Public-Sector Loans to Private-Sector Businesses:

An Assessment of HUD-Supported Local Economic Development Lending Activities

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Final Report

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Foreword

This report assesses the performance of the third party loans under principal programs that the Office of Community Planning and Development (CPD) of the Department of Housing and Urban Development (HUD) directs toward economic development: the Community Development Block Grant (CDBG) Program; the Section 108 Program; and the Economic Development Initiative (EDI). The research describes the CDBG, Section 108, and EDI programs, how they work, and what types of economic development they fund; estimates the size and quality of the loan portfolio; and appraises the success of these programs in terms of job creation, business success, loan pay back, leveraging, and cost per job created. Additionally, the study examines the reasons why communities have used Section 108, their experiences using Section 108, the effect of EDI money on that use, and the results of Section 108 projects. The concluding chapter assesses the feasibility of developing a secondary market for the economic development loans originating under the CPD programs.

The findings of this report demonstrate the scope and variety in the CPD programs and the range of locally-determined objectives served by third party loans. The more than $2.2 billion of HUD funds used for this purpose in the later half of the 1990s were examined. The nation's most populated and most distressed cities and urban counties account for the preponderance of this spending. Examination of nearly 1,000 loan files maintained by the 51 most active community users of CDBG and Section 108 funds for third-party lending indicates that local loan programs create jobs and leverage investment at costs that are comparable to those of other federal government programs.

The report merits the attention of all those concerned with the economic development of distressed urban areas and potential innovative developments in its funding, such as the establishment of secondary markets for third-party economic development loans.

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TABLE OF CONTENTS

EXECUTIVE SUMMARY

This research examines the results and performance of economic development loans to private businesses made by state and local governments using program funding from the U.S. Department of Housing and Urban Development (HUD). It finds widespread use of HUD funds for this purpose, amounting to some $2.2 billion over the second half of the 1990s. The nation's most populated and most distressed cities and urban counties account for the preponderance of this spending. Examination of nearly 1,000 loan files maintained by 51 of the most active community users of the HUD Community Development Block Grant (CDBG) and Section 108 programs for third-party lending indicates that local loan programs create jobs and leverage private investment in poor neighborhoods at costs that are comparable to those of other federal government programs. Although default rates in these loan programs are higher than those of private-sector lenders, substantial amounts of new money could be raised by selling these loans on a secondary market, without undermining the policy goals of the federal programs that fund them. HUD could help to encourage secondary market sales by accumulating and disseminating information about loan performance and setting standards for loan underwriting, servicing, and documentation.

Study Goals

A prevalent function of state and local governments in the United States is the promotion of economic development—attempting to increase the value of the goods and services produced by individuals and enterprises located within their jurisdictions. Public-sector transportation, land use, education, infrastructure, and other investments can help to stimulate increases in the value of these products, important in helping to create jobs and business opportunities in areas left behind by the private market.

One of the ways state and local governments have stimulated more investment and employment is through direct assistance to private-sector businesses that promise to start up or expand their economic activities in exchange for public-sector help. This government support sometimes takes the form of loans to business borrowers, typically at interest rates below those available from private lenders. An advantage of extending assistance in the form of loans is that, if successful, businesses repay the funds borrowed and these repayments become available (or are "revolved") to make new loans to other borrowers.

Several federal agencies have provided funding to state and local government agencies to create revolving loan funds. For example, the Economic Development Administration (EDA) of the U.S. Department of Commerce has, since 1965, made funds available to regional development organizations to make business loans. Likewise, community agencies have used funding from HUD to make loans to businesses that promise to create low-income jobs, serve

low-income areas, or make physical improvements that contribute to the economic prospects of distressed cities and counties. Three HUD programs have been used for this purpose:

- **The CDBG program** awards funds by a national formula to states, urban counties, and cities to allow them to design and carry out community and neighborhood improvements in such areas as affordable housing, public works, and economic development. Throughout the 1990s, nearly $41 billion in CDBG funding was devoted to community development activities.
- **The Section 108 program** allows CDBG grantees to borrow federally-guaranteed funds for community development purposes, including the on-lending of these funds to private businesses. Because they can borrow up to an amount that is five times the size of their annual entitlement, localities can undertake or support large-scale projects that otherwise would not be possible with their smaller annual CDBG allocations.[1] Throughout the 1990s, over $4 billion in community development investments was supported with Section 108 funding.
- **The Economic Development Initiative (EDI) and the Brownfields Economic Development Initiative (BEDI)** provide grants to states or communities to be used to reduce the risk (or "enhance the credit") of Section 108 loans, allowing grantees to provide additional funds to projects, create loss reserves in case borrowers fail to pay, or provide other kinds of credit enhancement. Since their creation in 1994 (EDI) and 1996 (BEDI), these two programs have provided $500 million in assistance to Section 108 participants.

There are two important reasons for studying the performance and results of HUD-supported economic-development loans. First, local, state, and federal policymakers can get better results for fewer dollars, and achieve a better match between their economic development goals and lending program outcomes, if they have good information on how results are influenced by the types of loans they make and to which kinds of borrowers. Second, local program administrators may be able to increase substantially the funding available to pursue community development aims if they can sell their loans to others, just as many housing loans made by mortgage lenders are sold to investors on the secondary market. Information about loan performance is vital to help construct this market.

[1] In the event grantees cannot pay back their Section 108 loans with project revenues or some other local source, however, they must repay using a portion of their future CDBG allocations.

Study Questions, Methods, and Data Sources

For purposes of this report, third-party loans are those originated by local governments (or other entities on their behalf) to private businesses or non-profit organizations engaged in economic activity and for which there is a reasonable expectation of repayment. Excluded, therefore, are grants, forgivable loans, loans to construct or rehabilitate housing or community facilities (unless part of a mixed-use commercial project), and loans to public agencies.

This study blends information gathered from five distinct sources covering all users of CDBG funds for third-party lending originated between 1996 and 1999, and Section 108 lending originated between 1994 and 1999. These sources and the scope of data included are:

1. Telephone interviews with economic development directors of 460 of the 962 entitlement communities that used CDBG funds for economic development purposes over the past decade, and 11 of 49 state economic development program directors.[2]
2. In-depth personal interviews with program directors and staff in 51 communities that made the largest volume of third-party loans using Section 108 or CDBG funds during the study period, accounting for 58 percent of all the CDBG lending volume and 96 percent of all the Section 108 lending volume nationwide.
3. Financial, underwriting, business characteristics, and other administrative data collected from loan application, approval, and servicing files for 976 third-party loans originated in the 51 high-loan-volume communities—totaling $659 million of a total $727 million in lending done in these places. Sampled loans account for 69 percent of the total $950 million estimated to have been lent nationwide over the same period.
4. Telephone interviews with 234 of the 750 business borrowers of CDBG or Section 108 funds who were still in business at the time of data collection.
5. Financial data collated from HUD's IDIS and predecessor grantee reporting systems, including information on the amounts of CDBG and Section 108 funding spent for third-party lending purposes nationwide.

Information was also gathered from the US Census 2000 (on the poverty rates of neighborhoods in which businesses operated) and the files of Dun and Bradstreet, Inc. (on business sales, employment, and survival). Finally, the views of several experts involved in previous secondary market transactions were solicited, including their assessment of potential

[2] The 50 states and Puerto Rico operate CDBG programs. However, information was not available for Hawaii and New York where, at state option, HUD administered programs for non-entitlement areas within the state during the study period.

market sales of CDBG- and Section 108-funded loans in light of the loan-level administrative data collected for this research.

It is important to note that third-party loans made by smaller communities with funds that flow through the states are not examined in this report as extensively as are those made by entitlement communities, reflecting the difficulty and higher costs of collecting administrative information from the former. This difficulty stems from the decentralized decisionmaking and program administration structures adopted by some states.

This report answers five basic questions about third-party loans and lending programs, listed below in the order in which they are reported in this summary. The actual chapter order is indicated in parentheses following each question:

1. What is the extent of third-party lending nationwide? How many and what kinds of communities have used the flexibility available to them under the CDBG and Section 108 programs to make third-party loans for economic development purposes? (Chapter 2)
2. What are the results of local third-party lending programs in terms of business development and job creation benefits? Do some kinds of borrowers, in certain types of neighborhoods, create jobs or leverage private funds at lower cost than others? (Chapter 4)
3. What are the characteristics of third-party loans and how do they perform? How extensive are loan repayment problems? Are some types of loans or borrowers more likely to encounter difficulties than are others? (Chapter 5)
4. What is the feasibility of creating a secondary market for third-party loans? What would a transaction structure look like? What prices would loan pools likely command? What issues would have to be resolved to induce buyers and sellers to participate? (Chapter 6)
5. What are some of the program and regulatory issues that affect local uses of the CDBG and Section 108 programs? (Chapter 3)

The Extent of Third-Party Lending

Nearly all states and CDBG entitlement communities across the nation funded some amount of economic development during the 1990s, totaling $8 billion of the $46 billion expended for the CDBG, Section 108, and EDI/BEDI programs over that timeframe. These expenditures included investments in public infrastructure, grants to local businesses, workforce development, and other economic-development activities. Third-party lending volume alone came to over $2 billion during the decade of the 1990s, which amounts to 27 percent of all economic-development funding. CDBG and Section 108 each contributed about $1 billion to

this national lending "portfolio." About one-half of all entitlement grantees used CDBG funding and one-third used Section 108 funding to make third-party loans. Over the 1990-99 period, third-party loan funding constituted 18 percent of funding for all Section 108 activities, and 3 percent of funding for all CDBG activities.

Grantee lending activity rose over the decade, as the share of economic-development funding devoted to third-party lending increased from 25 percent between 1991 and 1994 to 29 percent between 1995 and 1999. This increase reflects a more active use of the Section 108 program for third-party lending purposes following the introduction of EDI in 1994 and BEDI in 1996. By reducing the risk that communities would be required to use CDBG funds to repay their Section 108 loans in the event of default, the credit enhancement available from these initiatives appears to have made the Section 108 program more appealing. Indeed, community development administrators were close to unanimous in reporting that EDI and BEDI grants were important to their decisions to seek Section 108 funding.

Although large numbers of communities and states either regularly or occasionally use some amount of HUD support for economic development and third-party lending, spending for these purposes is, in fact, heavily concentrated among a relatively few grantees. Over the decade, for instance, the top 10 percent of entitlement grantees (in terms of third-party loan volume) accounted for more than three-quarters of all of the lending that was originated. These tend to be the nation's more populous and economically distressed central cities and urban counties.

Results of Third-Party Lending

Communities devise and use local third-party lending programs to create low- and moderate-income jobs and promote business investment in poverty-stricken neighborhoods. The first of these purposes is reflected in the frequency of grantee selection of one among several statutorily required national program objectives for which HUD community development funds can be used. Most (77 percent) of the dollars spent on third-party loans are justified as creating or retaining low- and moderate-income jobs within a community; remaining funds are qualified as benefiting low- and moderate-income areas (15 percent), eliminating slums or blight (six percent), or meeting some other objective (three percent). The second of these purposes is indicated by the fact that more than one-half of CDBG- and Section 108-funded lending flows to businesses in neighborhoods where 20 percent or more of the population lives below the federal poverty level. In fact, more than one-third of Section 108 program loan funds are invested in businesses in neighborhoods with poverty rates of 40 percent or more. And, about one-quarter of loans in both programs go to minority-owned businesses—substantially higher than their 15 percent share of the overall business population.

Grantees aim to achieve several types of economic-development outcomes with their third-party lending programs: they intend to help businesses carry out profitable economic activities, create low- and moderate-income jobs, and encourage private investment. Grantees often endeavor to accomplish these goals at relatively low cost, and without substituting public funds for private funds that might otherwise be invested. Data collected for this study allow the following observations:

1. Although firms doing business in poor neighborhoods might be expected to fail at higher rates than others, the survival rate of CDBG- and Section 108-assisted businesses is about the same as the national average for all businesses. Nearly 80 percent of borrowers of CDBG funds and 75 percent of borrowers of Section 108 funds were still in business three years or more after loan origination.

