, credit unions, small business lending companies and other nonbank lenders	For-profit small businesses that have demonstrated they could not obtain financing without the 7(a) program
HUD Section 108 guaranteed	CDBG grantees and their designated lenders	For-profit or nonprofit borrower
Community Reinvestment Fund (CRF)	Nonprofit, for-profit, and governmental CED lenders	Local business, affordable housing, and community facility borrowers
Proposed Commonwealth Development Associates (CDA)	Nonprofit, for-profit, and governmental CED lenders	Small business borrowers not served by local commercial financial institutions
Proposed CDBG / 108 unguaranteed	CDBG grantees and their designated lenders	For-profit or nonprofit borrower
Proposed Capital Access Program variation	CDFI lenders	Minority businesses, nonprofits, commercial real estate

Sources: SBA, HUD, CRF, CDA, Capital Access Group.

Types of Loans Pooled and Methods for Pooling Vary

These models securitize a variety of loan products to serve the borrowers and lenders described above. Table 7 details similarities and differences in the type and characteristics of loans that may be pooled in each model, including loan purpose, collateral positions, loan terms, and rates. For example, while each of the models accepts commercial real estate and business equipment loans into their loan pools, the models vary in their acceptance of working capital and community facility loans. Additionally, senior or subordinate collateral positions on these loans vary by model. For instance, the two SBA 7(a) models prohibit subordinate loans, while the SBA 504 and Capital Access models allow only subordinate loans. One proposed model, CDA, would only purchase seasoned loans rather than committing in advance to securitizing loans meeting certain underwriting

standards. Terms of the loans that each model may accept vary slightly; all of the models would purchase long-term loans between 10 and 20 years, but only one model—the SBA 504 model—does not purchase loans with maturities less than 10 years. Variation in loan rates also exists. For instance, all of the models allow fixed-rate loans to be purchased, but three of the models prohibit variable-rate loans. Most of the loans securitized by the two SBA 7(a) models included variable-rate loans. Four of the models purchase or would purchase only market-rate loans. Two purchase or would purchase market and below-market-rate loans, and the remaining two models purchase below-market-rate loans only. While data on average loan size was not readily available for most models, the two models that provided this information demonstrated a wide divergence in average loan sizes: \$165,000 for the SBA 7(a) loans in fiscal year 2003 compared with \$1.5 million for the Section 108 Loan Guarantee program since 1995.

Table 7: Types of Loans Pooled Varies by Model

	SBA 504 Program	SBA 7(a) guaranteed	SBA 7(a) unguaranteed	HUD Section 108 guaranteed	Community Reinvestment Fund	Proposed models		
						Commonwealth Development Associates	CDBG / Section 108	Capital Access program variation
Types of loans								
Commercial real estate	X ^a	X	X	X	X	X	X	X
Community facilities					X			
Business equipment	X ^b	X	X	X	X	X	X	X
Working capital		X	X	X	X		X	X
Loan position								
Senior collateral position		X	X	X	X	X	X	
Junior collateral position	X			X	X	X	X	X

(Continued From Previous Page)

	SBA 504 Program	SBA 7(a) guaranteed	SBA 7(a) unguaranteed	HUD Section 108 guaranteed	Community Reinvestment Fund	Proposed models		
						Commonwealth Development Associates	CDBG / Section 108	Capital Access program variation
Loan maturity								
Less than 10 years		X	X	X	X	X	X	X
10 to 20 years	X ^c	X	X	X	X	X	X	X
Loan interest rates								
Fixed	X	X	X	X	X	X	X	X
Variable		X	X	X ^d	X			
Market rate	X	X	X		X	X		X
Below market rate				X	X	X	X	
Underwriting criteria								
Advance loans	X			X	X		unknown	X
Seasoned loans		X	X	X	X	X	unknown	

Sources: SBA, HUD, CRF, CDA, Capital Access Group.

^a90 percent of all loans.

^b10 percent of all loans.

^c90 percent of loans are 20 years.

^dFor interim financing only.

Only SBA's 7(a) models and CRF hold loans on balance sheets of the pool assemblers until they assemble enough loans to pool and securitize. Other models predetermine the timing of their securities issuances, and sometimes their loan originations, in advance. For example, SBA's 504 program anticipates regular and predictable monthly issuances of its 20-year securities backed by CDC-originated, SBA-guaranteed loans. The Section 108 Loan Guarantee model also issues notes to investors in a regular and predictable manner—each year at the beginning of August. In between these public offerings, HUD provides interim variable-rate financing to CDBG grantees through a money market fund in Pittsburgh. (Appendix II contains brief descriptions of the structures for each securitization model.)

Distribution of Risks and Benefits Vary among Models

As explained in the following sections, models distribute interest rate risk (the risk of financial loss due to changes in market interest rates) and

credit risks (the risk of financial loss due to borrower default) among various participants differently. Benefits of various securitization models also vary among participants.

Interest Rate Risks Are Distributed Differently

The models distribute interest rate risk differently among participants, depending on whether loans allowed in the loan pool are fixed-rate or variable-rate, whether or not loans are held for extensive periods of time by lenders and loan pool assemblers until they can be sold (warehousing) to investors, and how these participants fund the loans they hold. Interest rate risk for lenders, loan pool assemblers, and investors depends on the terms to maturity of their own assets and liabilities, and their interest rates. For example, an investor in a long-term, fixed-rate asset would not face interest rate risk if this asset was funded with a long-term, fixed-rate liability with the same term. Such asset funding would lock in an interest spread (interest earned on the asset or interest paid on the liability) and negate the impact of interest rate movements on earnings. However, an investor that funds long-term, fixed-rate assets with short-term liabilities would face interest rate risk because a future increase in interest rates could require the investor to roll over the short-term liability when it came due into a higher-rate, short-term liability and narrow or reverse the interest rate spread. Similarly, a variable-rate asset if funded by a variable-rate liability with a lower rate would curtail interest rate risk. However, funding a variable-rate asset with a fixed-rate liability would create interest rate risk. A future increase in the variable rate on the liability above the fixed rate on the asset could create a negative spread. Borrowers of variable-rate loans could find their cost of borrowing becoming less affordable if interest rates increased, but could benefit from declines in interest rates. Borrowers of fixed-rate loans benefit when interest rates rise, but because business borrowers typically are penalized for prepaying loans, they may not benefit from declines in interest rates.

Credit Risks Are Distributed Differently

Credit risk is also distributed differently among participants in the models we reviewed. Investors assume limited or no risk relative to other participants, depending upon the amount and type of credit enhancements included in each model. As shown in table 8, all models use some form of internal (assumed by the lender, borrower, or securitizer) or external (third-party) credit enhancement to determine the credit risk assumed by all participants. The three models where the federal government assumes all credit risk require no additional internal or external credit enhancement. The five models where the federal government takes little or no credit risk result in other participants (usually lenders) assuming credit risks through internal credit enhancements. CRF uses, and CDA proposed,

multiple internal and external credit enhancements. CRF, a nonprofit, uses foundation grants and program-related investments to fund some of its credit enhancements.³³ The CDA model envisions a similar credit enhancement structure using public or private funding. Finally, while the Capital Access model does not specifically propose a publicly funded credit enhancement, virtually all 20 states that currently have Capital Access lending programs do provide state funding to loan loss reserve funds assigned to each participating lender, which may be used as credit enhancements if authorized by state law.

Credit enhancements can take a variety of forms. External credit enhancements rely on third parties to provide additional assurance of timely payment of principal and interest to investors. These enhancements can be governmentally provided (for example, loan guarantees) or privately provided (for example, loan guarantee insurance or letters of credit). With external enhancements, the credit quality and expected performance of the asset pool is often based on the credit quality of the external enhancement provider. Internal credit enhancements are not dependent on third parties and are often funded by lenders. These enhancements include senior or subordinate positions, in which cash flows from the pool of assets are structured so that the higher credit quality “senior” securities would fail to receive timely cash flows only after lower credit quality subordinated securities fail to receive their cash flows. Internal enhancements also include over-collateralization, in which the face value of the assets in the pool are greater than the face value of securities issued; excess spread, in which the difference between the cash flowing into an asset pool and the cash flowing out of a pool to security holders is set aside in a reserve fund to cover future, unexpected payment delays or losses; and loan loss reserves, in which monies are set aside to cover future unexpected cash flow delays or losses. Occasionally, such as with CRF, loan originators may be required to replace nonperforming loans with performing loans according to loan substitution agreements. Lender recourse are financial obligations of lenders to make a loan pool whole if the portion of the loan pool provided by that lender fails to perform.

³³Program-related investments include loans, loan guarantees, mortgage investments, and equity investments that are made by foundations such as the Ford Foundation or MacArthur Foundation for many CED purposes, to multiple CED entities. The foundation can receive favorable tax treatment from the IRS if the Program-related investments receive below-market-rates of return. Program-related investments can provide financial benefits to the foundation, as well as further the mission of the foundation and the receiving CED entities.

