SELLING OR SECURITIZING COMMUNITY DEVELOPMENT BLOCK GRANT (CDBG)-FUNDED LOANS USING THE SECTION 108 PROGRAM AND OTHER SECONDARY MARKETS

Purpose

This appendix discusses securitizing CDBG-funded rehabilitation and economic development loans using the Section 108 program or selling the loans to secondary markets. It also describes solutions for common problems and issues communities encounter when implementing securitization and sales programs.

Background

Many communities have substantial sums invested in CDBG rehabilitation and economic development loan portfolios. A study funded by HUD a few years ago, *Secondary Markets for City-owned CDBG Loans* (available from the Communities Connections Information Center at (800) 998-9999), estimated that the "combined portfolio (of CDBG rehabilitation loans) surely exceeds $2 billion" nationally. The volume of economic development loans is also substantial, because most economic development assistance to businesses is provided in the form of loans. While many communities retain and service the loans they originate, using the program income generated by loan payments to fund additional CDBG-eligible activities, other communities choose to speed up the return of the loan funds: they sell portions of their loan portfolios to a secondary market or securitize their portfolios using Section 108 loan guarantees.

The above-cited study of secondary market sales of CDBG rehabilitation loans describes and analyzes the mechanics of several types of loan sale efforts by several CDBG entitlement grant recipients during 1985–1992. The study inventoried the then-current use of CDBG revolving funds, summarized experience with the sale of CDBG rehabilitation loans, and illustrated the experiences of selected cities in their efforts to sell loan portfolios.

This Appendix focuses on why a community may choose to securitize or sell loans as part of its community development program and addresses specific regulatory requirements that must be met when a community uses this financing technique. Guidance on portfolio management and secondary markets, based on the HUD-funded study and other HUD experience, is also provided.

Definitions

This section contains simple definitions of some of the technical terms used in this Appendix.

- *Discount rate*—Usually, "discount rate" means the market interest rate the investor would expect to receive over the same period of time in a different investment. The discount rate is applied in determining the present value to the investor of the future income stream of a loan or security. The discount rate usually varies from investor to investor based on varying investor perceptions of risk inherent in the loan, and investor motivation.

  Since most CDBG loans are made at below-market (i.e., below discount) rates, this usually results in purchase offers that are substantially below the face value of the loans.

- *Income stream*—"Income stream" means the stream of loan payments (principal and interest) that the purchaser of the loan will receive over time as the loan is paid.

- *Loan*—"Loan" means to provide funds to a borrower in return for a promise to repay the principal, usually with interest. Investors are not often interested in forgivable and deferred loans because such instruments do not generate a predictable income stream.

- *Portfolio*—"Portfolio" means all the existing loans held by the grant recipient or subrecipient in a particular program or group of programs.

- *Present value*—"Present value" means the current value of the future income stream of an investment. The present value of an investment is calculated using a process called "discounting." In discounting, the investor takes the income stream from the loan and divides it into two portions: investment and return. The discount rate selected by the investor represents the return percentage he or she wants to achieve, so this rate is applied to calculate the maximum value he or she would be willing to invest now to purchase the income stream, and to assure the acceptable return later. Communities selling loans have generally found that the amount an investor is willing to invest in a community development loan is lower than the face value of the loan.

The amount the investor is willing to pay **now** to secure the future income stream is called the present value of the loan.

If the interest rate that borrowers are paying on the loan or group of loans being sold is below the market rate, the present value of the loan to an investor will often be below the face value of the loan. Thus, if purchased by a private investor, the loan will likely sell "at a discount" to allow the investor to receive an acceptable return from the payments.

❖ *Recourse*—"Recourse" means the provisions of a sale or securitization agreement that govern the seller's and buyer's responsibilities if a loan defaults. A sale made purely "without recourse" does not obligate the seller to take any action to protect the buyer's financial investment in the event of default. Neither is the buyer obligated to take any action to protect the seller's community development purposes. (However, under the CDBG program, grant recipients may not make sales without assuring that national objectives will be met.) Typical recourse options obligate the seller to repurchase a bad loan, to replace a bad loan with a good one, or to make payments on behalf of the borrower. The recourse agreement would obligate the buyer to pursue the selected alternate form(s) of recourse before, or instead of, pursuing foreclosure.

❖ *Seasoned loan*—A "seasoned loan" has a record of one or more on-time payments. Investors' requirements on the length of seasoning necessary prior to consideration for purchase may vary substantially.

❖ *Secondary market*—"Secondary market" means any investor (institutional or individual) that purchases loans.

