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Commentary

Can Community Development Finance Institutions Take on Muniland?

By Michael Gaughan
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From crowdfunding to online lenders, the finance world has been turned upside-down in the post-recession economy. With limited exceptions, namely pay-for-success and the crowdfunding startup Neighborly, this change has passed over muniland.

The potential for other forms of finance to occupy the well-traveled paths of muni bonds has, for the first time, reached a point where legitimate alternatives exist. The coalescence of direct lending, regulatory constraints, and the growing sophistication of community development finance institutions (or "CDFIs") has opened the door for unconventional sources to become a part of mainstream public finance lending.

One post-recession public finance change that is noteworthy, although a far cry from the disruptive quality of other finance innovations, is the growth of direct purchase loans. This involves banks holding tax-exempt bonds issued by public entities on their balance sheet versus a public sale to retail and institutional investors.

Direct purchase loans offer the possibility of faster execution and lower transaction costs, which has particular appeal to small issuers. S&P has noted the growing popularity of this form of lending in several commentaries, while also estimating that about 20 percent of municipal debt is now completed through a direct purchase loan. The change in execution has resulted in both a willingness to think outside the public, offering a paradigm as well as a preference for the simplicity of the execution.

Unfortunately for borrowers, the growing demand for direct placements has run into a regulatory environment where balance sheet loans promise to be more expensive for larger banks. This is due to efforts to balance the demands of new liquidity rules and related costs with the term and riskiness of loans. Moreover, the regulatory change is occurring amidst forecasts of rising interest rates that will challenge the economic rationale for the longer loan terms preferred by muni borrowers. The result is that many banks are looking back to the corporate world for a better balance of risk and yield.

The consequence of this convergence is an opening and, potentially, a corresponding need among many distressed communities for CDFIs to fill the void. Over the last 30 years this industry has grown from a small group of community lenders to a major participant in financing of critical social infrastructure. During the recession, the industry grew dramatically as total assets surged 14 percent annually from 2007 to 2014 while increasing from an estimated $25.5 billion to $64.3 billion by focusing on segments that traditional lenders often overlook.

Alongside the growing base of assets is a concurrent growth in sophistication and appetite for funded loans that can further advance the desired outcomes of these mission based lenders.

At first glance, there would seem to be an incredibly wide-divide between slightly less than $3 billion in CDFI loans originated and over $300 billion of municipal bonds issued in 2014. A closer look at sector specific data reveals a surprising parity between the forms of financing while also demonstrating a model for how CDFIs might begin to enter the public finance landscape in earnest.

First, CDFIs have long been on the leading edge of charter school financing and have continued in the sector even as conventional lending sources compete for transactions. A total of $8.2 billion in charter school bonds were outstanding as of the end of 2014 versus $2.1 billion in outstanding CDFI charter school loans as of the end of 2013.

Second, the housing sector demonstrates similar parity with $7.8 billion in new money bond issuance versus $1.2 billion in housing related CDFIs originations in 2014. Housing activity becomes even more evenly matched by when fairly compared against 2014 taxable issuance of $2.9 billion. In all cases, CDFI activity represents a share of sector specific activity that runs in-line with S&P's estimates of issuance volume that is being redirected to the direct purchase alternative.

Finally, the integration of CDFI ideas and tools into the public finance landscape may foreshadow the possibility of CDFIs taking a larger residence in muniland. This includes DC Water's partnership with the SIB Lab at the Harvard's Kennedy School to develop a pay-for-success model for green infrastructure as well as the National Development Council's work, a non-profit with a subsidiary CDFIs, in delivering and operating infrastructure through public-private partnerships.

As the above examples demonstrate, CDFIs are already at the public finance table at a time when their capacity promises to accelerate as a result of recent advancements in access to long term sources of capital. Three CDFIs recently received general obligation S&P ratings in the high investment grade range (AA-minus and higher). This development was preceded by the success of the Treasury Department's CDFI bond guarantee program that provides long term funding to CDFIs—authorized for $750 million in 2015.

For public borrowers, the promise of a balance sheet loan alternative may have appeal—particularly in distressed communities that may face difficulties with access to capital markets. For CDFIs, these same conditions often match their mission to support communities with access to capital. In the background of evolving CDFI capacity is the threat of tax reform that could pressure this dynamic and accelerate the process.

Flexible financing with committed lenders is essential if distressed communities are to fully recover and to invest at levels necessary to service their populations. CDFIs have a long track record of meaningful contributions in local communities. Financing essential services may be the next step in the essential role these organizations now play in the American financial landscape.

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