UNIVERSITY *of* NEW HAMPSHIRE

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Financial Innovations Roundtable
The Carsey Institute
University of New Hampshire
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Jodie Harris
Policy Specialist
CDFI Fund
U.S. Department of the Treasury
601 13th Street, NW., Suite 200 South
Washington, DC 20005

Dear Ms. Harris:

Re: Comment on CDFI Bond Guarantee Program authorized by the Small Business Jobs Act of 2010 (PL111-240)

Created in 2000, the Financial Innovations Roundtable (FIR), housed at the Carsey Institute at the University of New Hampshire, creates cross-sector partnerships among conventional and non-traditional lenders, investors, and markets to provide low-income communities with increased access to capital and financial services. The FIR appreciates the opportunity to comment on the implementation of the CDFI Bond Guarantee Program (CBGP) which was authorized in section 1141 of the Small Business Jobs Act of 2010.

Over the past eleven years the FIR has worked with community development organizations (largely CDFIs) to address and solve problems related to access to capital. The FIR does this by tapping the expertise of thought leaders from the institutional investment, banking, philanthropic, and community development industries. The recent book, *Capital Markets, CDFIs and Organizational Risk* (available at http://www.carseyinstitute.unh.edu/docs/Swack_CapitalMarkets.pdf) documents much of the work of the FIR over the last decade. Over the past year, the FIR has focused a considerable amount of time and discussion on the CDFI Bond Guarantee Program.

Financial Innovations Roundtable CDFI Bond Guarantee Task Force

Over the past year, the FIR has convened a task force to address policy and implementation issues related to the new Bond Guarantee Program. The goal of the task force is to provide input and recommendations to assist Treasury in developing and implementing a program that is both functional and accessible to all creditworthy CDFIs.

The task force is composed of bond counsel, representatives from underwriting and bond structure firms, institutional investors, and CDFI leaders. It is divided into four work groups: The Policy Work Group; the Credit Enhancement, Collateral Innovations & Subordination Strategy Work Group; the Issuer Protocol & Aggregation Strategy Work Group; and the Underwriting Standards, Bond Structure & Issuance Priorities Work Group.

The task force has addressed the following critical questions:

1. How can we utilize the new capital made available through the guarantee without increasing the leverage on CDFI balance sheets?
2. How can we identify and provide sufficient cash reserves and over-collateralization, if required, to Treasury's requirements (as determined by OMB "scoring") of 3 percent of bond total (see section "d" of statute—Risk Share Pool)?
3. How can CDFIs become "bond ready" without overtaxing CDFI resources and personnel? That is, how can they work with the bond administrator so that the borrower(s) are able to benefit significantly (in terms of the scale of capital they can access) and continuously (through a reliable capital source) at a low cost of capital without increasing the debt and leverage ratios of the CDFI's?
4. How can we ensure functionality and accessibility for all CDFIs—whether large, medium, or small, as long as they are successful lenders? How should the program be structured so as to include medium and small CDFIs?
5. Can the program be flexible? How can the rules insure flexibility? Specifically, flexibility in loan types, structure of relationship between CDFI and investor (recourse or not, other risk sharing arrangements, establishment of additional credit enhancements, etc.), and by issuing entity (aggregator or from a single CDFI). This is necessary because CDFIs and investors (i.e. the market) are best able to determine the optimum assets and terms for the bond. Ideally, CDFIs and the CDFI Fund would negotiate the optimum structure to address credit risk.
6. Generally, the law references back to the 1994 CDFI Fund statute for purpose and eligible uses. Should the program use those rules, and not set more restrictive rules regarding purpose and eligible uses? If so, the guarantee would cover any type of transaction that a CDFI can carry out with funds from the CDFI Fund.
7. The guarantee must be attractive to investors—so it should be simple and quick for the guarantee to be called by the investor, and easy to obtain by the issuer. How can it be structured so as to be easy and attractive to investors?