Table 8: Credit Enhancements Used to Distribute Credit Risks Vary by Model

Credit enhancement type	SBA 504 Program	SBA 7(a) guaranteed	SBA 7(a) unguaranteed	HUD Section 108 guaranteed	Community Reinvestment Fund	Proposed models		
						Commonwealth Development Associates	CDBG / Section 108	Capital Access Program Variation
External								
Governmental	X	X		X		X		
Private					X ^a	X		
Internal								
Senior / subordinate			X		X	X	X	
Overcollateralization					X	X		
Excess spread			X					
Loan loss reserve						X	X	X
Recourse to lender					X			
Loan substitution					X	X		
Private or publicly placed^b	Public	Public	Public or private	Public	Private	Private	Not specified	Private
Credit rating	No	No	Yes	No	No	Yes	Yes	No

Sources: SBA, HUD, CRF, CDA, Capital Access Group.

^aIn addition to external foundation monies, CRF may attempt a rated security that will include some external guarantee insurance on the senior tranche securities.

^bPublic offerings of securities must meet Securities and Exchange Commission (SEC) registration and disclosure requirements. In a private placement, securities issuers can avoid the costs of the registration and reporting process required of a public offering as long as there is no solicitation of the public, the investors are sophisticated in business matters, and investors have access to certain information.

Benefits Are Distributed Differently

These securitization models distribute benefits differently among participants. Investors can diversify their portfolios with new securities that have desirable risk, return, and maturity characteristics. For example, a number of institutional investors, particularly state or local and religious pension funds have been investing in “socially responsible” investments for over two decades, provided they could achieve market-rate returns with sufficient loss protection to satisfy their “prudent person” investment

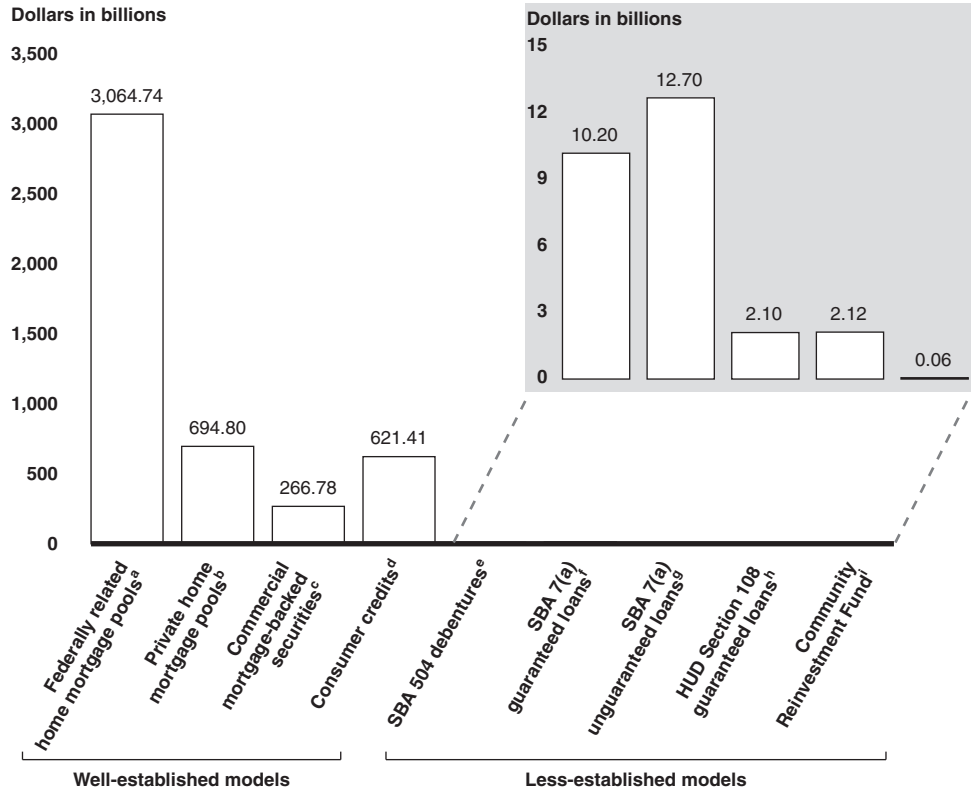
requirements.³⁴ As noted earlier, pension funds hold longer-term, fixed-rate investments for portfolio management purposes. These models provide lenders opportunities to better manage their risk and financial positions by selling certain loans they have originated from their portfolios and to further their missions by replenishing capital available for new loans or other purposes. For example, CRF's ability to warehouse CED loans improves CED lenders' ability to sell loans on occasions when the benefits of selling the CED loans are most clearly visible to CED lenders. SBA's attempts at regular and predictable monthly issuances of its securities backed by SBA-guaranteed 504 loans allows a more consistent mechanism for 504 CDCs to sell loans, rather than hold long-term loans in their portfolios thereby freeing their capital for other purposes. Borrowers in each of the models benefit from access to capital that would otherwise be unavailable.

Volume of Outstanding Securitized Loans Have Not Reached the Volume of More Well-Established Models

Figure 3 shows the total amount of outstanding securitized loans for well-established securitization models versus models for securitizing CED loans. Models with assets such as home mortgages, commercial mortgages, or consumer financings show the greatest amount of outstanding securitized loans. These models have been in existence for many years. Conventional home mortgages, for example, have been securitized for over 30 years. These industries have developed standards for documents and underwriting that enable wider securitization. The existing CED models we reviewed have not reached the level of securitization of the more well-established models. Among the CED models, the two SBA guaranteed models have a far greater amount of outstanding securitized loans than the other three models—7(a) unguaranteed, Section 108 guaranteed, and CRF.

³⁴Prudent person rules allow investment managers or fiduciary trustees the flexibility to make financial decisions regarding asset-types and rates of return that an ordinary, reasonably well-informed person would exercise. Prudent person rules tend to discourage speculative transactions, placing the potential for higher incomes and capital gains in a secondary position to preservation of capital.

Figure 3: Levels of Outstanding Securitized Loans Have Not Reached the Levels of More Well-Established Models



Sources: Federal Reserve Board, SBA, CRF, and HUD.

^aFederal Reserve Bulletin, Table A33, July 2003. Outstanding principal balances of Federal National Mortgage Association (Fannie Mae), Federal Home Loan Mortgage Association (Freddie Mac), and Government National Mortgage Association (Ginnie Mae) guaranteed or insured mortgage-backed securities. Includes one- to four-family mortgages.

^bFederal Reserve Bulletin, Table A33, July 2003. Outstanding principal balances of mortgage-backed securities issued through private mortgage conduits. Includes one- to four-family mortgages.

^cFederal Reserve Bulletin, Table A33, July 2003. Outstanding principal balances of nonfarm, nonresidential, mortgage-backed securities issued through private mortgage conduits.

^dFederal Reserve Bulletin, Table A34, July 2003. Includes outstanding balances of all pools of securitized credits, including revolving and nonrevolving credit.

^eSBA reported data as of September 30, 2002.

^fSBA reported data as of September 30, 2002.

^gSBA reported data as of September 30, 2002. This number represents loan balances at the time of securitization, not outstanding loan balances as of September 30, 2002.

^hHUD reported data as of August 29, 2003.

ⁱCRF reported data as of December 31, 2002. This number represents loan balances at the time of securitization, not outstanding loan balances as of December 31, 2002. This number excludes notes

backed by roughly \$41 million (loan balances at the time of securitization) of CED loans that were not issued through a special purpose vehicle. As of December 2002, these notes had an outstanding principal balance of about \$1 million.

We Identified Barriers to Securitizing CED Loans

We identified six categories of barriers for either lenders or capital markets investors in securitizing CED loans. First, uncertain borrower demand exists across targeted markets, and CED lenders generally lack incentives to participate in securitization. Second, management capacity for securitizing loans is limited. Third, external requirements attached to funding sources may directly or indirectly inhibit the securitization of CED loans. Fourth, CED lenders believe that selling below-market-rate loans would require them to absorb too high a discount to profit from a securitization. Fifth, lack of lender product standardization, documentation, and loan performance information impedes securitization by increasing transaction costs. Finally, mechanisms available to support securitization for CED loans are limited.

Uncertain Borrower Demand and Limited Lender Interest Limit the Ability to Securitize

According to studies, lenders, programs, and their associations, current and future borrower demand is not understood across target markets, and CED lenders do not see the benefit of securitization. Borrower demand—borrower’s need for capital in target markets served, given the risk levels lenders can absorb—is not understood by lenders, programs, and capital market participants across target markets because it can be volatile and is not consistently measured. In some federal programs, for instance, measurements of current borrower demand are assessed through lender annual reports. Other programs and their lenders also use proxy measurements of demand.³⁵ In addition, there are no mechanisms or standards for forecasting future borrower demand for such loans, making it difficult to determine what borrower demand might be across markets. Moreover, borrower demand is unpredictable, in part due to changes in local conditions in some markets. For some targeted communities, the favorable economic climate of the 1990s prompted conventional lenders to move down market (that is, lend to more risky borrowers), thereby pushing demand for CED loans into areas where CED lenders were less willing to take on further risk.

