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Capital for Communities—
Opportunities for People™

July 14, 2009

Alfred M. Pollard
General Counsel
Federal Housing Finance Agency, Fourth Floor
1700 G Street, NW
Washington, DC 20552
E-mail: RegComments@fhfa.gov

ATTN: Comments/RIN 2590-AA18

Dear Mr. Pollard:

On behalf of Community Reinvestment Fund, USA ("CRF"), I appreciate this opportunity to share our views on the Federal Housing Finance Agency's ("the Agency") proposed rule published in the *Federal Register* on May 15, 2009 regarding Federal Home Loan Bank Membership for Community Development Financial Institutions ("CDFIs").

BACKGROUND

Community Reinvestment Fund is a national CDFI that provides new loan capital for community-based development lenders by operating a secondary market for their loans. As a nonprofit financial intermediary, CRF purchases performing economic development, small business and affordable housing loans from private nonprofits (such as other CDFIs), governmental and quasi-public lending agencies. We pool these loan obligations and transform them into securities through the process of securitization. These securities are then sold to banks, thrifts, insurance companies, pension funds and other qualified institutional investors.

CRF pioneered the development of asset-backed community development securities helping community based lenders to access capital markets resources. In 2004, CRF began issuing rated securities backed by affordable housing and small business loans. In July of that year, we completed the sale of our first rated debt offering, with the highest class of certificates in this offering receiving a "AAA" rating from Standard & Poor's. These certificates are backed by a pool of loans totaling \$84.7 million and which consist of 45 multifamily, low-income housing tax credit properties in four states. In November 2004, CRF issued the first rated securities offerings collateralized by small business loans totaling \$51 million - including \$47 million in asset-backed securities, which received a "AAA" rating from Standard & Poor's and were sold to institutional investors. Despite tumultuous market conditions, CRF's third offering of securities backed by small business loans was issued in April 2008. This offering was fully subscribed by a dozen investors and totaled \$62 million - \$47 million (76%) of which received a "AAA" rating from Standard & Poor's.



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CRF also played an instrumental role in developing the New Market Tax Credit ("NMTC") program administered by the Community Development Financial Institutions ("CDFI") Fund and the Internal Revenue Service. Over the course of six funding rounds, CRF has received \$522.5 million in tax credit investment authority. We have used this credit to design and implement a highly successful and unique financing product that brings much needed credit to small businesses and community facilities in low income/underserved communities. Since its inception, CRF and its New Market Tax Credit affiliates have delivered more than \$1 billion in capital to over 700 communities across the country, which in turn leveraged an additional \$1.1 billion in other resources. In partnership with 156 local lending partners, we have funded a total of 2,263 loans located in more than 700 communities in 46 states and the District of Columbia. Through our secondary market activities, CRF has served 170,000 families, financed 16,000 affordable homes and created or retained 36,000 jobs.

COMMENTS ON CDFI ELIGIBILITY CRITERIA AND MEMBERSHIP REQUIREMENTS

The CDFI industry encompasses a wide range of organizations that are diverse in both their structure and activities. We believe this rule needs to balance the need for a rigorous regulatory structure that ensures the strength and viability of the FHLB System with the intent of section 1206 of the Housing and Economic Recovery Act of 2008 (HERA) - that non-federally insured, certified CDFIs be permitted to join this system. In our view, the final rule needs to facilitate membership of uninsured CDFIs in the FHLB System, as well as their ability to utilize the resources of this System to carry out their community development mission/activities. To that end, we have provided comments on several aspects of the eligibility criteria, membership requirements and general operating issues in the proposed rule that may hinder CDFI participation in the FHLB System due to the structure and activities of these organizations. In some instances we have commented on issues that the Federal Housing Finance Agency has not raised in its proposed rule but which we think need to be addressed.

