



Capital Management

"A CDFI is like a bicycle. The front wheel is the mission. It turns and adapts, and it leads the organization. The back wheel is the capital base, on which sustainability, risk, and transaction costs are seated. The two wheels need to be balanced or you won't get anywhere."

--Martin Eakes, Self-Help



Raising and Managing Capital for Development Finance Institutions

- Impact of capital structure and sources:
 - Shapes feasible type of financing
 - Determines financing level and scale
 - Ability to fund TA and development services
- Financing policies impact capital:
 - Level of profits and retained earnings
 - Ability to raise capital from investors
- Three aspects of capital management
 - Pricing
 - Loss management
 - Securing new capital



Pricing Loans and Investments

- Use market-rate interest rates or investment returns:
 - preserves capital
 - provide access to more sources
 - helps avoid capital substitution.
- If below market rates are used:
 - **Floor rate = cost of capital + expected loss rate + operating cost percentage**



Pricing Loans and Investments

- Risk of losses with fixed rate loans:
 - Loan value declines if interest rates rise
- Options to reduce interest rate risk:
 - Variable rates for short-terms loans or if borrower can absorb interest rate risk;
 - Sell or securitize fixed-rate loans
 - Match fund a large fixed-rate loans or a programs with fixed rate capital source
 - Risk of loss from prepayment still exists.
- Accelerating loan repayment:
 - Medium term with long-term amortization;
 - Call provisions if project becomes bankable
 - Interest rate kickers



Managing and Funding Loan Losses

- Excess losses can lead to organization failure
 - LA Community Development Bank with 40% losses
 - Recent financial crisis and bank failures
- Sound investment standards, policies and process
 - Understand, manage and price for risk of investments
- Set annual loan loss reserve at:
 - Higher of (a) expected losses or (b) average losses over an economic cycle
 - Build up reserves in good times to avoid “catastrophic” losses in recessions or sector declines



Managing and Funding Loan Losses

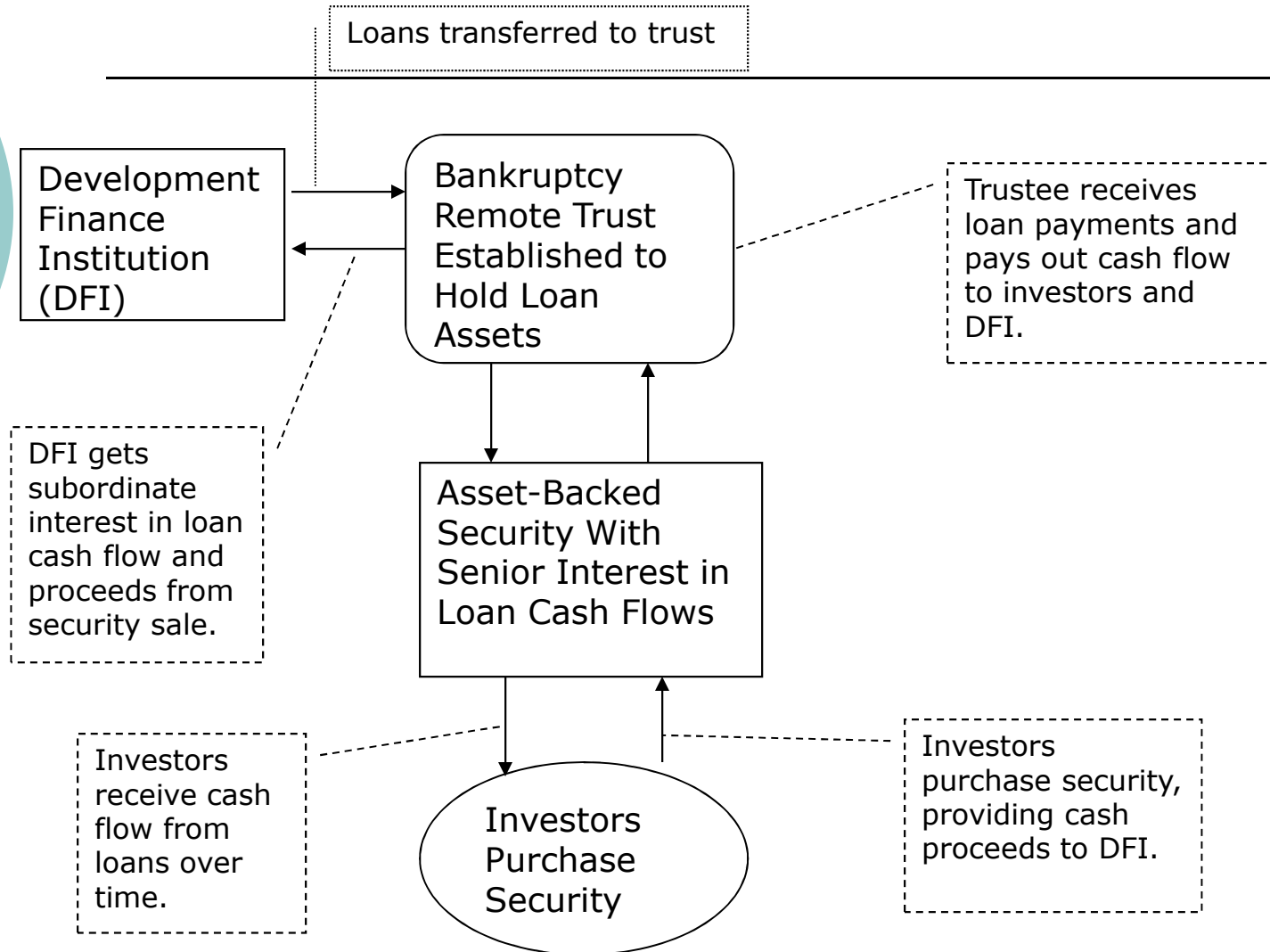
- Mechanisms to fund losses
 - Set interest rates to cover expected losses
 - Charge a loss insurance fee, e.g. CAP program
 - Raise grants to fund loan loss reserves, key for small and start-up entities or programs
 - Use of loan guarantees
 - Grow America Fund SBA 7a lending



