Financial Innovations Roundtable

Recommendations on the CDFI Bond Guarantee Program

June 2011

Introduction

Over the past eleven years the Financial Innovations Roundtable (FIR), located at the Carsey Institute at the University of New Hampshire, 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.

As part of the Small Business Jobs Act passed in the fall of 2010, the U.S. Department of Treasury will provide a federal guarantee of up to $1 billion per year, for four years, in bonds for use by CDFIs for community development purposes. The program could provide access to low cost (3 to 5 percent), long term (10-30 years) capital for CDFIs. A federal guarantee means that these bonds will be priced at a slight premium to U.S. Treasury bonds. This new bond legislation represents an unprecedented opportunity for bringing new, low-cost institutional capital to CDFIs.

Financial Innovations Roundtable CDFI Bond Guarantee Task Force

Over the past six months, 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. Below is the list of task force members and their affiliations.

Policy Work Group

Chairs: Linda Davenport, Rapoza Associates and Michael Swack, Carsey Institute

Members: Nancy Andrews, Low Income Investment Fund; Jeannine Jacokes, Partners for the Common Good & Community Development Bankers Association; Heidi Kaplan, Federal Reserve Board of Governors; John Moon, Living Cities; Luther Ragin, Jr., The F.B. Heron Foundation; Ellen Seidman; Jennifer Vasiloff, Opportunity Finance Network.

Credit Enhancement, Collateral Innovations & Subordination Strategy Work Group

Chairs: Greg Stanton, Wall Street Without Walls and Scott Young, CRF USA

Members: John Goldstein, Imprint Capital; Saurabh Narain, National Community Investment Fund.

Issuer Protocol & Aggregation Strategy Work Group

Chairs: Frank Altman, CRF USA and Robert Schall, Self-Help Ventures

Members: Alton Bathrick, Allied Capital; Elyse Cherry, Boston Community Capital; Catherine Dolan, Opportunity Finance Network; Julie Eades, New Hampshire Community Loan Fund; Elizabeth Glenshaw, Clean Yield Asset Management; Lisa Hall, Calvert Foundation; George McCarthy, Ford Foundation; Becky Regan, Housing Partnership Network; Clifford Rosenthal, National Federation of Community Development Credit Union, Michael Sloss, ROC USA; Anna Steiger, Federal Reserve Bank of Boston; Barbara VanScoy, Community Capital Management, Inc.

Underwriting Standards, Bond Structure & Issuance Priorities Work Group

Chair: Gregory Anderson, Lebenthal Inc.

Members: Catherine Dolan, Opportunity Finance Network; Annie Donovan, NCB Development Corporation; Peter Humphries, McDermott Will & Emory; Kimberly Latimer-Nelligan, Low Income Investment Fund; Daniel Sheehy, Impact Community Capital LLC.

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?

Current Report and Next Steps

The task force developed a set of preliminary recommendations that were presented to eighty participants at the FIR's annual meeting in partnership cosponsored with the Federal Reserve Bank of Boston on April 14-15, 2011. At the event the task force received feedback and additional recommendations which have been integrated into the report that follows in the next section (see Appendix A for a list of event participants). The task force continues to meet to drill down on details related to the recommendations in the report. Futher recommendations from the task force will be provided to the U.S. Treasury during the Public Comment Period or through a follow-up report. Additionally, the task force may also provide a report to CDFIs and other stake holders with recommendations that apply directly to them.

Policy Work Group

Guiding Principles and Objectives

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 Treasury, 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.
- 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 Assertions

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 $3.0 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 $3.0 billion available.
11. A key constraint in utilizing the $3.0 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.
15. Some of the possible solutions and uses of the bond guarantee program may be such that they cannot be fully vetted/implemented in time to use initially in the program. The industry needs to pay attention to a critical path to executable solutions and adjust priorities accordingly.

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.

See Appendix C and Appendix D for illustrations of our recommendations for how on-balance sheet and off-balance sheet bond guarantees structures could work.

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.
2. Maximize the ease of program administration by Treasury and the CDFI Fund: Establish a framework for the program under which any CDFI—***regardless of size***—can submit a capital distribution plan and become a "Qualified Issuer" of bonds/notes. Draw from the many successful governmental guaranteed and pooled loan financing program structures such as Ginnie Mae/Fannie Mae/Freddie Mac, SBA, HUD, and state revolving loan programs.
3. Maximize the accessibility and affordability of the program.
4. 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.
5. Facilitate the ease of execution and obtaining scale.
6. Minimizing interest costs: Minimize the yield that investors will require to purchase the bond.
7. 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.

