

Subsidy and the Charter School Facilities Finance Market

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Introduction

This study describes how Community Development Financial Institutions (CDFIs) have used public incentives to increase access to capital by public charter schools in the United States.

Charter schools are an important innovation that has improved the educational outcomes of many low-income children and positively affected the broader communities in which the schools are located. Charter schools are public schools; however, they are permitted to operate independent of the traditional structures that govern public schools in exchange for achieving the academic goals specified in their charter contract. Charter schools are not permitted to practice selective enrollment or to charge tuition. In most states, they are given a five-year period to demonstrate results and are required to have their charter renewed at the end of that term. "Chartering," as it is called, has made way for an era of educational entrepreneurship. New discoveries clearly demonstrate that all children can learn and excel academically regardless of their socio-economic background. However, as with every entrepreneurial endeavor, there are challenges and risks.

The funding formula for charters presents a significant obstacle. Public funds are usually allocated on a per-pupil basis at an amount comparable to what district schools spend to educate a child. Unfortunately, funding formulas consider only the cost of operations and do not factor in capital costs for facilities. Charter schools have generally had to find and finance facilities on their own, relying on the financial markets to supply capital. The capital markets have stubbornly resisted financing charter schools because of the risks inherent in the chartering and renewal processes and the relatively short operating history of the industry.

In response to these challenging circumstances, the federal government developed two national subsidy programs in the 1990s designed to help the charter school movement go to scale. The Charter Schools Program, first authorized in 1994, provides charter school organizers with early-stage venture capital to develop resources and get new schools started. The program also provides resources to collect and disseminate information on the policy and practice of charter schools.

A second federal initiative, the Credit Enhancement for Charter School Facilities Program (CECSF), began in 2002. This program helps charter schools obtain financing for facilities through intermediaries that offer credit enhancement to investors. While this program was not intended specifically for CDFIs, they have proven to be the most effective vehicle for organizing and delivering capital to this nascent market. CECSF has created greater access to capital, spurred financial product innovation, and bolstered the importance of CDFIs within the educational sector. CDFIs played a key role in helping charters gain access to capital, both by taking on risk early in the field's development and by using federal subsidies to attract considerable private capital to the charter school movement.

The federal programs used to support the charter school industry can be considered smart subsidies for several reasons. Charter schools convey social benefits deemed important by society through improving educational outcomes for low-income children, enabling them to become productive members of society, and reducing public expenditures related to poverty and unemployment. The two federal programs have clearly helped charter schools overcome common barriers to their establishment and development, resulting in substantive growth of the field. Additionally, CDFIs are effective and

efficient intermediaries between charter schools and the capital markets, putting federal dollars to work with good results and leveraging \$8 in private-sector capital for every \$1 of federal funds.¹

The Obama Administration has raised scale and innovation in education reform to a new level through Race to the Top and the Investing in Innovation Fund (i3 Fund) programs. These programs should benefit charter schools by improving the general environment for education; but it is unfortunate that these programs do not address the facilities financing issues for charter schools. Facilities are likely to remain a major constraint to scaling up the charter movement.

A Closer Look at Charter Schools and the Facilities Conundrum

In this section I describe why charter schools are promising innovations for underserved communities and the challenges these schools face in raising capital to finance facilities.

The Case for Charters

Charter schools have gained momentum not only because of weaknesses in the overall academic performance of public schools, but also because traditional public schools have not adequately addressed the achievement gap between white and minority students.

Since the publication of the 1983 landmark study, *A Nation at Risk*, education reformers have struggled to address what the report cites as “disturbing inadequacies” in our public school system that threaten to erode the foundations of American society.² According to the study, the underpinning of a thriving democracy is an educated population. Despite the overall gains in performance since 1983, the US ranks only 18th among the 36 industrialized nations in terms of secondary education, according to the Organization for Economic Cooperation and Development.³

In addition, despite the promise of school desegregation since *Brown v. the Board of Education*, the achievement gap between white and minority students has remained an intractable problem. The achievement gap is defined as the difference between the average scores of student subgroups on standardized assessments. According to *The Nation’s Report Card*, an annual report prepared by the National Assessment of Educational Progress (NAEP), in 2009 the 4th-grade reading achievement gap between white and black students was 26 points, and the gap between white and Hispanic students was 25 points (see Figure 1).⁴ About 42 percent of white, 16 percent of black, and 17 percent of Hispanic 4th-graders performed at or above the *Proficient* achievement level.⁵ In mathematics, the achievement gap between white and black students in 2009 was 26 points and the gap between white and Hispanic 4th-graders was 21 points (see Figure 2). About 51 percent of white, 16 percent of black, and 22 percent of Hispanic 4th-graders performed at or above the *Proficient* achievement level.

¹ The Charter School Coalition, an unincorporated group of 18 community development practitioners working together to preserve and enhance federal support for charter school facilities funding. <http://www.thechartercoalition.org/>.