³⁵For example, CDFI’s trade association noted a “deployment rate,” which is used as a proxy for the percentage of loanable funds that are actually loaned out.

According to several CED lenders, securitization studies, and reviews of federal agency securitizations, lenders lack incentive to participate in securitizations. For instance, EDA's securitization pilot study found that the primary barrier to securitizing RLF loans stemmed from the fact the lenders did not want to sell their loans.³⁶ According to key officials knowledgeable about one of the four demonstration projects, lenders did not find the deal attractive because they had access to cheaper capital through the EDA grant program. Additionally, lenders would not commit loans for sale into the loan pool in advance because they were unsure whether good borrowers would be available to whom they could relend the sale proceeds. Also, the Department of Commerce's Office of Inspector General recently found that some RLFs funded by EDA were carrying excessive capital reserves and required them to return these funds to the program, and that EDA monitor the RLF to ensure continued compliance. These lenders would not need the liquidity benefits from securitizing their loans. According to program officials in ARC, lenders funded by ARC do not wish to securitize their loans and are now prohibited from doing so. Officials explained that there were a number of reasons why ARC grantees did not want to securitize including loss of interest on loans they hold; limited yields accrued from securitizing their loans; and limited need for liquidity given readily available grant funding they receive through the ARC program. Preliminary results from the Department of Treasury's secondary market feasibility study indicates that while about one-third of the respondents have sold at least some loans they originated, CDFI participation in the secondary market for loans remains small. Many of the markets have not traditionally worked with CDFIs because of the small typical size of the CDFI loans, their nonstandardized loan portfolios, and concerns about the lenders' ability to meet loan-servicing requirements. About 23 percent of the respondents reported not knowing enough about the secondary market to participate. USDA piloted an effort to securitize IRP loans in 1998 but, according to program officials, it failed because the requirements for participation were too restrictive for most of the lenders to meet. For example, lenders who could not demonstrate an ability to repay the entire principal balance on their loan to USDA were ineligible to participate in any sale of the assets from their portfolios. HUD's Section 108 loan guarantee program, one of our five existing securitization models, is proposed for elimination in fiscal year 2004, according to the Office of

³⁶Kelly Robinson, "Expanding Capital Resources for Economic Development: An RLF Demonstration." (Washington D.C.: Economic Development Administration, 2001).

Management and Budget.³⁷ A recent HUD study cited the program's collateral requirements and lengthy approval process as the two major reasons for declining program usage.³⁸ Senior HUD program officials cited the elimination of the Economic Development Initiative (EDI) program as the principal reason for the decline in use of the Section 108 program in fiscal year 2001. Although the volume of lending has increased since that time, it has not returned to the pre-2001 loan volume level.

We identified other reasons for the lack of lender interest in the securitization efforts described above. First, the benefits of securitization are not always clear to lenders. Second, as indicated earlier, some of the lenders depend on income streams generated by their portfolios, making it difficult for some of them to sell portions of their portfolios. CED lenders that do not diversify their portfolios are particularly vulnerable to interruptions in the stream of income coming from a smaller pool of loans. During favorable economic times, the market in which CED lenders operate is pressured by competition from conventional lenders, thereby diminishing the demand for CED loans. While a number of securitization efforts have been undertaken, given uncertain borrower demand for CED loans and limited lender interest in securitizing loans, it is uncertain what volume of CED loans might be available for securitization on a wide scale. Without greater certainty, capital market participants do not have a reason to invest in developing a market for securitizing CED loans.

Insufficient Capacity Limits Lenders' Ability to Participate in Securitization

Limited lender capacity—constrained by factors such as reliance on small portfolios, insufficient financial information, and an insufficient number of staff or inadequate staff skills—limits some lenders from being able to participate in securitization. Many CED lenders' portfolios contain only or mostly small loans. For instance, the average loan size for microlenders is \$11,600. In addition, lenders work extensively with their borrowers to help them qualify for loans. This requires more time than required to make

³⁷A review of trends in HUD's unexpended balance report shows expiring balances in the program going from \$22.6 million in 1997 to \$109.2 million in 2001. These were 1-year appropriations that were not used at the end of the period. According to HUD, for the past several years, the actual demand for the program has been substantially below the loan guarantee level requested or provided in appropriations. HUD also recognized that grantees have not utilized the program at higher levels in part because of their reluctance to pledge future grant funds as collateral.

³⁸These collateral requirements refer to the additional security Section 108 borrowers must provide beyond the pledge of future CDBG program funds.

conventional loans and is often necessary to ensure borrower success. Although lenders operate this way to meet their mission, one study indicates it results in higher per loan costs, which in turn can increase the subsidy required on each loan financed.

According to studies, lender trade associations, and private-sector officials, lenders do not have sufficient financial information to determine how much of a discount they could absorb. To ensure that an asset an investor purchases provides market yields, capital market participants require lenders to sell loans at a discount to at least cover the additional risk—including interest rate risks and credit risks—they might incur from securitizing loans. Lenders might benefit from securitization if they could sell their loans at a price that best met their current financial needs. However, according to trade and program officials, some lenders do not have adequate financial information to determine whether a given price is or is not in their best interest, given the discount they would have to absorb in the sale. For instance, some may not know how much it was costing them to originate and service these loans and the income they could expect to earn from these loans. With better information, lenders would be better able to determine whether the discount being requested was appropriate and beneficial, given their knowledge of the performance and value of the loans in their portfolios.

In addition, studies and lender trade associations indicate lenders lack sufficient staff and staff with appropriate skills to manage the increased activity they believe securitization would create. According to a Ford Foundation study on CDFIs, many of these CED lenders offer salaries and benefits that are significantly lower than those attached to jobs with similar responsibilities and scope in the private sector.³⁹ As a result, these lenders may have a hard time competing for highly qualified and desirable candidates. Further, lender trade associations with whom we spoke noted that many CED lenders lack staff with the expertise to manage the increased workload lenders might incur from portfolio sales. In addition, some CED lenders experience difficulty originating and servicing loans, including working out impaired loans, in a timely manner because staff lack expertise and experience. The uncertainty about lender experience is factored into the discounts charged by the markets. The Ford Foundation

³⁹ Brody, Weiser, Burns Business and Organizational Consulting, *Strategies to Increase Community Development Finance—a Ford Foundation CDFI, Study Phase II*, January 2002.

study notes that while these impediments tend to be true across a range of CDFI lenders, the extent of these impediments vary by lender. For example, many of the larger loan funds have been able to increase salaries enough to have significant success in attracting staff from banks and other financial institutions, while the smaller loan funds have had much less success in doing so.

External Requirements May Prevent or Serve as a Disincentive for Securitization

Lenders receive funds from various sources and must comply with the various requirements or laws governing how the funds must be spent. These requirements may negatively impact CED lenders' ability to sell their loans to third parties, ultimately preventing securitization. The impact could be direct or indirect. For example, some CED lenders receive funds from more than one federal source and often underwrite loans to different specifications, as determined by the various federal regulations governing the funds. Disparate external requirements indirectly impact securitization because they serve as a disincentive for CED lenders to develop standard underwriting procedures, thus increasing the difficulty and costliness of structuring a securitization.

Several federal programs offer illustrations of how lending requirements may inhibit securitization. Some CED lenders reject the idea of securitizing loans made with federal funds because some federal programs, such as EDA, require that lenders use the proceeds on the sale of a loan to make subsequent loans with the same purpose. For example, an EDA RLF selling a disaster assistance loan would have to use the proceeds on that loan sale to make additional loans for disaster assistance. In addition, lenders in HUD's CDBG program that wish to sell their loans must ensure that the buyer will uphold requirements to meet HUD national objectives.⁴⁰ Some requirements have a direct impact on lenders' participation in securitization. For example, ARC prohibits CED lenders in its program from selling the loans they make with ARC funds.

⁴⁰These national objectives include benefiting low- and moderate-income persons, preventing or eliminating slums or blight, and addressing conditions that pose a serious and immediate threat to the health and welfare of communities served.