2. In the study's high-loan-volume communities, total jobs created by all borrowers amount to at least 93 percent of the total number of jobs that were planned at the time of loan origination.[3] Most borrowers who opted to meet the job-creation national objective appeared to create or retain some number of jobs.[4]

3. Reflecting the sometimes difficult business environment faced by borrowers of HUD program funds and the high-risk nature of start-up and expansion projects, only 56 percent of CDBG borrowers and 52 percent of Section 108 borrowers who promised to create or retain low- or moderate-income jobs as the condition of their loan met or exceeded their job targets.[5]

4. Many local third-party lending programs require that businesses secure project funding from private sources, which both provides added confidence that such projects are financially feasible and helps to encourage private-sector investment in poor neighborhoods. Each loaned CDBG dollar helped to attract (or "leverage") an additional $2.69 in private funding, and each loaned Section 108 dollar helped to attract $1.54 in private funding.

[3] Some grantees appear not to record the number of jobs created after targets are reached, making this a likely under-estimate of the actual percentage of jobs created relative to those planned.

[4] While HUD monitors grantees to verify that job creation and other national objectives are met, the audit procedures used by the Department differ from the research methods used to collect data for this study. The latter indicate that over 90 percent of grantees created the jobs they intended. However, jobs data were unavailable to researchers for about 15 percent of loan-funded projects, suggesting that some grantees may not have not complied fully with the CDBG program's documentary requirements.

[5] Because a number of larger projects exceeded their job goals by large margins, these percentages are considerably lower than the 93 percent figure contained in the preceding finding.

5. Each job created or retained as a result of CDBG-funded loans costs the program $2,673, within the range of $936 to $6,250 for other federal economic-development programs. Each job created or retained as a result of Section 108-funded loans costs the program $7,865, which is slightly higher than the upper bound for other programs.[6] These figures "subtract" the amounts that borrowers must repay and, as a result, reflect only the "subsidy value" to borrowers. In terms of full loan principal, each job resulting from a CDBG-funded loan is tied to $11,615 in loan principal, while each job resulting from a Section 108-funded loan is tied to $37,957 in loan principal.

6. Many local community development officials attempt to ensure that the loans they make do not simply replace or substitute for funds that business owners could have obtained from private lenders or from their own resources. That notwithstanding, 19 percent of borrowers of CDBG funds and seven percent of borrowers of Section 108 funds say that that their projects would have gone forward, *on the same scale and with the same timing*, in the absence of their third-party loan. In contrast, more than one-third (36 percent) of CDBG-assisted business owners and 39 percent of Section 108-assisted business owners report that their projects would not have gone forward *at all* without their third-party loan. The remainder of borrowers indicate that their investments otherwise would have been *reduced in scale or made over a more extended period* had they not received a third-party loan.

Among businesses that borrow CDBG program funds, larger establishments and those located in low-poverty areas tend to achieve better results than smaller businesses or those in high-poverty areas. Larger firms survive at higher rates, leverage more non-HUD-program funding, and create jobs at less cost than smaller businesses, but they are more likely to report that HUD funds substitute for private dollars. Businesses located in high-poverty and extreme-poverty tracts create fewer jobs, and the jobs they create cost more than jobs created by firms in low-poverty tracts. For extreme poverty tracts, at least, part of the explanation may lie in the firms' inability to attract other public and private funding in the same amounts as firms situated in other neighborhoods.

The relationship between business characteristics and the levels of benefits conveyed by Section 108-funded projects is less clear than that observed for CDBG-funded projects, reflecting a smaller number of large projects and the unique circumstances that pertain to many large-scale redevelopment efforts. Larger firms (in terms of sales and numbers of employees) create more jobs in relation to job targets than smaller firms and, for firms with large numbers of employees, these jobs are less expensive in terms of the face value of the loans than jobs

[6] Loans are converted to their grant equivalents to permit a fair comparison. Figures include jobs in businesses that subsequently failed.

created by smaller businesses. Firms with large annual sales, and those borrowing in large amounts, tend to leverage more public and private dollars than other firms—the latter showing below-average leveraging performance.

Characteristics and Performance of Third-Party Loans

Third-party loan program administrators, of course, want borrowers to repay their loans. Timely repayment is one sign of profitable business operation and a condition for continuing creation and retention of low- and moderate-income job opportunities. Repayment also ensures a sustained flow of economic-development funding.

The historical default rate for closed CDBG loans made between 1996 and 1999 is 23 percent, as measured by the loans that had either been fully repaid by borrowers or "written off" by lenders. Experience to date for loans still at the time of data collection suggests that the performance of outstanding loans will be similar to those now closed. Taken together, loans for which no further repayments were expected and loans more than 90 days overdue came to 25 percent of loans outstanding. These troubled loans were smaller, on average, than those in good standing at the time of data collection, accounting for only 13 percent of principal at origination.

At 42 percent, and excluding one community with an extremely high default rate, the historical default rate for Section 108-funded loans originated between 1994 and 1999 was higher than for CDBG-funded loans.[7] The troubled loan rate for open loans at the time of data collection was 33 percent, suggesting that the still-open portfolio of loans may perform better than those already closed. These troubled loans also were smaller, on average, than well-performing ones, also accounting for 13 percent of principal at origination. Two thirds of grantees used some of their CDBG loans to cover losses on defaulted loans, accounting for 16 percent of all Section 108 program participants.[8]

Measured by default rates, some CDBG loans are riskier than others, undoubtedly reflecting explicit public-sector decisions to invest in higher-risk businesses that operate in higher-risk neighborhoods. Loans encountering repayment problems tend, more often than those that perform, to: be for smaller loan amounts, be originated at higher rates, involve no private bank participation, be used for equipment and operating capital, and have no real estate as collateral. Non-performing loans also tend to be made to smaller, start-up, or independent

[7] Grantees were promised anonymity to elicit their cooperation. Consequently, the identity of this community is not revealed.

[8] This percentage pertains to grantees, not loans. Loan-level data on sources of repayment and amount of funds recovered are not available.

businesses (not branches or franchises) and businesses located in high-poverty neighborhoods. Similarly, more risky Section 108-fimded loans tend to be smaller, issued at higher rates, and are more often used for operating capital than are performing loans, but they also tend not to include other public funding or private equity and be used for inventory purposes. More risky borrowers also tend to be smaller businesses but, unlike CDBG borrowers, are more likely to be existing businesses rather than start-ups.

The Feasibility of a Secondary Market

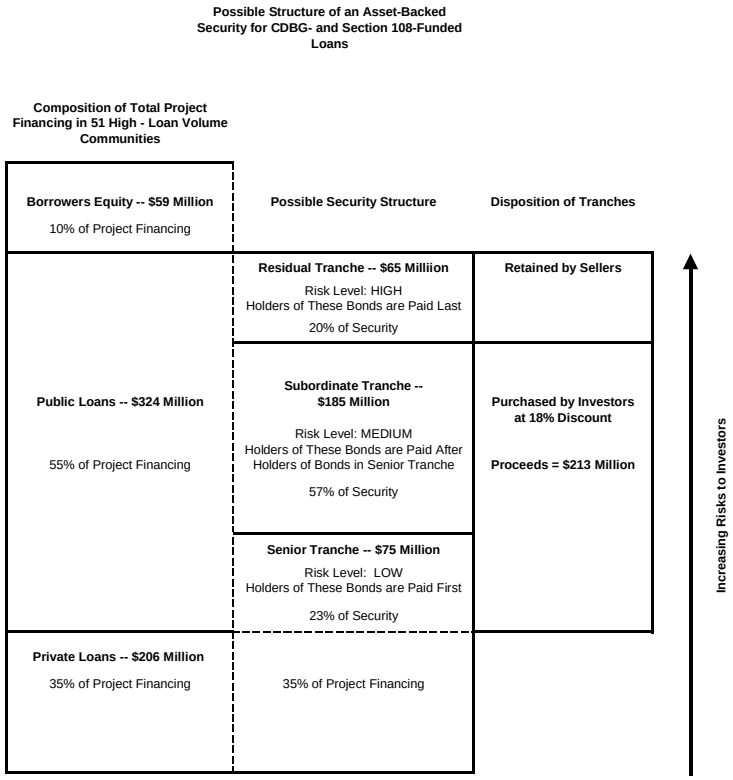
The flow of funds for additional economic development could be increased, in the short term, by sales of third-party loans to investors. Such sales could generate immediate, and potentially substantial amounts of cash to satisfy additional lending demand. But, past buyers of similar loans have not paid face value for them. Rather, they have discounted their prices to reflect the risk that some of the loans would not be repaid, and to reflect uncertainty surrounding default rates and the standards used (or not used) by lenders to evaluate borrower credit-worthiness and to collect loan payments in a timely way.

Any asset, no matter how risky, can be sold on a secondary market. A method to sell financial assets that is widely accepted in the marketplace is asset-backed securities (ABSs), which allow investors to buy a share of the cash flow generated by the underlying assets. For third-party loans, state and local government lenders most likely would contribute their performing loans to a loan pool, which would be created by investment bankers or other intermediaries and made available for sale on private capital markets.

Nearly all ABSs have some form of credit enhancement to reduce risks to buyers, including over-collateralization (in which the dollar amount of securities issued is less than the dollar value of the assets sold), creation of loan-loss reserves using some of the cash flow or proceeds from bond sales, and creation of structured transactions that include senior and subordinate debt. Such structured transactions contain three parts or “tranches:” an A-rated, low-risk senior tranche; a higher-risk subordinate tranche; and an unrated, high-risk, residual tranche. As the underlying assets generate cash flow, holders of the senior tranche get paid first, holders of the subordinate tranche get paid next and, holders of the residual get paid last, if at all.

Previous small-business and economic-development-loan sales suggest a likely transaction structure for the sale of locally originated third-party loans based on the amounts of private equity and market-rate loans in these projects: about 23 percent of a CDBG/Section 108-based ABS would be apportioned to the senior tranche, 57 percent would be apportioned to the subordinate tranche, and 20 percent would be apportioned to a residual retained by the sellers.

Because this senior tranche is small relative to other small-business ABSs, and the residual is large, sellers of a CDBG/Section 108-based ABS may expect to receive only about 66 cents on the dollar—the full loan principal less the 20 percent residual and a 17 percent discount because the public debt sold is subordinate to that of private lenders (the amounts "leveraged" by project loans). Therefore, assuming that the full $324 million of loan principal outstanding for performing loans in 2002 (in the 51 high-loan-volume communities sampled for this study) were pooled into a single ABS, the sale would yield approximately $213 million for new lending or other community development purposes.



Although the creation of a secondary market for HUD-supported third-party loans is certainly feasible, several issues would have to be resolved in order to induce routine participation by potential buyers and sellers. With respect to the latter, about one-half of local officials surveyed for this study expressed interest in potential sales, yet they also voiced serious concern that investors would cream only high-performing loans, require sharp discounts, and demand standardized underwriting before they would be willing to purchase loans. These officials also fear that such demands would undermine local agency relationships with borrowers, limit flexibility to pursue high-risk projects, and produce insufficient financial benefits for their communities. Some of these issues could be resolved without compromising the policy goals of local third-party lending programs, which would continue to dictate origination of high-risk loans. Although loan buyers will certainly discount their purchase prices where loans are perceived to be high-risk, public lenders (and HUD) can at least take steps to reduce the discounts that buyers would apply because of *uncertainty* about how loans might perform.

Lack of information about third-party loan characteristics and their risks of default are sources of uncertainty. But, the present research shows that loan terms, financial underwriting,

collateral, and business and community characteristics influence loan performance, meaning that the market can use this information to assess whether one pool of loans is likely to be of higher risk than another pool. For example, the default rate of a pool of loans consisting primarily of smaller loans to smaller businesses, located in high-poverty neighborhoods, to be used for operating capital and not secured by real estate, would be expected to exceed the default rate of a pool of larger loans to large enterprises located in low-poverty neighborhoods, to be used for real estate development and secured by real property.

Wide variation in community practice on how loans are underwritten, serviced, and documented is another source of uncertainty. But, introduction of standards for underwriting, servicing, and loan documentation could reduce this uncertainty without sacrificing the policy goals that underlay federal community development programs. To be useful to purchasers, these standards need not be as strict as those commonly followed by private lenders; they could be relaxed to preserve the policy goal of aiding higher-risk borrowers. Loan buyers, however, would welcome the reduction in uncertainty as to what underwriting and servicing policies were being followed, and documentary standards could be raised without limiting the types of loans made or borrowers assisted.

Selected Program Issues

While HUD's CDBG program affords grantees considerable latitude to pursue state and locally defined policy goals, it does so in order to achieve certain broad national policy objectives. Consequently, federal regulations are promulgated to ensure that these objectives are pursued. Invariably, however, such rules risk limiting grantees from pursuing legitimate local policy objectives without producing the offsetting public benefit of maintaining emphasis on the intended national objective.