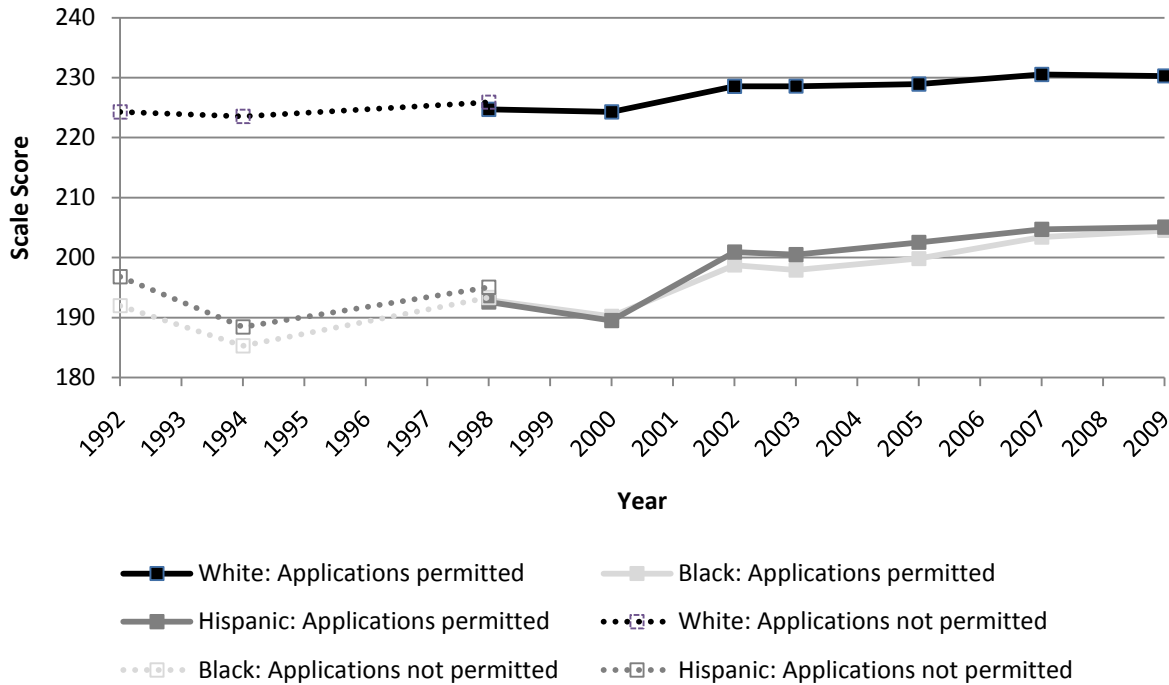
² *A Nation at Risk: The Imperative for Educational Reform*. The National Commission on Excellence in Education, 1983. <http://www2.ed.gov/pubs/NatAtRisk/index.html>.

³ “U.S. Slipping in Education Rankings,” United Press International, http://www.upi.com/Top_News/2008/11/19/US_slipping_in_education_rankings/UPI-90221227104776/.

⁴ *The Nation’s Report Card: Grade 12 Reading and Mathematics 2009 National and Pilot State Results*. National Assessment of Educational Progress (NAEP), 2010. <http://nces.ed.gov/pubsearch/pubsinfo.asp?pubid=2011455>.

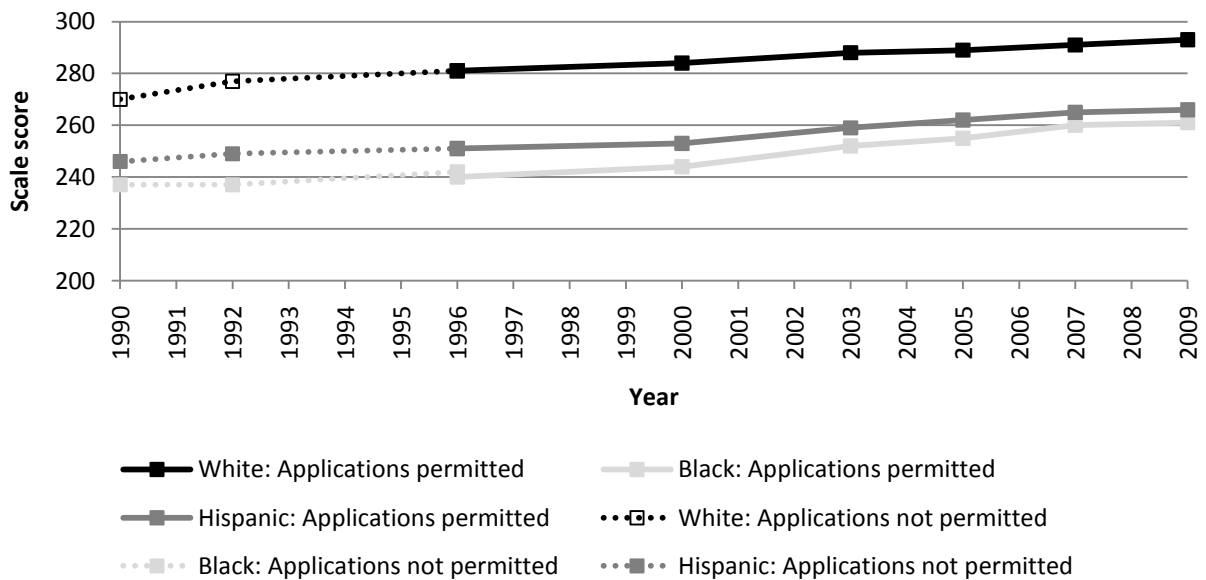
⁵ Alan Vanneman, Linda Hamilton, Janet Baldwin Anderson, and Taslima Rahman. *Achievement Gaps: How Black and White Students in Public Schools Perform in Mathematics and Reading on the National Assessment of Educational Progress*. National Center for Education Statistics, Institute of Education Sciences, U.S. Department of Education. Washington, DC, 2009.

