

INTRODUCTION TO THE CAPITAL MARKETS “101”

What are capital markets?

Capital markets are markets where individuals, governments and businesses with more funds than they need (because they save some of their income) transfer those funds to individuals, governments and businesses that have a shortage of funds. Capital markets promote economic efficiency by directing money from those who do not have an immediate use for the money to those who do. Stock and bond markets are two major capital markets.

I know that there are primary and secondary markets – what’s the difference?

The primary market is where new securities (stocks and bonds are the most common types of securities) are issued. A corporation or government agency that needs funds (the borrower) issues securities to purchasers in the primary market. Investment banks assist in this process by underwriting the security – they guarantee a minimum price for the security and sell them to the public. The primary market is limited to issuing new securities. The vast majority of financial transactions occur in the secondary market through stock exchanges, bond markets, futures markets and others. Secondary markets are involved in the trading of securities. Securities can be debt or equity instruments.

So aren’t CDCs and CDFIs already involved in the capital markets?

Yes, in a very limited way they are. Most CDFIs receive money from foundations and government agencies and lend it to individuals and communities that need the funds. In fact, many CDFIs have become quite good at assessing and managing risk and have developed loan portfolios that perform at a very high level.

So what’s the problem, what more do we need?

Well, foundations and government have limited funds. You may have noticed this. You may have also noticed that there is still a demand for capital in your community. People want to buy houses and start businesses. Organizations want to develop housing and community facilities. So CDFIs have become good at lending, but many have not grown to their full potential. They may want to access capital from other markets. Right now, most CDFIs lend money and hold the loans in their portfolios. This is known as portfolio lending. We believe that many CDFIs could expand their lending and better serve their communities by complementing portfolio lending with capital markets lending. After all, there’s a lot of money out there – and we want it.

What do you mean by capital markets lending?

Capital market lending means that CDFIs increase their liquidity by utilizing methods (pooling, insurance, participations, securitization, credit enhancements) that allow them to place loans (and other securities) with a range of institutional investors – beyond government and foundations.

So we want Wall Street to buy our stuff?

Sure.

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OK, what’s the hitch? What do we have to do? Discount our loans? Ignore our traditional borrowers? Sell our souls?

No, you don’t necessarily have to do any of the above. But you do need to understand how the capital markets work so you know what behaviors you might have to change. And it’s not just individual CDFIs that need to change behaviors, the CDFI industry needs to change some behaviors collectively in order to more access more of that money.

OK, so what behaviors might I need to change?

Again, I want to make it clear, it’s not just you individually – it’s us collectively. We need to review how we do business. Here’s what the capital markets are looking for:

1. Historical performance data – lots of information

How do we perform over time? What are delinquency rates, default rates and recoveries? Do we all measure these things the same way (see standardization, below)?

Capital markets like lots of information and data.

2. Standardization

This is a big one. Capital markets like vanilla. Not caramel, not strawberry, not chocolate. Vanilla. Capital markets want CDFIs to standardize things like data collection systems, loan performance tracking tools, servicing practices, underwriting and risk assessment methods, standard collections methods, etc. We need to adopt industry standards for these things and standardize them within the industry.

3. Volume

Capital markets like to deal with big numbers. We deal with small numbers. So, we have to develop mechanisms for pooling our assets so we can offer them big numbers.

4. Pricing

Are our loan products priced properly to risk? Do we offer a rate of return that would satisfy the market? Our first response may be “no”. But, in fact, we have identified CDFI portfolios that are offering rates of return that are very competitive. Often, a credit enhancement (see below) will make our products very desirable in the capital markets. Not all of our products may meet these criteria, but many will.

5. Credit Enhancement

To make our products more attractive to capital markets we can offer credit enhancements. There are many types of credit enhancements. Credit enhancement tools include letters of credit, insurance, etc. Government and foundation money may be more useful as “credit enhancers” than as direct loan money.