

Community Empowerment Fund

Technical Summary

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Introduction

HUD has proposed a Community Empowerment Fund (CEF) to expand, strengthen, and reinvent existing HUD tools to better serve the economic development needs of distressed communities. Specifically, the CEF:

Improves the Current Section 108 Loan Guarantee Program

Under the Section 108 program, communities issue promissory notes that are guaranteed by HUD. (All Section 108 guarantees provide for timely payment of 100 percent of principal and interest and are backed by the full faith and credit of the United States.) To secure the repayment of the guaranteed notes, the communities are required to pledge all grants they receive under the Community Development Block Grant (CDBG) program. If a community is located in a non-entitlement area in which the State administers the CDBG program, the State is also required to pledge its CDBG grants. Permanent financing of the guaranteed loans is provided through a Section 108 Trust, a legal entity created under a Trust Agreement between HUD and the trustee. The trustee for the Section 108 Trust issues certificates backed by a pool of the communities' guaranteed notes. HUD guarantees the trust certificates as well as the underlying notes.

Creates a New CEF Trust

The creation of the CEF Trust will make it possible for communities to pool economic development loans made with Section 108 funds, in order to provide a common security arrangement for repayment of the Section 108 guaranteed notes. Although the Section 108 loan guarantee program offers communities access to low-cost financing, many communities have not made as much use of this source of financing as they could. The CEF Trust will remove several impediments to the willingness of localities to use Section 108 for economic development purposes. Specifically, it will:

- Substantially reduce the risk to the CDBG program by creating a pool of individual loans large enough to create a “portfolio effect,” and by establishing a loan loss reserve (although under current law, the CDBG allocations must remain liable for repayment of the communities' Section 108 notes);
- Allow communities to finance types of loans that they would be unwilling to support without the reduction of risk provided by the loan pool;
- Help communities (especially smaller communities) with limited capacity for underwriting and servicing loans; and
- Help address the difficulties some communities have encountered in meeting the new collateral and security guidelines required under the Credit Reform Act of 1990.

To help implement a demonstration of the CEF Community Trust, HUD obtained the services of a team led by Abt Associates Inc. Abt Associates' effort was directed by Vice President James Wallace, an urban economist with over 25 years experience in the fields of real estate finance and housing policy, working along with senior analyst Paul Elwood and economist Meryl Finkel. The team included experts provided by the Economic Development Assistance Consortium (EDAC) and PricewaterhouseCoopers. EDAC provided four team members: Roger Frankoff, a development consultant with nationally recognized expertise in the Section 108 program; Frank Altman, president of the Community Reinvestment Fund; Marcus Weiss, president of EDAC; and Susan Horn-Moo, former general counsel for Boston's Economic Development Industrial Corporation. PricewaterhouseCoopers provided expertise from both their Washington Consulting Practice (Debra Cammer, Monte Stanford and Patrick O'Sullivan) and their Financial Advisory Services Practice (James Gregory). This document presents the results of their feasibility analysis and program planning work.

The first section presents the motivation for establishing the CEF Trust, describing the Section 108 loan guarantee program, the barriers that communities face in attempting to utilize Section 108 financing, and the mechanisms through which the CEF Trust will help communities overcome those barriers. The second section provides a description of how the CEF Trust will work. Subsequent sections address in greater detail three key features of the CEF Trust: legal structure, underwriting guidelines, and portfolio financial projections. A final section outlines the proposed implementation schedule.

1. Motivation for the Establishing the CEF Trust

The Section 108 loan guarantee program enables local governments to access private sector financial resources on favorable terms by taking advantage of the predictability of the CDBG program and the security of a federal guarantee. The Community Empowerment Fund enhances the existing Section 108 program by making it easier for communities to make loans to support their economic development efforts.

The Section 108 loan guarantee program was established by Congress in 1974 as a component of the Community Development Block Grant Program. Since the implementing regulations were published in 1978, HUD has approved over 1,100 loans with an aggregate value exceeding \$5 billion.

Under the Section 108 program, funds are initially raised from private investors in a government-guaranteed offering and provided to communities at a small market-determined spread over the rates of corresponding Treasury notes. An entitlement community may apply to HUD to borrow up to five times its latest CDBG entitlement amount, and a non-entitlement community may apply for up to five times the latest CDBG amount received by its State (although any outstanding Section 108 commitments will reduce the amount for which entitlement and nonentitlement communities can apply). The principal security for the loan guarantee is a pledge by the applicant community or the State (in the case of a nonentitlement community) of its current and future CDBG funds. Additional security is typically required and may include assets financed by the guaranteed loan.

Communities often use the proceeds of the Section 108 guaranteed loans to make loans to third parties, typically businesses seeking to locate or expand in areas targeted for revitalization. The underlying business loans made by communities to third parties are not themselves guaranteed by HUD, and communities must re-pay the Section 108 Trust even if the business does not re-pay the community. If a community failed to meet its obligations under a Section 108 loan, HUD would apply the community's available CDBG allocations. Because CDBG allocations are contingent on Congressional action to fund the CDBG program, under the Credit Reform Act, HUD is required to maintain a credit subsidy account from which investors would be repaid in the event that CDBG allocations were insufficient to cover loan losses.

The Existing Section 108 Loan Guarantee Program

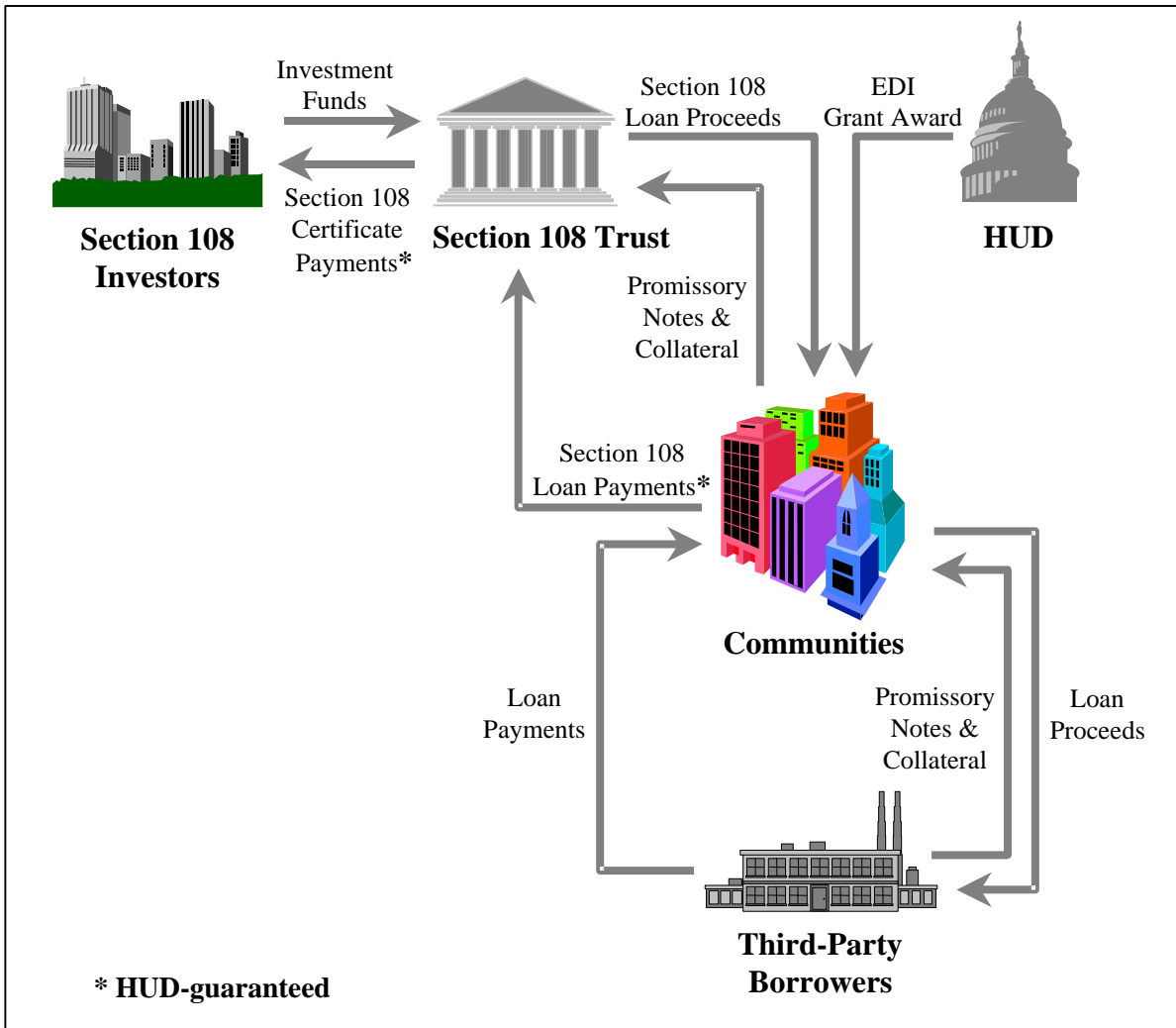
Communities submit applications for financing under the Section 108 loan guarantee program to HUD field offices, which assess the eligibility of each proposed activity under the national objectives of the CDBG program and make a recommendation to HUD Headquarters. Financial management staff at HUD headquarters review the loan application for its creditworthiness, ensuring that the loan meets standards for the collateral value of the underlying assets, debt coverage ratio, etc. If the application qualifies under all financial and programmatic criteria, HUD issues a commitment contingent on the community meeting certain specified conditions. Once these conditions are met, the loan guarantee is provided and financing is made available to the community. The application review and the closing process typically takes several months to complete, because many communities have difficulty preparing complete and creditworthy applications and because HUD's capacity to process these loans is limited. Public offerings are made once or twice a year depending on the volume of loans approved, and interim financing is available for loans approved between public offerings.

Exhibit 1 depicts the basic cash flows associated with the existing Section 108 loan guarantee program. The legal vehicle for the public offering is a trust which issues certificates to investors in exchange for cash. The Section 108 Trust exchanges the cash for promissory notes issued by communities. Communities' loan repayments are used to make payments to investors in the Section 108 certificates. HUD guarantees investors that timely certificate payments will be made, whether or not communities make timely payments on their Section 108-financed loans. If communities fail to repay the Section 108 Trust, HUD can divert allocated, unexpended CDBG funds to cover losses to the program.

The Economic Development Initiative

The Economic Development Initiative (EDI), signed into law in April 1994, provides support to communities using Section 108 financing for economic development purposes. The EDI program provides for grants which communities must use in conjunction with a Section 108 guaranteed loan. EDI funds are awarded on a competitive basis, and have been used by communities to subsidize interest rates and support economic development projects in a variety of other ways. Because EDI provides additional resources that can help lower the risk of loan losses under the Section 108 program, it has significantly increased the attractiveness of the Section 108 program to communities. In fact, HUD has approved more Section 108 loans in the four and a half years since EDI was authorized than it had in the previous fourteen years of the Section 108 program's existence.

EXHIBIT 1
SECTION 108 LOAN GUARANTEE PROGRAM FLOW OF FUNDS



Credit Reform Act

In addition to pledging their future CDBG revenues, communities must meet the requirements of the Credit Reform Act of 1990 that each loan have adequate collateral without recourse to as-yet unappropriated CDBG revenues. Before the implementation of the Credit Reform Act, communities could qualify for Section 108 financing primarily on the basis of their future CDBG revenue alone. Now communities must provide collateral in addition to the pledge of CDBG funds. Additional collateral can take the form of assets such as real property, machinery and equipment, etc. In evaluating the adequacy of the additional collateral, HUD applies underwriting standards, such as loan-to-value ratios, that are consistent with the subsidy rate for the Section 108 program developed in accordance with the Credit Reform Act. This change in policy has caused communities (and HUD) to take more care in their decisions to provide financing to economic development projects through the Section 108 loan guarantee program. It has also created difficulties for many communities which lack effective systems for evaluating the creditworthiness of economic development proposals.