8. The default scenario should be clarified (what happens if the 90 percent rule is violated by the CDFI?). Lack of clarity on what happens would discourage actors from using the program. What are suggestions for default scenarios that would satisfy both CDFIs and prospective investors?
9. Can the guarantee be used with FHLB advances—thus enabling CDFIs to join the FHLB system? This would be a win-win-win for the FHLB, CDFI Fund, and CDFIs.
10. The biggest hurdle may be the proper assessment of the credit risk of the bonds. It may be possible for OMB and the CDFI Fund to develop some general industry models that predict the credit risk of lending to CDFIs in general, but each bond will have a different risk profile. The assets in the bond will be different in each bond, of course. But, the degree to which recourse back to the CDFI issuer reduces credit risk will also be difficult to determine. Most of these bonds will probably be set up in SPEs with no recourse back to the CDFI; but other CDFIs will be willing to provide some degree of recourse, which should affect the total pricing and structure for the guarantee. Can we suggest some basic models and options for assessing different risk profiles?
11. How can we use the guarantee to access new capital resources for CDFIs?
12. What are the potential unintended consequences of the program and how can they be avoided?

The following recommendations emerged from the four FIR work groups. At the end of our recommendations, we present, on page 12, a <u>proposal to implement the program this year (2011) so as to not lose $1 billion in guarantee authorized by Congress.</u>

POLICY WORK GROUP

Guiding Principles and Objectives for Bond Program

1. Financial protection of treasury's guarantee position.
2. Flexibility in the design and attributes of individual bond issues.
3. Inclusiveness that allows for CDFIs across a range of sizes and asset classes to participate.
4. Documenting the contribution of CDFIs to the financial services industry through their lending to low-income borrowers and in low-income communities.

Financial Protection for Treasury

- Because the Investor in the bonds has a 100 percent guarantee from Treasury, Treasury is the party with the ultimate financial risk, and that risk must be adequately mitigated to ensure that the program is successful and that bondholders are repaid from revenues, not through payments on the guarantee.

- It is in the interest of the CDFI industry that Treasury be protected against loss on the guarantee as a demonstration of the underwriting skills of CDFIs and their ability to perform.
- Nonetheless, the bond program, together with such financial protection that may be required by Treasury, must take into account the size, experience, and performance of CDFIs and the asset classes represented by their lending—the standard yardsticks must be adjusted to fit these non-homogeneous types of issuers.
- We assume that Treasury will require additional financial protection for a given bond issue, which will be a matter of negotiation between Treasury and the CDFIs involved in the particular bond issue.
- A mechanism should be included such that over time, and with satisfactory performance, the amount of any required financial protection would be rolled back.
- Treasury should have as its goal the issuance of 100 percent of its bonding authority; that is, all reasonable steps must be taken to avoid a situation in which the bond program is not fully utilized, assuming demand.
- Assuming eligible CDFIs offer bond issuance plans that meet program requirements, Treasury's approval should hinge on the feasibility of getting the bonds issued within its time requirements, taking into account, however, efforts to be inclusive.

Flexibility

- Allow CDFIs (singly or in groups) to propose their individualized bond plan to the CDFI Fund, created in consultation with their bond experts and advisors, for an individual issue of $100 million, which may include requests for issues of less than 30 years, or include customary bond provisions, such as remarketing that effectively allow the bonds to continue for 30 years.
- To gauge demand, Treasury should design a "bond reservation system" that allows CDFIs to individually or collectively reserve one of the 10 bonds annually from 2012 through 2014.
- Treasury should set relatively short time frames for a review of each proposed bond financing plan, negotiating with the CDFIs as needed, and approving those plans that meet its criteria to move forward.
- The review process implies that Treasury has retained sufficient bond expertise to review a proposed plan and its feasibility, and give the designated group a time frame within which to have closed with an investor. (If there are investors other than the FFB.)
- The so-called "bond reservation" must expire at a point in time when it would be possible for a back-up CDFI or set of CDFIs to take over the bond reservation in the event the group with an initial reservation cannot close within the required timeframe.