Raising Capital & Expanding Funding Sources

- Four components of capitalization
 - Secure core grants and equity
 - Federal programs, foundations, some states
 - Cultivate stable debt sources
 - Leverages equity & grants for growth & impact
 - Eakes example: 38X vs 2.4X growth in 30 yrs
 - Deposits, PRIs, intermediaries, banks, fed programs
 - Manage funds for others investors
 - SBA 504, investment funds, participations
 - Loan sales and asset securitization
 - Community Reinvestment Fund
 - Direct securitization of pooled loan assets

Diagram of a Loan-backed Securitization





Solar City Securitization

- Application to small scale solar
- Several thousand roof top solar leases and small solar PPAs put in trust; cash flow used to repay debt
- Solar City converts long term leases into cash to install more systems
- Generates investor interest and financial capital for solar project
- May reduce interest rate on leases via accessing public markets



Community Reinvestment Fund

- Financial intermediary supplying capital to development finance sector
- Purchases and securitizes loans
 - Issues securities backed by purchased loans
- Direct loans to lenders secured by loans assets
- Completed 50 transactions and supplied \$1.5 billion in capital
- Qualified issuer for CDFI Bond program
- SBA 7a Preferred lender



CDFI Bond Program

- Created by Small Business Jobs Act
- Up to \$1 billion per year in US Treasury guaranteed bonds to finance CDFIs
 - Proceeds used for community and economic development purposes per CDFI fund
 - CD/CED in low-income or underserved rural areas
 - Maximum 10 bonds \geq \$100 million each
 - Loan to CDFI : \$10 million minimum
 - Can refinance existing CDFI debt
 - Bond proceeds must be used within 2 years
 - Recourse to CDFI with pledged loan assets
 - Up to 30 year term