Figure 1
Average 4th-Grade Reading Scale Scores, by Race/Ethnicity: 1992-2009



Source: U.S. Department of Education, National Center for Education Statistics, National Assessment of Educational Progress (NAEP), selected years, 1992–2009 Reading Assessments, NAEP Data Explorer.

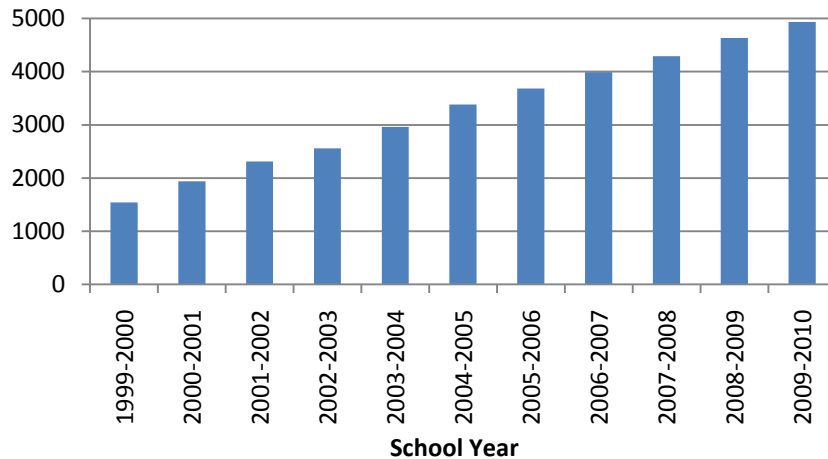
Figure 2
Average 8th-Grade Mathematics Scale Scores, by Race/Ethnicity: 1990–2009



Source: U.S. Department of Education, National Center for Education Statistics, National Assessment of Educational Progress (NAEP), selected years, 1990–2009 Mathematics Assessments, NAEP Data Explorer.

While many valuable experiments have been devised to spark changes in public school performance, no other innovation has been as widespread as the creation of charter schools. As of August 2010, 40 states and the District of Columbia had charter laws. Figure 3 illustrates the growth of charter schools since the first law was passed in Minnesota in 1991.

Figure 3
Number of Operating Charter Schools

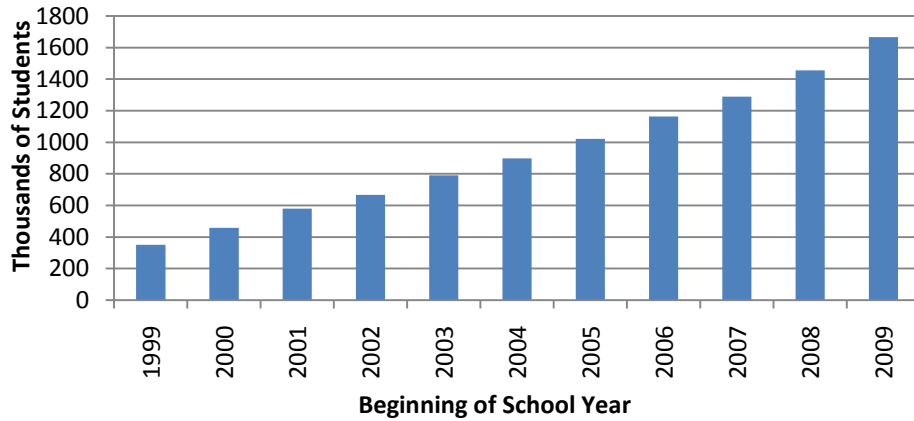


Source: National Alliance for Public Charter Schools (2010), <http://www.publiccharters.org/>.

Today, approximately 4,936 charter schools operate across the United States, with enrollment of more than 1.5 million students.⁶ They now make up 5 percent of all U.S. public schools. As the number of charter schools has grown, so has the number of students enrolled in these schools (see Figure 4). In some cities, such as New Orleans and Washington, D.C., charter schools account for a significant percentage of total public school enrollment. For example, New Orleans has 60 percent of its public school students enrolled in charter schools, making it the only city in the nation where the majority of public school students attend charter schools. Washington, D.C. has approximately one third of its total school population in charter schools.

⁶ National Alliance for Public Charter Schools (2010), <http://www.publiccharters.org/>.

Figure 4
Charter School Enrollment Over Time

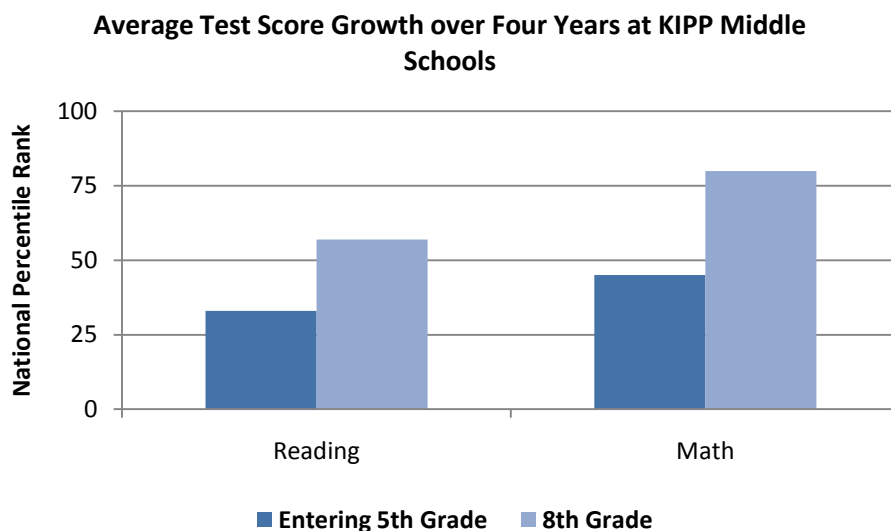


Source: National Alliance for Public Charter Schools (2010), <http://www.publiccharters.org/>.