MEMBERSHIP REQUIREMENTS

The proposed rule lays out the eligibility and the procedural requirements for CDFIs seeking to become members of a Home Loan Bank. The rule makes clear that individual Banks are responsible for determining specific aspects of their own membership requirements. Two requirements are of particular concern to CRF and are discussed below – related to minimum stock purchase and collateral provisions - although the rule does not request comment on these issues. Nonetheless, we believe it is critical to highlight these points as they will have a significant impact on the ability of CDFIs to become members and exercise the full value of that membership privilege. In our view, it is in the best interest of both individual Banks and the FHLB System to ensure that CDFIs become fully functioning Bank members as they are an effective tool for realizing affordable housing and community investment goals.



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Minimum Stock Purchase Requirement

Any applicant approved for membership in a FHLB Bank must purchase stock in the respective Bank as set forth in sections 4 and 6 of the Federal Home Loan Bank Act (the "Act").¹ Individual Federal Home Loan Banks have discretionary authority to determine the specific amount of stock a new member must purchase and this requirement is set out in each Bank's capital structure plan. Minimum stock purchase requirements will therefore vary from Bank to Bank. In addition, members may be required to purchase additional stock in order to borrow from their Bank or to access other Bank services.

If individual Banks chose to set minimum and additional stock purchase requirements that are too high or restrict the types of resources that can be used for such purchases, uninsured CDFIs could have difficulty meeting both of these requirements. In general, CDFIs are small institutions with limited holdings of cash and liquid assets that could be used for stock purchases. CRF believes that the Federal Housing Finance Agency should encourage Banks to consider establishing separate provisions for uninsured CDFIs that recognizes both the environment and regulatory structure in which they operate. In particular, we suggest that Banks set minimum stock purchase requirements taking into consideration the size of a CDFI's balance sheet and the types of internal and/or borrowed funds available to such an organization.

We also urge the FHFA to monitor the number of uninsured CDFIs that become members of the FHLB System and to review stock purchase requirements to determine whether these requirements are preventing CDFIs from joining the System. If, in fact, uninsured CDFIs are unable to become Federal Home Loan Bank members as a result of structural or operating issues specific to the CDFI industry, the Agency should develop an alternative regulatory standard for CDFIs that could be adopted by all Banks and would ensure these organizations have access to the FHLB System.

Collateral Requirements

In addition to purchasing stock in a Federal Home Loan Bank, members that seek advances from their Bank must pledge certain types of collateral to secure repayment of their loans. The Bank Act specifies types of collateral that can be used to secure advances and includes first mortgages on residential properties (current), securities collateralized by residential whole first mortgages, U.S. government or agency securities, cash or bank deposits, other real estate assets that can be easily valued and in which the Bank can perfect its interest. A special group of small insured depository institutions engaged in lending to small businesses and small farms are permitted to pledge a broader array of collateral for their advances including secured loans for small business, agriculture or community

¹ See 12 U.S.C. 1424 and 1426



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development activities, or securities backed by such loans.² As with stock purchase requirements, each Bank establishes its own lending and collateral policies which vary from Bank to Bank and which apply to all of its members.

CRF is concerned that CDFIs may not be able to meet the collateral requirements of individual Banks for several reasons. First, many uninsured CDFIs do not hold forms of eligible collateral such as Government or Agency securities. Second, some CDFIs, like CRF, do hold first mortgages in their loan portfolio, but these assets are not available to serve as collateral for advances because they are used to secure our warehouse line of credit or other facilities. Third, under the rule as proposed, uninsured CDFIs are not deemed to be Community Financial Institutions ("CFIs") and therefore cannot use secured loans made to small businesses, farms or for community development activities as collateral for their advances.

All of these factors could make it difficult for uninsured CDFIs to borrow from their Bank because they cannot meet the collateral requirements. Moreover, the requirements highlight the challenges of trying to adapt requirements designed for one set of institutions to a different set of organizations. One way to make it easier for uninsured CDFIs to meet collateral requirements is to align their treatment with that of CFIs. In other words, provide CDFIs with more flexible collateral standards so that they can use small business, farm and community development loans to secure their advances. (See our discussion below as to why CDFIs should be considered CFIs) Along these same lines, we suggest broadening the types of eligible collateral to include the other forms of community development assets that have been created to support the lending and investing activities of CDFIs. For instance, CRF securitizes both affordable housing and small business loans and in that process these assets are removed from our balance sheet. However, we do hold an interest in the securities created in the form of "retained interest in securitized loans". Allowing us to pledge assets, like our retained interest certificates, as security for advances would enhance CRF's ability to meet collateral requirements and to fully participate in the FHLB System. We would encourage the FHFA to take the lead in analyzing and promulgating an amended definition of eligible collateral for all FHL Banks, as the Agency has developed sufficient understanding of and expertise regarding CDFIs.