❖ *Securitization*—"Securitization" is the opposite of whole loan sales and happens when several investors each buy a share, or portion, of a pool of loans. The shares are called securities. The principal and interest payments made by borrowers on the loans are passed through to the owners of the securities. Pooling loans allows the risk that any one loan will default to be shared among several security holders and usually results in a higher resale value for the overall pool of loans. Pooling loans of various interest rates and terms can be complicated to manage. (See the section below discussing Section 108 securitization).

- ❖ *Whole loan sales*—"Whole loan sales" are the opposite of securitization. Instead of selling securities on a pool of loans, each loan is sold as a separate investment (although buyers often purchase more than one loan at a sale). Whole loan sales are often used when the volume of loans to be sold is relatively small, sales of loans infrequent, or money to be generated by the sales insufficient to justify the costs of managing a loan pool.

Why Sell?

In virtually all communities, the funds available at any given time for community development are not sufficient to meet all current community development needs. Also, sufficient funds may not be available at a particular time to permit a community to address a particular need. Selling or securitizing CDBG loans can: 1) bring an income stream that would otherwise be scattered over future years into the present, creating a pool of funds for current investment, and 2) increase the volume of community development dollars available for investment by increasing the number of times the funds are re-spent each program year or planning cycle.

One caveat to consider is that when community development loans sell at substantial discounts, the initial investment of CDBG dollars may not be fully recaptured. The price paid for the loan, because it is discounted, may be less than the present value of what the grant recipient would have received in principal and interest, if the loan were not sold. In either case, the grant recipient gets its initial investment back: sooner, if the loan is sold to an investor; or later, if the loan is paid back directly to the grant recipient over the term of the loan. When the loan is substantially discounted for sale to an investor, a part of that repayment may be "leaked" out of the long-term community development economy. Sales can increase the volume of money available for community development over time only if the reuse of funds is quick enough to offset the discount or if the funds are leveraged in some manner.

Thus, in deciding whether to develop an ongoing loan sale effort, a community should consider whether a continuing volume of marketable loans will be generated quickly enough by the relevant loan program to support a program of repeated loan sales. Further, a loan sale vehicle involving the minimum possible discount might be considered as the best vehicle for reducing possible leakage (see discussion of Section 108 securitization later in this Appendix.)

Valuing Loans

In determining whether to purchase CDBG loans, individual and portfolio loan value to the investor is not simply based on the dollar amounts and financial ratios involved. The value assigned in the discounting process is affected by the quality of the loan documentation, the payment record on the loan, how any defaults will be handled, the terms of the loan (for example, is it forgivable?), and on government policies that may affect the risk to the investor or cost of administering the loan portfolio. Usually, the private investor is trying to find a loan or security to purchase that offers maximum return for minimum risk. Some public and private purchasers have a second motive driving loan selection: they wish to invest in community development. These investors may therefore be able to accept a lower return if the loan program contributes to community development.

To most potential loan purchasers, quality loan documentation equals standardized loan documentation. This means the same underwriting tests, applications, and other documents are completed and present in EVERY loan file. A simple rule in dealing with secondary markets is to remember that the familiar, standard loan (whose return is more predictable) will nearly always sell better than a unique one that must be explained (sometimes called a "story loan"). Good files document each loan's payment record for purchasers to use in determining the risk to their investments. Many purchasers prefer to purchase seasoned community development loans with quality loan documentation.

How will defaults be handled? What recourse is available for the purchaser, the grant recipient, and the family or business paying the loan in the event the loan defaults? These are critical questions in determining the marketability of the loan. They are also important policy issues whose solutions should support community development purposes. This topic is discussed in the section below entitled *In case of default…* and is examined in detail in the HUD-funded study. CDBG rules affecting the handling of defaults are generally related to the rules about handling program income. (See 24 CFR 570.489(c) of the State CDBG regulations; other guidance on program income as well as defaults is available in the *Program Income Training Bulletin for the Entitlement Program* (HUD/CPD-90-1, April 1990), available from HUD.)

Government policies that may affect risk to the investor range from how the underwriting standards of the loan program are set to whether other community development support (in the form of assistance for affordable housing, infrastructure, businesses, and public service) is provided in the geographic areas served by the loan program. In general, the more risk perceived by the investor, the higher the return that investor will demand. So loans that are perceived to be more risky will generally sell for a greater discount off their face value. It appears from the HUD-funded study that large national or regional financial investors that have less of a stake in the local economy tend to look more at the financial risk factors associated with the loan, while local financial institutions are better positioned to evaluate the non-financial factors affecting investment risk. These local institutions may therefore accept a smaller discount on the loans and be more open to providing some additional benefits to the loan program.