Lenders Believe Below-Market-Rate Products Will Not Meet Market Requirements without Substantial Discounts

CED lenders' missions, along with the purpose behind the supporting federal programs largely dictate the loan products and services lenders offer. As such, CED lenders generally offer below-market interest rates or other flexible, nonconforming loan terms to small businesses that are generally unable to obtain reasonable credit terms from traditional lending institutions. Capital markets require discounts when securitizing below-market-rate loans so that the effort will result in investments with market yields, cover transaction costs associated with securitization, and offset the uncertain performance of the underlying asset. To cover potential credit concerns, capital markets may also require that lenders provide a credit enhancement to offset the uncertainty of loan performance. Some lenders believe that the discount or credit enhancement that investors would require for securitizing their loans would be too great. Some report that capital market investors would require higher discounts than they would for securitizing other assets because CED loans are not well understood. On the other hand, some federal program officials fear that should securitization become an option for CED lenders to obtain additional capital, lenders would shirk their mission in favor of lending to more conventional borrowers.

Even if lenders were only required to accept a discount to offset the below-market interest rate, they have a disincentive to sell their loans. When holding loans, lenders account for the value of loans by using the unpaid principal balance, less any allowance for loss—called net book value. However, if a lender were to sell a loan, it would have to recognize as a loss the difference between the sales price and net book value. When purchasing below-market-rate loans, investors would require a sales price below the unpaid principal balance to obtain a market yield—requiring lenders to recognize a loss and creating a disincentive to sell loans. In effect, selling loans would require a lender to recognize the market value, rather than the higher book value of their loans.

Lack of Standardization and Inadequate Performance Information Inhibit Securitization

CED lenders currently operate independently of each other, resulting in nonstandard loan underwriting, documentation, and servicing. CED lenders also lack an infrastructure for consistently recording the performance of lenders and loans. As mentioned previously, the sources of capital and the missions of CED lenders encourage CED lenders to underwrite and service loans tailored to meet the unique needs of borrowers in their communities. CED lenders also use varying definitions and documents and utilize differing servicing policies. Additionally, CED

lenders have difficulty providing sufficient and consistent performance information in a useable way. For example, few lender groups have a facility for aggregating current loan-level performance information across lenders. Lender reporting may or may not be automated, and the performance data reported are not defined consistently across lenders.

Investors in securitized financial assets generally require reliable assurances that the securities will pay interest and principal fully and in a timely manner despite the performance of the overall economy. Credit ratings from agencies such as Moody's or Standard & Poor's can often provide these assurances. Additionally, securitizations require a credit rating in order to be considered "investment-grade" and attractive to institutional investors.⁴¹ Credit ratings play an important role in determining how the securities should be structured and priced to appeal to investors, including feedback on any levels of credit enhancement that may be necessary to achieve a desired structure. Securities raters examine certain characteristics of proposed securitizations in order to provide their assessment of the performance of a pool of assets and ultimately their credit rating as follows:

- Rating agencies examine current and historical loan and lender performance data such as delinquencies, defaults, and losses to assess the expected performance of a pool of similar loans over time.
- Rating agencies examine originator and servicer characteristics such as management and financial strength, servicing and collection practices, back-up servicing, workout and liquidation policies, and data processing and reporting to assess originators' and servicers' capability to execute their functions adequately and in a timely manner.
- Rating agencies examine the legal structure of the transaction to, for example, assure investors that the pooled assets have been properly sold to the bankruptcy-remote vehicle.

Generally, the larger the number of similar loans included in a loan pool (that is, loans with more homogeneous loan underwriting, documentation,

⁴¹Many institutional investors, such as banks and pension funds are generally restricted to "investment-grade" securities (nonspeculative securities with higher credit ratings). One hundred percent governmental guarantees can also provide adequate assurance to institutional investors without a credit rating on the pool of assets. Investors willing to take on more risk can invest in lower-rated, or nonrated securities.

and servicing) the less costly securing a rating can be.⁴² Additionally, better and consistent data can reduce the costs of securing a rating and allow for more precise estimates of performance, also providing for accurate assessments of any required internal credit enhancements.⁴³ The variety of CED lender practices and inadequate performance information prevent or inhibit capital markets from satisfactorily understanding the performance of CED loans and increase the transaction costs involved with assessing performance. The benefits of securitization are greatly reduced for CED lenders to the extent they must fund any extra transaction costs for these services, as well as fund credit enhancements to cover unexpected losses that capital markets cannot satisfactorily profile. Proposals to reduce these costs through standardization are viewed by many CED lenders as contrary to their missions.

Limited Mechanisms Available to Support Securitization for CED Loans

According to trade association representatives and other interest groups, if securitization is to become a viable alternative for lenders, information-sharing and securitization mechanisms are needed to provide consistent avenues for lenders to sell their loans, achieve the volume of loans needed for a securitization, and achieve quality control. That is, lenders have no apparent and available network or facility from which to draw if and when selling loans. Likewise, investors have no apparent facility or entity from which to purchase securities backed by CED loans. In contrast to other mortgage-backed and asset-backed securitizations, there is no comprehensive mechanism for sharing information with interested lenders, investors, and capital market intermediaries. Ad hoc networks, lender trade associations, and investor organizations do exist, but they do not provide updated and comprehensive data and information on a regular basis regarding loan volume. Neither do they provide a list of interested lenders, potential investors, securitization mechanisms, and credit enhancement providers.

Existing securitization mechanisms are limited in two different ways. First, there are few mechanisms available to securitize small business and CED

⁴²Securities raters have traditionally required at least several hundred similar loans or assets in a pool in order to create a risk profile for the pool using statistical analysis. Statistical analysis is generally more cost-effective for securities raters on a per loan basis than other methods of analysis.

⁴³Many securitizations require originating lenders to assume first-loss positions or use other internal credit enhancements to provide credit support to the investment-grade securities.

loans. Second, some of those that do exist have limitations. As noted earlier, we could only find five existing models that securitize small business or CED loans and three of them use 100-percent federal credit enhancements. CRF is the only existing securitization mechanism that actually purchases and securitizes CED loans without direct federal government support. However, as we also noted earlier, CRF has several important limitations. It is the only securitizer to provide a credit enhancement and, as a nonprofit entity, depends on the availability of foundation and other philanthropic sources to fund its credit enhancements. Since CRF's securities depend on private placements and do not have credit ratings, the number of investors, particularly institutional investors, that are able to purchase its senior tranche securities is greatly limited too. The Section 108 model is limited by its collateral requirements and the lengthy time needed for HUD's approval of each loan, according to a recent Urban Institute study. The study also found that collateral requirements may have particular force in cases where Section 108 is used to capitalize small business lending programs and where borrowers may have little security to offer. In addition, since 2001, with the elimination of funding for the EDI grant program, grantees can no longer use EDI funds to satisfy, in part, collateral requirements. Finally, the administration is proposing to eliminate Section 108. Taken together, the limited extent of information sharing and the limitations of securitization mechanisms inhibit the CED lending industry's willingness and ability to efficiently sell their loans on a large scale.

Potential Options Exist to Overcome Barriers, but Most Imply Costs or Changes to Federal Programs

CED lenders, their organizations, some federal agencies, and others have identified options the federal government could employ to potentially overcome securitization barriers. Generally, these options involve either providing incentives or requiring or providing direct or indirect support to resolve identified barriers. However, implementing these options singly or in combination would have ramifications—both positive and negative—for federal programs and the clientele served by these programs. For instance, some options could require additional resources, while others could cause lenders to focus less on CED lending. Some options could directly resolve or address the barrier, while still others could improve program or lender management. Furthermore, the options for overcoming the barriers often entail federal costs. However, we did not determine whether the benefits exceed the costs that could result from such efforts and, therefore, do not endorse these options.

Potential Options for Overcoming Uncertain Borrower Demand and Limited Lender Incentives for Securitization and Their Implications

As discussed previously, uncertain borrower demand and limited lender incentives for securitization could result in unpredictable or insufficient loan volume necessary for securitization to work efficiently. We have identified options that could help to better define and measure borrower demand across markets and promote lender understanding of borrower demand and the cost and benefits of securitization. We also identified options for providing incentives to lenders to make loans available for securitization. Ultimately, however, the market will largely determine what the underlying demand for CED loans will be.

Overcoming Uncertain Borrower Demand Might Begin with Measuring Demand

Some of the specific options for addressing uncertain borrower demand involve requiring or supporting research into how to measure borrower demand, helping develop and ensure application of consistent definitions and measures for periodically measuring borrower demand across lenders and programs, and aggregating this information. These actions could promote increased understanding of borrower demand and may have the added benefit of improved lender and program management—provided procedures and definitions are clearly defined and implemented, and that measures are taken systematically and frequently to track ever-changing markets. However, it is unclear whether increased understanding of borrower demand, alone, would motivate lenders to participate in securitization. In addition, as with any data collection effort of this magnitude, it would likely be costly and time-consuming to put a system in place. Therefore, it may be necessary to preface any efforts with a cost-benefit analysis.

The federal government could promote lender understanding of borrower demand through the use of forecasting tools, either across target markets or as part of programs. Provided these tools were defined, applied, and aggregated consistently, they could provide greater understanding of future borrower demand across target markets. Again, given the potential costs, a cost-benefit analysis might be warranted before pursuing such an effort.