ELIGIBILITY CRITERIA

The proposed rule sets forth specific eligibility criteria for uninsured CDFIs that wish to become members of a Federal Home Loan Bank. Our comments again focus on specific criteria that may not be well suited/appropriate for uninsured CDFIs or where we believe the criteria should be modified.

Financial Condition

The proposed rule establishes five measures or ratios that would be used to assess the financial condition of uninsured CDFIs. These measures include a net assets ratio, earnings capacity, loan loss reserves, liquidity ratio,

² See 12 U.S.C. 1430(a)(3)(as amended)



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and self sufficiency or sustainability ratio. Generally speaking, we supported the proposed measures for loan loss reserves, liquidity and self sufficiency/sustainability. However, we do have concerns about the proposed net asset ratio and the expectations regarding CDFI earnings which we discuss below.

Net Assets

Under the proposed rule, CDFI applicants would be required to have a minimum net assets ratio of 20% where net assets are defined as the residual value of assets (including restricted assets) over the liabilities based on the applicant's most recent annual audited financial statements. FHFA specifically requested comments on two aspects of the proposed net asset ratio: whether restricted assets should be included in net assets; and is a minimum ratio of 20% the appropriate level for membership eligibility.

We agree that net assets should include restricted assets as this approach is consistent with industry practice. While grant dollars or government funding may be restricted for use as capital, these resources are available to absorb any losses. CRF supports the proposed approach of including restricted assets in the net asset ratio.

However, we do not support the proposed minimum net asset ratio of 20% on the grounds that this is not an appropriate level for a diverse industry like CDFIs. Although the CDFI Fund has used a 20% ratio as its Minimum Prudent Standard in its funding applications, this is not the appropriate level for many CDFIs that are able to operate efficiently and leverage substantial debt with small amounts of capital. For example, CRF's business model of securitizing loans allows us to attract capital to support our activities with a relatively small equity base and therefore, to operate with a lower net assets ratio.

The proposed rule also ignores the important role long-term debt plays in the capital structure of CDFIs. In particular, many CDFIs have raised equity equivalent investments ("EQ2s"). EQ2s are generally structured as unsecured debt with many equity-like features including being subordinate to all other debt, having a rolling renewable term, limiting the right of investors to accelerate payment and carrying lower interest rates. EQ2s essentially serve the same function as equity and are generally treated as equity by other lenders for the purposes of loan covenants.

In our view, a 20% net asset ratio is too high and does not reflect the ability of CDFIs to operate safely and leverage significant amounts of patient long-term debt on a smaller equity base. We strongly recommend the FHFA consider reducing the minimum net asset ratio to 10% - a level more in line with 8% total capital (which includes Tier 1 or core capital of at least 4% and remainder comprised of Tier 2 capital) banks are required to hold by their regulators. We also suggest that average rather than total figures be used for net assets and total assets as they better represent the true financial condition of CDFIs. Lastly, we urge FHFA to follow CDFI industry practice and include EQ2s in net assets for the purposes of this ratio, thereby recognizing the equity-like character of this debt. These modifications will make the proposed net asset ratio a more accurate measure of the capital strength of uninsured CDFIs.



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Earnings

The rule proposes that CDFI applicants be required to demonstrate earnings capacity by generating a positive net income for any two of the last three years based on the most recent financial statements. Net income is defined as gross revenues less total expenses and gross revenues include total revenues received from all sources. FHFA has requested comment on the minimum level and the appropriateness of this measure.