Securitizing With Section 108 Loan Guarantees

Section 108 provides all the tools needed to securitize new or existing loans. More information on the basics of the Section 108 program is included in Attachment A to this Appendix, and HUD field office staff are available to work with any community that would like to pursue using the Section 108 program.

To securitize *new* loans, Section 108 provides an interim financing facility for originating the loans. The Section 108 permanent financing program provides both the actual financing for the securities and a credit enhancement (the federal guarantee backed by the pledge of CDBG grants). Payments on the loans are passed through to the Section 108 note holders.

Section 108 provides a securitization opportunity for *existing* CDBG loans as well. The securitization would be structured in a fashion similar to the securitization of new loans, except that the community would sell (and HUD would guarantee) securities backed by a pool composed of existing CDBG loans. By pledging future payments on existing CDBG loans to the repayment of Section 108 obligations, a community can “unlock” those loans from its balance sheet. The proceeds from the issuance of the Section 108 obligations can then be used by the community to make additional loans. And the process can be repeated as the new loans begin to generate income.

Using Section 108 would almost always generate higher net proceeds from the securitization than could be realized from an unsubsidized sale of whole loans or from conventional securitization. This is true because the use of Section 108 involves a lower discount rate (the interest rate of Section 108 obligations is only slightly higher than rates on comparable Treasury obligations). A lower discount rate generates a higher present value (or sales proceeds amount). Further, the issuance costs for Section 108 obligations would be significantly lower than the costs (for example, accounting, legal, credit enhancement) associated with conventional securitization.

Other Secondary Markets

After the above discussion of Section 108 securitization, it may be asked: "Why pursue any other form of secondary market?" The answers to this question vary depending on the community development objectives of the grant recipient. One answer is that when the secondary market is a local bank, or group of banks, significant other benefits may accrue by developing local partnership arrangements. Several of the examples in the HUD-funded study involve local governments leveraging additional funds by implementing programs with local banks. Also, some other investors, such as the Neighborhood Reinvestment Corporation (NRC) acquire loans at quite attractive terms, essentially providing a subsidy to the community development programs they support.

Another benefit to pursuing loan sales or securitization through a private secondary market is that the purchaser will generally conduct a thorough review of the portfolio focused on the seller's underwriting and portfolio management practices. This review can provide valuable information, such as providing a realistic assessment based on private-market practices that supports allocating a dependable level of resources for managing these activities. Philosophically, some local governments may be most comfortable not involving another public resource or federal approval for selling what is, in most cases, a local asset.

A HUD-funded technical assistance demonstration project resulted in one sale of a well-managed portfolio to a private investor. Securitization was essential in that case because the state was unwilling to allocate additional grants or guarantees to continue an ongoing loan program for small businesses. Analysis in two other jurisdictions found that similar transactions (through a private foundation, bank, or other institution) might be feasible. However, in all three cases the securitization approach involved significant costs of assembling data and negotiating the basic assumptions of each transaction.

Issues

The issues discussed below arose during HUD staff discussions with communities developing and implementing loan sale programs.

Creaming:

"Creaming" means taking care of the richest of the poor, taking the fewest risks possible with community development dollars. Creaming may violate CDBG rules: activities that meet Low- and Moderate-Income national objective criteria must be designed so that they do not benefit moderate income persons to the exclusion of low-income persons. (24 CFR 570.483(b)) Creaming is an issue when (re)designing a community development loan program to facilitate later sale of the loans because loans to moderate-income persons in stable neighborhoods are going to be more attractive investments on their face than loans to low-income persons living in or adjacent to slum or blighted areas. The design of a community development loan program must be primarily focused on solving a community development problem, and secondarily supportive of possible loan sale efforts.

In case of default:

Grant recipients should pay close attention to the recourse terms in any loan sale. Although some may choose to sell their loans and be finished with them, this may not be the best course for assuring that community development objectives are met, and it may result in a deeper discount on the loans (without recourse, the buyer will have to take on all costs of any defaults). If loans are sold with recourse, the seller takes on any default risk, but generally will receive a higher price, because most buyers will pay more for a less risky investment.

Usually recourse terms require the seller to take responsibility for a defaulted loan, either through purchase, exchange, or by making good any payment shortfalls. Such repurchase using CDBG funds is eligible if the recourse terms are clearly specified in the original sale agreement. In the first two options, once the seller (usually the grant recipient or a subrecipient) has the loan, it can evaluate whether its community development objectives will be better met by negotiating a work-out agreement with the borrower, or by entering into foreclosure proceedings. Most purchasers, if not allowed this recourse, would move straight to foreclosure. By insisting on some alternate form of recourse, grant recipients will incur the additional administrative costs of handling any defaulted loans, but they can also ensure that their clients and goals are best served.