The federal government could require or support efforts to increase information exchange among lenders. For instance, incentives could be implemented for CED lenders and local banks to refer potential clients to one another. This option could help lenders gain access to better borrower demand information in their local markets. Another option, a peer-to-peer system, could inform CED lenders of potential loans available outside their traditional markets. This process could help CED lenders anticipate changes in borrower demand across target markets, perhaps nationwide.

The costs of implementing either of these options are not well known. Without a mandate, marketing tools may be necessary to promote the use of either of these options. Either of these options could help to make more transparent the demand for CED loans, provided this sort of exchanged information could be aggregated and analyzed in a useful way.

Federal Government Could Potentially Improve Lender Understanding of Securitization and Create Lender Incentives for Securitization

As we discussed earlier in this report, while some lenders do securitize their loans, others lenders with securitizable loans could realize, but do not perceive, the benefits to securitization. These lenders, for example, may have existing low-cost sources of capital and rely on interest income to support their operations and would have difficulty sustaining expanded lending operations that securitization would allow. We identified options for identifying those lenders that might benefit from securitization, informing those lenders about securitization and its benefits, and building incentives for lenders to securitize their loans.

The federal government could help identify lenders that could benefit from or are ready for securitization by financing or supporting the development of a study designed to establish criteria, procedures, and practices for identifying such lenders, or requiring that such procedures be implemented. However, defining and identifying lenders that could benefit from securitization might not directly cause these lenders to consider securitization. To do so, the federal government could also promote better understanding of the benefits to lenders of securitization so that those lenders that were able and would benefit from securitization would use securitization as a means to expand community and economic development lending. Such efforts would require costs to the federal government.

To provide greater encouragement, the federal government could also provide direct incentives for lenders to securitize their loans. For example, the government could build incentives for lenders (such as program set-asides, awards, or requirements) into existing federal programs. While built-in program incentives could have a direct impact on lenders' willingness to securitize their loans, the impact on lenders' missions could vary depending on how support for these incentives is provided. For instance, unless additional funding was awarded specifically for such incentives, providing incentives through program set-asides, or program awards application processes, might give qualified lenders the ability to securitize, but decrease, the amount of available funding for all other lenders awarded grants or loans decreasing the federal support to meet their missions.

Requiring lenders to use existing program dollars allocated to them for securitization would not impact other lenders. However, if all lenders with qualifying loans were required to use program dollars for securitization, fewer dollars might go toward borrowers in the short-term until those lenders gained access to capital from the sale of those loans. On the other hand, the government could also eliminate disincentives to selling loans by, for example, reducing the use of grant funds. Again, such an option would have an immediate impact on lender behavior but also potentially motivate lenders toward less risky lending.

Potential Options Exist to Overcome Limited Capacity, but Each Has Implications

Limited lender capacity is an underlying reason why lenders lack incentives to participate in securitization. To help lenders access or analyze information on whether securitization would be useful, and to manage increased workload they would incur if they were to securitize their loans, some lenders need to improve their staff skills and financial information capabilities. Additionally, lenders' long-term viability could be enhanced through greater diversification of their portfolios.

Options the federal government could exercise include providing, requiring, or supporting training and technical assistance to: (1) increase skill levels of lenders in order to reduce the staff time spent on loans, (2) improve financial and accounting information needed to make decisions on whether benefits outweigh the costs of securitization, and (3) inform lenders of the benefits of diversifying their portfolios. Possible options also include supporting an increase in the number of lender staff needed to manage any potential increases in workload they might incur by securitizing their loans.

These options could not only move the industry closer to securitization by improving lender knowledge and capacity needed to securitize their loans, but could also have the added benefit of increasing lender capability and, thus, more prudent use of federal program dollars. However, each of these options also has other implications. For instance:

- Exercising options such as training and information sessions designed to inform lenders of the benefits of diversifying their portfolios could result in lenders investing in either larger loans or more collateralized assets. However, altering lender portfolios in this way could result in lenders making loans to less risky borrowers, moving them slightly “up-market” (that is, to more creditworthy borrowers) and thus further away from their mission. On the other hand, diversifying their portfolios with

more of a balance of larger and smaller loans and loans of varying risks could help lenders' long-term viability.

- Exercising options to increase staff skill levels through training or providing tools to increase staff skills, improving financial and accounting information, and for increasing the number of staff will have added costs. Costs to the federal government will vary depending on whether the government takes a direct or supportive role in developing and implementing training courses or information sessions or funding increased staff or tools for these lenders. However, improved lender management and technical skills could increase lender efficiency.
- To ensure the effective use of limited federal resources, any support for training, technical assistance, or staffing would require appropriate federal oversight and evaluation.

Options Exist to Overcome Restrictive External Requirements, but Each Has Implications

Our research identified a number of requirements that either directly or indirectly limit lenders' ability to participate in securitization. To allow lenders the ability to pool and sell loans, these requirements and others like them, would need to be identified and either modified or removed.

The federal government could exercise several options for identifying and modifying or removing restrictive requirements, including requiring programs to work collaboratively to identify and resolve conflicting regulatory requirements that prohibit or inhibit securitization and develop proposals for resolving conflicting statutory requirements. While these options have the potential to expand the number of lenders that may consider securitizing CED loans, each option has other implications such as the following:

- Identification of conflicting federal, state, local, and private requirements governing how CED funds must be spent could be costly and time consuming because of the need to coordinate efforts on several levels.
- Removing some requirements may impact lenders' ability to meet the mission of the federal programs that support them. For example, if requirements that lenders use loan sale proceeds to make loans with the same purpose are eliminated, EDA has no assurance that the lenders it supports would continue to meet program goals and objectives. Before

removing such restrictions, their purpose and rationale should be weighed against the benefits of securitization.

Options Exist to Potentially Overcome Impact of Below-Market-rate Loans on Securitization, but Each Has Implications

Some studies we reviewed, and lenders with whom we spoke, cite the very nature of CED loans as a barrier to securitization because these loans often have below-market-rates. Discounts on below-market-rate loans are a consequence of the need to provide market yields on investments and to cover the transaction costs associated with carrying out any securitization. Securitization of CED loans may also require discounts to offset any additional transaction costs due to the lack of performance information and nonstandard loan underwriting. Loans made with limited collateral, and with riskier borrowers, will continue to need either some type of subsidized financing, such as the below-market-rate loans provided by these lenders, or other mechanisms such as offering longer loan terms that allow borrowers to make lower monthly payments.

The federal government could exercise several options to enhance lenders' abilities to securitize below-market-rate loans. The federal government could provide a direct subsidy or incentives for others to provide support to lenders to offset the discount charged to lenders for securitizing below-market-rate loans. The implementation of any one or all of the options discussed in other parts of this section (from measuring borrower demand to improving loan performance information) would diminish lender costs and diminish, in part, the need for lender discounts. However, as explained in those sections, these options have other implications as well. Provision of a direct federal subsidy or incentives for others to provide support would result in federal costs.

Options Exist to Overcome Lack of Standardization and Insufficient Performance Information, but Each Has Implications

The level of heterogeneity among community lenders and loans, and the lack of adequate performance information regarding these lenders and loans, results in disincentives to securitize. Capital markets cannot sufficiently, or cost-effectively assess the expected performance of a heterogeneous pool of loans and, thus, cannot accurately assure investors of the creditworthiness of a pool of CED loans. The benefits of securitization are greatly reduced for community lenders as they fund any extra transaction costs for these services and credit enhancements to cover unexpected losses that capital markets cannot adequately profile.

Developing a Level of Standardization Would Involve Supporting Data and Underwriting Standardization

The federal government could provide incentives (such as set-asides or awards) for federal programs and/or capital markets (or other financial institutions that securitize similar loans, such as commercial banks) to collaborate in order to develop standardized performance information, loan documentation, servicing, and underwriting criteria and procedures that are useable for both capital markets and CED lenders. Developing new criteria and procedures through this type of collaboration might improve CED lenders' ability to securitize or to develop innovative financing arrangements other than securitization. Given the varied and diverse nature of community lenders nationwide, providing outreach and education on any information or procedural standardization could also facilitate the timely implementation of any new criteria or procedures.

Developing and applying homogeneous loan and lender performance information—key performance data points, definitions underlying those data points, frequency for reporting data, and preferred format for collecting the data for CED lenders—has several implications. The earlier performance information could be developed and collected from CED lenders, the sooner CED lenders could communicate a useable performance profile to financial institutions and thus help to improve their overall effectiveness as CED lenders. Aggregating and maintaining performance information in a central facility—a “data-warehouse”—accessible by CED lenders, loan pool assemblers, and federal programs, may provide: (1) community lenders an easier way to report and monitor their performance, thereby reducing any administrative burdens accompanying repetitive federal reporting requirements; (2) loan pool assemblers and rating agencies more cost-effective means to assess and profile the risk of differing types of CED loans, helping to diminish the securitization transaction costs lenders currently fund; and (3) federal programs and Congress better data to make key programmatic decisions within and across programs. Federal support for efforts to develop and apply homogeneous loan and lender performance information would result in costs to the federal government, but it may improve program management in the long-term. Deciding where to develop, store, and manage this data should take in account, privacy, access, and Freedom of Information Act issues.