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?
  - 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 ***<u>prior to</u>*** 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 ***<u>any</u>*** Qualified Issuer (or Trustee).
  - Guarantees payment of the full amount of the principal, interest, and call premium (***<u>if any</u>***) 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—together with the needs of the market and the investor.

Appendix A – Participants of the FIR Annual Meeting, April 14-15, 2011, Federal Reserve Bank of Boston

Name	Affiliation
Jayne Adelman	Community Development Strategies
Roy Alston	ValueSpark Capital
Frank Altman	Community Reinvestment Fund, USA
Gregory Anderson	Lebenthal & Co., LLC
Jonathan Bieniek	University of New Hampshire
Thomas Bledsoe	Housing Partnership Network
Jeff Brenner	NCB Capital Impact
Alan Cantor	New Hampshire Community Loan Fund
Sol Carbonell	Federal Reserve Bank of Boston
Prabal Chakrabarti	Federal Reserve Bank of Boston
Jesse Chancellor	Calvert Foundation
Jacques Charest	Fiducie du Chantier de l'économie social
Elyse Cherry	Boston Community Capital
Charlotte Crow	Enterprise Community Loan Fund
Linda Davenport	Rapoza Associates
Lisa Davis	Ford Foundation
Catherine Dolan	Opportunity Finance Network
Brian Dowling	Community Development Trust
Julie Eades	New Hampshire Community Loan Fund
Caroline Ellis	Federal Reserve Bank of Boston
Kathleen Engel	Suffolk University Law School
Daniel F. Sheehy	Impact Community Capital LLC
Jon Freeman	Northern Community Investment Corporation
Noemi Giszpenc	Cooperative Development Institute, Inc.
Elizabeth Glenshaw	Clean Yield Asset Management
Erin Graves	Federal Reserve Bank of Boston
Eric Hangen	I Squared Community Development Consulting, Inc.
Kristen Harol	The Life Initiative
Donald Hinkle-Brown	The Reinvestment Fund
Glenda Humiston	USDA Rural Development
Jeannine Jacokes	Partners for the Common Good & CD Bankers Assoc.
Heidi Kaplan	Federal Reserve Board of Governors
Marjorie Kelly	Tellus Institute
Nina Krodel	Nonprofit Finance Fund
Henry Lanier	Forsyth Street Advisors
Kimberly Latimer-Nelligan	Low Income Investment Fund
Michael Loftin	Homewise
Willie Logan	Opa-locka Community Development Corporation
William Maddocks	University of New Hampshire

Name	Affiliation
Charles McLean	Federal Housing Finance Agency
David Miller	Center for Regional Change, UC Davis
John Moon	Living Cities
Saurabh Narain	National Community Investment Fund
Joseph Neri	IFF
Janet Ozarchuk	Local Initiatives Support Corporation
Anthony Poore	Federal Reserve Bank of Boston
Luther Ragin, Jr.	The F.B.Heron Foundation
Rebecca Regan	Housing Partnership Network
Gwen Robinson	Goldman Sachs
Clifford Rosenthal	National Federation of Community Development Credit Unions
Darryl Rutherford	Federal Reserve Bank of San Francisco
Bonnie Scadova	New Hampshire Community Loan Fund
Michael Schaaf	Community Investment Associates
Robert Schall	Self-Help Ventures Fund
David Scheck	Juniper Creek Partners LLC
Debra Schwartz	MacArthur Foundation
Ellen Seidman	
Michael Sloss	ROC USA Capital
Greg Stanton	Wall Street Without Walls
Anna Steiger	Federal Reserve Bank of Boston
Vicky Stein	Mission Markets Inc
Michael Swack	Carsey Institute, University of New Hampshire
Charles Tansey	Export-Import Bank of the United States
Newton Thompson	Federal Home Loan Bank of Boston
Stephanie Tirman	Impact Community Capital LLC
Yusi Turell	University of New Hampshire
Barbara VanScoy	Community Capital Management, Inc.
Kristina Vanstrom	Next Street
Jennifer Vasiloff	Opportunity Finance Network
Richard Walker	Federal Reserve Bank of Boston
Craig Welch	New Hampshire Community Loan Fund
Kenneth Willis	Federal Home Loan Bank of Boston
Fiona Wilson	Simmons School of Management
John Wilson	The Financial Group, LLC
Rob Wilson	CEI Capital Management LLC
David Wood	Initiative for Responsible Investment
Scott Young	Community Reinvestment Fund, USA
Robert Zevin	Zevin Asset Management, LLC

Appendix B – Creating a First Loss Guarantee from Unclaimed Financial Assets

By Greg Stanton, Wall Street Without Walls

Summary

The key structural tasks include not only (1) the combination of the First Loss Guarantee (FLG) with a U.S. Treasury guarantee and (2) employing other usual and practical risk offsets for bond financing in emerging markets, it also (3) improves the loan performance and loan data collection, and underscores for CDFI issuers evidence that access capital markets through the bond issuance platform improves when historical and performance data is complete, well-documented, and standardized.