The Section 108 loan guarantee program is a source of flexible, low-cost financing to communities. For example, communities can make 20-year, fixed-rate loans at a cost of 50 basis points above comparable term Treasuries, well below commercial lending rates. Despite its attractive features (low, fixed rates, flexibility as to uses and repayment terms), many communities have not made use of the Section 108 program, or have used it far less than they could.

Several factors contribute to the low level of utilization of the Section 108 loan guarantee program. Many communities have been reluctant to put their unobligated CDBG revenues at risk, and many have had difficulty evaluating and managing the risks associated with economic development lending. The local government agencies eligible to use the Section 108 program often do not have the in-house capacity to underwrite or service economic development loans. Some communities have had difficulty identifying, evaluating, and documenting appropriate collateral for their Section 108 guaranteed loans (as required under the Credit Reform Act of 1990). Finally, the lengthy loan approval process can make the financing unattractive. By addressing these issues, the Community Empowerment Fund Community Trust promises to make the Section 108 loan guarantee program more attractive and easier for many communities to use. Exhibit 2 outlines HUD's rationale for proposing the CEF Community Trust.

EXHIBIT 2
HUD'S RATIONALE FOR THE CEF COMMUNITY TRUST

- Despite the continuing success of the President's national economic policy, pockets of severe poverty and endemic unemployment can be found in many metropolitan and non-metropolitan areas.
- The private capital needed to bring economic growth and job opportunities to these distressed communities has not come forth. While there are a number of reasons for inadequate capital investment, they boil down to the fact that the social benefits of investing in these areas do not enter into the decisions of private investors.
- Local governments are uniquely qualified to identify business investment opportunities that would generate substantial positive spill-over effects in distressed communities.
- HUD's Section 108 and EDI programs give local governments the resources needed to support private investment in areas overlooked by the private market, but utilization of these programs has been low.
- Local governments have underutilized Section 108 and EDI programs because:
 - they are concerned about pledging future Community Development Block Grant allocations as security for the Section 108 loans,
 - they find it difficult to satisfy the underwriting criteria associated with the Credit Reform Act, and
 - some communities lack the capacity to underwrite and service business loans.
- The CEF Community Trust will increase utilization of Section 108 and EDI by:
 - reducing the risk to local government by establishing an effective loan loss reserve and by diversifying risk,
 - allowing communities to underwrite high-risk business loans by making a larger contribution to the loan loss reserve, and
 - setting up a national underwriting and servicing capability.
- The CEF Community Trust will also encourage the development of a purely private secondary market for economic development loans by:
 - standardizing underwriting,
 - providing reliable data on the performance of economic development loans, and
 - creating a securitization structure that the private market could easily replicate.

Overview of the CEF Trust

HUD will follow a two-phase implementation process for the CEF Trust. Phase I calls for establishing:

- a legal vehicle for pooling economic development loans made by communities with Section 108 proceeds;
- loan underwriting and pricing procedures; and
- loan servicing capacity.

These aspects of the Trust will be implemented immediately and are expected to stimulate greater use of the Section 108 program. Phase II entails the sale of securities backed by CEF Trust loans, without federal guarantees, to private investors. Phase II would occur only after the CEF Trust has established enough of a history to support a favorable credit rating for securities backed by a pool of its loans.

The CEF Trust will be created to acquire certain types of Section 108 loans, namely, loans made to finance revenue-producing economic development projects (typically small and medium-sized businesses). It is expected that the CEF Trust will issue certificates representing an ownership interest in the Trust, including both the loans held by the Trust and a Trust reserve account. The purpose of the reserve is to make up for principal and interest shortfalls occurring as a result of credit losses in scheduled payments to the CEF Trust. The Trust reserve will be capitalized with funds contributed by the participating communities, and Economic Development Initiative (EDI) funds will be set aside for this purpose.

HUD has developed underwriting guidelines to be used to evaluate loans. Standardized underwriting and documentation consistent with these guidelines will be key to the efficiency of the Trust's operations and to the ultimate attractiveness of the pooled loans to investors in Phase II. The operation of the Trust will provide communities with an incentive to meet these standardized underwriting guidelines, and through standardization, HUD will be able to streamline the loan approval process. The consistent application of the underwriting standards will also encourage communities to participate by increasing their confidence that loans in the pool that were originated by other localities are no more likely than their own loans to go into default.

To operate the CEF Trust, HUD plans to procure the services of a Program Manager, who will be responsible for establishing the CEF Trust, underwriting loans that communities seek to transfer to the Trust, and servicing loans acquired by the Trust. HUD envisions that the Program Manager will maintain a network of "designated underwriters" who will be responsible for underwriting loans sold to the Trust as well as "pricing" the loans (i.e., assigning the loans to one of three risk categories). The CEF Trust would relieve communities of the responsibility of servicing loans transferred to the Trust, because the Program Manager would engage a national servicing agency which would service the loans. Either the national servicer or a separate entity designated by the Program Manager would be responsible for pursuing recovery of amounts owed from collateral in cases where loans went into default.

Phase I Summary

Phase I implementation would achieve the following:

- Create an efficient mechanism to help communities selected in an EDI competition meet the requirements of the Credit Reform Act of 1990 (through the use of EDI funds to support a Trust reserve).
- Offer communities some protection in case a business defaults on a Section 108-backed loan (by drawing on the Trust reserve account).
- Relieve communities from the responsibility of servicing loans (by establishing a national servicer with that responsibility).
- Create a mechanism for tracking loan performance (through a database maintained by the national servicer).
- Ensure a highly qualified, independent underwriting of Section 108 loans (by relying on designated and national underwriters).

Phase I implementation would *not*:

- Relieve communities (and HUD field offices) from the responsibility of assessing the eligibility of projects under the CDBG national objectives.
- Remove all risk from communities making Section 108-backed loans (because cities would still pledge their future CDBG revenue and eventually be liable for losses in the event the CEF Trust became insolvent).¹
- Entail the immediate sale of pooled economic development loans to private investors (because that step awaits Phase II implementation).

Phase II Securitization

The CEF Trust will be structured to facilitate the ultimate sale of pooled Section 108-backed loans to private investors. However, the lack of historical data about loan performance presents a barrier to immediate implementation of Phase II. In the absence of a clear track record of loan repayment, investors would demand very high returns on their investment in the loan pool. But it is unlikely that either the business borrowers or the communities would accept the higher interest rates or greater discount from par value that such high returns to investors would entail. It is anticipated that the underwriting mechanism established in Phase I will result in a pool of loans with a reasonable performance history and that the servicing mechanism will yield consistent information about the performance of the pooled loans. With a clear track record to draw on, future loan pools can be structured for sale to investors.

¹ HUD may opt to include some form of recourse to communities, in which case communities may participate in losses associated with defaults on loans they transfer to the CEF Trust.

2. Functional Description of the CEF Trust

The core of the CEF proposal is the CEF Trust. The Trust is a legal entity organized for the purpose of acquiring the loans that communities make to businesses under the Section 108 loan guarantee program. The Trust would not exchange cash for a community's loan. Instead, it would assume the obligation to repay the Section 108 Trust, and it would receive the loan repayments made by the business borrower and deposits made by communities into a loan-loss reserve account. The CEF Trust will issue to participating communities certificates representing an interest in the Trust, including the stream of loan payments and the Trust reserve account.

In order to transfer any loan to the CEF Trust, a community would make a contribution to the Trust's reserve account in an amount determined during the underwriting process based on the loan's riskiness. If a business fails to repay its loan, the CEF Trust would draw first on the Trust reserve account to repay the Section 108 Trust. Exhibit 3 illustrates the flow of funds associated with the CEF Trust. Exhibit 4 presents the steps involved in a single CEF Trust transaction.

**EXHIBIT 3
CEF TRUST FLOW OF FUNDS**

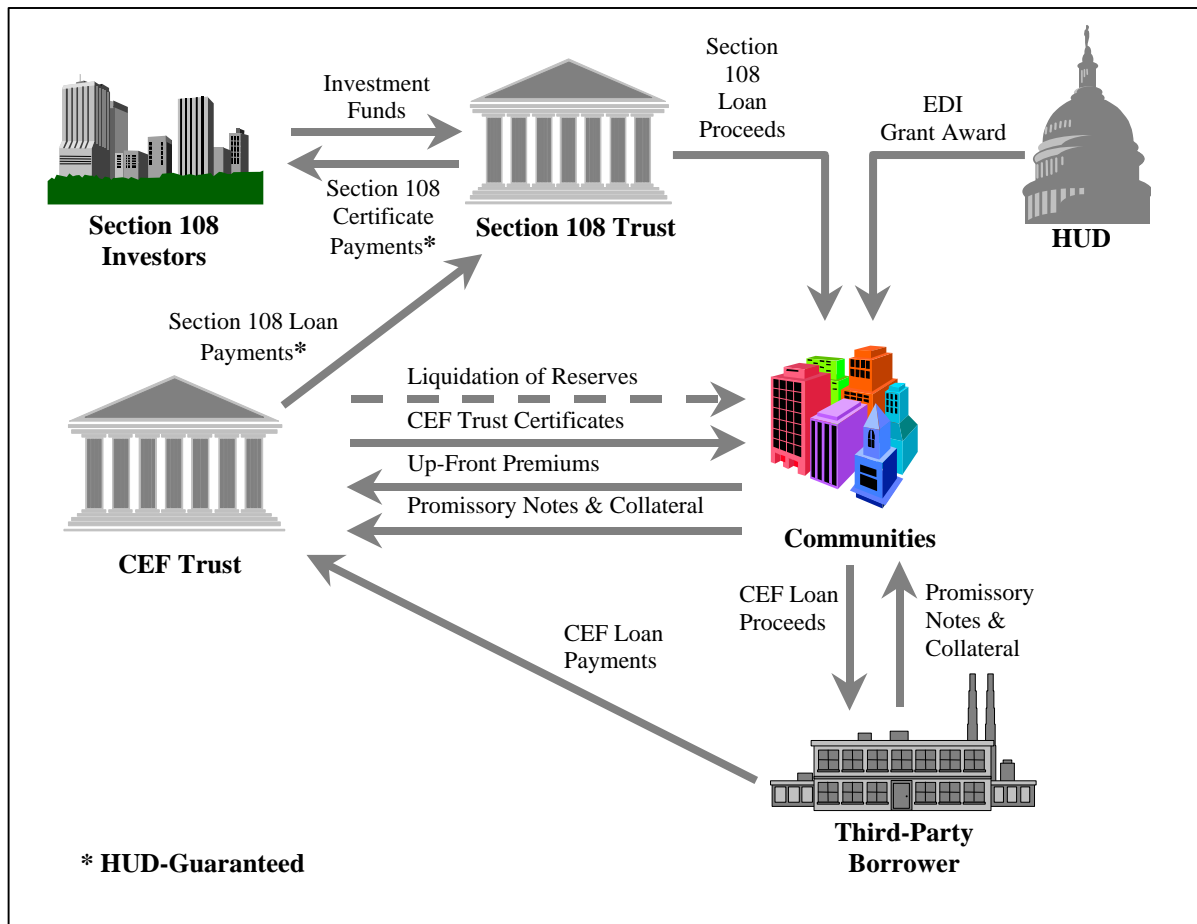


EXHIBIT 4
A CEF COMMUNITY TRUST TRANSACTION

HUD Notice of Funds Availability (NOFA)

1. HUD issues EDI NOFA for grant assistance to be used in conjunction with CEF transactions.

Community's EDI/Section 108 Application

2. Community submits application proposing to use EDI funds in conjunction with Section 108 loan to finance economic development projects in distressed neighborhoods. EDI funds are to be used to assist for-profit businesses in obtaining financing for real property improvements, machinery and equipment, or working capital.
3. Community receives EDI grant award, conditioned upon public entity's applying for and HUD's approval of a Section 108 loan.
4. Community applies for Section 108 loan guarantee assistance to carry out economic development projects by originating economic development loans for pooling under the Community Trust.
5. HUD approves community's Section 108 application and issues loan guarantee commitment.