In terms of addressing overall academic performance, charters show mixed results when aggregated. However, some charter schools outperform their peer public schools by large margins, and many are showing real progress in closing the achievement gap. For example, the well-known Knowledge Is Power Program (KIPP) begun in 1994 now has 82 schools serving 21,000 students in more than 40 underserved communities across the country. KIPP annually measures the performance of its middle-school students against national norms. The 2009 data show that students on average entered KIPP in fifth grade ranking in the 45th percentile in math and the 33rd percentile in reading. By the end of eighth grade, KIPP students were performing on average in the 80th percentile in math and the 57th percentile in reading (see Figure 5). These figures reflect comparisons against all students in the United States, not only other urban schools or other low-income, minority students. In the 2008–2009 school year, 100 percent of KIPP schools outperformed their district and state averages in both reading and math.⁷

⁷ Knowledge is Power Program (KIPP). Kipp Report Cards 2007 and 2009. <http://www.kipp.org/about-kipp/results/annual-report-card/annual-report-card/updateapp/false>.

Figure 5
Comparison of KIPP Schools to National Norms



Charter School Funding

Because they receive funding only for operations, not facilities, all charter schools struggle to secure a space to call home. Unlike school districts, charter schools do not have the authority to issue bonds that can be repaid with tax proceeds. The problem is made worse by the lack of funding parity with their traditional public-school counterparts. Data from the National Alliance for Public Charter Schools show that charter schools, on average, collect about 78 percent of what traditional schools are allocated on a per-pupil basis.⁸ Addressing the facilities problem is important because:

- Facilities issues absorb the time and energy of school administrators, whose expertise is education, not real estate development.
- Facilities costs can deplete resources that should be spent on instruction rather than on bricks and mortar.
- Facilities problems prevent some schools from expanding to meet demand and, in some cases, block new charter schools from opening.

Despite these challenges, the number of charter schools has grown rapidly, creating a demand for facilities financing in the tens of billions of dollars. Annual demand is conservatively estimated to be approximately \$1.5 billion.⁹

⁸ National Alliance for Public Charter Schools, 2008. <http://www.publiccharters.org/>.

⁹ There are no formal estimates of charter school demand for facilities financing. The author estimated demand using two methods. The first calculation assumed that each student requires 100 square feet of space, and that each square foot of space costs on average \$200 to develop, including hard and soft costs. Assuming an average life of the space of 20 years, and equal spacing of construction over 20 years, demand per annum at today's enrollment would be \$1.5 billion. If it is assumed that 20 percent of schools need facilities development, the number rises to \$6 billion.

Another calculation was made using the estimated demand for facilities investment by all public schools and multiplying it by the charter school market share of 3 percent. A June 2000 report from the National Center for

Why are Charter Facilities So Hard to Finance?

Charter schools that seek to finance their facilities face the challenge of finding capital in an underdeveloped market. Banks and other financial institutions have been reluctant to lend to all but the most credit-worthy charter schools. The reasons for this are not surprising. They include:

- Charter schools in need of financing are likely to be start-up or early-stage ventures with an unproven financial track record.
- The terms of their charters are usually three to five years, yet they may require amortization schedules of 20 years or more to make debt service affordable.
- Charter contracts stipulate the closure of the school if it fails to reach its academic goals.
- The risk of not meeting the conditions of the charter is increased by charter schools' tendency to enroll low-performing students.
- Charter school buildings are often single-purpose assets with limited reuse potential. In addition, the facilities are often located in low-income communities where real estate values may not support the cost of redevelopment.
- Charters can face opposition at the state and local levels from stakeholders within the traditional public school system. Objections are most passionate around the autonomy and resources granted to charter schools.

With such a long list of significant risks to mitigate, traditional investors have shied away from charter schools. Because of this—and because of the potentially high social benefits of supporting charter schools—efficient and effective use of public incentives are an important mechanism for attracting private investment. CDFIs entered the charter school market because they saw an opportunity to add value even before public incentives for financing facilities were made available. Further, CDFIs found charters to be a mission-rich market, as described more fully below.

The Role of CDFIs

CDFIs have been providing facilities financing to charter schools for more than 15 years. This section describes why CDFIs entered the charter market, how they have shaped it, and how CDFIs have effectively used federal subsidy programs to develop the market for facilities financing.

Why Charters?

Most CDFIs do not think of themselves as educational reformers. So what motivates them to be players in the charter school market? There are three major influencing factors.

The first is simply the demand for development capital. Because charter schools must look to the private market for capital to support facilities, from the outset they discovered that finding, developing, and paying for a facility were among the most formidable obstacles to starting and expanding their schools.¹⁰ Initially capital market investors were unresponsive to the financing needs of charter schools.

