CAG
Capital Access Group

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LONG TERM STANDBY PURCHASE COMMITMENTS (LTSPCs)
The Use of CDFI Bonds to Address the Need for CDFI Capital

Proposal

Treasury should permit CDFI Bond and Bond Loan proceeds to be used to purchase high quality securities to back insurance contracts that protect CDFIs against loan default risk. Such contracts can increase CDFI lending capacity by reducing the amount of economic and/or regulatory capital CDFIs hold against their loan assets. It can also help to improve the marketability of CDFI loans to private investors.

Summary

The CDFI Bond Guarantee Program will provide the CDFI industry long-term, low cost senior capital. While the Program will provide CDFIs funding for new loans, it will not provide the capital many CDFIs need to support growing loan portfolios.

The Long-Term Standby Purchase Commitment (LTSPC) Program described below provides a potential solution to this problem. An LTSPC is credit risk insurance in the form of an option to "put" qualifying loans to a rated counterparty. For example, many agricultural lenders use Farmer Mac LTSPCs to protect themselves against credit risk.

Unfortunately, there is yet no rated provider of credit risk insurance to the CDFI industry. Thus, to achieve the sort of high investment grade rating enjoyed by Farmer Mac, we propose that Qualified Issuers or CDFIs be permitted to use CD Bond or Bond Loan proceeds to collateralize LTSPCs employed by eligible CDFIs to insure seasoned, well-secured, performing loans. Rated insurance would reduce the amount of capital CDFIs are required to hold against these assets thus freeing up CDFI capital to support loan growth. In addition, it would increase the credit quality of the insured assets, facilitating their sale to private investors (as well as to other CDFIs).

Discussion

The nation's 150 largest CDFI banks and credit unions[1] hold about $37 billion in assets—an average of almost $250 million per institution. Going forward, these institutions are likely to need at least $3.9 billion in capital to meet the regulatory

[1] Those exceeding $25 million in assets

capital standards imposed by Basel 3. However, according to a 2009 analysis by A.M.Best, CDFI banks are both less adequately capitalized than their mainstream community bank counterparts and will find it harder than mainstream institutions to obtain new capital . There are a number of reasons--

1. Lower earnings than peer institutions mean less capacity to accumulate capital
2. Weaker access to an established investor base compounds the difficulty that all small institutions face in raising small amounts of capital.
3. Limited exit alternatives reduce the attractiveness of CDFI investments
4. Higher portfolio risks increase the need for capital while limiting asset growth and return on equity.

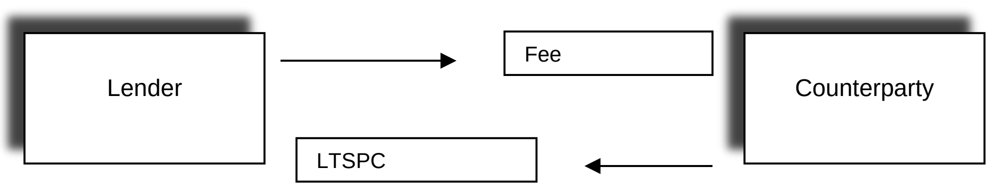
The nation's 91 large CDFI loan funds face even more severe problems. While CDFI banks typically have about $1 in assets for each 10 cents in capital, the average CDFI loan fund supports each $1 of assets with almost 90 cents in capital. The key reason: uncertain asset quality forces CDFI loan funds to hold large amounts of capital against their loans. The result is a highly inefficient use of capital, impaired lending capacity and limited loan growth.

Unfortunately, the CDFI Bond Guarantee Program will be of limited use to CDFIs needing additional capital to support new lending or to meet regulatory capital standards. The principal reason is that the proposed Interim Rule states that "Bond Loans may not be subordinated to any new or existing liability…" of the CDFI. In short, it appears that Bond Loans may not be used to finance subordinate debt, EQ2 investments or other forms of debt that might qualify as either regulatory or economic capital.

<u>Long-Term Standby Purchase Commitment (LTSPC) Program</u>

A LTSPC is a bilateral contract between a lender and a highly-rated counterparty (Fannie Mae and Farmer Mac are two companies that issue LTSPCs to eligible lenders) under which the counterparty agrees to purchase specified assets of the lender. In exchange for giving the lender this insurance or "put" option, the counterparty is paid a quarterly or semi-annual fee. Figure 1 is a diagram of an LTSPC transaction.

Figure 1.



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Using a rated LTSPC to transfer loan portfolio credit risk would allow CDFIs to free up capital to support existing assets and/ or new loan originations.