Given the current economic crisis, the minimum standard for earnings capacity could create significant challenges for CDFIs seeking membership in the FHLB System. The unprecedented conditions in the capital markets have limited CRF's ability to pool and securitize affordable housing and small business loans. Historically, CRF has generated positive net income, however, we will likely report a loss for FY 2009. We are not alone. CDFIs are experiencing significant earnings difficulties that do not reflect the true profitability of this industry but rather the challenging economic environment in which they are operating. To avoid penalizing CDFIs for these exceptional circumstances, we strongly recommend that FHFA allow CDFI applicants to demonstrate a pattern of positive income over a longer period of time and to use an average net income figure as described below.

We support a proposal offered by the Opportunity Finance Network that CDFIs be permitted to use a rolling three-year average figure to demonstrate a pattern of positive net income. This approach has been used by CDFIs in their loans covenants to offset accounting practices that artificially inflate/deflate earnings as a result of the way grants are booked as income in the year they are received. We believe this approach better reflects the earnings capacity of CDFIs.

Finally, CRF has concerns about the definition of gross revenues which currently includes unrealized gains and losses. We believe that these gains and losses should not be included in gross revenues because they have not been realized and given the state of the capital markets, these accounting items may be difficult to value accurately. To better assess the true earnings capability of CDFI applicants we suggest that the FHL Banks should focus on the change in "unrestricted" net assets rather than the change in "total" net assets. Moreover, accounting rules require entities that hold loans for sale on their books to recognize the "lower of cost or market" in marking their assets to market. This accounting rule prohibits such entities from recognizing unrealized gains, while recognizing unrealized losses during the holding period. Such a methodology could impair CRF's ability to meet the proposed standard.

Other Criteria

Commitment to Housing Finance

Insured depository institutions seeking to become members in the FHLB System must have *at least* 10 percent of their assets in residential mortgage loans. Non-depository applicants, such as insurance companies, are required to have



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"mortgage related assets that reflect a commitment to housing finance."³ FHFA believes the same rationale should apply to CDFI applicants and proposes that they meet the same standard as other non-depository institutions. Although no separate standard is being established for CDFI applicants, the Agency does state that it "...expects that the Banks will assess the commitment to housing finance requirements in light of the *unique community development focus of the business of CDFIs*."⁴ (Emphasis added)

CRF applauds the approach regarding the housing commitment criteria for CDFIs. Nonetheless, we are concerned that without stronger guidance from FHFA, individual Banks could set rigid guidelines that ignore the unique activities of CDFIs and the way they serve their markets. We recommend that FHFA direct the Banks to set a flexible standard that reflects the diversity of uninsured CDFIs and the wide range of affordable housing activities they finance in low income communities. A flexible standard is critical for a CDFI, like CRF, that provides a secondary market for affordable housing, small business and community facilities loans. In any given year, CRF's funding and purchases of affordable housing loans vary based on the demand for liquidity from our lending partners and market conditions in general. We provide a vital outlet for these loans that allows community development lenders to access liquidity and recapitalize their loan funds. If a Bank(s) requires a specific percentage of CDFI assets be dedicated to housing finance, we might meet the standard one year but not the next. In our opinion, stronger guidance from FHFA is needed. We propose that FHFA mandate that an assessment of CDFI commitment to housing finance must take into account a number of factors – including, the nature of the financing activities and any benefits such activities provide to the housing finance market. It should also be determined based on a long-term analysis over at least three years rather than an annual compliance period.

Community Support Standards

In order to maintain access to advances, members of the FHLB System must meet certain community investment or support standards. Insured depositories meet these requirements through their CRA activities. Members not subject to the CRA, like insurance companies and credit unions, are only required to meet the first-time homebuyer lending standard. Since CDFIs are not subject to the CRA, the rule proposes that they would be treated in the same manner. While FHFA believe CDFIs should be able to meet the first-time homebuyer lending standard, the Agency requests comments on whether the proposed approach is appropriate or if it should adopt an alternative community support standard for CDFIs that better reflects their activities.