Developing homogeneous loan underwriting, servicing, and documentation standards would likely require a balance between the level of standardization necessary for cost-effective, reliable performance estimates and a sufficient level of flexibility for CED lenders to meet the needs of their communities. The tighter the standards, the less likely CED

lenders would be able to tailor their services to their communities, thus potentially diminishing the effectiveness and benefits of CED lenders to communities. Conversely, the looser the standards, the more costly assessing the performance of CED loans becomes, thus diminishing the benefits of securitization as a funding source for CED lenders. Developing a range of underwriting and servicing standards for a variety of loan products would limit lender flexibility for a particular loan product, but these standards may be designed to accommodate the mission of community lenders. Additionally, with enough available loan and lender information, a range of standards may allow a pool assembler to assemble a reasonably homogeneous pool of similar loans from a nationwide pool of mission-oriented CED lender portfolios. Developing standards for underwriting, servicing, and documentation can require substantial effort. To the extent that these efforts are funded through federal programs, or through incentives provided lenders and others, these efforts may impose federal costs.

Credit Scoring Could Diminish Need for Other Information

The federal government and CED lenders could examine the use of credit scoring as an indicator, for example, of the likelihood of borrower repayment of principal and interest. Some commercial banks now consider credit scores primary criteria for underwriting small business credit decisions. Several studies and interviews have indicated that credit scoring is a technique with the potential to reduce the need for standardized underwriting procedures. Using credit scores to estimate the likely performance of a pool of loans based upon borrowers with similar creditworthiness might be more cost-effective than estimating the performance of a pool of heterogeneous loans. If credit scores produce performance probability estimates reliable enough for rating agencies, investors and lenders can more accurately assess their financial incentives and disincentives to securitize CED loans. Additionally, credit scores may reduce the cost of loan origination. Whether credit scoring loans will affect the missions of CED lenders is somewhat dependent on the lender. Credit scoring may allow CED lenders to underwrite loans tailored to their target markets and sell occasional loans to pools accepting certain credit score ranges. Or, some CED lenders might only originate loans with credit scores acceptable for resale into pools accepting certain credit score ranges, thereby limiting the types of lending they would do in their communities. Credit scoring might limit borrowers with little or no credit history from accessing CED financings. Finally, questions still exist as to whether credit scoring disadvantages minority or other segments of the population.

Use of Governmental Credit Enhancements Could Minimize the Need for Other Loan Performance Data

Governmental credit enhancements could be applied in a number of ways, but could result in increased costs to the federal government. However, the level of the credit enhancement would determine the extent to which standardization and performance data would be needed. A security issued with a 100-percent federal credit enhancement could minimize the need for standardization and loan performance data because it is backed by the full faith and credit of the federal government and, therefore, would not need to obtain an independent credit rating. However, such a federal credit enhancement could expose the federal government to potentially greater risk and cost and would also require a minimum degree of standardization and review, depending upon the capabilities and loan performance record of the lender. For example, in FHA's Multifamily Insurance Risk-Sharing Program, state and local housing finance agencies receive a 100-percent federal credit enhancement, and the most experienced lenders are allowed to use their own underwriting standards and documents in return for assuming 50-90 percent of the credit risk. Compared with a 100 percent credit enhancement, a partial federal credit enhancement reduces the government's risks and potential costs, but generally subjects the loans to be securitized to an evaluation by the credit rating agencies or investors (for unrated securities). Such an evaluation would necessarily include the standardization and loan performance issues discussed earlier. Whether a 100 percent or a partial federal credit enhancement, federal agencies will need sufficient loan performance data to estimate the credit subsidy cost of the credit enhancement. Given the possible increased cost and risk the government incurs, credit enhancements should be minimized and their continuing need be assessed periodically. Such assessments would require criteria for determining the continued need for credit enhancement.

Options Exist to Potentially Overcome Limited Mechanisms for Securitizing, but Each Has Cost and Other Implications

Lack of or limits in information sharing and securitization mechanisms are seen by many as a barrier to securitization. Currently, there is no comprehensive mechanism for lenders, investors, and capital market intermediaries to share information on loan volume with interested loan buyers and sellers. There are also few mechanisms available to securitize small business and CED loans, and there are limitations with some of the existing mechanisms. We have identified several options for creating a consistent mechanism for securitizing CED loans. These options are as follows:

- The federal government could help establish formal networks for lenders and capital market participants to exchange information on loans available for sale and for interested loan purchasers to provide

specialized origination and loan sale functions. Examples of networks could include a formalized group of lenders, investors, and capital market intermediaries or super-regional CED lenders who would be part of a voluntary regional network of local CED lenders. For the networks to be effective, they would need to provide tangible benefits to both lenders and capital market participants. For example, super-regional lenders could specialize in originating and selling larger, long-term loans referred to them by retail lenders, who could participate in the underwriting and loan servicing responsibilities and share in the loan fees. This may also allow local lenders more time to concentrate on smaller, short-term loans to be held in their portfolios. Implementing the networks may also require different degrees of federal funding.

- Two existing securitization mechanisms that could serve as a basis for greater securitization of CED loans are CRF and the Section 108 guaranteed security programs. However, these structures have certain limitations that would first need to be addressed. CRF depends on the availability of foundation and other philanthropic sources to fund its credit enhancements, thereby limiting its capacity to sell more securitized loans to investors. Since CRF's securities have only been privately placed and do not have credit ratings, the number of investors, particularly institutional investors, who are able to purchase its senior tranche securities is limited. Increasing CRF's capacity to securitize more loans and providing it with a large enough credit enhancement would allow CRF to obtain a credit rating. Addressing CRF limitations could include providing direct federal funding for partial credit enhancements or match funding to attract other funding sources such as state and local government and program-related investors, as well as assistance in developing standardized loan products. However, providing partial federal credit enhancements could have both positive and negative effects depending upon the credit risks associated with the lenders and loans included in each loan pool to be securitized. Such credit enhancements would likely impose costs on the federal government. In addition, these options may have a negative impact on lender mission if standardization reduces lender flexibility to the point that loan terms no longer meet borrower needs or excludes targeted borrowers. However, lenders may be able to target greater resources to serving targeted markets if they can offer new loan products such as, long-term, fixed-rate real estate loans. In addition, the Urban Institute study found that the average loan size of Section 108 loans to third

parties was about \$1.5 million.⁴⁴ Thus, the model securitizes much larger loans than many of those financed by many lenders covered in our review. For example, the average loan size for CDFIs is \$66,000 for business loans and \$11,600 for microenterprise loans. Finally, as indicated previously, the administration is proposing elimination of the Section 108 program. If the program remains or the model is adopted elsewhere, the model's current limitations could be addressed. For example, the government could address the collateral concerns, particularly by communities that capitalize loan funds, while taking into account risks borne by the federal government. The government could also assess why the Section 108 model is not used more widely to securitize CED loan funds. This would require a better understanding of the extent to which Section 108 loan guarantees are used as a funding source for loan funds. Such efforts would involve costs for the federal government, but could lead to improvements in the program's and the securitization mechanism's usage.⁴⁵

- The government could also opt to create new securitization mechanisms ranging from those with little or no credit enhancements to options with full credit enhancements. These structures could be supported by different entities such as the federal government or the private sector. For example, the government could create a new mechanism similar to the CDA securitization model with a partial federal credit enhancement. Another option might be a demonstration program with a 100-percent federal credit enhancement of the security plus sharing the credit risk of the underlying loans in a manner similar to the FHA Multifamily Risk-Sharing Program described earlier. For instance, if the risk-sharing demonstration with a 100-percent federal enhancement of the security were limited to CED lenders with high performing portfolios and high loan volume, standardization requirements would be minimized, thereby reducing lender mission impact. But this sort of federal credit enhancement might have negative cost consequences for the federal government, depending on the effectiveness of the risk-sharing mechanisms adopted and the quality of the lenders and loans included in the program. The implications for the proposed CDA model are less

⁴⁴Some of the loans securitized under the Section 108 program are used to fund smaller loans to individual businesses through RLFs and nonprofit intermediaries such as CDCs.

⁴⁵In providing technical comments, HUD suggested that fees could be but are currently prohibited from being charged to create a loan loss reserve for securitizing these loans. However, we did not assess the implications of this option.

known since there are no current securitization models that use partial federal credit enhancements to securitize any loans. Since CDA proposes to purchase only seasoned loans and update their borrowers' credit scores, the need for standardization may be minimized because credit rating agencies would know the loans' short-term financial performance and their borrowers' current creditworthiness. Since the rating agencies would still not have the long-term loan performance data they need to statistically predict loan delinquencies and defaults, they would adjust the amount of credit enhancement upward, but by a smaller amount than required for pools of new loans with outdated credit scores. Overall, any options for providing enhancements to create additional mechanisms for securitization will require administrative effort and federal costs.