- CDFIs would have the flexibility to build their team, identifying the members of their team, their business plan, and their investor(s).
- Treasury needs to establish minimal program rules to allow groups to start forming this year, in order to be able to submit proposals as soon as the regulations are issued.

Inclusiveness

- We should assume that the program is oversubscribed every year, and that accordingly, Treasury must include mechanisms that allow for inclusivity of all types and sizes of CDFIs.
- Treasury should consider reserving one bond issue each year until a date certain to allow smaller CDFIs to partner together.
- Treasury should consider reserving one bond issue each year until a date certain to allow CDFIs offering underserved asset classes to put together a bond proposal.
- However structured, these efforts should not result in the loss of any annual bond authority.
- CDFIs should be able to include loans for any purpose authorized under the Riegle Act; and the statute is specific that this may include refinancings.

Documentation

- The access to capital the bond program represents is a tremendous opportunity for CDFIs to further demonstrate both their capacity and their importance as a delivery mechanism within the financial services industry.
- It will be important for Treasury and/or the CDFI Fund to build reasonable reporting requirements into the program such that the performance of CDFIs and the underlying assets is documented.

Credit Enhancement, Collateral Innovations & Subordination Strategy Work Group

Goals

- Recommend a method that Treasury can use for setting credit enhancement levels for bond issues across a wide variety of asset classes.
- Determine feasible credit enhancement sources and structures.

Recommendations

1. Treasury should design a program that allows guaranteed bond issuance using the range of community development asset classes available to CDFI's to serve as the primary collateral for the bonds and create disciplined methods to ascertain the credit enhancement level for each asset class.
2. Treasury should design a program that allows a variety of credit enhancement structures and sources to obtain the required credit enhancement level.
3. Treasury should employ methods similar to the rating agencies for purposes of determining the required credit enhancement level. Risk analysis techniques used by the rating agencies should be employed in this platform (but not include the actual rating agencies in this process) because their techniques can be emulated and custom tailored for this specific bond issuance program.
4. Treasury should allow the following community development asset classes used as collateral securing the bonds:

    CDFI recourse unsecured debt

    CDFI recourse secured debt (secured by the CD assets listed below)

    CDFI non-recourse debt: Secured by CDFI originated assets (loans to the following:)

    - Small Business
        - SBA definition
        - Micro small business
    - Housing
        - Affordable multifamily
        - Single family
        - Manufactured homes: park and single family
    - Charter schools
    - Community facilities
        - Assisted living/Supportive housing

5. Treasury should ensure full utilization of the program. The program should strive to reduce the related liabilities to CDFI's. The program should minimize any related

increased leverage by allowing outside creative enhancement sources and non-recourse/off balance sheet structures.

6. Treasury should facilitate and lead efforts to use Federal Unclaimed Financial Assets (UFAs) to serve as credit enhancement for this program. UFAs from Treasury should be used to collateralize the First Loss Guarantee (FLG) in connection with bonds issued with the guarantee. Use of UFAs would protect the treasury guarantee and significantly improve the utilization of the program by reducing the capital required to be sourced by CDFI's for the credit enhancement. A more detailed recommendation on the use of UFAs is included in Appendix B of this report.