Business Loan Application

6. Community publishes notice describing its economic development financing program and solicits applications from qualified businesses.
7. Community processes loan application from business and determines whether all CDBG program requirements (e.g., national objectives and public benefit standards) will be met.
8. Community submits business loan application to a designated underwriter for review to determine whether it meets the CEF Community Trust's underwriting standards.
9. The designated underwriter also assigns the business loan to a risk tier and determines the required risk premium, based on the risk level, interest rate, and term of the loan.
10. The designated underwriter notifies the community that the loan is suitable for pooling and that an upfront premium in a specified amount must be paid to the CEF Trust.
11. The community borrows under its Section 108 commitment and make the loan to the business.
12. The community delivers to the CEF Trust the business loan documents and remits payment in the amount of the upfront risk premium. (Payment of risk premium is made with EDI grant funds.) In exchange, CEF issues trust certificates. CEF Trust pools the business loan with loans from other Section 108 communities. CEF Trust deposits cash from payment of the risk premium in a loss reserve for all loans included in the pool.

Loan Payment and Servicing Arrangements

13. Business remits P&I payments to CEF Community Trust servicer.
14. CEF Community Trust remits amount due to Section 108 Trust. Section 108 Trust remits payments to Section 108 investors.

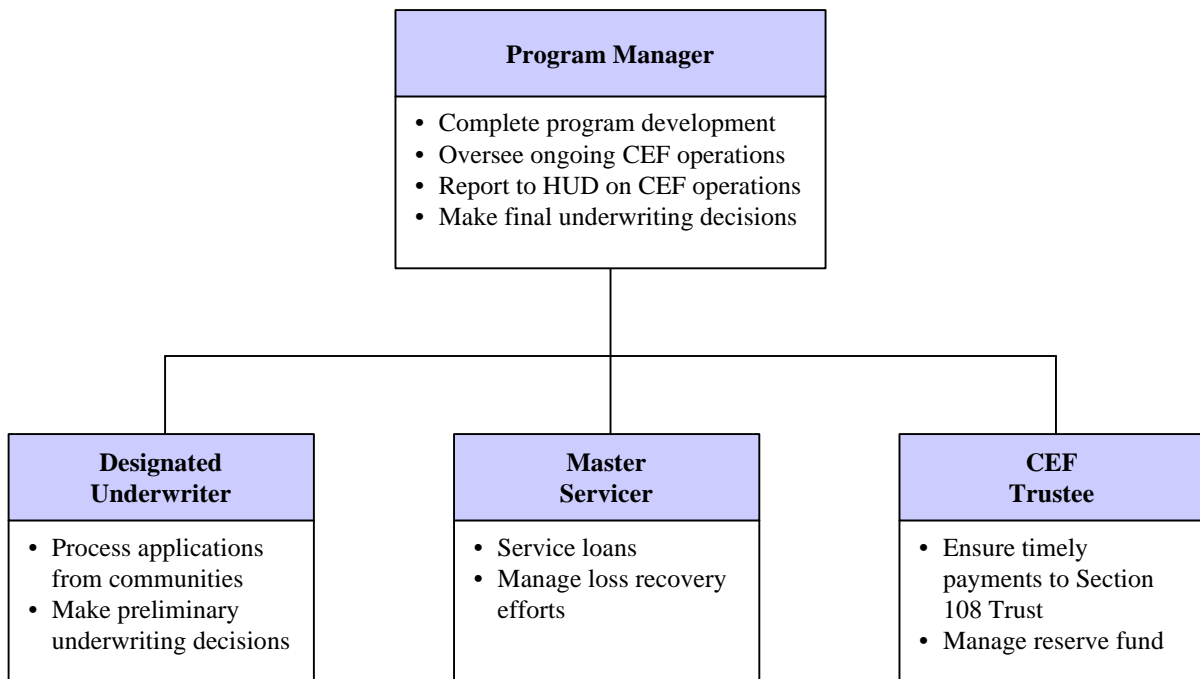
Procedures for Handling Defaults

1. Business defaults on its loan. Liquidation agent initiates foreclosure on mortgaged property.
2. CEF Trust transfers amount required for debt service on Section 108 loan from loss reserve to payment account and forwards amount due to Section 108 Trust.
3. Mortgaged property is sold and proceeds from sale (less expenses) are transferred to CEF Trust.

CEF Trust Program Manager

HUD will contract for the services of a CEF Trust Program Manager to administer all aspects of the CEF Trust. HUD will retain oversight and policy-making responsibility, and the Program Manager will be responsible for establishing the CEF Trust, underwriting and servicing loans acquired by the Trust, making scheduled payments to the Section 108 Trust, and reporting to HUD on all aspects of CEF Trust operations. Exhibit 5 depicts the program management roles of the CEF Trust.

EXHIBIT 5
CEF PROGRAM MANAGER RESPONSIBILITIES



Underwriting

HUD envisions that the Program Manager will establish a two-tiered system of underwriting, including initial reviews performed by a widely distributed network of “designated underwriters” and a second review performed by a centralized office of the Program Manager. The designated underwriters will review individual business loans that communities want to transfer to the CEF Trust, applying uniform national standards for underwriting and loan documentation. The designated underwriters must be independent, i.e., free of any conflict of interest with either the community lenders or the third-party borrowers. The Program Manager, and its designated underwriters, will represent the interest of CEF Trust certificate holders (and HUD) in ensuring that loans meet the underwriting guidelines. The system of locally or regionally based designated underwriters accommodates the program’s need for a thorough, timely, and cost-effective review of individual loans, while oversight by a national Program Manager creates a clear and efficient mechanism through which accountability to HUD can be maintained.

Standardization is essential to the function of the CEF Trust. Communities will find that even some revenue-generating economic development projects will not qualify for transfer to the CEF Trust. These communities will have the option to either apply for Section 108 loans without seeking to use the CEF Trust, or restructuring their financing to meet the CEF Trust underwriting criteria. The communities that participate will want the reassurance that all loans in the pool meet the eligibility criteria, because the attraction of the loan-pooling mechanism depends in large part on its ability to share risk equitably among the participating communities. Standardization of loan underwriting and documentation is also key to the efficiency of the Trust's operation and to the ultimate attractiveness of the pooled loans to Phase II investors

Standardization will in part be achieved by assigning all loans acquired by the Trust to one of three categories, according to the level of risk associated with the loan. HUD has developed a set of draft underwriting guidelines which specify the three categories of eligible loans and a loan pricing model for calculating a risk-adjusted discount associated with loans in each category. An amount equal to the risk-adjusted discount will be contributed to the loan loss reserve, and communities will draw on EDI grants to help fund their contribution to the Trust reserve.

Trustee

The trustee is the intermediary between the servicer and the holders of the CEF Trust certificates. There may be a conflict of interest if the trustee is involved in originating or underwriting the loans purchased by the Trust. Under the grantor trust structure, the trustee is a "disinterested" or even "passive" conservator of the assets held by the trust. Originating or underwriting some of the loans in the trust may appear to undermine that disinterested stance by giving the trustee another type of interest in the asset. As a result, the Program Manager will need to establish a trustee that is independent of the underwriting function. The trustee's responsibilities will include issuing CEF Trust certificates (which will be held by the participating communities in Phase I). The trustee will ensure that timely payments are made to the Section 108 Trust and that reserve funds are managed effectively.

The trustee receives a fee to administer the trust. In addition, depending on the structure, the trustee could also derive some benefits from the interest float, as payments from the servicer will not usually coincide with payments to the certificate holders. However, the portfolio analysis presented below assumes that the float is available to cover all the obligations of the Trust and that any funds remaining at Trust liquidation would be distributed to certificate holders.

Servicing

It is not envisioned that HUD will have an ongoing role in servicing; rather, the Program Manager will be responsible for all aspects of servicing, presumably by selecting and contracting with a servicer with relevant experience in servicing similar loans. HUD and the CDBG recipient communities will retain responsibility for ensuring that the projects funded through the CEF program meet the programmatic requirements of the CEF program (including programmatic requirements of the underlying EDI and CDBG programs).

The Program Manager will specify the servicing needs for loans in the pool, establish the necessary credentials for loan servicers, and contract with an entity or entities meeting these requirements to service the loans. The Program Manager may also contract with other entities to participate in such matters as loan workouts, foreclosure proceedings, or liquidation of collateral following foreclosure.

Servicers are responsible for collecting principal and interest payments on the assets when due and for pursuing the collection of delinquent accounts. They also provide the trustee with monthly and annual reports about the portfolio of assets sold or used as collateral. These reports should detail the sources of collected and distributed funds (principal versus interest), the remaining principal balance, and the amount of fees payable out of the Trust. The trustee then determines whether or not the information complies with the requirements of the pooling and servicing agreement between the CEF Trust and the servicer.

Under the terms of a servicing contract, the servicer is usually paid a basic servicing fee equal to a certain percentage of the outstanding principal balance of the loans included in the pool (supplemented in our scenarios by interest float as described above). The major items that the CEF Trust servicing agreement should address are:

- The servicer will have the full power and authority to do all things necessary or appropriate for managing and servicing the portfolio.
- The servicer will be required to make all reasonable efforts to collect all scheduled loan payments and to follow the appropriate collection procedures that it customarily follows with respect to all comparable loans that it services for itself or others, in accordance with standard servicing procedures of prudent lending institutions.
- The servicer will be required to provide the trustee with an annual report describing the activities of the servicer for the preceding 12 months. The servicer will also be required to deliver an independent accountant's report and audit of its financial statements.
- Under certain conditions associated with defaults, the program manager may have the option of replacing the servicer.

The Program Manager should also focus on the methods used to service the loans, as well as the information and reporting systems that will be used to generate reports for the CEF Trust. The key components to consider are:

- **Loan Acquisition.** Establishing and implementing procedures for acquiring and adding assets to the Trust, including document review to ensure loan documentation reflects underwriting decisions and is legally sound, as well as set-up, data conversion, and verification of loan data.
- **Loan Servicing and Administration.** This includes review and compliance with servicing documents and collection of operating statements.

- Verification of Tax and Insurance Payments. A percentage of real estate loan payments is typically escrowed for taxes and insurance payments, and the servicer must establish the frequency and methodology of setting the contribution to the escrow, and potentially hire a third-party disbursement service.
- Procedures for foreclosing on loans and managing and liquidating assets.
- Loan servicing systems or asset management systems used.
- Contingency plan in place to provide for backup facilities in the event of difficulties.

Because the servicer is not the originator of the CEF loans, its information system may not be compatible with that of the communities and the trustee. A servicer's ability to efficiently service the CEF loans will in part depend on the ability of the CEF program to establish standardized applications and loan origination documents.

Pricing

The current Section 108 cost of funds is approximately 50 basis points above Treasuries with equivalent maturities. It is estimated that the activity delivery costs of the CEF Trust will add approximately 100 basis points to the cost of funds.

It may be advisable to add a small spread of up to 50 basis points to serve as a "cushion" to augment the loan loss reserve fund. The net result will be a cost to borrowers in the range of 150 to 200 basis points above Treasuries of equivalent maturity.

The following are five examples of loans that the CEF Trust would acquire, assuming a Section 108 interest rate of 5.00 percent:

Tier I Scenario

Hometown USA applies to HUD for an EDI award to support an economic development project that includes a \$500,000 loan to Apple Pie Inc. The project receives an EDI award of \$29,200 contingent on approval of a \$500,000 Section 108 loan and approval of a CEF Trust application. Hometown approves a 10-year, \$500,000 loan to Apple Pie Inc., with a fixed interest rate of 6.00 percent and closing costs paid by the borrower of 1 percent (\$5,000), contingent on approval of an CEF Trust application. Hometown submits an application to the designated underwriter, who determines that the loan is a ***Tier I loan*** and requires a risk-adjusted premium of \$29,200. Hometown originates the loan to Apple Pie Inc., using its EDI award to make the required contribution to the CEF Trust reserve account.