In fact, however, this risk appears not to be especially serious with respect to HUD-supported third-party lending programs. Larger, more distressed cities and urban counties are the most frequent users of CDBG and Section 108 funds for third-party lending; these types of communities have spent more money for this purpose, more consistently over the years, and in greater amounts than smaller, less distressed suburban communities. This relationship between community characteristics and program use implies that local conditions and needs strongly influence local decisions to adopt business lending as an appropriate response. Further, asked whether federal requirements associated with the CDBG or Section 108 programs pose a major hindrance to their programs, a majority of local officials charged with administering them reported that they did not.

That notwithstanding, however, a substantial minority of officials is concerned about the effects of federal low- and moderate-income job creation (especially documentation)

requirements on their loan programs, primarily because these are perceived to increase costs to both businesses and administering agencies. While some grantees see these and other rules as detrimental to their interest in carrying out economic development and third-party lending programs, it should be mentioned that some of this appears to be due to grantee misunderstandings about the range of options available to them. The confusion often centers on rules for qualifying expenditures as meeting national objectives, which, in the view of many local officials, requires them to qualify most expenditures in terms of low- and moderate-income job creation. In reality, however, other options may be available that are less burdensome to smaller business or to certain neighborhood programs, indicating a need for more technical assistance and guidance in this area.

With respect to Section 108, those communities that spend relatively small amounts of money on third-party loans appear less willing than others to accept the special requirements that pertain to that program—including the long-standing requirement that a community's CDBG funding be pledged as collateral in the event of default on loan repayment. In this regard, local community development officials attach considerable value to EDI and BEDI as tools to help them reduce what, to some, is a substantial risk. Also, additional security requirements introduced in 1996 and the considerable time required to receive HUD approval of Section 108 applications are issues of concern to a broad spectrum of grantees.[9]

State community development program administrators second the concerns raised by some local entitlement grantees concerning the difficulty of complying with the income and documentation requirements of the job-creation national objective in both the CDBG and Section 108 programs. They appear, however, to be somewhat more risk-averse in response to Section 108 requirements than local officials; administrators representing three of the four state Section 108 borrowers interviewed for this study indicate they will not apply to the program in the future—largely because of disappointing loan repayment performance on the part of borrowers.

[9] On the latter point, HUD officials acknowledge a slow-down in application processing times during the flood of applications received after EDI was introduced in 1994, but suggest that this has been subsequently resolved by an increase in staff devoted to reviews.

CHAPTER 1: INTRODUCTION: RESEARCH QUESTIONS AND METHODOLOGY

To stimulate local economic development, city and county government officials sometimes use a portion of their federal community development dollars to make what are known as "third-party" loans to private, for-profit businesses or non-profit organizations (hereafter, "businesses," "firms," or "enterprises") within their jurisdictions. These loans can help to start or expand enterprises, create or retain jobs, and leverage additional public or private investment. When paid back by the businesses, the money is available for reuse by localities for other community or economic development purposes. Although such loans have been made for many years, little information had previously been available about the extent, efficacy, or possible expandability of this public-sector approach to supporting local economic development.

> **Third-party loans,** for purposes of this report, are those originated by state or local governments (or other entities on their behalf) to private businesses or non-profit organizations engaged in economic activity, using HUD program funds, for which there is a reasonable expectation of repayment. Excluded are grants, forgivable (or "soft") loans, loans to construct or rehabilitate housing or community facilities (unless part of a mixed-use commercial project), and loans to public agencies.

This is a report on the scope, nature, and results of local government third-party lending practices deriving from several major community development programs administered by the U.S. Department of Housing and Urban Development (HUD). It is the first report on this subject to be based on a large-scale, primary data-collection effort involving numerous communities and loans across the nation. It is also the first report to assess the potential for creating a secondary market for HUD-supported third-party loans based on analysis of an extensive body of empirical data on such loans.

> Once a (primary) loan—including a HUD-supported, third-party loan—is originated to a business by a lender (a local government agency or an intermediary organization lending on its behalf), the loan can be sold by the lender and bought by an investor—like any other good. The market for such an exchange is referred to as a **secondary market.**

For background purposes, this chapter describes HUD's general approach to investing in community and economic development and supporting local third-party lending initiatives, as well as its programs for accomplishing these ends. It outlines the major issues to be addressed, presents the samples and data collections methods that were used in the study, and provides a guide to the kinds of analyses that follow in subsequent chapters.

HUD's Local-Discretion Approach to Supporting Community Development

Through its Office of Community Planning and Development (CPD), HUD administers several programs that provide funds to units of general local government—in some instances directly to them and, in others, by way of states—for the purpose of promoting community development. The landmark Community Development Block Grant (CDBG) program, enacted

in 1974, was the first of its kind to allow communities significant discretion in the use of federal funds with regard to whether or how to provide public infrastructure, facilities, or services to enhance community development. The program allows communities to carry out these activities either through local public agencies or through grants or loans to community-based organizations, non-profit service providers, or profit-making businesses.

Exhibit 1.1
Predecessor Programs to CDBG

CDBG grew out of the consolidation of the following eight categorical programs, for which communities competed nationally for funding:

- Open Space grants;
- Urban Renewal grants;
- Neighborhood Development Program grants;
- Historic Preservation grants;
- Model Cities supplemental grants;
- Public Facilities loans;
- Neighborhood Facilities grants; and
- Water and Sewer grants.

Indeed, flexibility and local discretion in the use of federal funds have been hallmarks of CPD programs since the enactment of CDBG. Before then, the federal government administered a wide array of competitive "categorical" community development programs in which there was extensive federal review and approval of proposals and extensive reporting of program activities to federal authorities (see Exhibit 1.1). Pre-1974 community development policy was primarily intended to improve downtown districts or to revitalize distressed urban neighborhoods, and federal funds could only be used for program-specific, federally designated purposes. Block grants revolutionized federal support for local community development by entitling "grantees"—larger cities and urban counties as well as states (on behalf of smaller communities)—to a block of community development funds distributed by formula and spent at local option, within a broad set of guidelines established by the Congress. Since 1974, newer programs administered by CPD essentially follow this model, providing flexible funding intended to accomplish a fairly broad range of community development purposes.

As a programmatic category, "community development" encompasses a wide range of activities—call them community investments—that, in one way or another, are intended to support the stabilization, revitalization, or improvement of communities. For example, communities can invest in: *housing construction and rehabilitation* to help preserve the stock of decent and affordable dwellings, to enable families with differing income levels to live in the community, or to encourage private investment in homeownership and home improvements; *public infrastructure and facilities* to attract and retain private businesses; *services* such as job training and placement or after-school youth programs to address critical community needs or prepare residents to take advantage of economic opportunities; or *neighborhood improvements and amenities* such as parks or streetscapes to enhance a community's overall image and well-being or to encourage households as well as businesses to locate and invest there.

At best, such publicly supported activities are mutually reinforcing, and the flexibility allowed by HUD's programs is intended to permit local decision-makers to determine which mix of investments they believe will help to sustain or build their individual communities. A 1995

Urban Institute evaluation of the CDBG program found that communities do, indeed, take advantage of the flexibility offered by block grants: there is substantial variation across jurisdictions and types of communities with respect to the mix of activities undertaken.[1] For example, central cities generally allocate a larger share of funds than do suburban jurisdictions for housing, and a smaller share for public facilities. The Urban Institute analysis also documented considerable differences in the way individual jurisdictions use their CDBG resources from year to year, and in the extent to which they target CDBG resources to particular neighborhoods or pursue a more diffuse "citywide" development strategy. In sum, contemporary federal community development policy allows and encourages local jurisdictions to design their own comprehensive strategies and plans.

Economic Development as a Local Community Development Option

Among competing community development needs (such as to construct community facilities, provide services, or rehabilitate housing), another such need—to promote the health and vitality of the local economy—is important to many local governments. HUD funds can be spent for this purpose (see Exhibit 1.2). Multiple sources of federal dollars flow to local jurisdictions, either directly from HUD or indirectly from HUD through states, to be utilized for either economic development or other community development uses. Within broad limits, the specific mix of uses and funding proportions is dependent on community-level decision making.

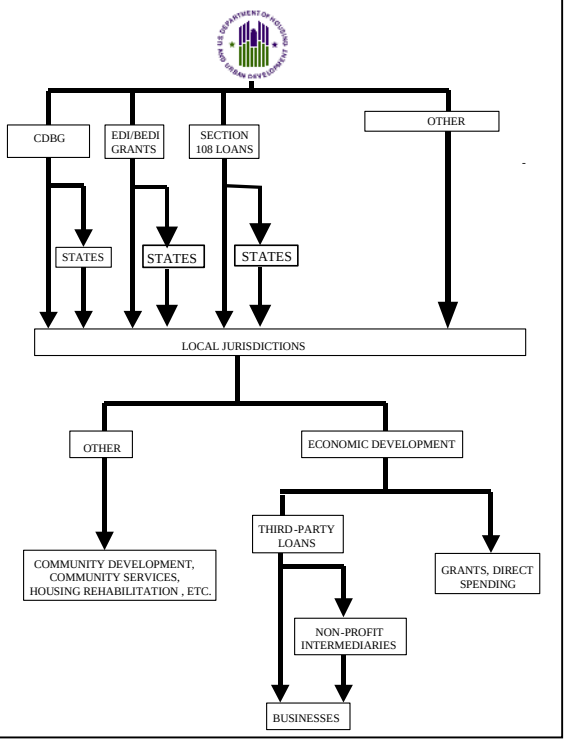
The concept of "local economic development" can have varying meanings, but it essentially refers to public- and private-sector activities intended to attract, retain, or expand industrial, commercial, or service enterprises in a defined location (neighborhood, city, county, etc.), and to create or retain jobs associated with that place. Experts generally agree that certain conditions are especially conducive to creating a local economic climate that supports and enhances, rather than inhibits, business development. These conditions include having:

- access to affordable capital;
- adequate infrastructure and other support services, including transportation for supplies and products;
- accessible information, along with research and development to support innovation and entrepreneurship;
- a suitably educated and skilled work-force;
- suitable and affordable land availability; and
- a local regulatory and tax regime that supports and enhances business investment.

[1] *Federal Funds, Local Choices: An Evaluation of the Community Development Block Grant Program*, U.S. Department of Housing and Urban Development, May, 1995.

Certain kinds of economic development activities designed to create a positive economic climate—like those involving development of supportive infrastructure (e.g., parking garages) or public facilities (e.g., convention centers), or provision of training or business support services—are typically undertaken by government agencies or through public-sector grants to non-profit organizations. Those designed to create or retain jobs, however, are often provided through public-sector grants or loans to private enterprises. Local government loans to businesses, then, represent one among several approaches to economic development that can be supported with federal community development resources.

Exhibit 1.2
Flow of Funds from HUD's Community and Economic Development Programs



Third-Party Lending as a Local Economic Development Option

Although some communities are not comfortable giving funds directly to for-profit businesses and chose, instead, to provide indirect assistance through supportive programs, many, in fact, elect to make direct grants or repayable loans to business owners. The premise is that helping business enterprises to get started or expand both creates and retains jobs and enhances the tax base, thereby helping to stabilize and revitalize the community. Such loans can be either administered directly by local government agencies or by non-profit intermediaries that assume responsibility for various or all aspects of the lending.

Since there is no "right" way or single standard for carrying out local economic development loan initiatives under HUD's programs, there is bound to be considerable variation across communities as to both how they are structured and how they are implemented. With respect to the former, some localities undertake limited initiatives involving only a few loans while others develop very large revolving loan programs.

Revolving Loan Funds (RLFs) involve the use by state or local public agencies of either, or a combination of (a) new loan or grant funds from federal or state agencies, (b) repayments of previously made loans to businesses, or (c) interest and other related income, to create revolving sources of capital to finance business enterprises. RLFs are generally designed to alleviate the high cost and short supply of capital for businesses by providing flexible loan terms: typically, RLF's allow communities to lower the rate, lengthen the term, or reduce the risk of a loan. In light of a growing scarcity of new development funds, the recycling of money through RLFs makes such programs particularly valuable.

Some concentrate on revitalizing low-income commercial areas while others focus elsewhere or take a less focused approach. Some make occasional loans while others do so on a consistent and continuing basis. And, some make numerous small loans to micro-businesses while others aggregate all of their funds into larger projects. With respect to implementation, the flexibility inherent in HUD's programs means that many communities have developed their own underwriting procedures as well as unique administrative, legal, and financial documents and internal reporting systems. Some implement their loan programs with staff who have substantial prior banking or underwriting expertise while others do so with staff who have little or no expertise in economic development or lending practices.