Primary Emphasis: Highlight ***innovative yet simple structural improvements and collateral credit enhancement options*** which would provide stability to the key stakeholders in this CDFI Bond Guarantee Program because it utilizes a collateral tranche—a FLG of approximately 10-15 percent of the total bond issue with a FLG comprised of Unclaimed Financial Assets (UFAs) and further protected by a full U.S. Government Guarantee (a direct or implied AAA credit quality) using simple credit models taking advantage of the current quantitative tools used by the major rating agencies for simple bond issuance programs.

No Additional Leverage to Participating CDFIs: Because CDFIs operate on very tight budgets, they do not have any interest in increased leverage or adding debt to their balance sheets. **Safeguard the Treasury:** Since bond investors would be protected from risk and loss under a AAA Treasury guarantee, the primary purpose for establishing a FLG or collateral based credit enhancement facility would be to safeguard the interests **of the Treasury** by credit enhancing the CDFI loan portfolios as they become ready for financing. **UFAs Yield the Highest Common Good:** The use of UFAs comprise the core assets for the collateralization program to protect the Treasury. The FLG would be designed to achieve revenue neutrality with no cost to the U.S. taxpayers yet yield the highest common good through national job creation. As standalone credits, CDFIs would have to add a certain level of collateral through the FLG or overcollateralization to achieve the minimum credit quality required for a "B" rating before the Treasury and CDFI Fund agrees to apply the Treasury bond guarantee.

Summary of the Sources of Unclaimed Financial Assets Available to the U.S. Treasury

Unclaimed Financial Assets (cash or near cash)		Dollar Amount
Unredeemed U.S. Savings Bonds	$	17,000,000,000
Missing Stocks & Bonds	$	3,000,000,000
Undelivered IRS Refunds	$	123,000,000
HUD Mortgage Insurance Premium Refunds	$	500,000,000
Unclaimed Railroad Pension Benefits	$	133,000,000
Unclaimed Stocks & Bonds	$	10,000,000,000
Forgotten Stock Dividends (annually)	$	500,000,000
Unclaimed Social Security Checks	$	500,000,000
Unclaimed IRAs, CDs & Savings Accts @ FDIC Insured Banks	$	3,000,000,000
Total Unclaimed Assets as of 2010	**$**	**34,756,000,000**