Tier II Scenario

Hometown USA applies to HUD for an EDI award to support an economic development project that includes a \$500,000 loan to Apple Pie Inc. The project receives an EDI award of \$31,350 contingent on approval of a \$500,000 Section 108 loan and approval of a CEF Trust application. Hometown approves a 10-year, \$500,000 loan to Apple Pie Inc., with a fixed interest rate of 6.00 percent and closing costs paid by the borrower of 1 percent (\$5,000), contingent on approval of an CEF Trust application. Hometown submits an application to the certified underwriter, who determines that the loan is a ***Tier II loan*** and requires a risk-adjusted premium of \$31,350. Hometown originates the loan to Apple Pie Inc., using its EDI award to make the required contribution to the CEF Trust reserve account.

Tier II Scenario - with interest rate subsidy²

Hometown USA applies to HUD for an EDI award to support an economic development project that includes a \$500,000 loan to Apple Pie Inc. The project receives an EDI award of \$55,820 contingent on approval of a \$500,000 Section 108 loan and approval of a CEF Trust application. Hometown approves a 10-year, \$500,000 loan to Apple Pie Inc., with a fixed interest rate of 5.00 percent and closing costs paid by the borrower of 1 percent (\$5,000), contingent on approval of an CEF Trust application. Hometown submits an application to the certified underwriter, who determines that the loan is a ***Tier II loan*** and requires a risk-adjusted premium of \$31,350. Hometown originates the loan to Apple Pie Inc., using its EDI award to make the required contribution to the CEF Trust reserve account (\$31,350), and to write down the interest rate (\$24,470).

Tier III Scenario

Hometown USA applies to HUD for an EDI award to support an economic development project that includes a \$500,000 loan to Apple Pie Inc. The project receives an EDI award of \$55,200 contingent on approval of a \$500,000 Section 108 loan and approval of a CEF Trust application. Hometown approves a 10-year, \$500,000 loan to Apple Pie Inc., with a fixed interest rate of 6.00 percent and closing costs paid by the borrower of 1 percent (\$5,000), contingent on approval of an CEF Trust application. Hometown submits an application to the certified underwriter, who determines that the loan is a ***Tier III loan*** and requires a risk-adjusted premium of \$55,200. Hometown originates the loan to Apple Pie Inc., using its EDI award to make the required contribution to the CEF Trust.

Tier III Scenario - with interest rate premium²

Hometown USA applies to HUD for an EDI award to support an economic development project that includes a \$500,000 loan to Apple Pie Inc. The project receives an EDI award of \$30,073 contingent on approval of a \$500,000 Section 108 loan and approval of a CEF Trust application. Hometown approves a 10-year, \$500,000 loan to Apple Pie Inc., with a fixed

² The actual mechanisms for implementing an interest rate subsidy or premium have not yet been developed. The cost calculations are presented here for illustrative purposes only. Subsidy and premium costs were calculated using a simplified model in which the difference between the monthly Section 108 certificate payments and the monthly CEF loan payments is discounted at an annual rate of 4 percent.

interest rate of 7.00 percent and closing costs paid by the borrower of 1 percent (\$5,000), contingent on approval of an CEF Trust application. Hometown submits an application to the certified underwriter, who determines that the loan is a ***Tier III loan*** and requires a risk adjustment of \$55,200, partially offset by excess interest income of \$25,127. Hometown originates the loan to Apple Pie Inc., using its EDI award (\$30,073) to make the required contribution to the CEF Trust.

Technical Assistance

HUD's CEF concept calls for the provision of technical assistance to communities to support their economic development lending activities under the CEF program. These technical assistance resources should be deployed to support communities in understanding and making effective use of the CEF Trust, including developing effective and fiscally prudent economic development loan programs, structuring specific economic development projects, and preparing CEF loan applications. The availability of technical assistance can certainly improve the functioning of the CEF Trust. Communities will presumably submit a higher proportion of loan applications that are properly prepared and adequately documented, their applications may have a higher approval rate, and they may be more prudent lenders, potentially lowering the loss rate on loans submitted to the Trust. Over time, HUD could use its technical assistance resources as an incentive for prudent lending, rewarding communities with a track record of submitting loans that perform well with additional technical assistance resources. HUD could also withhold technical assistance resources from communities that establish a poor track record, or make technical assistance to poor performers conditional on specific improvements to their economic development lending practices.

3. Legal and Financial Structure of the CEF Trust

NOTE: HUD has not retained Abt Associates Inc. or its subcontractors or consultants as legal counsel. The following discussion does not represent a legal opinion. Instead, we offer an expert reaction to HUD's CEF concept and an explanation of legal and financial structures that HUD might consider. Further legal review of the CEF Trust concept is presented in Appendix A.

The CEF program is constrained both by the fact that the loan originators (and the original owners of the Trust's certificates) are public entities, and by the requirement that EDI funds (the source of the communities' contribution to the loan loss reserve) must be awarded directly to communities for projects that include a Section 108 loan (and, for instance, can not be used to make a direct federal contribution to capitalize the CEF Trust). Because the ultimate market for this financing is the thousands of local government entities that receive CDBG funds, the legal structure must be straightforward and easy to use and understand, yet flexible enough to work with a wide variety of economic development agendas.

At Phase I, the CEF Trust is a loan pooling mechanism which will acquire loans that are made to businesses under the Section 108 loan program.

Three basic structures were considered as vehicles for CEF Trust:

- Grantor Trust / Pass-Through
- Owner Trust / Partnership
- FASIT (Financial Asset Securitization Investment Trust)

For Phase I, the grantor trust appears to hold the most promise, although the reserve account required for the CEF program may raise classification issues that would call into question the tax status of the trust or might cause the reserve fund itself to be considered a separate entity for tax purposes. In this document, we do not discuss at length the owner trust and FASIT structures, because these are options that would be more appropriately considered at a later stage in the development of the CEF Trust concept. If further legal review indicates that purposes of the proposed Trust reserve account will not be served through a structure that is compatible with classification as a grantor trust, it will be necessary to consider in greater detail the owner trust or FASIT.

Grantor Trust

The simplest legal structure for the CEF would be a grantor trust. A qualifying grantor trust is effectively disregarded for Federal income tax purposes. The trust itself is not subject to taxation as a corporation or other entity, and the holders of trust certificates evidencing beneficial ownership in the trust assets are treated as if they held the underlying assets directly.

Qualification of an entity as a grantor trust is not achieved solely by labeling the entity as a trust. It must also meet certain substantive requirements. The managers or custodians of the trust must not have any managerial or investment powers that would be treated as an

impermissible power “to vary the investments” of the certificate holders. In addition, with certain limited exceptions, the trust may have only a single class of ownership interests. Although the restriction on multiple classes prohibits time-tranching of cash flows and similar arrangements, it does allow the creation of separate classes of ownership interests in a trust that represent interests in the cash flows on separate items of trust property (including rights to interest “coupons” on a bond or to the “corpus” of a bond after “stripping” the “coupons” from the “corpus” in a qualified coupon stripping transaction), and the creation of senior and subordinated interests in the cash flows on the same underlying assets.

As proposed, the CEF Trust structure provides that certificates would be issued representing a 100 percent beneficial ownership interest in both the CEF loans and the Trust reserve account. This structure generally is allowable under the grantor trust rules, although care must be taken in the structure of what is effectively a reserve fund to ensure that it does not create an impermissible “power to vary” the certificate holders’ investments.

In general, it should be possible for a grantor trust to invest and reinvest assets held in a reserve fund inside the trust without creating a power to vary if the investments are subject to the same constraints as temporary investments, if the reserve fund is not excessive, and if ownership of the reserve fund is limited to a single investor. In many cases, however, sponsors prefer to keep the reserve fund outside of the trust in order to avoid power-to-vary and multiple class trust issues. In cases where the reserve is held outside of the trust, it can be viewed as an asset of the owner that is pledged to secure a non-recourse guarantee. Also, further legal review is necessary to determine the extent to which state and local statutes may restrict the ability of communities to hold an ownership interest in the Trust. Given these considerations, and in particular the fact that the Trust reserve is to be owned by multiple municipalities, it may be advisable for the reserve fund to be held outside of the CEF Trust as described below.

Although the grantor trust rules are more restrictive than those applicable to owner trusts and FASITs, the structure is simple and easily administered, and may provide enough flexibility to satisfy the requirements of the program at Phase I.³ Although the power-to-vary test generally prohibits reinvestment, a grantor trust can temporarily reinvest payments received on investments pending distribution as long as the temporary investments are in high-quality debt instruments that mature no later than the anticipated distribution date and are held to maturity.⁴

Advantages of a grantor trust:

- Laws and regulations governing the grantor trust are relatively simple and easy for communities to understand.
- Legal costs associated with establishing a grantor trust may be less than those associated with the other options.

³ Thus, for example, the grantor trust rules allow for the commingling of fixed-rate and variable-rate loans and allow the sponsors to repurchase defaulted loans after they are placed in the trust (provided the proceeds are distributed and not reinvested).

⁴ Based upon IRS letter rulings, investments generally should be considered temporary if the period is needed to bridge the gap between the timing of distributions on investments and on trust certificates and is not longer than seven months. Based upon the analogous REMIC rules, barring unusual circumstances, a period longer than thirteen months is unlikely to be considered temporary.

Disadvantages associated with a grantor trust:

- There is no protection against interest rate risk, i.e., the possible change in the value of loans due to changes in prevailing interest rates between loan origination and pool formation. Once the CEF Trust is formed, no additional assets can be included, and the return on the certificates is fixed.
- Placing the reserve fund outside of the trust could raise rating agency issues and create additional tax classification issues.

Owner Trust

Where an owner trust has multiple owners and a power to vary investments, it is generally treated for Federal tax purposes as a partnership. Otherwise, it would likely run afoul of the grantor trust rules. ***Further legal analysis will be required to determine the implications of using an owner trust for the CEF Trust.*** If the trust is treated as a partnership, it will be treated as an entity (rather than a pass-through) for certain purposes and will be subject to the partnership provisions of the Tax Code. There are a number of potentially significant differences between the tax treatment of trust beneficiaries and partners in a partnership. As noted above, the holder of an interest in a grantor trust is treated as if it owned directly an interest in trust assets (with the trust being ignored). By contrast, a partnership is recognized to be an entity (and a partnership interest is treated as an interest in an entity) for various tax purposes and is subject to the relatively complex provisions of Subchapter K of the Code.

It should be noted generally that pension plans, charitable organizations, and certain other tax-exempt organizations are subject to tax on their “unrelated business taxable income” (UBTI). Because substantially all of the cost of the assets of an owner trust is financed with debt, the income from an owner trust normally would be considered “debt-financed” under the UBTI rules. As a result, otherwise tax-exempt entities may be taxable on substantially all of their income from an equity interest in an owner trust, regardless of whether the trust is classified as a grantor trust or partnership. Accordingly, the tax status under the UBTI rules of municipalities participating in the CEF Trust and the effect of such rules, if any, on such entities must be considered.

FASIT

A third option would be to use a FASIT (Financial Asset Securitization Investment Trust). FASITs are somewhat similar to REMICs, although they can be used for all types of loans and, most importantly, may acquire new assets and issue new securities at any time.⁵ This added flexibility is intended to help in the securitization of short-term and revolving assets, such as business and consumer lines of credit, small business loans, home equity loans, and trade receivables. FASIT also may be useful for construction loans since such loans can be converted into permanent loans and kept in the FASIT pool.