Structural and implementation variations across communities are presumably explained by various historical, situational, or even perceptual differences. Previous research, for example, has observed that local decision makers generally make choices about which types of economic development programs and projects they will fund based upon their understanding of the risks and potential outcomes for their communities.[2] Sometimes this understanding is based on fact and is a component of thoughtful analysis while other times it is based upon a generally held perception about an activity that may or may not be factual (e.g., that grantees should "never do micro-business lending because such loans always default"). Whatever the reasons, the bottom line is that cross-community (and even within-community) differences are likely to result in diverse program styles as well as in varying program quality and outcomes.

HUD Programs that Support Third-Party Lending

Title I of the Housing and Community Development Act of 1974 (the Act), as amended, authorized several HUD programs that can be used by units of local government to support economic development lending (see Exhibit 1.3). These are the CDBG program, the Section 108 Loan Guarantee program, the Economic Development Initiative (ED), and the Brownfields Economic Development Initiative (BEDI). Below is a brief description of the basic features and key program requirements of these programs, as they pertain to economic development and third-party lending uses. It is important to have a basic familiarity with core program rules so as to understand what local community development officials have to consider when making decisions about alternative program uses and to follow the logic of the analyses presented in this report. However, readers already familiar with these program features and requirements may choose to skip to the section of this chapter that deals with the study's research questions and methods.

[2] *Ibid*.

The CDBG program. While the CDBG program has been used to foster economic development for many years, interest in and the opportunity to take advantage of this possible use of CDBG funds has benefited from the following:

- Enhanced regulatory flexibility and clarity resulting from CDBG rule changes in 1995, as will be discussed later in this section;
- Increased local job-training and job-creation needs resulting from welfare reform;
- Greater recognition of the potential for small business creation in low-income communities; and
- Renewed emphasis on an integrated approach to neighborhood revitalization—combining social services with housing and economic development efforts to revitalize neighborhoods.

To address job creation, retention, and business formation needs through CDBG, local governments may provide assistance to micro-enterprises, to for-profit and nonprofit businesses, or to community-based development organizations (CBDOs). The assistance can be in the form of a loan or grant and may cover training and other business support services. It can be provided directly by units of local government to a business entity or delivered through intermediaries. In turn, businesses may use CDBG assistance to cover costs ranging from working capital to rehabilitation or construction of a business facility.

Exhibit 1.3
Title I of the Housing and Community Development Act of 1974

The primary objective of this Act is the development of "viable urban communities" through provision of the following—principally for persons of low- and moderate-income:

- Decent housing;
- A suitable living environment; and
- Expanded economic opportunities.

Eligible activities include: public works; acquisition, disposition, or retention of real property; rehabilitation of residential and non-residential buildings; provision of public (social) services; and economic development.

In 1981, the Act was amended to include provision of assistance to private, for-profit entities when such assistance is necessary or appropriate for carrying out economic development projects that: create or retain jobs for low- and moderate-income persons; prevent or eliminate slums and blight; meet urgent needs; create or retain businesses owned by community residents; assist businesses that provide goods or services needed by and affordable to low- and moderate-income residents; or provide technical assistance to promote any of these activities.

All activities carried out under the Act must meet specified national objectives, conform to the eligible activities specified within it, comply with the documentary requirements needed to ensure that these provisions have been met, and otherwise conform to the environmental, labor standards, equal opportunity, and other federal requirements that apply to many federal government programs.

In thinking about how CDBG can support local economic development, it is helpful to understand the program distinctions that are made between entitlement and non-entitlement components and between recipients and subrecipients. Familiarity with the kinds of economic

development activities that are eligible under the program, its national objectives and requirements for documenting them, its public benefit standards, and other program rules is also useful. Finally, it is important to know about changes that were made to the CDBG program in the mid-1990s. These are briefly discussed below.

CDBG program components. CDBG funds are allocated through either the Entitlement or State and Small Cities components. The former consists of that portion of CDBG that provides grants to metropolitan cities and urban counties; it receives 70 percent of CDBG appropriations. Entitlement communities are cities with a population of over 50,000 persons, designated central cities of metropolitan statistical areas, or urban counties with more than 200,000 people. Although entitlement communities must submit applications to HUD, the annual allocation process for CDBG funds is not competitive. Instead, grant amounts are determined by the higher of two formulas—involving the extent of either: overcrowded housing, population, and poverty; or age of housing, population growth lag, and poverty.

The State and Small Cities component of the CDBG program provides grants to state governments. With the exception of the state of Hawaii, where HUD directly administers this component, state agencies use the grants to provide funds to non-entitlement communities (those with populations of 50,000 or less within their jurisdictions), using allocation processes that vary from state to state.

CDBG "floats." Floats represent a mechanism for making short-term use of CDBG funds. In annual plans prepared for HUD, communities allocate their CDBG dollars to various activities, some of which may take months or years to get fully underway. For example, a water-line construction project may involve significant planning and environmental reviews. Thus, the funds allocated to the construction may sit idle while a community undertakes these preliminary efforts. The float allows the community to use these funds for other, short-term projects that have a defined repayment period—two years or less—after which the repaid funds are used to undertake the original project. Float activity must meet all applicable CDBG rules and must also be included within a grantee's annual plan.

CDBG recipients and subrecipients. Units of general local government are the grant recipients or "grantees that receive CDBG funds either directly from HUD—in the case of the Entitlement component—or, indirectly, from their state—under the States and Small Cities component. Grantees can contract with "subrecipients," typically private, nonprofit organizations, to assist them in implementing and administering CDBG-funded activities, such as managing a job training program or administering all or a portion of a business lending program.

Eligible economic development activities. In choosing among possible program activities, CDBG grantees are free to select those that best meet the needs of their communities as long as such activities are in accordance with the program's national objectives and

requirements. In particular, under CDBG rules, economic development activities may involve the following:

- *Special economic development activities*, consisting of real estate and real property activities undertaken by the recipient or a subrecipient, assisting a for-profit business, or providing economic development services in connection with other eligible CDBG special economic development activities.
- *Micro-enterprise activities*, consisting of financial support, technical assistance, and general support to commercial enterprises with five or fewer employees, at least one of whom owns the enterprise; and training and technical assistance to support services to increase the capacity of recipients or subrecipients to carry out micro-enterprise activities.
- *Commercial rehabilitation*, including assistance provided to for profit or nonprofit entities for the rehabilitation and/or renovation of existing buildings for a variety of commercial uses (e.g. manufacturing plants.)
- *Special activities undertaken by Community-Based Development Organizations (CBDOs),* done in connection with neighborhood revitalization, community economic development, or energy conservation projects.
- *Public facility activities*, undertaken to promote commercial development or create jobs, such as roads or water/sewer into an industrial park.

CDBG's national objectives. Each activity involving CDBG funds must meet one of three national objectives. It must either be of benefit to low- and moderate-income persons, or aid in the prevention or elimination of slums and blight, or meet other urgent community development needs.

- *Benefit to low- and moderate-income persons ("low-mod" benefit).* The four types of activities that qualify as meeting this national objective are: (1) *area benefit activities*, which benefit all residents in a particular area where at least 51 percent of the residents are low- and moderate-income ("LMI") persons; (2) "*limited clientele" activities* that benefit a limited number of people as long as at least 51 percent of those served are LMI persons; (3) *housing activities* undertaken for the purpose of providing or improving residential structures that, upon completion, are occupied by LMI persons, and (4) *job creation or retention activities* designed to create or retain permanent jobs—at least 51 percent of which are made available to or held by LMI persons.[3] Although some economic development activities may be documented

[3] Jobs are counted in terms of full-time equivalents (FTEs).

under the LMI area-benefit national objective, most are documented under the LMI job creation/retention national objective. The LMI limited clientele may be used with some microenterprise and job training activities, while the LMI housing national objective is not used for economic development.

- *Elimination of slums and blight.* These activities are designed to prevent or eliminate slums and blighted conditions. To qualify under this national objective, activities must either: (1) prevent or eliminate slums and blights on an area basis, (2) prevent or eliminate slum and blight on a spot basis, or (3) be related to completing projects under the Urban Renewal program. The slum-and-blight national objective is occasionally used with economic development projects. Expenditures under this national objective, when combined with any expenditures under the urgent need national objective, cannot exceed 30 percent of total expenditures over a one-to-three-year period.

- *Urgent need.* Use of this national objective category is rare; it is designed only for activities that alleviate emergency conditions. To qualify as an urgent need, existing conditions must pose a serious and immediate threat to the health or welfare of the community; they must be of recent origin or recently have become urgent (generally, within the past 18 months), and the community must be unable to finance the activity on its own. Due to these requirements, this national objective is generally not used with economic development activities.

Required documentation of national objectives. Some CDBG- or Section 108-funded activities, by their nature, only qualify under one national objective. Others may qualify under more than one and, then, the community grantee usually chooses that objective requiring the least burdensome documentation. Activities qualifying under the LMI-area-benefit, LMI-limited-clientele, or slum-and-blight national objectives usually require more limited paperwork than activities qualifying under the LMI-job-creation/retention national objective. In general, activities qualifying under the LMI-area-benefit national objective require documentation of the income of the area served by the activity. Activities qualifying under the limited-clientele national objective require documentation of the LMI beneficiary's income. And, activities qualifying under the slum-and-blight national objectives require documentation of the income characteristics of the blighted area or blighted site.

The LMI-job-creation/retention national objective covers activities designed to create or retain permanent jobs, at least 51 percent of which (FTE's) are required to be made available to or held by LMI persons. The 51 percent threshold is applied to <u>all</u> jobs created or retained as a result of CDBG or Section 108 assistance, regardless of the number of jobs initially forecast. Community grantees selecting this way of qualifying economic development expenditures must document *either* that jobs are *held* by LMI persons or that they are *available to* such persons:

- *To document available jobs*, community grantees must supply to HUD a written commitment by the business that it will: make at least 51 percent of the jobs available to LMI persons and will provide training for any of those jobs requiring special skills or education; indicate which jobs are covered by this commitment; describe how "first consideration" will be given to LMI applicants, including what type of hiring process was used, which LMI persons were interviewed for a particular job, and which LMI interviewees were hired. Grantees must also document that businesses have, indeed, adhered to the terms of the commitment to make jobs available to LMI persons.

- *To document jobs held by LMI persons*, community grantees must supply to HUD a written commitment by the business that at least 51 percent of the jobs on a full-time-equivalent basis will be held by LMI persons; list which jobs are covered; and, for each LMI person hired, provide information on the size and annual income of the person's family prior to the time the person was hired for the job—or evidence that the person qualifies, as presumed by the person's address.

- *If jobs are not newly-created but "retained,"* community grantees must show (in addition to the items above) that, in the absence of CDBG or Section 108 assistance, the jobs would have been lost. For each retained job claimed to be held by a LMI person, the grantee must collect information on the size and annual income of the person's family. For jobs claimed to be available to LMI persons based on job turnover within two years, the grantee must document that the job would have been taken by a LMI person.

CDBG's public benefit standards. Especially in cases where funds for economic development activities are provided to for-profit entities, HUD must ensure a sufficient return for CDBG or Section 108 investment in economic development projects. To this end, HUD developed and promulgated through regulation public benefit standards.[4] The standards are triggered for economic development activities qualified under (a) the special economic development category, (b) public facility activities designed to create jobs where these jobs cost more than $10,000/FTE, and (c) economic development activities undertaken by a CBDO that would otherwise qualify under special economic development. The public benefit standards are as follows:

- *The individual project rule.* For each economic development project under one of the activity categories noted above, community grantees need to either spend no more

[4] These replaced a previous requirement that community grantees determine that such projects were "necessary and appropriate;" inasmuch as grantees found compliance with the "necessary and appropriate" standards to be unclear and difficult.

than $50,000 of CDBG or Section 108 resources per FTE job created or retained or to spend no more than $1,000 of CDBG or Section108 resources per LMI person receiving goods or services. HUD also determined that there are certain kinds of economic development activities that, by their nature, *fail* to provide sufficient public benefit.[5]

- *The aggregate rule.* For an entire program year, community grantees must add together their expenditures and benefits with respect to the types of activities noted above, separating projects into those counted under the "jobs" public benefit test and those counted under the "goods-and-services" test. The average of the projects under the "jobs" test can be no more than $35,000 of CDBG or Section 108 resources per FTE job created or retained. The average of the "goods-and-services" test can be no more than $350 of CDBG or Section 108 resources per LMI person receiving goods and services.