CRF supports the community support standards, however, we find the first-time homebuyer lending standard to be narrow given the diverse activities of CDFIs. As an intermediary, we do not provide direct services, such as homebuyer counseling or technical assistance services, to first-time homebuyers. Our role is to act as a liquidity

³ Federal Register, pgs. 22851–22852, Vol. 74, No. 93, May 15, 2009, Proposed Rule: Federal Home Loan Bank Membership for Community Development Financial Institutions

⁴ *Ibid*, pg. 22852



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provider rather than financing particular niches within the affordable housing market. CRF's commitment to affordable housing, like that of many other CDFIs, is quite simply to increase the volume of resources available to finance these activities. We do so by purchasing mortgages for affordable rental properties as well as certain single-family mortgages. We are also committed to increasing homeownership (where appropriate) in low income communities. The one activity where we do have direct contact with borrowers is through our highly successful contract servicing operations. Through these capabilities, we have played a pivotal part in resolving a property flipping crisis in the Twin Cities and are beginning to address the nationwide foreclosure crisis.

A review of the eligible first-time homebuyer lending activities contained in 12 CFR part 944.3(c)(1) suggests that we might have difficulty meeting this standard. Yet we believe our commitment to affordable housing is aligned with the community support standards included in the Bank Act. To remedy this situation, we suggest that uninsured CDFIs be granted additional flexibility in meeting this standard by modifying the list of eligible activities. For example, 12 CFR part 944.3(c)(1)(ii)(C) allows applicants to meet this standard by "Participating in loan consortia for first-time homebuyer or loans that serve predominantly low- or moderate-income borrowers;". Virtually all of the affordable housing loans CRF purchases or funds serve low- or moderate-income borrowers. If the list of eligible activities was expanded to include "*The origination or purchase of loans that serve predominantly low- or moderate-income borrowers*" many CDFIs, such as CRF, would be able to meet this standard.

GENERAL ISSUES

CDFIs *are* Community Financial Institutions

We would like to share our views on the question posed by FHFA as to whether the legislative history to HERA provides any support for essentially treating CDFIs as Community Financial Institutions ("CFIs"). While we have not reviewed the legislative history, we believe that CDFIs should in fact be considered CFIs for the simple reason that they perform the same function of lending to borrowers that often have difficulty accessing credit. Under the Gramm-Leach-Bliley Act, CFIs were authorized to obtain advances from the FHLB System for lending to small businesses, small farms and small agri-businesses. In return, they were permitted to pledge more flexible collateral including secured loans for small businesses, agriculture, or securities representing a whole interest in such loans. Amendments included in HERA allowed CFIs to obtain long-term advances for the purpose of funding "community development activities" and further allowed CFIs to pledge secured loans for "community development activities" as collateral for their advances.

Like CFIs, CDFIs are small lending institutions that emerged in response to the lack of access to responsible credit and capital in economically distressed communities. The industry's mandate is to provide loans and investments to borrowers who are not able to access conventional lending institutions. Because CDFIs serve target areas comprised either of specific geographic investment areas or disadvantaged populations, they are the very essence of



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"Community Financial Institutions". Moreover, the HERA amendments only confirm this fact by specifically authorizing CFIs to use FHLB advances for "*community development activities*" and allowing them to pledge community development loans as collateral for their borrowings. The key difference between CDFIs and CFIs is that the former are not *insured* institutions. In our view, the regulations permitting CDFIs to join the FHLB System place CDFIs on equal footing with CFIs and thus should be accorded the same treatment under the regulations.

CONCLUSION

In closing, we appreciate this opportunity to share our views on the proposed rule regarding CDFI membership in the Federal Home Loan Bank System. This is an important opportunity for CDFIs to access a critical resource for lending and investing in underserved communities. Given the economic challenges we face, it is essential that regulations recognize the unique business model of the CDFI industry while ensuring that FHLB resources are used in a responsible manner. CDFIs offer the System an effective means of delivering capital and credit to communities hardest hit by the current economic crisis. We commend the staff of the Federal Housing Finance Agency for drafting the proposed rule in such a thoughtful and expeditious fashion. We would be pleased to answer any questions regarding the comments provided in this letter.

Sincerely,

A handwritten signature in blue ink, appearing to read "Frank Altman", written in a cursive style.

Frank Altman
President and CEO