Meeting a national objective:

Even after loans are sold, HUD holds the grant recipient responsible for ensuring that each loan meets all program requirements, including meeting a national objective. Note that most housing rehabilitation loans qualify under the Low- and Moderate-Income Housing national objective. This objective is met on occupancy of the rehabilitated unit by an income-qualified household upon completion of the rehabilitation. Thus, by the time of sale, most of these loans will have met a national objective. The Department expects that loans with national objectives unmet at the time of sale will primarily be for economic development. It is important that a community selling its economic development loan portfolio take precautions to ensure that the national objective has already been met for each loan (usually by creation of jobs) or that the responsibility for doing so is passed on to the purchaser of the loan.

Program income:

Program income is income received by the state, state grant recipient, or subrecipient directly generated from the use of CDBG funds. Generally, program income must be treated as additional CDBG funds, subject to all applicable requirements governing the use of CDBG funds (24 CFR 570.489(e)). If a state grant recipient sells a loan, the proceeds of the sale are program income. In such a case, the income from the loan repayments, which are received by the investor, is no longer program income. Also, if the aggregate amount of income received by the state grant recipient and its subrecipients during a single year totals no more than $25,000, such income would not be program income (24 CFR 570.489(e)(2)(i)).

Portfolio management:

The HUD-funded study identified deficiencies in portfolio management as one of the most common road blocks to the sale of CDBG loans. Such management deficiencies may also result in a grant recipient's failure to effectively meet its community development objectives or in unwitting regulatory violations. In the context of this Appendix, sensible portfolio management can decrease loan defaults and delinquencies and thereby increase the sale value of CDBG loans. Although local government community development policies that dictate higher-risk loan types or clients may also entail a higher default rate, prudent management can maximize the value of even the riskiest loans.

HUD encourages grant recipients to take a "systems approach" to improving portfolio management. This means that, although portfolio management technically is concerned with activities taking place after loans are made, an effective portfolio manager examines every step of the process from marketing and application review to loan closing and disbursement, through the years of loan management until the final payoff. A systems approach to portfolio management will not only decrease delinquency and default rates, it will assure the best service for the borrowers and ensure CDBG regulatory compliance.

The systems approach to portfolio management allows each decision made in designing the loan program to be examined for its ultimate effect on default and delinquency rates and payoff. Clearly, designing a loan program with the sole goal of the highest possible return and lowest delinquency-default rates would not result in a program that served low- and moderate-income borrowers or loan needs such as gap financing for small start-up businesses. Using the systems approach to design a program to serve higher-risk borrowers will result in the lowest possible delinquency-default rates for that type of program. Already, some trade magazines for the home mortgage and banking industries have noted, with some surprise, that the default rates for many programs offering supposedly higher-risk lending to lower-income borrowers are not nearly as high as expected, often falling within acceptable mainstream rates. This record can be further improved by following the principles of effective loan portfolio management, which are:

- ✓ Institutional commitment to recovering funds,
- ✓ Active management of the portfolio,
- ✓ Comprehensive systems planning,
- ✓ Written policies and procedures,
- ✓ Complete documentation of loans, and
- ✓ Dedication to staff training in all aspects of the portfolio management process.

For in-depth information on the systematic approach to portfolio management, HUD has developed a guide called “Loan Portfolio Management” through a contract with Price Waterhouse. The guide includes a self-assessment for grant recipients to complete in determining how to improve their portfolio management system and program design. A paper or electronic copy of this guide, plus a list of any other available publications on related topics, may be obtained by contacting the Communities Connections Information Center (telephone 800-998-9999, or electronic mail at Comcon@aspensys.org). This guide was developed with a focus on economic development loans, but the principles are the same for almost any type of loan management by local governments.

Attachment A
Department of Housing and Urban Development
Office of Community Planning and Development

Section 108 Loan Guarantees

Section 108 is the loan guarantee provision of the Community Development Block Grant (CDBG) program. Section 108 provides communities with a source of financing for economic development, housing rehabilitation, public facilities, and large scale physical development projects. Regulations governing the Section 108 program may be found at 24 CFR 570, Subpart M, "Loan Guarantees."

Eligible Applicants and Activities

Eligible applicants include the following public entities:

- ✓ Metropolitan cities and urban counties (i.e., CDBG entitlement recipients);

- ✓ Nonentitlement communities that are assisted in the submission of applications by states that administer the CDBG program; and

- ✓ Nonentitlement communities eligible to receive CDBG funds under the HUD-Administered Small Cities CDBG program.

The public entity may be the borrower or it may designate a public agency to be the borrower.