Other federal rules that apply to the CDBG program. There are a number of other requirements that may be triggered when a community undertakes economic development activities with CDBG or Section 108 funds. A few of these include:

- *Davis-Bacon.* Some economic development activities involving construction may trigger the Davis-Bacon requirements regarding wages and other labor standards.
- *Environmental review.* If construction is anticipated, grantees may also need to show compliance with the environmental review requirements.
- *Relocation and acquisition.* In some instances, economic development projects may involve acquiring land or structures or displacement of an existing business. In these instances, the Uniform Relocation and Real Property Assistance Act (URA) would be triggered.

Mid-decade changes in CDBG program rules. A 1995 Urban Institute evaluation of the CDBG program found some economic development requirements to be particularly troublesome to communities, particularly with respect to low- and moderate-income job documentation by private businesses. City personnel reported they believed the requirements to be excessive, especially with respect to small loans and technical assistance activities. In several communities, business resistance to the required collection of employee income level and household size ultimately led to decisions to reduce economic development program activity.

[5] See 24 CFR Part 570.203 and 570.204.

Subsequently, CDBG regulations were revised in ways that were expected to be favorable to the program's use for economic development purposes. These changes responded to community grantee desire for more flexibility and regulatory clarity, as well as for other statutory changes.[6] Three broad classes of changes included the following:

- In terms of the low-mod national objective, the revised CDBG regulation, under certain circumstances, allowed for the presumption of low- and moderate-income status for employees or prospective employees based on the census tract in which they lived or worked; and added a new "limited clientele" national objective provision for persons owning or developing a microenterprise and for job training—under certain circumstances when less than 51 percent of the beneficiaries will be LMI. The regulation also provided new flexibilities regarding when recipients can aggregate jobs in order to document national objective compliance.
- The revised regulation established mandatory guidelines (standards) for "public benefit" (described above) to ensure that the amount of public benefit is commensurate with the amount of CDBG funds used for certain economic development projects, and established standards for how and when infrastructure projects must meet the public benefit standards. Voluntary guidelines were established for "financial and cost" objectives—now known as "underwriting" guidelines.
- The revised regulations contain a new category of eligibility to provide assistance for the "establishment, stabilization and expansion of microenterprises." New flexibility is allowed for job training outside of the standard 20 percent cap on public services uses of CDBG and new flexibility was offered to grantees that submit a Neighborhood Revitalization Strategy that targets resources to a particular part of their communities, and to grantees that qualify as Community Development Financial Institutions (CDFIs).

The Section 108 program. Section 108, which authorizes federal guarantees of locally issued notes or other obligations (see Exhibit 1.4), can also be used for economic development purposes—including for infrastructure and other types of "supportive" activities (such as acquisition or clearance and demolitions) well as for loans to businesses. Communities have made different types of Section 108-funded loans, in some instances capitalizing loan pools that finance projects undertaken by small-to-medium-sized firms while, in others, providing special loans for very large-scale projects. However, the program's financing, administrative, and collateral requirements have led communities, more often than not, to use it for larger projects that have a likely greater return to the community—whether in terms of jobs created or potential

[6] Most changes of interest were reflected in a January 5, 1995 rule.

for loan repayment. Examples include development of hotels, business incubators, retail shopping centers, and manufacturing facilities. Hence, for some communities, Section 108 serves as a vehicle for expanding CDBG resources and for financing larger economic development projects than would otherwise have been possible under an annual CDBG entitlement—like those that used to be funded through the earlier Urban Renewal or Urban Development Action Grants (UDAG) programs.

Many of the rules of the Section 108 program are identical to those of CDBG—including requirements pertaining to meeting national objectives, activities eligibility criteria, job documentation, level of public benefit criteria, and public-benefits-documentation. Both programs also are subject to crosscutting requirements that apply to federal programs in general. But, unlike CDBG, Section 108 is a "special purpose" program and is, therefore, different with respect to its application requirements, its pledge against loan repayment, and its requirements for additional collateral. These are each discussed below.

Community application to HUD. Communities must apply to HUD for Section 108 loan approval. This requires both HUD field office and Headquarters reviews for compliance with citizen participation requirements, project eligibility criteria, and project financial-feasibility and likelihood-of-repayment standards. Communities may either apply for a program of use (e.g., capitalization of a loan pool) in which individual transactions are not identified but use and underwriting criteria are specified, or for individual project funding in which the HUD Headquarters office reviews the specific details of each project.

Exhibit 1.4
The Section 108 Loan Guarantee Program

The Section 108 loan guarantee assistance program authorizes HUD to guarantee notes and other obligations issued by CDBG grantees, permitting them to commit to large projects that could not otherwise be accomplished with a single year's CDBG allocation. It provides communities with a source of financing for housing rehabilitation, public facilities development, large-scale physical development projects, and economic development activities. HUD has standardized a model variable/fixed rate note that CDBG grantees issue to receive funding for these types of eligible community development activities. HUD guarantees the timely repayment to the purchasers of the certificates, funded by the pool of grantees' repayments of their notes. Jurisdictions can borrow up to five times the value of their most recent CDBG grant amount, with up to 20 years to repay the loan. Section 108 certificates purchased by investors are not tax exempt.

Section 108 notes are sold in a public auction, generally once a year. To enable communities to access funds for approved transactions prior to the date of the public sale, HUD provides an interim credit facility. A Fiscal Agent generally serves as the interim lender and provides funds to the community at the 90-day London Interbank Offering Rate (LIBOR), plus two-tenths of one percent. The interim loan is taken out by permanent financing at the next public offering. The interest rate of the permanent notes is fixed and is approximately one-eighth to six-tenths of a percent above Treasuries for a comparable maturity. A community can re-loan Section 108 funds to a third-party borrower or can use the funds to carry out activities themselves. If the community re-lends the funds to a third-party borrower, the community can elect to offer an interest rate that is less than, equal to, or more than its cost of funds.

CDBG pledge against loan repayment, and additional collateral requirements. Section 108 requires that communities repay borrowed funds to the lender/investor. To reduce the risk of default on such loans, communities are required to pledge some of their anticipated future CDBG entitlement income as

collateral. Therefore, however valuable Section 108-funded activities may be for a community, local officials must carefully weigh their need for such funds against the potential risk the loan represents to receipt of future CDBG funding. For some communities, this pledge is clearly perceived as politically challenging or overly risky.

The risk to a community associated with use of Section 108 increased over the last decade with full implementation of the Credit Reform Act of 1990, resulting in enhancement of underwriting standards for Section 108. The Act requires a federal agency that administers a credit program to estimate the "subsidy rate" of the program and seek a Congressional appropriation to cover that cost. The subsidy rate for programs with no interest rate subsidy, which would include Section 108, is determined by estimating the discounted present value of expected future losses and dividing that by the principal amount of the guaranteed loans.[7] This involves increasing the level of security required for a loan. Given the implementation guidelines for the Credit Reform Act established by the Office of Management and Budget (OMB), HUD must require most Section 108 borrowers to furnish additional security as loan collateral—such as other community income, funds, or tangible items of value—beyond the pledge of future CDBG resources.[8] To ensure compliance, HUD officials review proposed project underwriting associated with a Section 108 loan to ensure that the net present value of potential Section 108 losses (after liquidation of collateral) is equal to or less than the OMB credit subsidy rate[9]. Although HUD has never been required to make a payment to the holder of an obligation guaranteed under Section 108, pursuant to a claim for payment under the HUD guarantee, some communities have repaid delinquent notes with their CDBG grant or undertook various workout arrangements,[10] with a number of these always intending to repay their Section 108 loans with their CDBG grants.

[7] The calculation of the subsidy rate for Section 108 is complicated by the fact that HUD has never incurred a loss on any loan guaranteed under Section 108. This is due primarily to the availability of pledged CDBG funds to cover any amounts due on a Section 108 loan, even if another source of repayment was intended and failed to materialize. However, under the OMB guidelines that implement the Credit Reform Act, HUD cannot assume that future CDBG appropriations will be available to cover losses. In order to avoid a significantly higher subsidy rate (and attendant appropriation), HUD requires community borrowers to demonstrate that their guaranteed loans can be repaid without reliance on future federal appropriations.

[8] In the case of Section 108 projects involving third-party lending, the additional security is composed of the assignment of the third-party loans (including the collateral for those loans) to HUD. If HUD did not require the additional security, the Credit Reform subsidy rate model would generate an extremely high subsidy rate.

[9] This is currently pegged at 2.3 percent.

[10] Some technical defaults have occurred on a Section 108 note; in fact, any default by a business borrower under a third-party loan would, in most cases, be a permissible basis for HUD to declare the Section 108 note in default.

The EDI and BEDI programs. Established in the early 1990s, EDI is a program of grants that are competitively awarded to communities undertaking Section 108 initiatives. They are intended to enhance the security of Section 108-funded loans and reduce a community's risk to its CDBG funds inherent in Section 108—as discussed above. The availability of EDI grants have had a significant influence on the number of communities participating in the Section 108 program. More recently established, BEDI is also awarded competitively in conjunction with Section 108. It is available for redeveloping **"**brownfields**"**—abandoned, idled, or under-used industrial and commercial sites where expansion or redevelopment is complicated by real or perceived environmental contamination. States and both CDBG entitlement and non-entitlement communities can apply for assistance under EDI and BEDI, and they use the funds in a number of different ways to help to implement a Section 108 project—including directly loaning the grant funds to assisted businesses (see Exhibit 1.5).

Exhibit 1.5
Typical Uses of EDI/BEDI Funds

As funding reserves—Because the cash flow generated during the early stages of a project may be insufficient to meet operating expenses and debt service obligations, an EDI/BEDI grant can provide reserves to enhance the feasibility of the project.

For over-collateralization for a Section 108 loan—For example, a loan pool can be funded with both EDI/BI and Section 108 funds, with the total portfolio pledged as security for the Section 108 notes. This use assists with the additional security requirements.

As a credit enhancement—EDI/BEDI funds can be used to cover the costs of credit enhancements, such as the costs of a standby letter of credit to fund amounts due on a Section 108 loan in case other sources of repayment fail to materialize. Such a letter of credit would serve to protect the community's future CDBG funds.

As below-market financing—EDI/BEDI funds can serve to "buy down" the interest rate up front or make full or partial interest payments, allowing businesses to be financially viable while in the early start-up period. This strategy is particularly useful where a community undertakes a large commercial/retail project in a distressed neighborhood—acting as a catalyst for other development in the area.

In sum, CDBG, Section 108, and EDI/BEDI can provide federal support to localities for the purpose of making third-party loans to private businesses—if community officials elect to use these funds for that purpose. Once they make that choice, the officials have a number of options as to how they can design and implement their loan programs. These are discussed below.

Design Options for Local Third-Party Lending Programs

Just as HUD's community development programs allow localities to select from a wide range of eligible activities, local officials who opt to implement a third-party lending initiative have a great deal of flexibility with respect to how to structure it. Within the basic regulatory framework of the CDBG and Section 108 programs, communities can design a third-party lending program to suit their own unique local market conditions, political environments, and

internal organizational capacities. Key design decisions that community officials make when establishing a third-party lending program involve: the kinds of administrative structures to utilize; the types of borrowers to be assisted; the kinds of activities to finance; the underwriting criteria to use; and the types of loan structures to put in place. Each of these is briefly considered below.

Program administration. An initial program design decision faced by local officials involves how to administer their third-party lending programs. All such programs have certain essential administrative components—program marketing and intake, loan underwriting, loan origination, loan servicing, and program reporting. Depending on staff capacity, both in terms of technical knowledge and time availability, some community development recipient agencies elect to take on these responsibilities themselves, while others chose to pass funds along to other entities to administer programs on their behalf. Common options include delegating program administration to other governmental or quasi-governmental entities, such as redevelopment authorities, or to non-profit community development corporations. Another possibility is to divide program responsibilities, with different entities undertaking marketing, underwriting, or servicing responsibilities.

Types of borrowers assisted. Some, but not all third-party lending programs are designed to attract certain types of borrowers. Factors by which lending can be targeted or explicitly restricted include any mix of the following:

- *Business size.* Lending can be aimed at businesses anywhere on a scale ranging from large corporations to small “mom and pop” businesses—with business size operationalized in a number of ways, too, including gross receipts or number of employees.
- *Business stage.* Local officials have to decide whether loans will be made only to businesses with a long track record, to start-up businesses, to expanding businesses, or to any mix of such considerations.
- *Industry type.* The question here is whether the community wants to attract or retain certain types of industries, such as those involved in manufacturing, high-technology, or tourism.
- *Business location.* It needs to be decided whether loans will be available across the jurisdiction, only in targeted revitalization districts, only at environmentally challenged brownfields sites, or wherever.