Education Statistics estimated that \$127 billion is needed to fix America's school buildings (*Condition of America's Public School Facilities*). This figure is consistent with the findings of a 1994 GAO study that estimated the cost of bringing schools into good overall condition to be \$112 billion (*School Facilities: Conditions of America's Schools*). Others estimate that the cost to construct new schools and classrooms and to modernize existing schools is more than \$300 billion nationwide. If we take the lowest estimate of \$112 billion and multiply by 3 percent, this would result in a demand calculation of \$3.4 billion. To be conservative, it is assumed that demand is at least \$1.5 billion.

¹⁰ Paul Bernan, John Ericson, Beryl Nelson, Rebecca Perry, and Debra Silverman. *A National Study of Charter Schools: Second-Year Report*. U.S. Department of Education, July 1998.

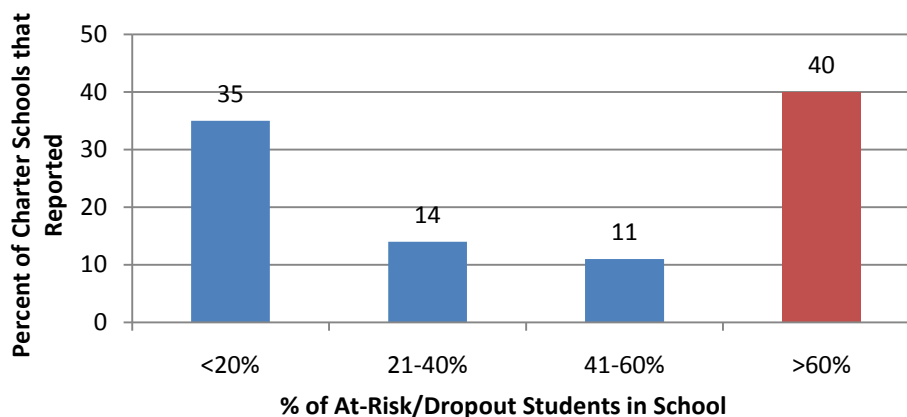
As a result, CDFIs moved in to fill the void. However, even after more than 15 years of operations, charter schools still find financing facilities to be a major concern.

A second factor that drew CDFIs to the market is that, although created to improve the quality of public education, charter schools are proving to be an effective tool for community development and revitalization. Because they tend to serve low-income, minority students, charter schools are disproportionately located in urban areas that are financially underserved—a prime market for CDFIs. Charter schools often redevelop underused or dilapidated properties and convert them into attractive spaces. The adaptive reuse of existing facilities helps to preserve land and reduce sprawl. These smart-growth principles contribute to community and neighborhood sustainability. The schools create jobs and attract ancillary businesses and services to the immediate neighborhood, helping to anchor community development efforts.

A third factor, and perhaps the most compelling, is that charter schools are designed to improve the quality of education for low-income students in many communities. Most charters are founded by parents, teachers, educational entrepreneurs, and other community leaders seeking better educational outcomes for low-income children who otherwise have no choice but to participate in an educational system most agree is failing them.

Depicted in Figure 6 are data from the Center for Education Reform showing that 40 percent of charter schools serve student populations among whom 60 percent or more are considered “at-risk.” In communities where children have less than a 50-percent chance of completing high school, some charters work to prepare these students for college. This is a significant poverty alleviation strategy.

Figure 6
Charter School Demographics: At Risk/Dropout



Source: *Annual Survey of America's Charter Schools*, The Center for Education Reform, 2010.
http://www.edreform.com/Resources/Publications/?Annual_Survey_of_Americas_Charter_Schools_2010.

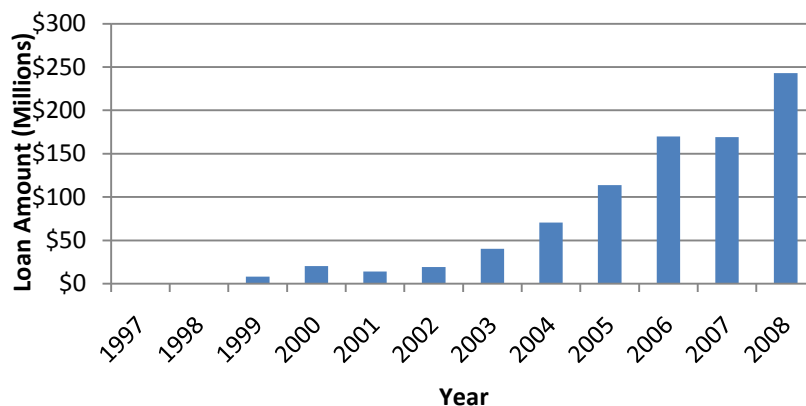
The Impact of CDFIs

CDFIs began addressing the needs of charter schools shortly after the first state charter law was enacted. In 1993, NCB Capital Impact made a small pre-development investment of \$25,000 in EdVisions, a teacher-owned cooperative that opened Minnesota New Country School (NMCS), one of a small group of charters operating in 1994. According to the Local Initiatives Support Corporation (LISC),

there are now 29 private nonprofit organizations offering facilities financing.¹¹ Collectively these organizations provided more than \$1.1 billion in direct financial support. All organizations surveyed in the report are either certified as CDFIs by the Treasury Department’s CDFI Fund or are nonprofit organizations with a common mission of providing development finance to one or more underserved markets.