Source: US Federal Government

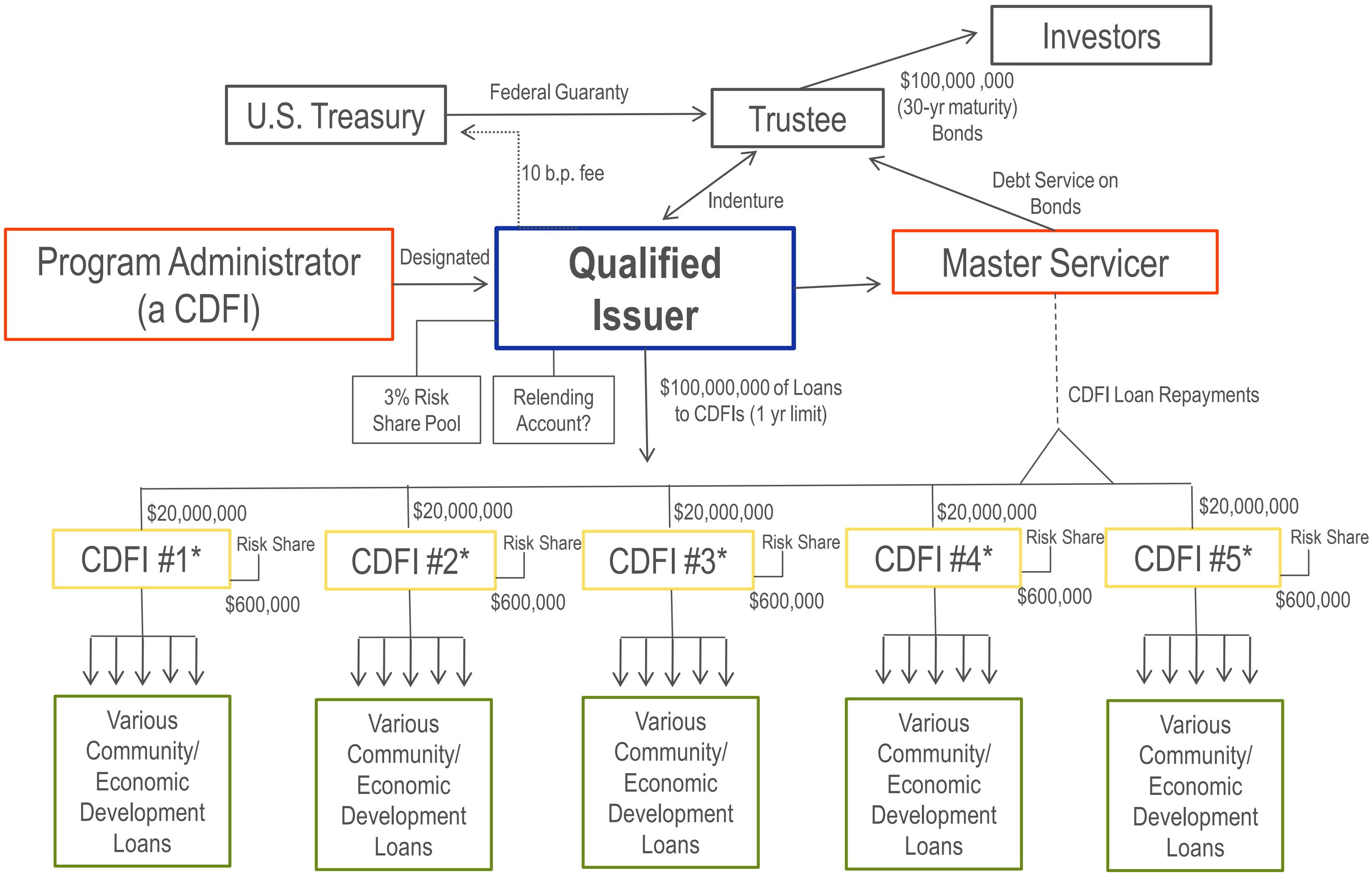
The First Loss Guarantee is used to achieve a minimum credit quality of "B," since the collateral of UFAs are considered fungible, transferable, and substitutable. When the risk is reduced, the amount of overcollateralization is reduced and the collateral will flow back to the CDFI Fund either for recycling with another bond issue or returned to the Treasury for other uses or needs.

Risk Offsets: UFAs as a Strategic Deployment of Resources. This FLG comprised of near cash assets of a portfolio of UFAs is both an overcollateralization and is the protection level that insures and protects the Treasury guarantee for each participating CDFI bond issue from being called upon.

Making the Case: With a simple yet innovative use of UFAs for national objectives—an Unclaimed Financial Assets FLG brings high social utility from simple, unused resources. The CDFI Fund can further the capital access goals of the CDFI community and consciously improve the common good by employing commonly held resources to optimize the number of jobs created. Currently the UFAs held by the Treasury are not used as strategic assets for job creation and community and economic growth. Through the targeted use of UFAs, a bond issue of loans would be over-collateralized to meet risk offset levels determined to be prudent and safe by the Treasury. The credit enhancement option which steadfastly uses proven rating agency techniques has the potential to yield the greatest social and financial returns and value of the common good for taxpayer-owned assets.

Risk Analysis: Apply the Risk Analysis Methods of the Rating agencies: A Bond Guarantee Program needs to utilize the same risk analysis and quantitative analyses employed by the U.S. rating agencies to evaluate projected losses within the loan pools and determine the following: estimating the loan portfolio's default probabilities, estimating the recovery rate assumptions, and estimating a variety of scenarios using a range of default, recovery, and worst case experience. The result of these estimates is to determine the amount of protection necessary for the bonds to perform, given the expected losses determined when the model predicts a particular stress level or worst case scenario. Thus, the amount of cash reserves and the amount of a FLG and the other risk offsets and diversification can be determined that would ensure that the issuer is ready to safely use a Treasury supplied bond guarantee.

Appendix C – On-Balance Sheet Bond Guarantee Structure



* Each an “eligible community development financial institution” which applied to Special Purpose Single Member LLC for a loan and contributes amount equal to 3% of guaranteed amount of Bonds (3% of $20,000,000(?) = $300,000).

Appendix D – Off-Balance Sheet Bond Guarantee Structure