Guiding Principles and Assumptions

1. Treasury will not issue a guarantee unless it is determined that the guarantee's cost will be zero.
2. Market assessment of risk is a fact of the financial markets. Terms of credit are provided based on assessment of risk.
3. A debt instrument desiring to get an execution that is more favorable than its actual market risk must have credit enhancement to assume the risk gap between the actual market execution and desired execution. Credit enhancement allows the instrument to get more favorable terms than it otherwise deserves.
4. Credit enhancement is necessary to achieve a zero cost to Treasury.
5. Credit Enhancement has historically been provided by a variety of means such as cash reserves, letters of credit, subordination, pledges of additional collateral, etc.
6. The CDFI industry finances various asset classes that have different risk profiles.
7. CDFI recourse debt is an asset class much like various asset classes financed by CDFI's.
8. Different asset classes require different levels of credit enhancement to support a zero cost to Treasury.
9. The CDFI industry does not have "excess" net asset capital to support an additional $4.0 billion of recourse debt (it would require an additional $600M of equity to support $3 billion at 4:1).
10. The industry desires a solution that allows it to fully avail itself of the $4.0 billion available.
11. A key constraint in utilizing the $4.0 billion is the amount of net asset capital required by a CDFI in connection with the actual risk retained by a CDFI.
12. The lower the amount of risk retained by CDFI's …the lower the amount of net asset capital necessary to utilize the program.
13. Liquidity required to fund credit enhancement levels is different than net asset capital required to support retained risk.

14. The level of credit enhancement required to be sourced solely by CDFI's (liquidity) and the level of overall risk retained directly by CDFI's (capital) will directly affect the amount of lending capital made through this program.

Issuer Protocol & Aggregation Strategy Work Group

Recommendations

1. PRI Covenants: Agree on a common approach for CDFIs and funders to modify PRI/Note financial covenants. This will be needed to permit greater leverage for CDFIs.
2. Separate Credit Risk: Permit Issuers to maintain separate reserves. If a CDFI borrows funds from an Issuer that is lending to multiple CDFIs, individual CDFIs will not want to bear the losses of other CDFIs. The 3 percent risk-share pool required by the legislation should permit Issuers to maintain separate reserves for the respective CDFIs they make loans to so the CDFIs don't have to pay for losses caused by other CDFIs.
3. Special Purpose Entities: Consider SPEs established by CDFIs as the Borrower/Issuer CDFIs to qualify for the guarantee.
4. Transparency to Underlying Borrowers: Provide transparency to investors. After the disaster with sub-prime securities, investors will want to see through the guarantee to the underlying loans.

Underwriting Standards, Bond Structure & Issuance Priorities Work Group

Recommendations (Summary)

1. Maximize the marketability of the bonds: Consider establishing a single issuing entity for guaranteed bonds and notes that would manage a significant amount of the guarantee, thus allowing smaller CDFIs to participate. A single issuer that could serve multiple CDFIS of varying sizes and asset classes would not prohibit a well- qualified CDFI from applying as a single issuer itself. (i. e. the Fund could set aside $700 million for an issuer who could serve a majority of CDFIs with needs of under $1000 million, while still maintaining opportunities for other issuers who could issue and use $100 million **(See page 12 re: a proposal to implement this year (2011) using a single issuer.)**

2 Maximize the accessibility and affordability of the program.
3. Maximize the value of the guarantee: Structure the guarantee in such a way that investors purchase, hold, and trade CDFI bonds based on the full Treasury guarantee

provided for in the enabling legislation. As such, the guarantee should be simple, straight-forward, and direct.

4. Facilitate the ease of execution and obtaining scale.
5. Minimizing interest costs: Minimize the yield that investors will require to purchase the bond.
6. Maximize the financing flexibility of the program: Maintain the ability to utilize alternative financing structures.

Maximize the Marketability of the Bonds

- Utilizing a single issuer of bonds and notes facilitates:
  - Establishing a broad market awareness and acceptance of the Program.
  - Minimizing the "story" nature of the bonds.
  - Providing continual market access:
    - Primary market, new issue sales.
    - Secondary market, trading liquidity.
  - Would not preclude a CDFI from separately issuing bonds and/ or notes.
- "Investment in guaranteed bonds ineligible for Community Reinvestment Act Purposes."
  - Objective: To expand the volume of affordable, long term capital for CDFIs by creating an investment security that appeals to a broad investor base.
  - Opportunity: To dramatically change the capital and financing structure of the CDFI industry. Access new funding sources that will be complementary and additive to traditional bank and foundation sources.
- Take full advantage of the flight to quality by taxable fixed income investors.