Figure 7 shows the aggregate growth of charter lending volume among the nine most active CDFIs: Community Loan Fund, IFF, LISC, Low Income Investment Fund, NCB Capital Impact, Raza Development Fund, Nonprofit Facilities Fund, Self-Help, and The Reinvestment Fund. From 1997 to 2008, CDFI disbursements grew from \$275,000 to nearly \$250 million per year. Cumulative disbursements over this 12-year period exceeded \$870 million, a volume that achieves sufficient scale to affect the industry and attract the attention of the capital market investors. Over 80 percent of the schools financed serve a majority of low-income children. CDFIs provided a range of products, including loans for mortgages, leasehold improvements, and working capital.

Figure 7
CDFI Loans to Charter Schools



Source: NCB Capital Impact Survey

In the earliest days of the charter movement, schools had to raise start-up funds through charitable gifts and high-risk loans. When the Clinton administration established the Charter Schools Program in 1994 to provide start-up funding under Title X of the Elementary and Secondary Education Act, the need for high-risk start-up working capital loans was alleviated.

The problem of finding, leasing or buying, and renovating space then rose to the top of the list as the biggest barrier to opening schools. The first studies of charter schools commissioned by the U.S. Department of Education in the late 1990s showed that charters tended to be smaller than the average public school, with seven out of ten leasing space, a trend that continues today.¹² Average enrollment in

¹¹ Elise Balboni, Reena Bhatia, Kathy Olsen, Sara McCuiston, Jeffrey Meyers. *Charter School Facility Finance Landscape*. Local Initiatives Support Corporation, June 2010. <http://www.lisc.org/content/publications/detail/18446/>.

¹²Berman, Ericson, Nelson, Perry, and Silverman, 1998.

charter schools has been 22 percent lower than in conventional public schools, and only 33 percent of charter schools own their buildings.¹³

When it came to space, many schools had to improvise, occupying temporary spaces, church basements, vacant storefronts, or unused public school buildings. Accordingly, leasehold improvement loans, as well as first-mortgage loans available to those schools capable of owning their facilities, have been important products of CDFIs. Loan amounts tended to be in the \$250,000 to \$2 million range. Charter school loans held by CDFIs have performed well, despite the perceived risks in the market. Most CDFIs experienced default rates of less than one percent, with no history of loan losses. By borrowing and paying back loans, charter schools were beginning to establish creditworthiness.

Banks, however, were still reluctant to get involved. While the tax-exempt bond market, the source of affordable, long-term debt for traditional public schools, was beginning to pay attention to charter schools, there was still a healthy dose of skepticism elsewhere. Not more than a handful of bond deals for charter schools had been executed. In 1999, Moody's Investment Services published its first analysis of the charter school market. Standard and Poor's and Fitch soon followed. Most bond deals were rated below investment grade, which meant that charter schools were still paying relatively high rates for capital. In a 2002 report, Fitch asserted that despite strong demand, "Schools without three to ten years of successful operating history or substantial credit enhancing features will remain hard pressed to earn investment-grade ratings. Most proposed bonds in the sector possess credit features consistent with the 'BB' or 'B' rating categories."¹⁴

The continued growth in charter school demand, as evidenced by increased enrollment at existing schools and the opening of new schools, put more pressure on those already willing to make charter loans. CDFIs were quickly running out of capacity to provide financing. Enrollment was growing at double-digit rates. Charter operators needed room to grow, and also wanted to upgrade their space to reflect their becoming long-term institutions.

Occupying permanent space was a way to achieve both. Transaction sizes began to climb as a result, requiring CDFIs to find even more creative solutions to serve the market. Fortunately, the federal government devised a useful way to help.

Federal Support for Charter School Facilities

To encourage investors to respond to the needs of charter schools, Congress appropriated \$25 million in 2001 to create a credit enhancement demonstration program.¹⁵ The original purpose of the program was to find innovative, market-based solutions to the facilities financing problem. After a successful first year, the Charter School Facilities Program (CECSF) program was authorized under the No Child Left Behind Act and funded at approximately \$36 million per year through 2007. In 2008 and 2009, funding dropped to \$8.3 million per year.

To date, the U.S. Department of Education, through the Office of Innovation and Improvement, has awarded \$222 million under the program, 85 percent of which has gone to CDFIs.¹⁶ Although the program is open to a variety of organizations, CDFIs have proven to be the most effective vehicles for delivering capital to this nascent market. As referred to earlier, data compiled by The Charter School

¹³ *Annual Survey of America's Charter Schools*. The Center for Education Reform, 2010.

¹⁴ *Growing Pains: Charter Schools Begin their Second Decade*. Fitch, Inc., April 29 2002. <http://www.fitchratings.com>.

¹⁵ The term "credit enhancement" in this context is defined as any mechanism that reduces the credit risk of investors in a financial transaction or shields investors from losses. Loan guarantees and reserves for loan losses are commonly used credit enhancements.

¹⁶ See the Department of Education Web site for a list of awardees by year, <http://www.ed.gov/programs/charterfacilities/granteelist.doc>.

Coalition show that program grantees have raised \$8 of private capital for every dollar of federal funding. Cumulative program awards to date have infused more than \$1.7 billion into the market. Despite an estimated annual demand of \$1.5 billion per year and an even greater total market size, the program is still not big enough to meet the full needs of the market. But CECSF has unquestionably created greater access to capital, spurred innovation, and bolstered the importance of CDFIs to the sector.