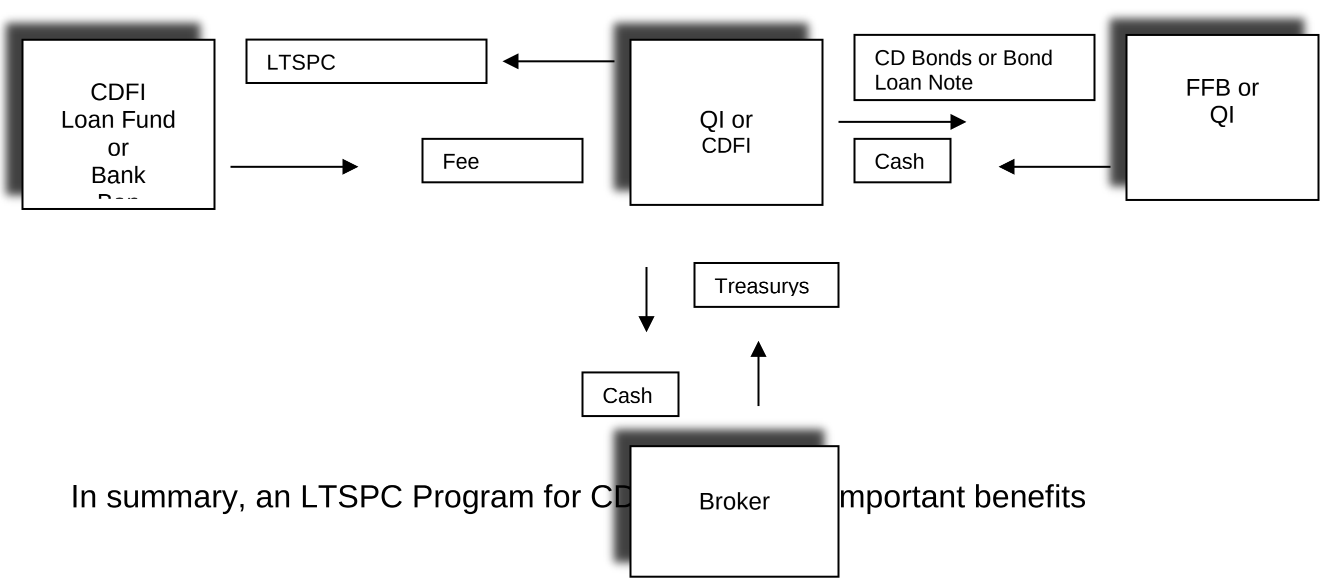
<u>CD Bond-backed LTSPC Program</u>

An LTSPC typically carries the credit rating of the issuer. That is, an LTSPC issued by Farmer Mac or other GSE will carry the implicit backing of the federal government and, thus, confer a AAA rating on the assets insured by the LTSPC. However, there is presently no equivalent of a Farmer Mac or Fannie Mae for CDFIs. Thus, in order to secure a AAA rating for an LTSPC covering CDFI assets, the LTSPC must be backed by high-quality collateral, such as Treasury securities.

The CD Bond Guarantee Program could be used to provide this collateral. The Program might employ the following structure:

1. The QI or CDFI would sell LTSPCs to CDFIs that meet certain tests of asset quality. In general the LTSPCs would cover only well-seasoned, performing loans.
2. A Qualified Issuer (QI) or CDFI would use Bond or Bond Loan proceeds to purchase Treasury securities.
3. The selling QI or CDFI would pledge the Treasury securities as collateral for the LTSPCs.
4. With a AAA rating conferred upon its loan portfolio, the insured CDFI would be able to reduce the amount of capital held against its existing portfolio, freeing up this capital to support asset growth.

Figure 2.



In summary, an LTSPC Program for CD mportant benefits

1. It allows CDFIs to use existing capital more efficiently. As pointed out above, CDFI depositories have insufficient capital to support asset growth; CDFI loan funds hold excessive amounts of capital against their assets, mainly because of the greater (perceived) risk of their loan portfolios. Transferring credit risk is a solution to both problems.

2. It improves the liquidity of CDFI loans. Once the credit risk of the CDFI's loans has been transferred to a strong counterparty, CDFIs can sell or hypothecate their loan portfolios for liquidity purposes.

3. It minimizes risk to the federal government. LTSPCs would be used exclusively to insure performing, well-seasoned assets with a very low probability of default. Thus, CD Bonds would be well-protected.

4. It provides CDFIs increased lending flexibility. CD Bond proceeds can only be used directly to finance first lien loans. However, using the Bonds to free up existing capital should enable CDFIs to secure private financing that can be used to fund a broader variety of loan structures.

Progress State Bank: A Hypothetical Example

Progress State Bank is a community development bank with $100 million in seasoned, performing commercial loans. Under current regulatory rules, these loans are assigned a regulatory risk-weight of 100%. Because banks must hold capital equaling approximately 10.5% of the risk weight of their assets, Progress needs at least $10.5 million in capital to support its $100 million in loans. However, with only $8 million in total capital, Progress needs an additional $2.5 million simply to meet minimum regulatory requirements. Equity has been impossible to obtain because of the bank's small size, higher-than-average portfolio risk and the limited exit options available to investors. Bond Loans cannot be subordinated to the bank's other liabilities such as FHLB advances and (presumably) deposits. Thus, the CDFI Bond Guarantee Program does not represent a suitable solution.

As an alternative, Progress secures an LTSPC to transfer the credit risk associated with its loans to a Qualified Issuer. The fact that the LTSPC is rated AAA reduces the risk-weight of Progress's loans from 100% to 20%. In other words, the regulatory risk weight of the loans declines from $100 million to $20 million. Accordingly, the amount of capital Progress needs to hold falls from $10.5 million to $2.1 million (10.5% of $20 million). This frees up $5.9 million of Progress's existing capital to support new asset growth. (The fact that Progress's loans are backed by a AAA credit enhancement also makes it easier for the bank to sell the loans for earnings or liquidity reasons).

PROGRESS BALANCE SHEET (000)	Before LTSPC	After LTSPC
Loan Portfolio	$100,000	$100,000
Assigned Risk Weight	100.00%	20.00%
Weighted Portfolio Value	$100,000	$20,000
Total Balance Sheet Capital	$8,000	$8,000
Required Regulatory Capital	$10,500	$2,100[2]
Capital Surplus (Deficiency)	$(2,500)	$5,900
Permissible Asset Growth	$-	$56,190

PROGRESS INCOME STATEMENT (000)	Before LTSPC	After LTSPC
Total Earning Assets	$100,000	$156,190
Asset Interest Rate	7.00%	7.00%
Total Interest Income	$7,000.00	$10,933.33

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[2] Compliance with leverage rules would increase amount of Tier 1 capital held by the bank to $4 million