⁵ In general, REMICs, or Real Estate Mortgage Investment Conduits, must satisfy certain tests, including a requirement that “substantially all” of the REMIC’s assets consist of qualified mortgages or permitted investments. Therefore, using a REMIC is not an option where, as in the case of the CEF program, loans other than real estate loans secured by mortgages are being securitized. It should also be noted that where real estate loans are being securitized, the “taxable mortgage pool” provisions of the Code are designed to insure that REMIC is the exclusive vehicle for issuing multiple class securities without the imposition of an entity-level tax.

One important requirement of FASIT is that the so-called “ownership interest” must be held by a single domestic corporation (and not a tax-exempt entity or governmental municipality or locality). The current CEF proposal calls for the residual interest in the CEF Trust (namely, the loss reserve account) to be held by the sponsoring governmental entities. Although a FASIT structure may be feasible, the current proposal would require some restructuring to avoid this limitation. It may not be possible for the governmental entities to retain a residual interest in the loss reserve account, unless the maximum yield on the holder’s investment satisfied certain requirements of the FASIT rules. Use of this approach would require additional analysis by legal counsel to determine its feasibility.

Trust Reserve

The HUD proposal for the CEF Trust calls for the establishment of a cash reserve fund that can be used to cover shortfalls due to the credit risk associated with loans transferred to the Trust. Reserves can also be used to cover delays in payments to the Trust. The reserves would significantly reduce the probability of the communities having to use their future CDBG funds to cover losses.

Each community will deposit the difference between the face amount of the CEF loan and the discounted value of the loan calculated by the loan pricing model (see discussion below). Communities could apply to HUD for EDI grants to fund the risk premium, or communities could fund the risk premium from other sources. If the risk premium is priced properly, the Trust reserve account will be sufficient to pay all future losses resulting from CEF loans.

Additional legal analysis of the Trust structure is reported in Appendix A. Further legal analysis will be needed as the CEF Community Trust concept is implemented.

Default

If the Trust reserve account structure described above were found by HUD to be a viable and appropriate legal structure, the trust might be able to handle defaults in the following manner. When a borrower fails to make a payment on a CEF-owned loan, the Trust would draw on the Trust reserve account to make the payment. This would deplete the value of the Trust reserve account and the ultimate pay-out to holders of the Trust reserve account (assuming the communities’ contribution to the Trust reserve account is cross-collateralized and cross-defaulted). If, over time, losses significantly exceed the expected rate, the Trust reserve account would be depleted. After the Trust reserve account is depleted, the communities would lose the protection provided by the CEF Trust against having to use future CDBG funds to pay back Section 108 loans.

Distribution of Loan Payments

If all loan repayments are made as scheduled, the amount available in the holding/escrow account will be sufficient to make all scheduled payments to the Section 108 Trust, and to pay all appropriate fees and expenses to the trustee and servicer. However, the Trust Agreement establishes a priority schedule for the distribution of funds if the amount is not adequate because of loan defaults or late payments. For the CEF program, the priority of payments might be as follows:

- Fees earned and expenses incurred by the Trustee since the last distribution date (the trustee typically receives an annual fee for all services rendered and is reimbursed for reasonable expenses associated with its duties);
- Fees and reasonable expenses incurred by the servicer since the previous distribution date as well as any unpaid expenses incurred by the servicer;
- Scheduled payments to the Section 108 Trust;
- Any excess income, i.e., what is left after the Section 108 Trust and other expenses have been paid, will be reinvested and available to cover losses on CEF-owned loans.

The communities holding the CEF Trust certificates will not receive any payments unless and until the loan payments are sufficient to pay all obligations to the Section 108 Trust and other priority expenses. This condition will not obtain until all CEF loans held by the CEF Trust have been paid off or the CEF Trust is liquidated.

Alternative Forms of Credit Enhancement in Phase I

A primary purpose of the CEF Trust is to limit the exposure of communities to the risk associated with loans made under the Section 108 program. Because Phase I does not entail selling the loans to private investors, the only type of risk that must be taken into account is credit risk. The Trust reserve account described above would provide a layer of protection between loans transferred to the Trust and the communities that originated the loans. In our analysis, we reviewed other approaches to managing the credit risk associated with Phase I securitization, either as an alternative to the cash reserve or in addition to the cash reserve. The main alternatives we considered were insurance, loan substitution, overcollateralization, and recourse of various kinds. All of these alternative options appear to be infeasible, although the option to maintain bottom-loss recourse to the community deserves continued consideration.

Insurance. Instead of using EDI funds to fund a Trust reserve account, funds could be provided to communities to purchase insurance against loan losses. Theoretically, this could be done either for individual loans or as a contribution to insurance on a pool of loans. If it were done at the level of individual loans, the result would be a new loan insurance program rather than a loan pooling mechanism. Although potentially feasible from a technical standpoint, the creation of a new insurance program is at odds with HUD's basic concept and

policy goals for the CEF program. The option for purchasing insurance on the pool of CEF loans is consistent with HUD's policy objectives; however, it is probably infeasible for the early stages of CEF Trust operation. A private insurer would essentially require the same information about loan performance that prospective investors would require in order to efficiently price the insurance. In the absence of performance data, the price of pool insurance would be prohibitively high.

Overcollateralization. Another option available to enhance the creditworthiness of individual loans is overcollateralization. However, one purpose of the CEF is to provide communities with some relief from the burdensome collateral requirements of the 1990 Credit Reform Act. Thus, a requirement that communities overcollateralize their CEF loans would have to be accompanied by a source of funds to provide the collateral. To the extent that EDI is the source, this approach becomes functionally equivalent to funding a cash reserve, without the benefits of pooling. Unlike the cash reserve, EDI funds used to overcollateralize a loan would not be available to help cover losses on other loans.

Loan Substitution. The CEF Trust could also impose a repurchase or substitution requirement on the communities to augment the cash reserve. This approach is used by secondary market institutions in the home mortgage market to protect the secondary market institution from flawed underwriting by originating lenders. The substitution obligation would be triggered if a loan in the Trust is found to have inadequate documentation or otherwise fails to satisfy the representations and warranties provided at closing. It could also be triggered by a breach of certain covenants contained in the servicing agreement. The substitution requirement is effective only to the extent to which the communities have, or can obtain, qualified loans or other resources with which to substitute or replace loans. Thus, loan substitution offers protection from flawed underwriting, but not from losses resulting strictly from the poor performance of the borrower. Under the CEF model, the ultimate responsibility for underwriting rests with the Program Manager (i.e., the secondary market institution). Therefore, the loan substitution requirement is not appropriate, because the originators (i.e., the communities) are not performing the underwriting function. Furthermore, many communities would not have a portfolio of similar loans from which to draw a substitute.

Recourse. Recourse is an important alternative to consider for the CEF program. Maintaining recourse to the underwriter (either the designated underwriter or the Program Manager) is appealing because of the incentive structure that would be created. However, in our assessment, recourse to the underwriter would raise the cost of the underwriting to a level that would make the program infeasible. Recourse to the community is also appealing because it would help address the problem of adverse selection ("cherry picking," where communities have an incentive to pass only their bad loans on the CEF Trust and retain their good loans in their own portfolio). However, the practical impact of a recourse provision raises some concerns, primarily about undermining the communities' incentives to participate in the program. We do not have the benefit of systematic information about the potential demand for the CEF Trust program, so the severity of this disincentive is difficult to gauge.

Currently, the risk to future CDBG revenues is a critical barrier to wider community use of the Section 108 program. A recourse provision would limit the degree to which the CEF

program removed this barrier to community participation. How much the recourse provision affected communities' appetite for the CEF program would depend on the specific nature of the recourse provision.

There are three main types of recourse to consider: top-loss, bottom-loss, and proportional risk-sharing. Top-loss functions like a deductible – in the event of a loss, the community would not be able to take advantage of the Trust reserve account until it paid a certain amount from its own funds. A bottom-loss provision limits the pool's exposure to loss from a particular loan. The community would have to cover losses that exceed a fixed amount. Proportional risk-sharing would require the community to match any pay-outs from the Trust reserve account in a fixed ratio. Under any of these scenarios, HUD could require communities to set aside funds in advance to be available in the event of loan losses.

If HUD were to include some form of recourse, a bottom-loss provision would be most advisable. Such a provision could be designed so that the Trust reserve would pay for a substantial share of any losses, but would not cover 100 percent of the value of the loan. In the event of a catastrophic loss, the amount the Trust would draw from the reserves would be limited (to perhaps 40 percent of the total value of the loan). Losses greater than the limit amount would be covered by the originating community. Although some communities would be discouraged from participating in the program because they would not be relieved of *all* risk associated with the CEF loans, other communities might be encouraged to participate because the pool would be protected from catastrophic loss resulting from another community's imprudent lending. Because the Phase I securitization does not defease the Section 108 obligation, communities ultimately do retain risk in the event the Trust's reserve account is depleted and the Trust is unable to cover further loan losses.

Because we are unable to estimate the likely impact of recourse to communities on the demand for the CEF program, we are reluctant to recommend that HUD include such a provision. If the underwriting is done properly and the pricing model accurately estimates the losses experienced by the pool, the Trust reserve account should have sufficient funds to cover all losses. Adding a spread to the price of the loans creates an additional layer of protection against the possibility that loss rates will be higher than estimated by the model. HUD may be able to learn more about how recourse to communities could be effectively employed through its proposed pilot project.

4. Underwriting Guidelines and Procedures

The CEF program builds on a set of draft underwriting guidelines developed for the Section 108 program. These guidelines, which will serve as the basis for underwriting loans for transfer to the CEF Trust, identify six standard credit criteria for business lending and five for real estate lending. Loans are sorted into three risk tiers based on their performance in the underwriting criteria listed above. For each risk tier, a risk-based premium is determined based on anticipated losses associated with the risk level. As described below, the premiums are calculated using the Section 108 loan pricing model. The model uses historic performance data for the SBA 7(a) program to estimate the required premiums for Section 108 loans (because no historic performance data on the Section 108 program is available). The SBA 7(a) loans are thought to be most similar to Tier II loans. For Tier I (low-risk loans) and Tier III (high-risk loans), adjustments are made to the baseline premium to account for the added or decreased risk of losses. Exhibit 6 shows how the six criteria would be applied to each of the three risk tiers.

EXHIBIT 6
RISK-BASED CLASSIFICATION OF CEF BUSINESS LOANS

Underwriting Criteria	Tier I (Lower Risk)	Tier II (Base Case)	Tier III (Higher Risk)
Ability to Repay	Existing businesses seeking to expand, at least three years of strong financial performance, growing sales, profitability, retained earnings and cash flow. Debt Coverage Ratios (DCRs) of 1.25 or higher (typically from existing cash flow).	DCRs between 1.15 and 1.25, in some cases a portion of cash flow from the business expansion.	Nearly all start-up businesses would be classified as Tier III. DCR for these businesses at least 1.15. For existing businesses with weak cash flow, DCR should be at least 1.05.
Collateral	Loan to value ratios of 75 percent or lower.	Loan to value ratios of 80 percent or lower.	Loan to value ratios of 90 percent or lower.
Guarantees	Business and personal guarantees provided by business principals.	Business and personal guarantees provided by business principals.	Crucial that Tier III loans have both business and personal guarantees from business principals.
Analysis of Balance Sheet (Capital)	Sound balance sheet based on six areas: collecting receivables, controlling inventory, paying bills, accrual, reinvesting in the company, and quality of debt.	Balance sheet may raise minor concerns in any of the six areas.	Questionable balance sheet, i.e., serious concerns in some of the six areas.
Experience of Management	Experienced management in all phases of the business.	Moderate or limited experience in this particular area. Success in other areas	Limited experience in this area. Some evidence of transferable skills or other management support.
Character of Principals	Business principals have no history of bankruptcy, criminal activity or past or pending litigation that could affect the outcome of the project.	Business principals have no history of bankruptcy, criminal activity or past or pending litigation that could affect the outcome of the project.	Business principals have no history of bankruptcy, criminal activity and past or pending litigation that could affect the outcome of the project.