Maximize Accessibility: Facilitate the Ease of Execution and Obtaining Scale

- Ease of execution: Utilizing a program/trust/fund structure:
  - Provides CDFIs with direct access to low-cost funding through Treasury.
  - Strengthens the underlying credit quality of the program.
  - Can potentially provide continual funding beyond the $4 billion authorization through the Relending Account.
- Obtaining Scale: Consider the issuance of "Bond Anticipation Notes" to capitalize the program or establish a warehousing facility to aggregate loans prior to bond issuance.
  - Initial note offering could be a private placement: Direct placement within Treasury? (Use of FFB makes this easier to accomplish)
  - Notes would mature in one year: Or one year, 90 days—to comply with repayment provision if less than 90 percent of bond/note proceeds are used to make loans for eligible community or economic development purpose.

- Note proceeds disbursed over the course of the year could be used to make direct loans to CDFIs and purchase Qualified Issuer "bonds."
- Guaranteed bonds issued prior to note maturity could be used to retire notes and provide long term financing for loans made to CDFIs and "bonds" purchased from Qualified Issuers.
- Utilizing note financing:
  - Provides CDFIs with direct short term financing.
  - Minimizes negative arbitrage prior to loan origination.
  - Best insures compliance with 90 percent Repayment Provision ***prior to*** the issuance of long term bonds.
  - Eliminates the cost of marketing bonds with mandatory early redemption provision.

Maximize the Value of the Guarantee

- The guarantee:
  - Is a written agreement between Treasury and ***any*** Qualified Issuer (or Trustee).
  - Guarantees payment of the full amount of the principal, interest, and call premium (***if any***) on bonds and notes issued under the Program.
  - Represents the full faith and credit of United States.
- Guaranteed bonds/notes proceeds used to make loans to eligible CDFIs:
  - To finance loans for eligible community or economic purposes.
  - To refinance loans issued for such purposes.
- Loans are defined as "any credit instrument" extended under the "Program." Provides tremendous flexibility to structure alternative financial relationships between Treasury, CDFIs, and CDFI Borrowers and support CDFI's customized and responsive financing solutions for their targeted low-income, low-wealth markets.

Minimizing Interest Costs

- Bond interest cost will be based on many factors:
  - Market conditions at the time of sale.
  - Perceived credit quality of the bonds (strength of guarantee, credit rating or lack thereof, source of repayment, underlying credit).
  - Issue structure (maturity structure, expected repayment, prepayment provisions).
  - Familiarity with and understanding of the issuing entity.
  - Interest rates on comparable securities.
- Minimizing the interest cost of the bonds:
  - Reduces the interest cost of the program to participating CDFIs.
  - Reduces the costs of loans made by CDFIs.

  - Minimizes impact of additional program costs: Guarantee fee, servicing fees, trustee fees, etc.

Maximize the Financing Flexibility of the Program

- Fixed rate bonds/notes.
- Variable rate bonds/notes.
- Bonds/notes structured with mandatory tender or optional put feature.
- Alternative forms of credit enhancement.
- Varying forms of asset classes.
- Varying debt repayment structures: 30-year bond structured for level annual debt service requirements:
  - Monthly principal and interest.
  - Annual principal installments with interest payable semiannually: Annual principal installments can be aggregated into separate term maturities (5,10…30) and offered to different classes of investors.
- Optional redemption provisions: A valuable debt management tool that provides financing and refinancing flexibility to the issuer/borrower.
- The needs of the borrower should be an important consideration in determining the most appropriate bond structure.

A proposal to implement this year (2011) so as to not lose $1 billion in guarantee authorized by Congress.

The CDFI Fund is encouraged to create a platform from which to launch the Program on a phased-in basis.