Activities to finance. Closely related to the issue of the types of borrowers a program can assist is that of the types of activities a loan program can finance. Most loans are made for one or more of the following purposes:

- *Working capital*—i.e., loans to cover short term cash needs such as the purchase of inventory;
- *Machinery and equipment*—i.e., loans made to purchase durable business assets (e.g., a delivery truck or a machine press); or
- *Real estate*—i.e., loans made to acquire, construct, and/or rehabilitate real property.

Another variation community officials consider is whether they will finance "user deals"—loans made to businesses that are repaid out of future business cash flow—or "developer deals"—loans made to developers of commercial properties that are repaid out of the rental and other income derived from the business tenants of the properties.

Underwriting criteria. Each community must establish criteria by which it will evaluate loan requests. Tacit in the decision to create a third-party lending program is the belief that there are viable borrowers who are not currently being served by other public or private lending programs. Thus, third-party lending programs tend to be more flexible with respect to underwriting criteria or, as described in the following paragraph, the terms of the financing they offer. Common criteria used to evaluate applicants include credit history, available collateral, projected cash flow available for debt service, and the experience and character of the principals requesting the loan. Communities take very different approaches to underwriting. At one extreme, some program officials are risk averse and employ underwriting standards that are on a par with those of private banks while, at the other, some are willing to offer more flexibility on the presumption that risk is absolutely essential for generating investment in certain areas.

Loan structure. Again, a great deal of flexibility is available to communities with respect to how they structure loans. Almost any variation of loan term, interest rate (including interest-free loans), security requirements, deferral, or interest-only-period is possible. Some community officials seek to maximize program income and structure their loans in a fashion that is similar to the terms offered on the private market, while others offer more generous terms to benefit their borrowers.

Although it is known that many communities have worked through the above options and established third-party lending programs, neither the precise number of such communities, the specific kinds of loan programs they develop, nor the performance or impacts of the loans they originate have been systematically established to this point. Hence, there was clearly a need to learn more about the extent and character of, and what has results from, local government third-party lending efforts.

An Overview of the Research Questions and Methods

Presented below are the key research questions that frame this study of HUD-funded third-party economic development lending activities, and the basic research methods employed.

More detail on each, where relevant, is provided in subsequent chapters as well as in the Appendix.

Research questions. Several fundamental questions, posed by HUD, guided this study. The rationale for asking each of them, as well as the answers, are presented in the remainder of this report.

- *The extent of third-party lending:* What is the level of local CDBG, Section 108, or EDI/BEDI use for economic development, as opposed to other purposes and, more particularly, for originating third-party loans to private businesses?
- *Regulatory issues:* Are there rules that especially discourage or hinder local or state use of HUD community development programs for third-party lending purposes?
- *Lending impacts:* What are the community impacts of third-party loans with respect to generating jobs or leveraging additional financial support for community economic development activities?
- *Loan portfolio characteristics:* What are the characteristics of the national portfolio of third-party loans, how well is the portfolio performing with respect to loan repayments, and what factors contribute to loan performance?
- *Secondary market potential:* What is the potential for creating a secondary market for locally-originated third-party loans that could provide localities with additional economic development capital beyond the funding levels available through HUD's CPD programs?

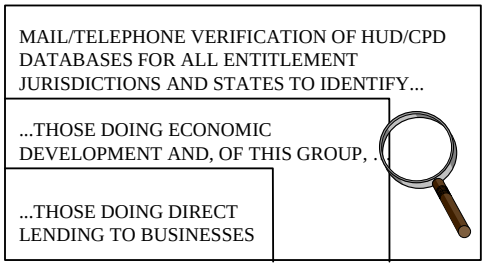
Research methods. The research strategy employed to answer these questions follows from both the diversity of issues to be addressed and the character of the CPD programs supporting local third-party lending initiatives. As is evident with respect to the former, the issues range from those involving experiences and perspectives of local program officials and business owners to those involving loan performance and impacts. The implication is that multiple kinds are data are needed to address such an array of questions. And, as discussed earlier, the local discretion allowed in the uses of national programs supporting third-party lending programs results in considerable cross-community diversity in lending practices and outcomes. The consequence of this for research is that an especially large body of data is needed to be able to capture the full spectrum of experiences. To accommodate both issue and program diversity, this study combines analysis of nationally representative surveys of local officials and loan recipients with an extensive body of administrative data from a large number of third-party loans, business recipients, and communities. The study timeframe, the samples utilized, and kinds of data gathered for analysis, are discussed below.

Timeframe. The timeframe for analyzing local third-party loan programs and loan portfolios was dictated by four distinct, somewhat competing concerns. The first was to ensure that local third-party lending activities be understood in the context of the longer-term, historical trends that have occurred in economic development uses of CPD programs. The second concern was to ensure that community third-party lending experiences were recent enough for good information to be available about community policies and practices and about individual loans—i.e., emphasizing those that are of recent vintage. The third was to ensure that loans were sufficiently 'seasoned' so that their performance and impacts could be adequately assessed—i.e., emphasizing loans originated some years ago. The fourth concern was to ensure that the impact on Section 108 utilization of the 1995 implementation of the Credit Reform Act (as discussed above) could be captured.

Consequently, the period selected for study considers and attempts to balance these various concerns. For analyzing longer-term trends in economic development and third-party lending uses of CPD funding, as well as local policy and program trends, the timeframe consists of the entire last decade—from 1990 to 1999. For analyzing the performance and impacts of CDBG-supported loans, the study period consists of loans originated between 1996 and 1999. And, for analyzing Section 108-funded loans and associated EDI/BEDI grants, the study period consists of loans originated between 1994 and 1999.

Samples. A variety of samples are employed in this study, including: a national sample of CDBG entitlement communities (i.e., large cities and urban counties); a nested sub-sample of entitlement communities exhibiting the highest dollar volume usage of CPD funds for third-party lending purposes; a sample of loans in these high-loan-volume communities; a sample of owners of businesses receiving loans in high-loan-volume communities; a sample of states; and a sample of persons with substantial expertise in secondary market issues. Because the study design is quite complex, both a narrative and a schematic description of these samples, and the kinds of data they were used to collect, are presented below.

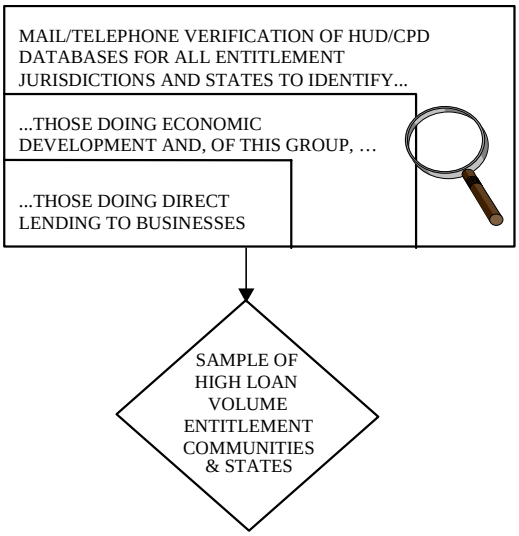
1. National sample of CDBG entitlement communities. Initially, data regarding the level and type of CDBG, Section 108, and EDI/BEDI program usage of all of the nation's entitlement communities were extracted from a succession of HUD program monitoring systems used during the 1990s—known as GPR, PER, IDIS and FMD.[11] Since, however, these systems have both changed over time and do not always capture information in a form that unambiguously



[11] These systems—the Grantee Performance Report (GPR), the Performance Evaluation Report (PER), the Integrated Disbursement and Information System (IDIS), and the Financial Management Division (FMD) database—are further discussed in Chapter 2.

identifies economic development or third-party lending usage, extracted data from these systems were provided to communities so that local officials could verify their accuracy and, where appropriate, correct the record. Based on verified program usage data,[12] then, a nested sub-sample of high-loan-volume communities (described below) was drawn, and a random sample of 445 additional communities was selected from the remaining communities that used at least some of their CDBG funds for economic development at one point or another during the decade of the 1990s. This national sample of 500 communities was intended to provide breadth and diversity of coverage for learning about community strategy and policy with respect to third-party lending use.

2. Nested sub-sample of high-loan-volume communities. Also based on verified data from HUD's program monitoring systems, entitlement communities that used some of their CDBG funds for economic development were arrayed with respect to the dollar volume of third-party loan usage over the last decade. The 35 communities with the highest dollar volume of CDBG third-party loans and the 35 communities with the highest dollar volume of Section 108-funded loans were selected. Given the overlap between the two categories, the combined sub-sample consisted of 55 communities with high levels of spending on third-party loans to businesses. For a variety of reasons, however, four of them could not ultimately be included in the study,[13] thereby reducing the size of the sub-sample to 51.[14]



[12] Sixty-eight percent of communities responded to the verification request. Appendix B describes how these data contribute to the Economic Development Funding Database, discussed below.

[13] New York City records related to its third-party lending program were located in a building adjoining the World Trade Center and were, consequently, inaccessible during the study period. The loan program office of the City of Reading, PA was in transition during the study period and, as a consequence, program staff were not available to participate in the study. Local officials in charge of the third-party loan programs of Harris County, TX and Tampa, FL declined to participate. In addition, a major sub-recipient of third-party lending funds in Washington, DC declined to participate in the study; therefore, the Washington, DC lending program was not completely reviewed.

[14] The communities are: Birmingham, NY; Boston, MA; Buffalo, NY; Canton, OH; Chicago, IL; Cleveland, OH; Columbus, OH; Cuyahoga County, OH; City and County of Denver; CO; Detroit, MI; Eugene, OR; Ft. Worth, TX; Hartford, CN; Houston, TX; Hudson County, NJ; Jacksonville, FL; Jersey City, NJ; Johnstown, PA; Long Beach, CA; Louisville, KY ; Los Angeles, CA; Los Angeles County, CA; Lowell, MA; Luzerne County, PA; Lynn, MA; Memphis, TN; Monroe County, NY; New Orleans, LA; Oakland, CA; Omaha, NE; Philadelphia, PA; Pittsburgh, PA; Portland, OR; Prince George's County, MD; Providence, RI; Quincy, MA; Roanoke, VA; Rochester, NY; Rock Island, IL; Charleston, SC; Spokane, WA; St. Louis, MO ; St. Paul, MN ; San Francisco, CA; Seattle, WA ; Tacoma, WA; Toledo, OH; Utica, NY; Washington, DC; Wichita, KA; and Youngstown, OH.

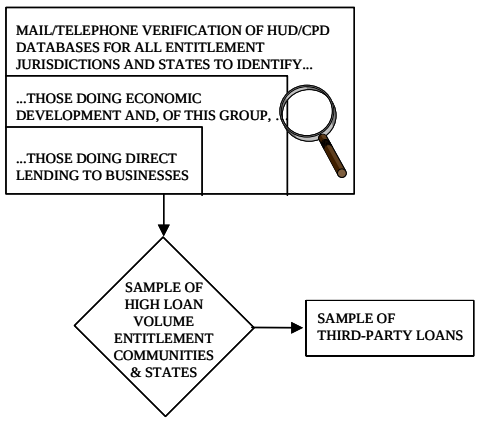
Inasmuch as selection was based on dollar volume of third-party lending use, the 51 communities constitute 58 percent of CDBG, 96 percent of Section 108, and 83 percent of all spending for third-party lending across the country for the years covered by this study (see Table 1.1).

Table 1.1
Community and State Grantees' Share of Total Expenditures
(1996-99 for CDBG and EDI/BEDI, 1994-99 for Section 108)

		Federal Funding Source					
		CDBG		*Section 108*		*EDI/BEDI*	
CDBG Program Components	Number of Grantees	Total Third-Party Loan Dollars, 1996-99	Percent of Dollars	Total Third-Party Loan Dollars, 1994-99	Percent of Dollars	Total Third-Party Loan Dollars, 1996-99	Percent of Dollars
		(in millions)		(in millions)		(in millions)	
Local Entitlement Grantees							
Site Visited Grantees	51	$177,765,182	58 %	$631,806,091	96 %	$2,699,700	38 %
All Other Grantees	911	128,971,623	42	27,770,604	4	4,441,000	62
Total	**962**	**$306,736,805**	**100 %**	**$659,576,695**	**100 %**	**$7,140,700**	**100 %**
State Grantees							
Interviewed Grantees	11	$117,043,037	57 %	$57,046,000	100 %	0	NA
All Other Grantees	39	88,908,247	43	0	0	0	NA
Total	**50**	**$205,951,284**	**100 %**	**$57,046,000**	**100 %**	**0**	**NA**

Source: Urban Institute Economic Development Funding Database--Third-Party Lending Study 2002.