The five underwriting criteria for real estate lending are applied to the three risk tiers in Exhibit 7.

EXHIBIT 7
RISK-BASED CLASSIFICATION OF CEF REAL ESTATE LOANS

Underwriting Criteria	Tier I (Lower Risk)	Tier II (Base Case)	Tier III (Higher Risk)
Ability to Repay	Debt Coverage Ratios (DCRs) of 1.25 or higher, a strong market for the leasable area and/or significant pre-leasing by qualified tenants, ability to support project during stabilization of occupancy (about 2 years).	DCRs of 1.15 or higher. Longer leasing period and a weaker market than a Tier I project.	DCR of 1.05 or higher.
Collateral	Loan to value ratios of 75 percent or lower.	Loan to value ratios of 80 percent or lower.	Loan to value ratios of 90 percent or lower.
Development Team Capacity/ Experience	Each team member should have experience in completing a similar project.	Developer capacity and experience may be slightly less than for Tier I.	Developer capacity and experience same as Tier II, though projects may be of a different scale or nature.
Developer Commitment	Evidence of strong financial commitment by developer.	Developer may have fewer resources than a developer of a Tier I project.	Developer may have fewer resources than a developer of a Tier II project.
Character of Principals	Favorable credit history, and past performance in a legal, reasonable and professional manner.	Favorable credit history, and past performance in a legal, reasonable and professional manner.	Favorable credit history, and past performance in a legal, reasonable and professional manner.

It is important to remember that the underwriting guidelines are just that – guidelines, and ***assignment into a risk tier is not formula-driven but rather requires the judgement of an experienced underwriter.*** The underwriter should consider all available information and not just the financial ratios in assigning a project to a risk tier. For example, loan applications that are riskier than the Tier III categorization (e.g., if their DCR is below 1.05, or the LTV is over 90 percent) may be approved for transfer to the Trust if there are mitigating factors that would allow these low DCR or high LTV loans to qualify as Tier III projects.

Different levels of initial and ongoing review would be required depending on loan size. In addition to requiring closer scrutiny for large loans, it may be necessary to limit the size of any particular loan, to limit the number of loans that can be placed in the Trust from the higher risk tiers, and potentially to require some sort of recourse for certain categories of loans.

Maximum Loan Size

The size of any one loan should be limited so that any one loan will not put the entire pool in jeopardy. A rule of thumb to use for an ongoing pool is that no loan be more than 1-2 percent of the entire outstanding balance of the pool. If we assume that the first group of pooled loans would be about \$100 million, this would imply a maximum loan size of \$2 million. If the initial pool is smaller, a smaller loan cap would be needed. Conversely, if the pool size is larger, a larger loan cap would be allowed. If communities are interested in transferring larger loans to the Trust, it would be possible to establish a risk-sharing arrangement for these larger loans.

High-Risk Loans

After the Trust has developed some history, HUD will be able to recalibrate the pricing model to better estimate the risk associated with CEF loans. Until that is possible, it will be necessary to limit the overall exposure of the pool to high-risk loans. The premiums associated with the loan pricing model were developed based on the Small Business Administration 7(a) program. The program is most similar to the Tier II risk category described above. Adjustments to the premiums required were made for lower and higher risk categories. Because these adjustment factors were not developed based on CEF loan data, they may not accurately reflect the experience of Tier III loans. Thus, HUD should implement mechanisms for limiting exposure in the Tier III category. This can be accomplished in several ways:

- Limit the proportion of the pool from Tier III, for example by specifying that up to 25 percent of the pool can be Tier III loans;
- Require some sort of recourse for Tier III loans;
- Require that Tier III loans be “seasoned” for some period of time, e.g., two years, before they can be transferred to the Trust; or
- Require that a portion of the risk-adjusted premium for Tier III loans come from a non-EDI source.

Designated Underwriter

A key player in the CEF Trust is the “designated underwriter” who is responsible for underwriting loans transferred to the CEF Trust and for quantifying the required reserve contribution based on the project’s risk profile. The designated underwriter must have the ability to underwrite loans with local knowledge and on-site review. HUD must also have confidence that underwriting is performed consistently and that the underwriter will represent the interest of the CEF Trust, and not the community or the third-party borrower. Thus, a hybrid local/national structure is recommended, consisting of a national Program Manager responsible for a network of designated underwriters.

The Program Manager would be responsible for identifying, screening, training and monitoring the designated underwriters. The Program Manager would also be responsible for reviewing the analysis of the designated underwriters and reconciling any differences between the two reviews before any loan is accepted into the pool.

Compensation

The Program Manager and the designated underwriter would represent the *certificate holders'* (and HUD's) interest in ensuring that loans meet the underwriting guidelines. A portion of the costs related to underwriting would be covered by an application fee paid by the community (either directly or passed on to the third-party borrowers).

The underwriters must be independent, i.e., free of any conflict of interest with either the community originating the loan or the third-party borrower. This means that their compensation should not be tied to the outcome of any deal. The fee should reflect the size, difficulty of analysis, and complexity of the transaction. Both penalties and incentives can lead the designated underwriters to make inappropriate decisions. The threat of penalties for unsuccessful deals can lead to overly cautious underwriting and would limit the number of loans approved. Penalties would also likely raise the fee required by the designated underwriters to a level that would be prohibitively expensive.

Tying compensation to positive outcomes could also lead to inappropriate underwriting decisions. Incentives for closing deals could lead to overly lenient underwriting, with a goal of closing as many deals as possible. Tying fees to the ultimate success of a deal would require delaying compensation to five or more years after a deal closes, because only at that time will it become clear whether a project is successful. Making this type of arrangement acceptable to designated underwriters would require an unacceptably high level of compensation.

As part of the loan performance tracking system, the Program Manager must establish procedures to detect problems early, and develop systems to intervene and correct problems with specific designated underwriters in a timely manner. It is likely that monitoring of designated underwriters by the Program Manager, and the fact that their reputations and opportunities for future work depend on the quality of their performance, will be sufficient to encourage prudent underwriting.

Calculation of Risk Premium

A project's risk-based premium is determined using the Section 108 Loan Guarantee Pricing Model, based on the expected loss rate associated with its risk tier. The loan pricing model was designed by HUD with support from PriceWaterhouseCoopers consultants, to estimate a community's cost of originating a portfolio of Section 108 guaranteed loans to third-party borrowers under a range of user-defined parameters. The model can also be used to estimate the required risk-adjusted premium associated with any given loan as long as certain assumptions about the portfolio are made. The model requests a series of input parameters from the user, including loan volume, Section 108 interest rate, third-party borrower interest rate, reinvestment rate, loan term, and risk tier. Using these and other input parameters, the model identifies the net present value of cash outflows and inflows, and the premiums required to cover expected losses. The models allow for premiums to be paid up-front or on annual basis based on the outstanding balance of the portfolio.

Because there were no available data on the performance history of the Section 108 portfolio, the model relies on data from the SBA 7(a) program as the basis for modeling performance of the portfolio. The SBA 7(a) program is the most similar loan portfolio for which performance data are available, but it can be expected only to roughly approximate the performance of CEF loans. ***To the extent the two loan programs have different risk profiles, the actual performance of the portfolio will differ from the predicted performance.*** This could lead to an over- or under-funded Trust reserve, and thus the Program Manager must monitor performance vigilantly to avoid losses to the Trust. In the future, once data on Section 108 loans are collected and analyzed, the loan pricing model should be modified to reflect actual loan performance.

The loan pricing model takes as its starting point a base case derived from historic performance data for the SBA 7(a) program. It allows the user to make adjustments to control for riskier or less risky loans. The SBA base case is most similar to the ***Tier II risk level***. Tier I loans would be considered less risky, and Tier III loans more risky, than the base case. Because it is impossible to identify a unique adjustment factor relative to the base case for each loan, all loans within a given risk tier are assigned the same risk-adjusted premium rate.

5. Portfolio Cash Flow Projection

In order to assess the financial feasibility of the Community Empowerment Fund (CEF) Trust, Abt Associates contracted with PriceWaterhouseCoopers to extend its work on the Section 108 loan pricing model by building a related model for analyzing cash flows for a portfolio of CEF loans. The model was designed to be used in conjunction with the Section 108 Loan Guarantee Pricing Model to estimate the receipts and disbursements of the Trust under a range of user-defined parameters. It should be noted that this portfolio cash flow projection does not represent a traditional formal pro forma financial projection. Both Price Waterhouse and Abt Associates are well aware of the limitations of this approach to assessing the financial feasibility of the CEF Trust. ***While useful as part of an initial feasibility assessment, the portfolio model is not a substitute for a full-fledged financial analysis conducted by qualified accountants.*** Furthermore, the model in its current form is limited in its ability to simulate certain features of the CEF Trust proposal. Additional analysis will be required to improve the model's ability to estimate CEF Trust cash flows.

The financial projections produced by the portfolio model show that under a plausible set of assumptions, a \$100 million CEF loan pool would require a contribution of about \$7.4 million in Economic Development Initiative (EDI) funds, in addition to borrower payments and the cash flows generated by the Trust, in order to cover activity delivery costs and potential losses. Varying the baseline assumptions will lead to changes in the EDI funding requirements.

The baseline scenario evaluated assumed a ten-year trust consisting of a pool of \$100 million of Section 108 loans where Tier II loans comprise 50 percent of the Trust and Tier I (lower risk) and Tier III (higher risk) loans comprise 25 percent each. In order to support this pool, about \$7.4 million of EDI funds would be required to fund up-front premiums. The premiums would pay for a portion of activity delivery costs and fund the Trust reserve. (Additional EDI funds may be required to provide interest rate subsidies to borrowers or to fund technical assistance to the communities or borrowers.) Under this scenario, at the end of ten years the remaining Trust balance, after all Section 108 certificate payments have been made, would equal about \$2.1 million, which would be distributed to the communities holding CEF Trust certificates. Changing the baseline assumptions will change the Trust's cash flows, and lead to changes in the EDI funding requirements and in the funds remaining at liquidation. For example, increasing the proportion of high-risk loans in the pool, and decreasing the proportion of low-risk loans (40 percent Tier III and only 10 percent Tier I) would require premiums of about \$8 million in order to ensure that the trust balance was never below the minimum balance (which was set to one-twelfth of the value of annual certificate payments).⁶

⁶ Tier II loans are assumed to have the same cumulative default rate as the SBA base case in the Section 108 pricing model, i.e., 15.9 percent. Tier I loans are assumed to default at a rate 10 percent lower, i.e., 14.3 percent, and Tier III loans at a rate 100 percent higher, i.e., 31.8 percent. Each of the portfolio scenarios includes loans from each risk tier. The blended cumulative default rate for the baseline scenario is 19.5 percent. The blended default rate for the higher risk scenario is 22.1 percent.

Overview of the Pro Forma Financial Projection Model

The Pro Forma Financial Projection model is set up to simulate the cash inflows and cash outflows of the Trust to assess premiums, EDI funds, and Trust reserve funds necessary to support the trust. Trust receipts include borrower payments, premium fees, recoveries on losses, and reinvestment returns. Trust disbursements include certificate payments, default losses, and activity delivery costs. The pro forma also calculates the “ending trust balance” which is the difference between cash inflows into the Trust and cash outflows. If the ending balance is positive, the residual funds would be disbursed to the communities holding CEF Trust certificates. (Alternatively, if a mechanism were developed to allow the trust to borrow funds for periods when cash outflows exceed inflows, then adjustments to the model inputs could be made to create a scenario in which the final Trust balance equals zero. In that case, expected cash inflows would just cover expected outflows.)⁷

The basic model consists of a front-end interface where the user can input descriptors of the scenario to be estimated. Using these inputs, as well as parameters input into the Section 108 Loan Pricing Model, a set of outputs is provided describing the cash flows resulting from the trust.