CDFI Bond Guarantee Structure

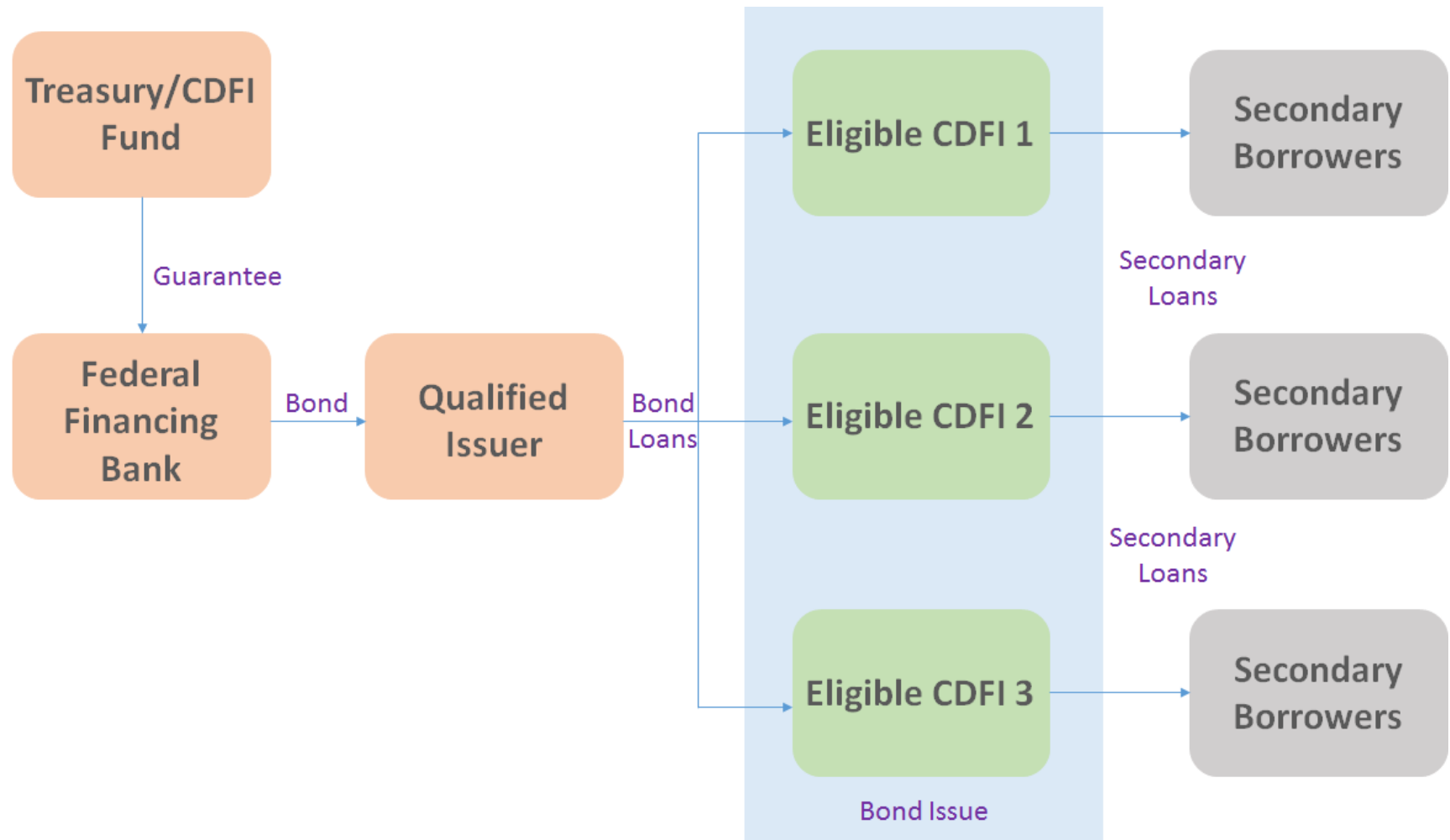


Image by MIT OpenCourseWare.



CDFI Bond Transactions

- September 2016: \$265 million
 - CRF issued \$165 for CIP, LIFF,TRF
 - Bank of America issued \$100 for Self-Help
- August 2014 \$325 for 4 CDFIs
 - LISC, Enterprise, Clearinghouse CDFI, and Community Development Trust
- October 2014 \$200 million issuance
 - CIP (\$55),IFF (\$25),LIFF (\$65),TRF (\$55)

MIT OpenCourseWare
<https://ocw.mit.edu>

11.437 Financing Economic Development
Fall 2016

For information about citing these materials or our Terms of Use, visit: <https://ocw.mit.edu/terms>.