- The government could also build upon existing structures that securitize non-CED loans by providing incentives for private sector entities to securitize CED loans. However, private sector securitization entities may not agree to securitize CED loans or may “demand” too high a cost to the federal government. In addition, because private securitization mechanisms require standardized underwriting, lenders’ mission may be negatively impacted. However, the impact standardization might have on lender mission could be mitigated if securitization could provide CED lenders with new kinds of loan products that they generally do not now originate, that is, larger, long-term, fixed-rate loans. Overall, providing incentives to private sector entities to securitize CED loans would require federal costs. To ensure the effective use of federal resources, any such program or incentives would also require appropriate federal oversight and evaluation.

Observations

Given the importance of volume in achieving efficiencies that could help securitization work effectively, uncertain borrower demand and limited lender incentives are critical barriers that would need to be addressed if CED loans are to be securitized widely. Therefore, securitization may not be a significant alternative for these lenders until the volume of loans available for securitization is known industrywide, and lenders are convinced of its benefits enough to participate. Further, limited lender management capacity, prohibitive external legal or regulatory limitations and requirements, and discounts due to below-market-rate financing are barriers consequent to the nature of CED lending. For varying reasons discussed in detail above, these barriers also combine to explain the lack of lender incentives to securitize their loans. Therefore, these barriers, along

with the cost associated with their elimination, are factors to be addressed if CED loans are to be securitized widely. In addition, eliminating these barriers entail costs.

The remaining barriers—lender heterogeneity, insufficient performance information, and limited mechanisms for securitizing loans—are traditional barriers that have been experienced to some degree in the development of other securitization models. Some of the actions we outline, such as developing homogeneous documentation and performance information, may help to improve lenders' overall effectiveness in dealing with local and national capital markets in a range of financing transactions, including securitization, and could help improve program management. However, the costs and benefits of these actions should be assessed before they could be considered viable. Developing homogeneous underwriting and servicing policies requires recognition of the tension between the flexible underwriting these lenders employ to serve their communities versus the standardization needed to cost-effectively securitize loans. Additionally, any mechanisms developed to further CED loan securitizations will not succeed without visible financial benefits for lenders and capital market participants.

In addition, some of the options we have identified to improve lender management practices, data on lenders and loans, and consistency in assessing and documenting loans could not only move the industry closer toward securitization, but could have the added benefit of improved management and oversight for lenders and the federal programs that support them. However, their costs and benefits need to be assessed. If cost/benefit analyses prove them to be cost-effective, these are steps that could help the industry regardless of whether securitization becomes a viable option.

While the options we identify have many likely implications, we did not measure the extent to which each may affect lenders' mission, federal costs, program oversight, and other potential implications. Likewise, we did not determine whether the potential benefits exceed the costs that could result from such efforts. We, therefore, do not endorse these options. Nonetheless, the information we present provides a framework for understanding the challenges when considering the federal role in facilitating securitization.

Agency Comments and Our Evaluation

Officials in all agencies provided technical comments that we incorporated into the report, where appropriate. The technical comments from HHS were from officials in HHS's Administration for Children and Families. Generally, the agencies did not indicate whether they agreed or disagreed with the report's findings.

We are sending copies of this report to interested congressional parties and to the Secretaries of Agriculture, Commerce, Health and Human Services, Housing and Urban Development, and Treasury, the SBA Administrator, and the Federal Co-Chair of the Appalachian Regional Commission. Copies will be made available to others upon request. In addition, the report will be available at no charge on the GAO Web site at <http://www.gao.gov>.

Please contact Mathew J. Scirè, Assistant Director, or me at (202) 512-8678, or by e-mail (sciremj@gao.gov or shearw@gao.gov) if you or your staff have any questions concerning the report. Key contributors to this report were Diane T. Brooks, Tiffani L. Green, Mitchell B. Rachlis, Barbara M. Roesmann, Keith A. Slade, and James D. Vitarello.



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List of Congressional Requesters

The Honorable Hillary Rodham Clinton
United States Senate

The Honorable Susan Collins
United States Senate

The Honorable Christopher J. Dodd
United States Senate

The Honorable Tom Harkin
United States Senate

The Honorable James M. Jeffords
United States Senate

The Honorable Edward M. Kennedy
United States Senate

The Honorable John F. Kerry
United States Senate

The Honorable Patrick J. Leahy
United States Senate

The Honorable Carl Levin
United States Senate

The Honorable Jack Reed
United States Senate

The Honorable Paul E. Kanjorski
House of Representatives

The Honorable James A. Leach
House of Representatives

The Honorable John M. McHugh
House of Representatives

The Honorable Jack Quinn
House of Representatives

Objectives, Scope, and Methodology

Our objectives were to: (1) describe the characteristics of selected federally sponsored Community and Economic Development CED lenders; (2) describe the characteristics of selected federal programs that support CED lenders; (3) describe selected efforts to securitize economic development loans; (4) determine the barriers to securitizing economic development loans; and (5) identify options for overcoming these barriers, as well as the implications of the identified options. We limited the scope of our work to securitization and did not include alternative means for lenders to access private capital.

CED Lender Characteristics and the Performance of Their Loans

Our review focused on the seven types of federally sponsored CED lenders that we were specifically requested to include and identified as key CED lenders.¹ They are the following:

- Community Development Financial Institutions (CDFIs),
- Revolving Loan Funds (RLFs),
- Intermediary Relenders (IRPs),
- Community Development Corporations (CDCs),
- Small Business Administration's (SBA) 504 Certified Development Companies (504 CDCs),
- lenders supported by entitlement city and state grantees under the U.S. Department of Housing and Urban Development's (HUD) Community Development Block Grant Program and lenders supported by the Section 108 Loan Guarantee program, and
- microlenders.

To describe the characteristics of selected federally sponsored CED lenders, we reviewed and synthesized studies, reports, data, and information from industry nonprofits, trade associations, and federal

¹Although we identified one other lender group—Community Development Entities under Treasury's New Markets Tax Credit—we did not review these lenders because Treasury just recently (2002) established Community Development Entities, and limited information was available on them.

program data on selected CED lenders and lending programs. We also interviewed CED lenders, their trade associations, and other industry groups. We then used the information collected from the identified sources to document and describe, where available, the following:

- purpose of (mission) and target markets served by the lender group;
- lender's sources of capital;
- characteristics of the lender group (for example, number of loans, amount of loans);
- reported impacts on target markets served; and
- attempts to measure and define demand for liquidity and capital.

Finally, we documented the availability of data describing the characteristics and performance of the loans that CED lenders make. Loan performance data were inconsistently available for all lender groups; therefore, we were unable to assess the performance of CED loans in general. However, we were able to document differences in how loan performance was measured. We also identified three current efforts to collect loan-level data on CED loans made by select CED lenders in EDA, HUD, and Treasury's CDFI Fund. We attempted to obtain summary data from these sources on the dollar amount and number of loans in default in order to estimate a cumulative default rate for each program. However, Treasury's CDFI Fund data were inconsistent and incomplete for our analysis. Comparable data on HUD loans were not available at the time of this report. We did not independently verify the data, but we corroborated it against various sources.

Selected Federal CED Programs

Our review focused on 11 federal programs that support the seven types of CED lenders targeted.² Programs selected for review, the lenders they fund, and the agencies that administer them are listed in table 9.

²While there are other federal programs that support economic development activity, we focused on those within the seven federal agencies we were requested to review that support seven types of CED lenders targeted. For example, HHS administers the Community and Economic Development Discretionary Grant program. However, the program could only recently be used to fund RLFs. Also, see previous footnote.

**Appendix I
Objectives, Scope, and Methodology**

Table 9: Federal CED Lending Programs, Lender Types, and Sponsoring Agencies Included in Our Review

Federal program	Lender type	Sponsoring agency
Intermediary Relending program (IRP)	IRPs	U.S. Department of Agriculture (USDA)
Rural Business Enterprise Grant program (RBEG)	RLFs	USDA
Economic Adjustment Assistance Program	RLFs	U.S. Department of Commerce Economic Development Administration (EDA)
Business Development Revolving Loan Fund program	RLFs	Appalachian Regional Commission (ARC)
Community Development Block Grant (CDBG) (entitlement cities and state-administered)	Local lenders	U.S. Department of Housing and Urban Development (HUD)
Section 108 loan guarantee	Local lenders	HUD
Community Services Block Grant (CSBG)	Local lenders	U.S. Department of Health and Human Services (HHS)
Enterprise Community/Empowerment Zone Grant (EZ/EC)	RLFs	USDA, HHS, and HUD
Financial Assistance component of CDFI Fund	CDFIs	U.S. Department of Treasury (Treasury) CDFI Fund
504 Certified Development Company (504 CDC)	Certified Development Companies (CDCs)	Small Business Administration (SBA)
Microloan Program	Microlenders	SBA

Source: GAO.