Pro Forma Financial Projection Scenarios

In order to assist HUD in assessing the financial impacts of the CEF Trust, a baseline scenario and several alternative scenarios have been developed. Below we describe the assumptions used to estimate the baseline scenario. Appendix B provides definitions of key model elements and more information about key assumptions.

Baseline Scenario Description

- Loan Volume: \$100 million
- Trust Term: 10 years
- Trust minimum annual ending balance: \$1,079,205⁸
- Risk Tiers: 25% Tier I (low risk), 50% Tier II (baseline risk), 25% Tier III (high risk)
- Tier I adjustment factor: default risk 10% lower than Tier II
- Tier III adjustment factor: default risk 100% higher Tier II
- Trust balance reinvestment rate: 4.00%⁹
- Float reinvestment rate: 4.00%¹⁰

⁷ It may be possible for the Trust to arrange financing as an alternative to overfunding the loss reserve. The precise impact on the reserve requirement will depend on the terms of the financing.

⁸ In all four scenarios, it is assumed that the Trust must maintain a minimum balance equal to one-twelfth of the value of the certificate payments due annually to the Section 108 Trust.

⁹ To maintain its status as a grantor trust, the Trust can only make short-term, low-risk investments.

¹⁰ The loan pool generates “float” because deposits of monthly payments from borrowers earn interest in the period before semi-annual payments are due to the Section 108 Trust. A reinvestment rate of zero would simulate a scenario in which all proceeds from the float are paid out as compensation to the Trustee and/or Program Manager.

- Up-front activity delivery costs, fixed amount: \$1 million. Includes \$500,000 for start-up costs, plus \$500,000 as the fixed amount on a pool size up to the \$50 million threshold.
- Up-front activity delivery costs, variable amount: \$500,000 (1% of the amount over the \$50 million threshold).
- Annual activity delivery cost: 1% of average outstanding principal balance.
- Section 108 interest rate: 5.0%
- Third-party interest rate: 6.0% (assumes that a 100 basis point spread over the Section 108 cost of funds covers ongoing activity delivery costs; assumes no risk cushion and no interest subsidy or premium)
- Section 108 loan term: 10 years
- Payment deferral period: 0 years
- Loss recovery rate: 50.77%

Under the scenario described above, total EDI premiums collected (to cover a portion of activity delivery costs and reserve requirements) would be about \$7.4 million. The premium structure will cover all expected losses, leaving an ending Trust balance of about \$2.1 million at the end of the 10-year period. These funds would be disbursed to the communities as a return on the CEF Trust certificates. Under the baseline scenario, a positive balance is remaining at the end of the Trust term because the Trust incurs more loan losses in the early years than in later years. In later years, the combination of borrower payments and reinvestment earnings exceeds the amount required for Section 108 loan payments, resulting in an excess reserve available for disbursement when the Trust is liquidated. If a mechanism were developed that enabled the trust to borrow funds to cover a temporary negative balance, the amount of the required EDI premiums would be lower. Exhibit 8 shows the annual cash inflows and outflows associated with this base case scenario.

In order to test the sensitivity of the pro forma model to the assumptions used, as well as to describe other alternative scenarios, several alternative scenarios were modeled.

Alternative Scenario One: A Riskier Portfolio than the Base Case

Under Alternative Scenario One, the mix of loans in the Trust is changed. Tier II loans would still comprise 50 percent of the trust but Tier I loans would only comprise 10 percent and Tier III would comprise 40 percent of the pool. In order to ensure that the Trust balance was never negative, over \$8 million in EDI funds would be required. As in the baseline scenario, a final balance of about \$2.1 million would remain in the Trust at the end of the 10-year period.

EXHIBIT 8
ANNUAL CASH FLOW PROJECTIONS FOR BASELINE SCENARIO

Years	1	2		4	5	6	7	8	9	10
Trust Balance, Beginning	\$7,354,091	\$6,101,461	\$4,397,187	\$1,732,321	\$1,092,275	\$1,135,299	\$1,307,489	\$1,520,828	\$1,728,997	\$1,930,497
Receipts										
Borrower Payments	\$13,322,460	\$13,322,460	\$13,322,460	\$13,322,460	\$13,322,460	\$13,322,460	\$13,322,460	\$13,322,460	\$13,322,460	\$13,322,460
Premium Fees	\$7,354,091	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -
Recoveries on Losses	\$ -	\$38,643	\$1,021,510	\$1,966,434	\$1,387,343	\$743,327	\$355,973	\$145,525	\$48,970	\$11,087
Interest Earned (Float)	\$231,935	\$236,601	\$241,554	\$246,812	\$252,395	\$258,322	\$264,615	\$271,296	\$278,389	\$285,920
Interest Earned (Trust Balance Investment)	\$268,628	\$209,596	\$122,370	\$56,390	\$44,471	\$48,768	\$56,465	\$64,880	\$73,058	\$81,045
Total Available	\$28,531,205	\$19,908,761	\$19,105,081	\$17,324,418	\$16,098,945	\$15,508,177	\$15,307,002	\$15,324,989	\$15,451,874	\$15,631,009
Disbursements										
Certificate Payments	\$12,950,457	\$12,950,457	\$12,950,457	\$12,950,457	\$12,950,457	\$12,950,457	\$12,950,457	\$12,950,457	\$12,950,457	\$12,950,457
Losses	\$76,115	\$2,012,035	\$3,873,221	\$2,732,605	\$1,464,106	\$701,149	\$286,635	\$96,454	\$21,838	\$2,413
Administrative Costs	\$2,049,081	\$549,081	\$549,081	\$549,081	\$549,081	\$549,081	\$549,081	\$549,081	\$549,081	\$549,081
EDI Funding for Premiums	\$7,354,091	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -
Total Disbursements	\$22,429,744	\$15,511,574	\$17,372,760	\$16,232,144	\$14,963,645	\$14,200,688	\$13,786,174	\$13,595,993	\$13,521,377	\$13,501,952
Cash Surplus (Deficit)										
Financing										
Reserve for Loss	\$76,115	\$2,012,035	\$3,873,221	\$2,732,605	\$1,464,106	\$701,149	\$286,635	\$96,454	\$21,838	\$2,413
Cash Balance, Ending	\$6,101,461	\$4,397,187	\$1,732,321	\$1,092,275	\$1,135,299	\$1,307,489	\$1,520,828	\$1,728,997	\$1,930,497	\$2,129,057

Alternative Scenario Two: All Premiums Funded Through EDI

Under Alternative Scenario Two, borrowers no longer pay an interest spread to cover activity delivery costs. Instead EDI funds are assumed to be used to cover both up-front and annual activity delivery costs in addition to the risk premium. It is assumed that all EDI funds are deposited into the trust upfront. At the end of 10 years the trust would have the minimum \$1 million balance remaining, but \$11.5 million of premiums funded by EDI would be required.

Alternative Scenario Three: Twenty-year Term

Alternative Scenario Three models a CEF Trust consisting of Section 108 financed loans with 20-year terms. Compared to the baseline scenario, activity delivery costs and loan losses increase significantly, as do reinvestment earnings. As a result, more EDI funds (\$9.4 million) are required up-front, but more funds are remaining for disbursement at Trust liquidation (\$4.6 million).

Exhibit 9 below summarizes the inputs and outputs associated with the Pro Forma Financial Projection for the baseline scenario and the three alternatives. Clearly, other assumptions can be tested as well.

EXHIBIT 9
CASH FLOW PROJECTIONS FOR FOUR PORTFOLIO SCENARIOS

	Baseline Scenario	Riskier Portfolio	EDI Funds All Premiums	20-year Term
Scenario Description				
Trust Term	10 years	10 years	10 years	20 years
Loan Volume	\$100,000,000	\$100,000,000	\$100,000,000	\$100,000,000
Section 108 Interest Rate	5.0%	5.0%	5.0%	5.0%
Borrower Interest Rate	6.0%	6.0%	5.0%	6.0%
% Tier I Loans	25%	10%	25%	25%
% Tier II Loans	50%	50%	50%	50%
% Tier III Loans	25%	40%	25%	25%
Trust Balance Return Rate	4.0%	4.0%	4.0%	4.0%
Float Return Rate	4.0%	4.0%	4.0%	4.0%
Tier I Adjustment Factor	10%	10%	10%	10%
Tier III Adjustment Factor	100%	100%	100%	100%
Trust Minimum Balance	\$1,079,205	\$1,079,205	\$1,079,205	\$1,079,205
Model Outputs				
Cash Inflows				
Total Borrower Payments	\$133,224,602	\$133,224,602	\$127,278,618	\$171,943,454
Total EDI Premiums	\$7,354,091	\$8,092,909	\$11,490,000	\$9,366,818
Total Recoveries	\$5,718,813	\$6,554,634	\$5,580,324	\$9,153,225
Trust Balance Reinvestment Returns	\$1,025,672	\$1,092,834	\$1,725,980	\$2,456,738
Float Reinvestment Returns	\$2,567,839	\$2,567,839	\$2,500,629	\$3,022,077
Cash Outflows				
Certificate Payments	\$129,504,575	\$129,504,575	\$129,504,575	\$160,485,174
Up-front Activity Delivery Costs	\$1,500,000	\$1,500,000	\$1,500,000	\$1,500,000
Annual Activity Delivery Costs	\$5,490,814	\$5,490,814	\$5,490,814	\$11,322,929
Total Loan Losses	\$11,266,570	\$12,481,629	\$10,993,602	\$18,029,501
Ending Balance	\$2,129,057	\$2,124,142	\$1,086,560	\$4,604,707

Appendix A

Additional Legal Analysis of the CEF Community Trust Concept

Appendix B

Portfolio Financial Model Definitions and Assumptions

I. Pro Forma Model Inputs

Trust Term

The trust term is the length of time that the trust will exist. The trust term cannot exceed 20 years and must be expressed as a whole number. Note that the trust can have a term different from the Section 108 loans included in the Section 108 Pricing Model. If the terms are of different lengths, the pro forma projection will use the Section 108 Pricing Model cash flows beginning with Year 1 of the loan term. It is assumed that loans enter the trust upon origination.

Loss Reserve Balance Investment Return Rate

The loss reserve balance investment return rate is the rate at which the trust invests the available funds in the loss reserve. It is calculated as the interest compounded monthly on the annual average outstanding reserve balance. The available balance may be invested in short term securities. Assuming that all premiums are deposited into the loss reserve upon origination of the loan (rather than on an annual basis), investment return on the loss reserve balance will substantially lower required premiums.

Three Risk Tiers for Loans

The pro forma financial projection allows the user to determine the mix of loans in the trust. The user can input the percentage of loan volume in the trust that is low (Tier I), baseline (Tier II), and high risk (Tier III). This loan mix is used to calculate weighted average conditional default rates for loans in the trust. The default rates for each tier are taken from the Section 108 Pricing Model. The percentage for each tier should not exceed 100 percent and the sum of the three tiers should equal 100 percent.

The Tier II conditional default rate profile is generated from the historical performance data of SBA's 7(a) program as of 1995. Since users have the option to select a loan term of up to 20 years, and only 13 years of historical data are included for SBA's 7(a) program, the Section 108 Loan Pricing Model holds conditional default rates constant after the thirteenth policy year. The conditional default rate profiles for Tier I and Tier III loans are estimated from the Tier II profile, based on the Tier I and Tier III adjustment factors selected in the Section 108 Pricing Model user interface. These rates can only be adjusted within the Section 108 Pricing Model.

Initial Premium

The initial premium is the amount charged to the communities up front on the original loan amounts of the loans in the trust. A different initial premium can be charged to the three tiers of risk in the trust. This initial premium will be used to fund the loss reserve fund and to cover up-front administrative costs associated with the trust.