- The Program can, and probably should, be implemented in stages with the inaugural version characterized as the "demonstration" or "prototype". Program Regulations can be amended over time, and likely will be so, to incorporate modifications and enhancements.
- The initial phase (discussed further below) will commence with the issuance of:
  - streamlined Program Regulations (referred to below as "Prototype Regulations") ***prior to*** September 27, 2011, and
  - a guarantee, prior to September 30, 2011, on a $1 billion note issued by an Eligible Issuer or a Master Issuer designated by one or more Eligible Issuers (the "Prototype Guarantee").

Aims and Desired Goals of the Proposal:

- To provide the CDFI Fund with an approach that will:
  - Facilitate issuance of $1 billion of guarantee authority by September 30, 2011;
  - Allow for a staging and phasing in of the Program;
  - Permit the CDFI Fund to maximize absolute functional control and maintain program integrity within an organized process;
  - Establish a built-in CDFI evaluation process;
  - Provide the opportunity for ongoing Program enhancements to best position the Program to achieve its full potential;
  - Minimize cost to the CDFI Fund.

Implementation of the Proposal; Functional Components

- As soon as practicable after August 15, 2011 and prior to September 27, 2011, the CDFI Fund would issue Program Regulations in minimum form and content (the "Prototype Regulations"), but sufficient to meet federal standards and provide a basis for issuance of the Prototype Guarantee. The Prototype Regulations would be drawn in such a manner as to preclude them from being utilized to gain access to an effective, in force guarantee.
  - The Prototype Regulations would contain, in specific manner, many of the elements in the Act, and refer generally to others. For example, many, if not most, of the defined terms can be incorporated 'as is', and the process to be followed by an Eligible Issuer or Master Issuer in applying for a guarantee can be retained for these Prototype purposes.

    - A principal feature of the Prototype Regulations is that an Eligible Issuer or Master Issuer will be required to submit a Capital Plan (see below), but one that is consistent with the Prototype Regulations.
    - For purposes of these Prototype Regulations, we suggest that the CDFI Fund need not make determinations regarding, for example:
        - Loan/asset type underwriting and program requirements;
        - The proportion of new originations versus refinances;
        - Alternative percentage reserve requirements.
    - The CDFI Fund will need to approve the following (other elements need not be in place at this stage):
        - Master Issuer SPE
        - Trustee
    - The CDFI Fund will need to create:
        - Basic form of a restricted guarantee contract (the "Prototype Guarantee"). The restrictions will be such that the guarantee will be inaccessible/ineffective until the Prototype Regulations had been amended and modified, and operative Program Regulations had been issued.
        - An exception for fiscal 2011 to the 90% utilization rule.
    - Although useful at this stage to select a Master Servicer, it will not be necessary to do so. That process can be undertaken once the Prototype phase is launched.
- The Master Issuer will issue a note in the par amount of $1 billion. The Note will be unfunded and placed with the Trustee.
- The Master Issuer will present a Capital Plan to the CDFI Fund that conforms with the Prototype Regulations. The CDFI Fund will then issue its Prototype Guarantee of the Master Issuer's $1 billion note. The Prototype Guarantee will be held by the Trustee. The Prototype Guarantee Contract would, among other things, would require CDFI Fund prior approval for the Prototype Guarantee to become 'effective' for a funding, in any amount, of the Master Issuer's note.
- At such time as the Prototype Regulations are amended, and all elements of the Program are defined the:
    - Master Issuer and the CDFI Fund will go through the process of processing a conforming Capital Plan and amending each of the Prototype phase instruments and documents,
    - CDFI Fund will proceed to qualify such other Eligible Issuers, issue all other relevant guidelines and proscribe all remaining processes and procedures, and
    - Master Issuer will then be in a position to accept Eligible Loans for funding.

We thank you for the opportunity to offer these comments.

Sincerely,

Michael Swack

Michael Swack, Chair
Financial Innovations Roundtable