For each program we analyzed the following:

- purpose and target markets served by the program,
- how the federal government supports the CED lending program,
- restrictions on the use of the federal funds,
- types of performance and lender activity information that the program collects,
- volume of program activity, and
- budgetary costs of funding the program’s CED lending activity.

Selected Securitization Efforts for CED Loans

Our review focused on eight models—five existing and three proposed—that are intended to serve small business and CED lenders. SBA's 7(a) guaranteed and unguaranteed models and the two HUD Section 108 models were specifically requested. The remaining four models were identified through our contacts with agency officials and other parties.

The five existing models are:

1. SBA's 7(a) guaranteed model,
2. SBA's 7(a) unguaranteed model,
3. SBA's 504 model,
4. HUD's Section 108 model,
5. The Community Reinvestment Fund's (CRF) model

The three proposed models are:

1. HUD's proposed CDBG/Section 108 unguaranteed model for securitizing CED loans,
2. Commonwealth Development Associates' (CDA) proposed model for securitizing CED loans,
3. Capital Access Group's proposed securitization model, building on existing state-level Capital Access lending programs

For each of the models, we then collected and summarized information about the following:

- models' structure, including lenders and borrowers served;
- securitized volume of each model;
- loan types included in the models' loan pools;
- financial benefits and risks to the participants in the models; and
- barriers to securitization the models faced.

Barriers to CED Loan Securitization

To identify barriers to securitization, their causes and proposed solutions, we (1) reviewed and synthesized studies and reports obtained from literature searches completed on securitization of economic development loans and selected sources we thought were most relevant to our review; (2) relied on relevant documents and studies identified in interviews with program officials, lenders, and their trade associations referred to previously; and (3) pinpointed barriers faced in the eight securitization models reviewed and the extent to which the barriers have been overcome. We limited our review to those documents that identified barriers to CED loan securitization and did not include those that discussed barriers to accessing capital through other means. We synthesized information on barriers in these documents into a single matrix uncovering over 264 citations of barriers to securitization, their causes, and any proposed solutions. We then developed logical groupings that characterized the barriers and assessed the reliability of these groupings by having teams of two independently code them and reach consensus on areas where original coding did not agree. The six categories that appear in this report are as follows:

- uncertain borrower demand and limited lender interest,
- insufficient lender capacity,
- external requirements attached to capital sources,
- below-market-rate loan products will not meet market requirements without a discount or subsidy,
- lack of standardization and inadequate performance information, and
- limited mechanisms available to support securitization for CED loans.

Options for Securitization and Their Implications

We relied upon the proposed solutions identified in the barrier analysis described above and our professional judgment to identify strategies for overcoming barriers to securitizing economic development loans. We considered a range of options available to the federal government to address the barriers developed in our analysis. Federal options generally include the following:

- potential modification(s) of legal or program requirements,

- potential incentives within existing programs to promote participant interest and/or the ability to securitize, and
- potential actions to help improve lender capacity.

We do not endorse the options we identified and, given the scope of this report, note that these options are designed to address barriers to securitization, rather than improving access to capital through other means.

We also used our professional judgment and that of experts in the field to determine the potential implications of each option. We developed a range of implications based upon our research and discussions with program and industry experts. The potential implications of the options generally considered whether the option could result in

- conflicts with lenders' mission,
- need for new federal funding or resources,
- direct and/or immediate impact on the barrier being targeted, and/or
- improved lender or program management.

While we recognize that options could entail additional federal costs, we do not determine whether the benefits exceed the costs that could result from such efforts.

Our work was conducted in Manchester, New Hampshire; Philadelphia, Pennsylvania; and Washington, D.C., between October 2002 and July 2003 in accordance with generally accepted government auditing standards. We obtained comments on a draft of this report from U.S. Department of Agriculture; U.S. Department of Commerce; U.S. Department of Housing and Urban Development; U.S. Department of Treasury; U.S. Small Business Administration; U.S. Department of Health and Human Services; and the Appalachian Regional Commission which we incorporated into the report, where appropriate.

Model Descriptions

Model	Lenders	Borrowers	Model structures
SBA 504 program	Certified Development Companies	Creditworthy, for-profit small businesses who have qualified for conventional loans	In existence since 1986, the SBA 504 program provides creditworthy small businesses with fixed-rate, long-term subordinate loans, primarily for commercial real estate (not to exceed 40 percent of the total loan amount). A third-party lender must provide at least 50 percent of the project amount. Each 504 CDC loan is funded by a guaranteed debenture and sold by SBA's designated trust agent, who pools them and issues U.S. Government Guaranteed Development Company Participation Certificates. These certificates are sold to investors through underwriters with timely payment of principal and interest guaranteed by SBA.
SBA 7(a) guaranteed	Commercial banks, credit unions, small business lending companies and other nonbank lenders	For-profit small businesses that could not obtain financing elsewhere	SBA has been authorized to securitize 7(a) guaranteed loans since 1984. The program provides a guarantee on a portion of a small business loan ranging from 50 percent to 85 percent, following SBA's review and approval of each loan unless originated by a preferred lender. The lender may elect to sell the guaranteed portion of each loan to an SBA-approved loan pool assembler, which issues SBA-guaranteed securities to investors. Working capital, equipment, and real estate loans may be included in these loan pools, which normally carry a variable interest rate.
SBA 7(a) unguaranteed	Commercial banks, credit unions, small business lending companies and other nonbank lenders	For-profit small businesses that could not obtain financing elsewhere	SBA first authorized the sale of unguaranteed portions of 7(a) loans on the secondary market in 1992. On February 10, 1999, SBA issued a Final Rule that created a new regulatory regime for all participating lenders in this program. Lenders pool their loans and issue securities to investors that include internal credit enhancements provided by the lender. To date, each security has been rated as investment-grade by credit rating agencies.
HUD Section 108 guaranteed	CDBG grantees and their designated lenders	For-profit or nonprofit borrower	Operating since 1978, the Section 108 permanent financing program provides both the actual financing for the securities and a 100 percent federal credit enhancement. Payments on the loans are passed through to the Section 108 note holders. The principal security for the loan guarantee is a pledge by the applicant community or the state (for nonentitlement communities) of its current and future CDBG funds. Additional security will also be required by CDBG grantees to assure repayment of the guaranteed obligations.
Community Reinvestment Fund (CRF)	Nonprofit, for-profit, and governmental community development lenders.	Local business, affordable housing, and community facility borrowers	CRF is a nonprofit secondary market maker for CED-based lenders nationwide. It purchases and warehouses loans from community lenders and uses the loans to back securities issued to private investors through private placements. These securities include a variety of credit enhancements, including subordinated tranches that are typically financed with loans and grants from private foundations.
Proposed Commonwealth Development Associates (CDA)	Nonprofit, for-profit, and governmental community development lenders.	Small business borrowers not served by local commercial financial institutions	CDA was part of the Economic Development Administration's securitization pilot in 1999. CDA proposed to pool economic development loans and acquire a rating using a credit-scoring model. Under the CDA model, loan originators were to hold the loans until enough loans became available for a rating and sale as a private placement, with partial internal credit enhancements funded by each participating lender, as well as external enhancements funded with public or private monies. Since CDA was unable to achieve the minimum loan volume required by the credit rating agency, the model was never implemented.

**Appendix II
Model Descriptions**

(Continued From Previous Page)

Model	Lenders	Borrowers	Model structures
Proposed CDBG / 108 unguaranteed	CDBG-grantees and their designated lenders	For-profit or nonprofit borrower	Under contract with HUD, the Urban Institute has proposed a structured finance securitization model that includes a small senior tranche, a large subordinated tranche, and a residual retained by the loan seller equal to about 20 percent. This assumes that a bank has provided 35 percent of the project cost with a senior collateral position. The remaining 55 percent has been provided by the community with either Section 108 or CDBG funds in a junior collateral position. The senior tranche would be sold to investors as an investment-grade security. An alternative is to include the senior bank loan portion in the loan pool, thereby also increasing the size of the senior tranche.
Proposed Capital Access Program variation	CDFI lenders	Minority businesses, nonprofits, and commercial real estate properties	Proposes to purchase subordinated loans to small businesses and nonprofit organizations (25–40 percent of total loan amount), that would require 100 percent financing, assuming a commercial bank agrees to provide the remaining 60–75 percent as a senior collateral position. Only the subordinate loan would be sold as securities, with primarily the borrower and possibly the lender, the state, or the federal government providing the necessary credit enhancements to investors.

Sources: SBA, HUD, CRF, CDA, Capital Access Group.

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