3. Nested sub-sample of loans originated in high-loan-volume communities. Within the sub-sample of 51 communities, a further sub-sample of third-party loans originated during the study period was selected. The full universe of 1,943 such loans was stratified into five categories by dollar size for each type of loan (CDBG and Section 108). Loans in the stratum corresponding to the largest size category, by type, were selected with certainty, while loans in the remaining four strata were randomly selected within each stratum. This disproportionate sampling method was meant to increase the probability of the inclusion of larger loans, with weights then used to allow estimation to the universe of all such loans. The resulting sample includes 976 loans, and is described more fully in Appendix B.

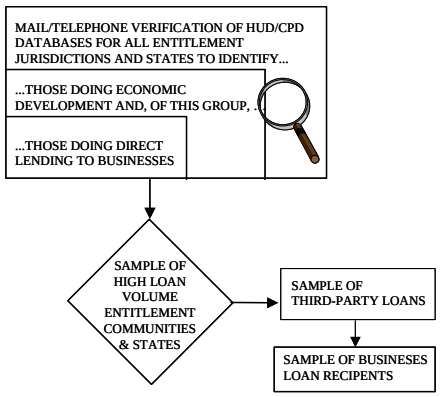


The loan sample supports 930 distinct "projects," each of which received at least one third-party loan. The number of projects is smaller than the number of loans because, in some instances, more than one loan was made to the same business for the same project, in many cases on the same day. For example, some

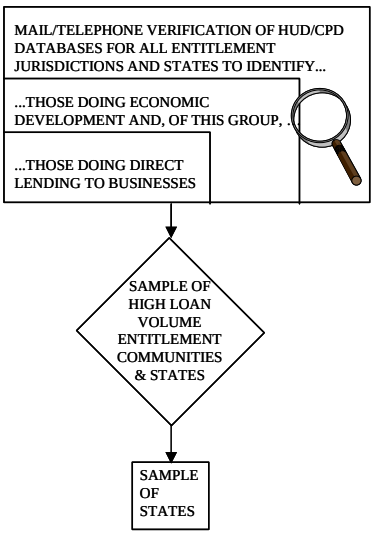
CDBG	723
CDBG Float	15
EDI/BEDI	18
Section 108	174
Total Projects:	**930**

jurisdictions separated available funds programmatically by funding source—CDBG or Section 108—or by allowable use—such as real estate or machinery and equipment. In other cases, a second loan represents funds needed for a cost overrun or a second phase of the same physical project. If businesses signed separate loan agreements for each program but shared jobs forecasts or overall project budgets, the loans were sampled separately; if both were reviewed, data were unduplicated to avoid double counting of jobs created or of funds leveraged.

4. Sub-sample of businesses receiving loans in high-loan-volume communities. The sample of loans originated in high-loan-volume communities consists of 900 separate business establishments. This number is smaller than either the number of loans or the number of projects because, in some cases, multiple loans were made to the same business but for unrelated purposes—with unique job forecasts and budgets, and usually on widely separated dates. Of these 900 establishments, 750 were estimated to still be in business at the time of the study and, therefore, available for possible inclusion in a telephone survey (described in the next section).



CDBG	699
CDBG Float	15
EDI/BEDI	18
Section 108	168
Total Businesses:	**900**



5. Sample of states. Using verified data from HUD's program monitoring systems, states were arrayed based on the dollar volume of their spending on third-party loans during the study period. Initially, two samples were selected: the first consisted of the 10 states with the largest dollar volumes of spending on loans; and the second consisted of a single state within each of HUD's 10 administrative regions with the largest dollar volume of loan spending. The latter sample was designed to ensure broad geographical coverage. The two samples were then merged. Given the overlap between the two, the resulting sample consists of 14 states[15] with high-dollar-volume spending on third-party loans to businesses, although not all of them are included in the study.

[15] Interviews with Community and Economic Development Department Directors were concluded in 11 of the 14 states: Alabama, Arkansas, California, Connecticut, Kansas, Minnesota, Missouri, Montana, New Jersey, South Carolina, and Washington. Officials were not available to be interviewed in the states of Iowa, Maryland, and Nebraska.

6. Sample of secondary market experts. Finally, a small purposive sample of persons who are involved in, or knowledgeable about the workings of secondary markets was selected—based on reputation, the literature, and referrals.

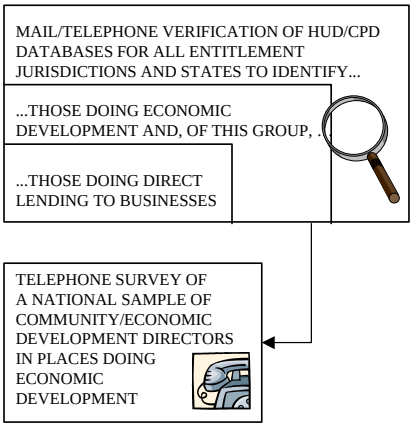
As summarized in Exhibit 1.6, these samples were used as the basis for collecting a variety of types of data. These are discussed below:

Exhibit 1.6
Summary of Samples, Sample Selection Methods, and Sample Coverage

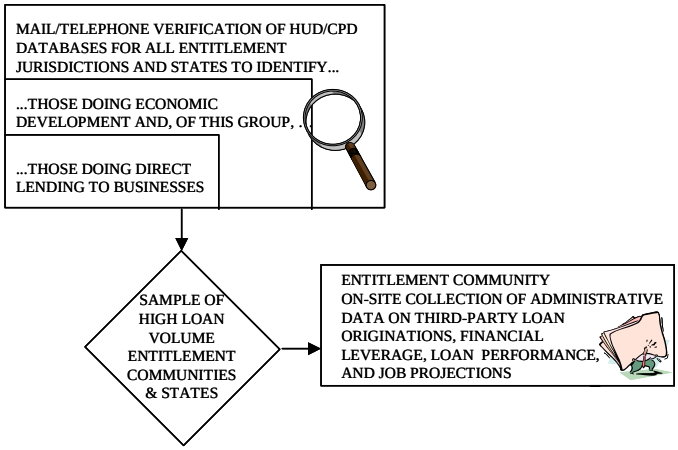
SAMPLE	SELECTION METHOD	COVERAGE
National Sample of CDBG Entitlement Communities for the purpose of conducting a telephone survey with Community and Economic Development Department Directors	500 entitlement communities consisting of: the top 55 entitlement users of combined CDBG (1996–1999) and Section 108 (1994–1999) funds for third-party lending purposes; *and* a random sample of 445 of the remaining entitlements.	CD directors in 460 cities were interviewed (a 92 percent response rate). This includes 46 percent of all entitlement communities nationally that use CDBG for economic development purposes, and 64 percent of all entitlement communities that use Section 108 for economic development purposes.
Nested Sample of High-Loan Volume Communities for the purpose of conducting an on-site survey and loan file review and conducting in-person interviews with Community and Economic Development Department Directors and loan program administrators	Top 55 entitlement community users of combined CDBG (1996–1999), Section 108 (1994–1999), and ED (1994–1999) funding for third-party lending purposes.	51 communities were included in the study, for a total of $659 million in third-party loans—50 percent of all entitlement community lending.
Sample of States for the purpose of conducting a telephone survey with Community and Economic Development Department Directors	Top 10 state CDBG users of CDBG, Section 108, and EDI for third-arty lending purposes, plus 4 states with the largest loan volumes in HUD regions not already included in the above list, equaling 14 states.	11 states were included in the study.
Nested Sub-Sample of Loans Originated in High-Loan-Volume Communities for the purpose of conducting loan file reviews	Sampling proportionate to loan amount, including certainty selection for above-median loan amounts in each of CDBG and 108 programs.	976 loans—of the universe of 1,943 loans (50 percent) originated in the 51 high-loan volume communities during the study timeframe—were sampled; these loans were made to 900 separate businesses and support 930 distinct projects. The sampled loans represent $659 million of a total $727.3 million in lending (90.6 percent).
Sub-Sample of Businesses Receiving Loans in High-Loan-Volume Communities for the purpose of conducting telephone interviews with business owners	Same as nested sub-sample of loans originated in high-loan-volume communities.	Completed interviews with 234 of an estimated 750 surviving businesses (31 percent) that received loans in the 51 high-loan-volume communities during the study timeframe.

Data: Several kinds of data were gathered for, and are employed in this study, including: formal interviews with Community and Economic Development Department Directors, loan program staff, owners of businesses receiving third-party loans, and state Community Development Department Directors; discussions with secondary market experts; and various kinds of administrative data pertaining to third-party loans, businesses, and communities.

1. Interviews with Directors of local Community and Economic Development Departments and their loan program staff: Three types of interviews were conducted with persons who are knowledgeable about the uses of CDBG, Section 108, and EDI/BEDI funds for economic development and third-party lending purposes. Based on the national sample of local Community or Economic Development Departments, 460 agency directors were interviewed by telephone to learn about their communities' strategies for community and economic development, the rationale behind their use or non-use of third-party lending programs, and the experiences of those who have done third-party lending (referred to as the "Community Development Administrators Phone Survey"). In addition, 49 directors and 69 loan program managers from the sub-sample of high-loan-volume communities were also interviewed in person to explore further their use of third-party loans (referred to as the "Community Development Administrators On-Site Survey").

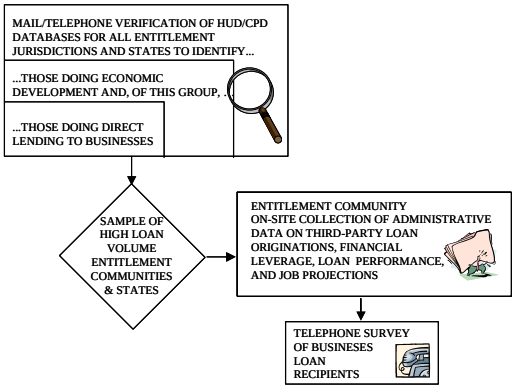


2. Collection of administrative data. For 996 CDBG local grantees and 50 CDBG state grantees, a database was created consisting of locally verified data, when available, on CDBG, Section 108, and EDI/BEDI funding usage, as culled from HUD's GPR, PER, IDIS and FMD systems (referred to as the "Economic Development Funding Database"). For the sub-sample of 51 high-loan-volume communities, several additional kinds of administrative data were also assembled. Detailed information about loan terms, conditions, performance, and projected impacts was extracted from individual loan origination and servicing files for the 976 loans in the loan sub-sample (referred to as the "Loan File Review Database"). These consist of 756 CDBG-funded loans, 201 Section 108-funded loans, and 19 EDI loans—amounting to approximately $635 million, or 90 percent of all third-party loans originated by

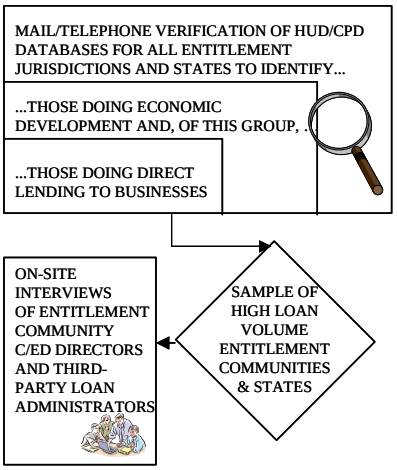


these communities during the study period. In addition, data from Dun and Bradstreet files on 925 of the businesses assisted by third-party loans was also collected, as was year 2000 Census data on each of the 51 high-loan-volume communities.

3. Interviews with owners of businesses receiving third-party loans. Telephone interviews were conducted with owners of 234 businesses that had received third-party loans in high-loan-volume communities during the study period (referred to as the "Business Survey"). These covered the character and status of the business, the terms and status of the loan, and the business activity and job generation it financed.