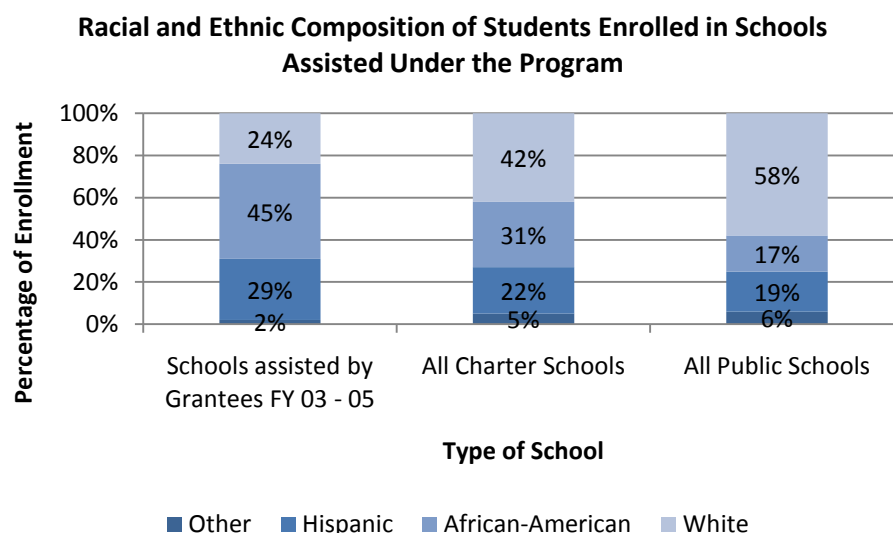
In 2008, the Department of Education issued a report on the CECSF program.¹⁷ While the study period extends only from 2003 to 2005, its findings are still useful for assessing the effectiveness of the program. The report draws the following conclusions:

- Many charter schools are unable to qualify for loans that could be used for facilities-related purposes because lenders perceive them to be too great a risk. The credit enhancements funded by the program reduce lenders' exposure to losses in the event that a charter school defaults on its loan. As a result, the program has improved charter schools' access to capital markets, resulting in more lending than would have occurred without the program.
- Many of the assisted schools, according to representatives of grantees, commercial lenders, investment banks, and rating agencies, would not have received facility loans at any price before the program, because lenders believed that these schools reflected a prohibitively high level of risk. With the addition of credit enhancements, assisted schools received loans with rates and terms that were better than would otherwise be available.
- Based on a review of loan-level data and information provided by grantees and assisted schools, there is evidence that grantees are using innovative methods, especially related to helping charter schools borrow directly from private lenders.
- Grantees disproportionately made loans to charter schools in which lower-income and minority students comprised a larger share of enrollment as compared to all charter schools and all U.S. public schools.
- Finally, the assisted charter schools themselves were located in census tracts with lower median household incomes and a larger proportion of minority residents than the counties in which the schools were located.

Figure 8 shows that 59 percent of the 23,162 students enrolled in CDFI-assisted charter schools were eligible for free or reduced-price lunches, compared to 39 percent of all students in public schools and 44 percent of all charter school students. Minority students accounted for a larger proportion of students in schools assisted by credit enhancement program grantees between FY 2003 and FY 2005 compared to students enrolled in all charter schools and all public schools. Between FY 2003 and FY 2005 the proportion of white students was 24 percent in schools assisted by grantees, 42 percent in all charter schools, and in all public schools it was 58 percent.

¹⁷ *Report on Implementation of Credit Enhancement for Charter School Facilities Program*. U.S. Department of Education, 2008.

Figure 8
Comparison of Racial/Ethnic Composition Served by Different Types of Schools FY 2003–FY 2005



Source: U.S. Department of Education, 2008

These results show that subsidy can effectively increase access to capital. CDFIs have been necessary intermediaries in the effective execution of the program. As banks utilized a small amount of credit under the CECSF program, it appears that without CDFI intervention, most banks would not have been motivated to come to the table. That the program disproportionately serves low-income students creates added social benefit. The CECSF helps address inequities in the capital markets as well as public education, a worthwhile use of public dollars.

Subsidy Spurs Access to Capital and Innovation

To understand further the benefits of the program, it is useful to describe some of the initiatives and products that have been created with CECSF support. They tell the story of how CDFIs have used subsidy for innovation and collaboration to shape a market response to the financing of charter school facilities.

With first-round funding, The Reinvestment Fund (TRF) and NCB Capital Impact collaborated to create the Charter School Capital Access Program (CCAP) Fund. TRF and NCB Capital Impact used a \$6.4 million grant as a first-loss reserve to create a \$45 million lending pool capitalized by leading banks and thrifts such as Citibank, JPMorgan Chase, and Bank of America. For many of the participants in the fund, CCAP was their first foray into charter school lending. Part of the goal for TRF and NCB Capital Impact was to demonstrate that charter loans could be prudent investments.

CCAP was a much easier proposition for financial institutions to consider than a direct loan to a charter school, in part because the banks did not actually have to make the loans themselves and therefore did not have to establish an in-depth understanding of the industry. At the time of creation, TRF and NCB Capital Impact each had at least five years of experience in the market, a collective portfolio of nearly \$40 million, and no loan losses to date. The two organizations had underwriting criteria that were consistent and time tested. The first-loss reserve was also attractive, since it fully protected investors for the first \$6.4 million of loan loss. Additionally, TRF and NCB Capital Impact each invested \$5 million into CCAP in a subordinate position to further protect the senior lenders. Under such a scenario, it became highly unlikely that investors would suffer losses.