To calculate the up-front premium for each risk tier, the user can create the desired performance scenario and select the "Calculate Premiums" button. The model will calculate

the up-front premiums for each of the risk tiers necessary to make the trust self sufficient if the *reserve balance investment return rate* is set to 0. In this case, the up-front premium must cover all up-front administrative costs and all expected future losses.

When the reserve balance investment rate and/or the float balance investment rate are greater than 0, a portion of the total expected loss will be covered from the returns received on the reinvestment of the trust balance. In this case, the up-front premium will cover the up-front administrative costs and a *portion* of the expected loss. Thus the premiums required to create a revenue neutral pool must be calculated iteratively in the model. In the future, adjustments to the loan pricing model could be made to account for these additional cash flows into the model, so that the premiums calculated in the Section 108 Loan Pricing Model would directly feed into the pro forma.

Annual Premium

The model was originally designed with activity delivery costs paid in part by an annual premium. For our scenarios, we set the annual premium payment to zero percent.

Annual Activity Delivery Costs

Annual activity delivery costs are expected to average about 1 percent of outstanding principal balance (about 25 basis points for servicing, 25 basis points for central fiduciary responsibilities, and 50 basis points for other portfolio management activities such as loss mitigation and review and reporting on loan performance). In our cash flow projections, these ongoing activity delivery costs are spread evenly over the entire term of the Trust. In other words, we first calculated the total ongoing activity delivery costs on the basis of the principal outstanding in each year of the Trust, summed across the years, and divided the total by the number of years the Trust would operate to estimate the annual activity delivery costs.

Percentage of Premiums Funded by EDI Funds

This variable represents the amount of premium payments covered by HUD through EDI funding. The user interface allows the user to enter an assumption for both the initial premiums and annual premiums. For the pro forma projections presented, it is assumed that all upfront premiums are funded using EDI monies, and that there are no annual premiums.

HUD can also provide credit enhancements through loan payment deferrals and interest rate subsidies. The user can include these credit enhancements in the analysis through the Section 108 Pricing Model user interface. The projections capture these credit enhancements as reduced borrower payments (though they are not included in the pro forma as EDI premiums, since they are external to the pro forma).

Activity Delivery Cost (Up-front - Fixed Amount)

The up-front activity delivery cost represents the amount initially required for the establishment of the trust. This cost can be represented as a fixed dollar amount. Up-front costs include:

- Establishing the legal structure of the trust
- Developing the underwriting process and establishing a system of underwriters
- Developing the loan servicing arrangements
- Developing materials for communities

We estimate that the start up costs will be about \$500,000 (\$100,000 for establishing the legal structure of the trust, \$75,000 for developing the underwriting process, \$175,000 for establishing the system of underwriters, \$100,000 for developing the loan servicing arrangements, and \$50,000 for developing materials for communities).¹¹

In addition to one-time start up costs there are activity delivery costs associated with establishing each specific pool, including developing the trust documents and the costs of underwriting the loans. Below a certain minimum threshold, assumed here to be \$50 million, these costs are fixed, and once this minimum threshold is reached, the additional activity delivery costs are assumed to be a fixed percentage of the loan amount.¹²

Activity Delivery Cost Loan Volume Threshold

The user can input a loan volume threshold at which an additional percentage is added to the up-front activity delivery costs. This should be used if the fixed activity delivery cost amount represents less than one percent of the loan volume. As noted above, the default value for this threshold is set at \$50 million.

Activity Delivery Cost (Up-front - Variable Amount)

This percentage represents the additional activity delivery costs associated with establishing the trust as a percentage of the loan volume above the threshold amount. These costs cover loan underwriting and legal fees for preparing Trust documents. This amount is added to the fixed up-front cost amount to calculate the total up-front activity delivery costs. The default value is set at 1 percent of loan volume.

¹¹ No precise data were available on the start up costs for similar programs. Thus, we used the best estimates of the team and other experts to estimate start-up costs.

¹² Activity delivery costs are assumed to be about 1 percent of the loan amount above the threshold. This is a simplifying assumption for calculating costs. These costs must also covers costs for loans that are reviewed but not approved as well loans that are ultimately approved. In reality, part of the costs for loans that are not approved will be covered by an application fee paid by all loan applicants. It is also expected that up-front underwriting costs should be tied to the complexity of the deal, rather than set as a fixed percent of each loan. In addition, EDI funds can be used for providing technical assistance to communities and borrowers. If technical assistance funds can improve the loan applications, the underwriting may be less costly.

II. Inputs to the Section 108 Loan Pricing Model

Loan Volume

This variable represents the total dollar volume of the pool. The loan volume necessary for a self-sustaining trust will depend on the loss experience of loans in the trust and the administrative costs associated with the trust. No standard exists for a minimum loan volume size. For the Small Business Administration secondary market program, the minimum pool size has been approximately \$20 million. However, underwriters typically prefer pool sizes of \$50 million and greater. It should be noted that the trust's loan volume will be a function of HUD's ability to leverage EDI funds.

Section 108 Interest Rate

This variable represents the interest rate at which the Section 108 eligible community borrows from investors. In the loan pricing model, the same rate is used to discount the future cash flows of the portfolio.

Third Party Borrower Interest Rate

This variable represents the interest rate at which third parties borrow money from the Section 108 eligible community. In the model, this rate is used to estimate the constant annual principal and interest payments that third party borrowers are obligated to repay to the community.

The user may select a different third party borrower interest rate from the Section 108 interest rate. For instance, if the community decides to lend at an interest rate lower than the rate at which it borrows money from investors, the effect is an interest rate subsidy to the borrower. Since the community is taking in smaller principal and interest payments than the amount that it is obligated to repay to investors, it will incur additional costs on the portfolio. These costs can also be funded using EDI funds. Conversely, the community can lend at an interest rate higher than the rate at which it borrows from investors in order to cover administrative costs or to provide an additional risk cushion borne by the borrower.

Section 108 Reinvestment Rate

This variable represents the reinvestment rate for the funds collected from the borrower's monthly principal and interest payments. Positive interest rate arbitrage can occur because the borrower makes monthly principal and interest payments, and the Trust makes annual principal and semiannual interest payments to investors.

Loan Term

This variable represents the expected length in years of the portfolio's loan term. The model will estimate the future cash flows of the portfolio for the number of years as specified under the loan term assumption.

Payment Deferral Period

The loan pricing model allows the user to input a payment deferral period. This deferral period represents a time when the community subsidizes all principal and interest payments that are owed by the borrower. The variable is input in whole years.

Tier I (Low Risk) Adjustment Factor

This variable shows the percentage reduction in default rate relative to Tier II for the low risk default profile loans (Tier I). In the baseline pro forma scenario presented below, we have conservatively assumed that Tier I loans have a risk adjustment factor of 10 percent, indicating that the Tier II baseline cumulative default rate is reduced by 10 percent for Tier I loans..

Tier III (High Risk) Adjustment Factor

This variable shows the percentage increase in default rate of the high risk loans (Tier III) relative to the Tier II default profile. In the baseline pro forma scenario presented below, we have conservatively assumed that Tier III loans have a risk adjustment factor of 100 percent, indicating that the baseline cumulative default rate is increased by 100 percent for Tier III loans relative to Tier II loans.

III. Trust Cash Inflows

Borrower Payments

The borrower payments represent the principal and interest payments made by borrowers to the trust. These borrower payments are generated by the Section 108 Pricing Model. Credit enhancements such as payment deferrals and interest rate subsidies will be reflected in reduced borrower payments.

Initial Premiums

This line item includes the initial premium which is taken as a percentage of the beginning loan volume that can be found in the Section 108 Pricing Model user interface. The initial premium includes both a portion designated to cover activity delivery costs as well as a portion that covers expected losses. If a positive return on trust balances is set, then the initial premiums do not have to cover all the expected losses. A portion of the expected losses will be covered from the reinvestment returns on the trust balance.

Recoveries on losses

This line item represents the amount that is recovered on loans in the trust that default. It is assumed that a one year lag exists between default and recovery. The projections assume a recovery rate of 50.77 percent which is taken from the historical performance data of SBA's 7(a) program as of 1995. The model output includes the total amount recovered on defaults. The recovery rate cannot be changed.

Interest Earned, Float

This line item reflects the return on investment of borrower payments and is generated by the Section 108 Loan Pricing Model. Positive interest rate arbitrage can occur because the borrower makes monthly principal and interest payments, and the trust makes annual principal and semiannual interest payments to investors. The model in its current form only accounts for the float that accrues to the Trust reserve.

Interest Earned, Trust Balance Investment

This line item reflects the return on investment of the trust balance. The calculation is based on the annual average outstanding balance of the trust and is generated by the "Trust Balance Investment" sheet.

IV. Trust Cash Outflows

Certificate Payments

The certificate payments represent the principal and interest payments made to investors. These certificate payments are generated by the Section 108 Loan Pricing Model.

Losses

This line item represents the defaults that occur in the trust and is calculated in the "Default" sheet. The losses are based on the weighted average of the conditional default rates for the three loan risk tiers. The model output includes the total amount of losses resulting from default.

Activity Delivery Costs

This line item includes the initial fixed and variable costs associated with establishment of the trust as well as the annual costs associated with administering the trust and servicing loans in the trust. The user interface includes the total amount of activity delivery costs associated with the trust.

EDI Funding for Premiums

The EDI funding for premiums represent the amount of initial and annual premiums that are funded by HUD using EDI funds. Credit enhancements such as payment deferrals and interest rate subsidies are reflected as reductions in the borrower payments line item.

Trust Balance, Ending

The model output provides the final ending balance of the trust. If a trust is to be exactly self sufficient, the final ending balance would be equal to zero. The model user can adjust the premiums for each scenario to achieve a zero balance. If the final trust balance is positive, the funds would be disbursed to the communities as a return on the CEF Trust certificates.

Appendix C

Glossary and Acronyms

Glossary

CEF Community Trust: The proposed legal vehicle through which communities pool economic development loans made with Section 108 proceeds.

Designated Underwriter: The individual or entity designated by the Program Manager to perform the initial underwriting of loans proposed for acquisition by the CEF Trust.

Grantor Trust: A legal entity that functions for tax purposes functions as a pass-through to the owners of the trust. A grantor trust does not have the discretion to independently conduct business or make investments and thus is not itself a taxable entity.

Phase I: The first phase of Community Empowerment Fund implementation, in which a pooling mechanism, and underwriting and servicing procedures are established. The certificates of ownership in the loan pooling trust would be held by participating communities, and would not be sold to private investors, but

Phase II: HUD envisions that the second phase of Community Empowerment Fund implementation would entail the sale to private investors of certificates representing an ownership interest the pool of CEF Community Trust loans. Phase II would not be fully designed until after the Phase I loans have established a sufficient track record to allow investors to estimate the risks associated with investments in a pool of CEF loans.

Program Manager: The Program Manager is a contractor hired by HUD to operate all aspects of the CEF Community Trust, including establishing trust administration, underwriting, and servicing.

Section 108 Loan Guarantee Program: Authorized as part of the CDBG, the Section 108 loan guarantee program provides financing for economic development projects. HUD guarantees that communities will repay the Section 108 Trust and that the Section 108 Trust will make scheduled payments to certificate holders.

Section 108 Trust: The legal vehicle for a HUD-sponsored public offering under the Section 108 loan guarantee program.

Servicer: The entity responsible for collecting, accounting for, and reporting on payments made to the CEF Community Trust.

Trustee: The entity responsible for trust administration.

Acronyms

CDBG – Community Development Block Grant

CEF - Community Empowerment Fund

FASIT – Financial Asset Securitization Investment Trust

REMIC – Real Estate Mortgage Investment Company

SBA – Small Business Administration

UBTI – Unrelated Business Taxable Income

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