Activities eligible for Section 108 financing include:

- ✓ Economic development activities eligible under CDBG;
- ✓ Acquisition of real property;
- ✓ Rehabilitation of publicly owned real property;
- ✓ Housing rehabilitation eligible under CDBG;
- ✓ Construction, reconstruction, or installation of public facilities (including street, sidewalk, and other site improvements);
- ✓ Related relocation, clearance, and site improvements;
- ✓ Payment of interest on the guaranteed loan and issuance costs of public offerings;
- ✓ Debt service reserves;
- ✓ Public works and site improvements in colonials; and

- ✓ In limited circumstances, housing construction as part of community economic development, Housing Development Grant, or Nehemiah Housing Opportunity Grant programs.

For purposes of determining eligibility, the CDBG rules and requirements apply. As with the CDBG program, all projects and activities must either principally benefit low- and moderate-income persons, or aid in the elimination or prevention of slums or blight, or meet urgent needs of the community.

How the Program Operates

Maximum commitment amount:

Commitments are limited as follows:

- ❖ *Entitlement public entities.* An entitlement public entity may apply for up to five times the public entity's latest (approved) CDBG entitlement amount, minus any outstanding Section 108 commitments and/or principal balances on Section 108 loans.

- ❖ A non-entitlement unit of general local government may borrow up to $7,000,000. However, the maximum amount of guaranteed outstanding guaranteed loans for all non-entitlement borrowers in a state cannot exceed five times the amount of the state's most recent annual CDBG allocation.

- ❖ *Nonentitlement public entities eligible under the HUD administered Small Cities Program.* For a public entity in Hawaii, the maximum commitment amount is five times the public entity's latest grant under 24 CFR Part 570, Subpart F, minus any outstanding Section 108 commitments and/or principal balances on Section 108 loans.

Security. The principal security for the loan guarantee is a pledge by the applicant public entity or the state (in the case of a nonentitlement public entity) of its current and future CDBG funds. Additional security will also be required to assure repayment of the guaranteed obligations. The additional security requirements will be determined on a case-by-case basis, but could include assets financed by the guaranteed loan.

Loan repayment. The maximum repayment period for a Section 108 loan is twenty years. HUD has the ability to structure the principal amortization to match the needs of the project and borrower. Each annual principal amount will have a separate interest rate associated with it.

Financing source. Section 108 obligations are financed through underwritten public offerings. Financing between public offerings is provided through an interim lending facility established by HUD.

Interest rates. Interest rates charged on interim borrowing is priced at the three-month London Interbank Offered (LIBO) rate plus 20 basis points. Permanent financing is pegged to yields on Treasury obligations of similar maturity to the principal amount. A small additional basis point spread, depending on maturity, will be added to the Treasury yield to determine the actual rate.

Default. To date, there has been no default under Section 108 resulting in a payment by HUD as a result of a claim by a holder of the guaranteed obligation. In the event of default requiring a payment, HUD would continue to make payments on the loan in accordance with its terms. The source of payments by HUD pursuant to its guarantee would almost always be pledged CDBG funds. However, HUD does have borrowing authority with the Treasury if the pledged funds are insufficient.

Developing an application. Nonentitlement communities wishing to apply for Section 108 loan guarantee assistance are advised to contact HUD and their state in advance for guidance in preparing an application. Public entities may contact either the Community Planning and Development staff at the appropriate HUD field office or the Section 108 office in Washington at (202) 708-1871.* Application guidance can also be found in the Section 108 regulations at 24 CFR 570.704, "Application Requirements."

**Hearing impaired users may call the Federal Information Relay Service at 1-800-877-8339.*

Program Trends and Accomplishments

The Section 108 program has undergone several major changes since its establishment in 1974. In 1987, HUD was directed by Congress to utilize a private sector financing mechanism to fund the loan guarantees as opposed to using federal funds. In 1990, legislative changes increased public entities' borrowing authority to five times the CDBG allocation, extended the maximum repayment period to twenty years, and made units of general local government in nonentitlement areas eligible to apply for loan guarantee assistance. Since its implementing regulations were published in 1970 the following activity has occurred:

Fiscal Year	# of Commitments	$ Amount (000)
1978	1	476
1979	9	30,810
1980	23	156,933
1981	48	156,487
1982	52	179,377
1983	22	60,627
1984	29	86,952
1985	63	133,475
1986	25	113,290
1987	13	30,007
1988	43	143,578
1989	48	122,970
1990	44	119,260
1991	26	84,466
1992	46	163,780
1993	43	229,300
1994	88	350,520
1995	218	1,847,005
1996	89	433,775
1997	118	277,683