The CCAP Fund has now run its course, and the credit enhancement dollars are being recycled into new deals, increasing the leveraging impact of the program. As of September 30, 2009, CCAP, along with an additional \$3.6 million supplemental grant added in a subsequent round of funding, has enhanced \$63 million in loans to 20 charter schools. Total leverage in these transactions was \$142 million, or over 14x.

Another grantee, IFF, used the CECSF program to pioneer the use of the CECSF program to enhance tax-exempt bonds for charter schools in Chicago. Through its Illinois Charter Capital Program (ICCP), created with an \$8 million grant from the CECSF, IFF facilitated bond issuances for charter operators by funding loss reserves that reduced the cost of bond insurance. The first two transactions, totaling \$18.7 million, created four new campuses serving 1,873 students, approximately 90 percent of whom are low income. The bonds are 25-year fully amortizing notes and are attractively priced.

In 2009, LISC used \$1 million in credit enhancement to leverage a \$10 million Program-Related Investment from the Gates Foundation to back over \$70 million in tax-exempt bonds for several schools in Texas. This was the first time a foundation pledged its balance sheet to enhance a bond, and it would not have happened without LISC's participation.

Another program currently under development is the Charter School Financing Partnership (CSFP). Though the financial crisis slowed its progress considerably, the program is still moving forward. In this case, the CECSF program enabled CDFIs to expand the boundaries of collaboration to achieve both product innovation for charter schools and industry innovation for CDFIs. A group of leading CDFIs facilitated by the Housing Partnership Network (HPN) gathered in Chicago at the MacArthur Foundation several years ago to discuss ways of working together to gain greater access to the capital markets. Various strategies were discussed, ranging from creating a CDFI-owned bank to aggregating and securitizing pools of loans. The conversation was initially not specific to charter schools but included all asset types originated by CDFIs. To find common ground, participants submitted data on lending activities segregated by asset type.

The data revealed something important that had not yet been quantified by participants: CDFIs were building enough scale in the charter sector to be taken seriously by the capital markets. To pursue the concept of securitizing charter school loans, a subgroup was formed that included the Low Income Investment Fund, NCB Capital Impact, the Raza Development Fund, Self-Help, The Reinvestment Fund, HPN, and the Community Reinvestment Fund, a national nonprofit financial intermediary that securitizes economic development loans.

The group created the CSFP as a cooperatively owned nonprofit LLC originally designed as a conduit to accumulate charter school debt and sell securities backed by the debt into the capital markets. It received a \$15 million grant from CECSF to implement its strategy. Unfortunately, shortly after its incorporation, secondary markets virtually disappeared in the financial melt-down. CSFP responded nimbly by crafting new approaches that it tested in the market until it reached its current design, a tax-exempt bond product targeted to charter schools that are either too small or too risky to access the tax-exempt market on their own. Alone, these charter schools would likely have credit ratings just below investment grade. The CSFP product will allow them to reach investment-grade rates and enjoy the benefits of better pricing and terms. CSFP attracted an additional \$5 million PRI from the Walton Family Foundation that is structured to achieve even lower interest rates than the market would offer on its own. The program is sized at approximately \$100 million.

The depth of collaboration required by CSFP exceeds any prior experience of its members. To accomplish its goals, CSFP participants use common underwriting criteria, adopt standard documents, and take shared risk in transactions. Further, the financial model of CSFP does not follow the "old rules." CDFIs do not hold originated assets in their portfolios, except for small residuals. This has an impact on both the income statements and the balance sheets of the CDFIs who originate loans. Fees replace earning assets, helping liquidity. To make the model work for both the market and CSFP, a high volume

of product origination is needed. Customized loan structuring as a way of doing business, a hallmark of CDFIs, is challenged under this model.

Finally, the most recent innovation spurred by CECSF is a \$250 million program created by JP Morgan Chase (JPMC) to finance charter facilities. JPMC chose three program grantees (NCB Capital Impact, TRF, and LIIF) to be its lending partners in a program that blends credit enhancement, subordinate capital, and New Markets Tax Credits to create seven-year, interest-only loans for charter facilities. The subordinate capital supplied by the CDFIs is in part funded by grants from JPMC to program participants. The grants will represent about 15 percent of total deal size. While the grants are restricted capital for the CDFIs, they nonetheless serve to strengthen their balance sheets.

The success of CECSF clearly illustrates the value of subsidy to create both access to capital and innovation in an underserved market. In this case, subsidy creates a better-functioning market. It is a key part of the formula for inducing market investment that creates social impact and long-term economic opportunities.

Conclusion

Charter schools are an important innovation in education that holds considerable promise to help low-income people and communities end the cycle of poverty. However, charter school laws have created a gap in funding for school facilities. CDFIs and the federal government have used subsidies to induce private capital to address this need.

The value of subsidy provided by the federal government for credit enhancement cannot be understated. Without the incentives generated by the CECSF program, and without CDFIs to structure and administer them effectively, the growth of the charter school movement would have been inhibited.

CDFIs have proven their value as strategic players who can correct market failures by combining resources from the public and private sectors, resulting in the efficient deployment of capital to otherwise underserved markets, as they have done in the charter school facilities market.

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