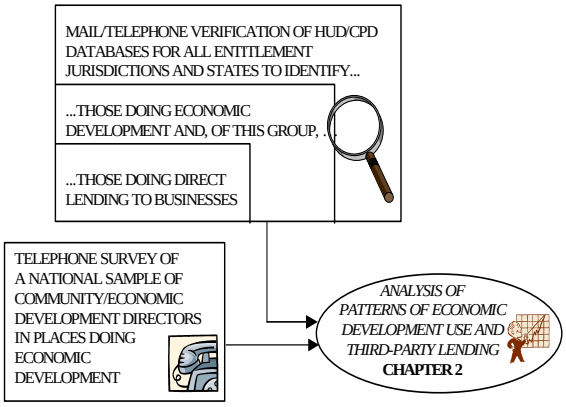
4. Interviews with state Community and Economic Development Department Directors. Telephone interviews were conducted with 11 of 14 directors of state community or economic development departments to discuss their role and perspective on the use of state CDBG or Section 108 funds for third-party lending purposes (referred to as the "State Community Development Administrators Phone Survey").



5. Discussions with secondary market experts. To identify and consider key issues associated with the establishment of a secondary market for third-party loans, discussions were held with a small number of practitioners—identified by reputation—who had participated in secondary market transactions using collateral similar to CDBG and Section 108 third-party loans.

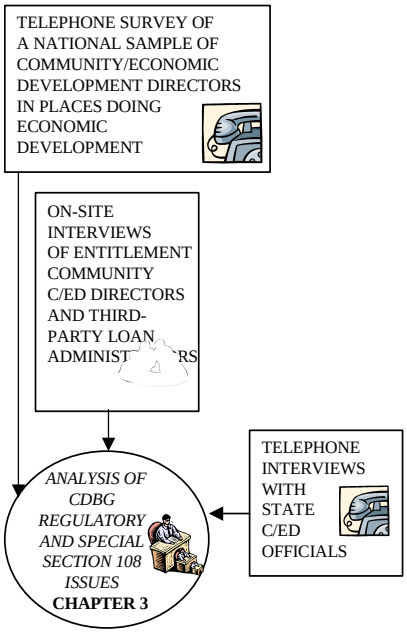
Organization of the Report

Each of the five remaining chapters of this report deals with one of the study's key research questions. Chapter topics are briefly described below, accompanied by a schematic diagram depicting the various databases that are employed to answer the research questions.



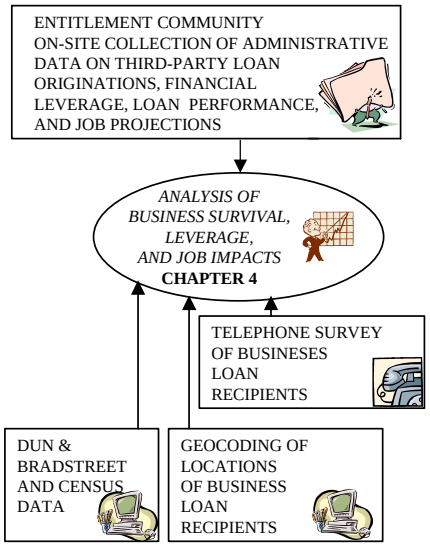
Chapter 2 provides an analysis of national, cross-jurisdictional patterns of CDBG, Section 108,

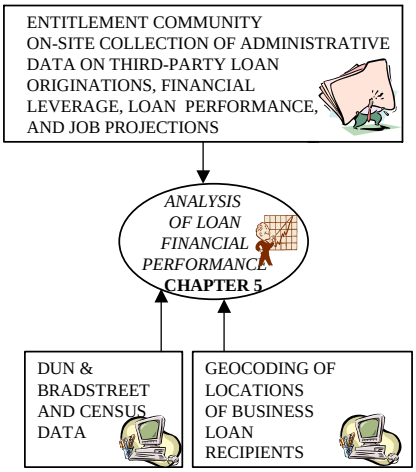
and EDI/BEDI use for economic development—generally, and for third-party lending purposes. For information on both entitlement jurisdiction and state program usage, the chapter draws primarily on data from the Economic Development Funding Database and also from the Community Development Administrators Phone Survey.



Chapter 3 provides an analysis of the effects of both CDBG and Section 108 regulations on the program usage choices made by entitlement-community and state officials—as perceived and expressed by those officials. The chapter relies on data from the Economic Development Funding Database and both the Community Development Administrators Phone and On-Site Surveys,.

Chapter 4 focuses on business survival, job creation/retention performance and cost, and the amount and type of additional dollars leveraged by CDBG-, Section 108-, and EDI/BEDI-funded loans. It utilizes data from the Loan File Review Database, the Business Survey, Dun and Bradstreet files pertaining to business loan recipients, year 2000 Census data, and geo-coded data involving the locations of business that received third-party loans.





Chapter 5 provides a characterization of the loan portfolios of high loan volume communities, reviews the financial performance of third-party loans, and considers the factors that help to explain variation in third-party loan performance or predict the likelihood of loan distress. It draws heavily on the Loan File Review Database, but also utilizes Dun and Bradstreet data, year 2000 Census data, and geo-coded data on the locations of business loan recipients.

Finally, Chapter 6 analyzes the feasibility of establishing a secondary market for CDBG-, Section 108-, and EDI/BEDI-funded third-party loans. It relies on data from the Community Development Administrators Phone and On-Site Surveys, the Loan File Review Database, and discussions with secondary market experts.

Exhibit 1.7 shows the full set of databases employed in this study and associates each with the analyses that are central to the subsequent chapters of this report.

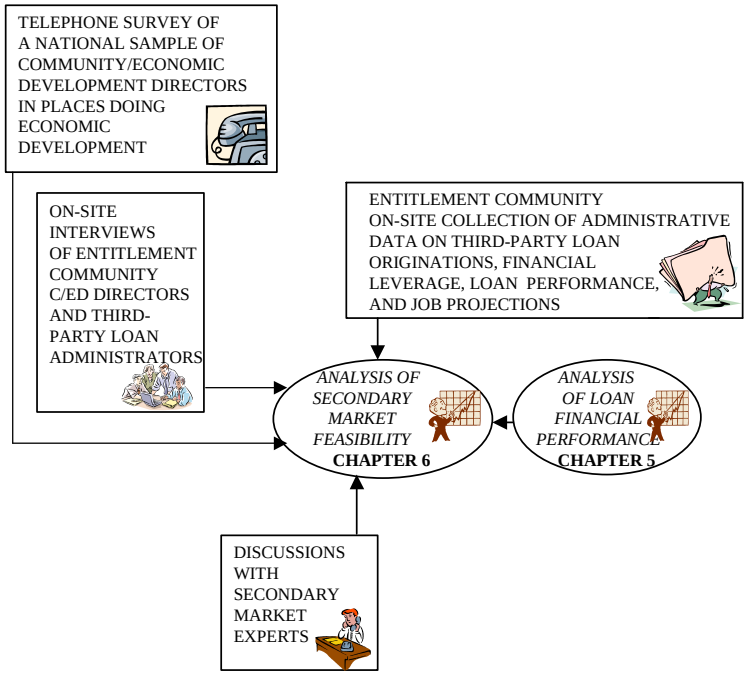
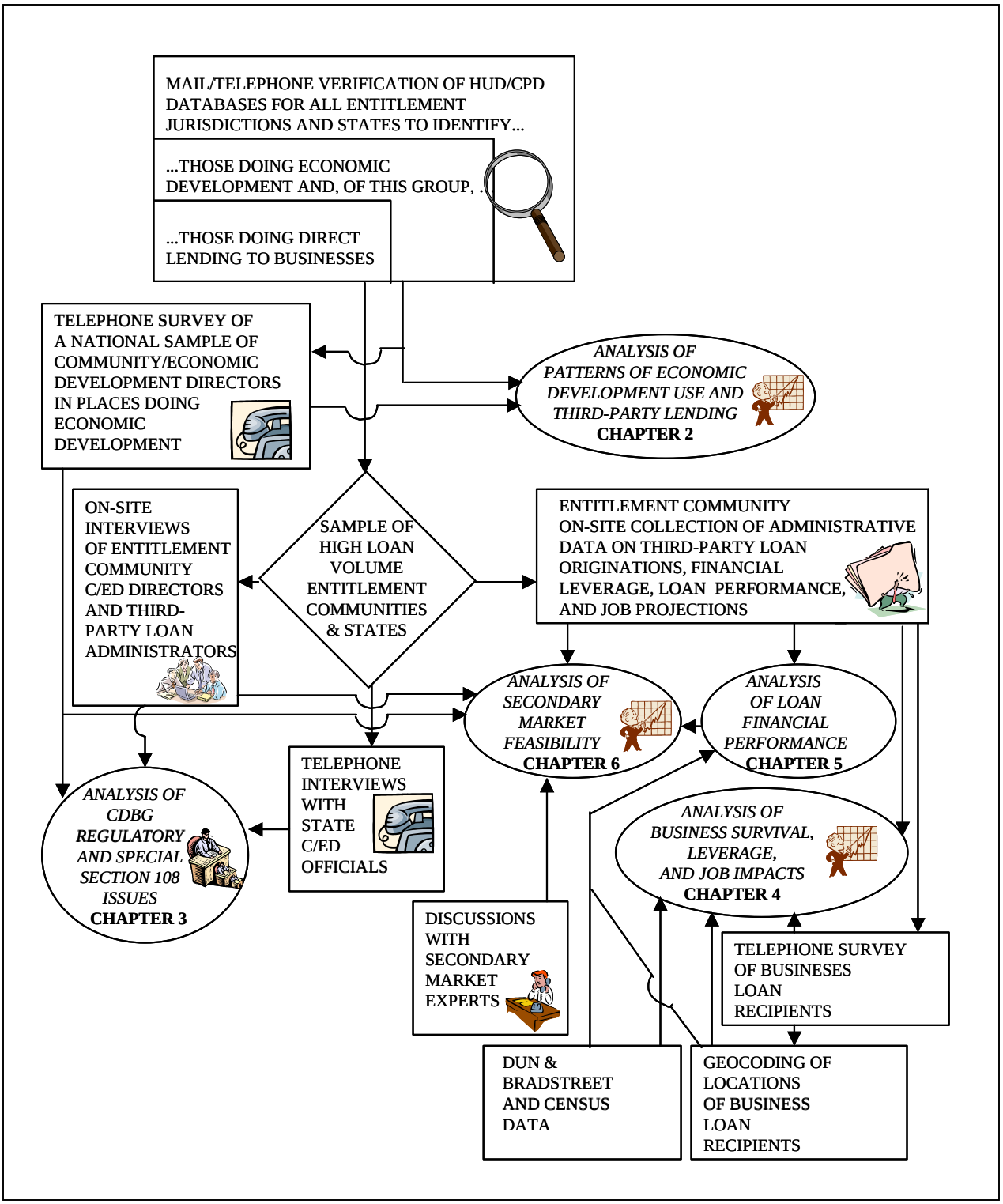


Exhibit 1.7
Schematic Representation of the Relationship Among Samples, Data, and Analyses



CHAPTER 2: NATIONAL PATTERNS OF, AND TRENDS IN, ECONOMIC DEVELOPMENT AND THIRD-PARTY LENDING USE

Highlights

There is considerable cross-community variation in the extent to which the CDBG and Section 108 programs are used to fund economic development, as opposed to other community development activities, and in the types of economic development projects undertaken. Likewise, while the EDI/BEDI programs are designed specifically to address economic development needs; communities have considerable latitude as to how such funds are actually used. This chapter explores variations in patterns of program usage for economic development, generally, and third-party lending, specifically, during the 1990s under these programs, and examines some of the factors explaining these variations. Key observations are:

- Almost all states and entitlement communities funded some amount of economic development during the 1990s, and approximately 82 percent of states and 50 percent of entitlement communities funded third-party loans.
- Economic development funding totaled approximately $8.3 billion during the 1990s, or 18 percent of all funding under CDBG, Section 108, and EDI/BEDI.
- Funding for third-party loans totaled approximately $2.2 billion during the 1990s, or 27 percent of all economic development funding.
- More grantees funded economic development and third-party loans under CDBG than under Section 108 or EDI/BEDI; however, in the entitlement program, CDBG and Section 108 accounted for roughly equivalent shares of total funding for economic development and third-party loans.
- Introduction of the EDI/BEDI programs, and the resulting increase in the use of Section 108, coincided with a significant increase in the share of total program funding allocated to economic development and third-party lending.

Funding for economic development and third-party lending is heavily concentrated among grantees that:

- *Spent the most on economic development.* The 10 percent of entitlement grantees that spent the most accounted for more than three-quarters of all funding for economic development and third-party lending.
- *Used a combination of CDBG, Section 108, and EDI/BEDI to support economic development.* This group accounted for 75 percent of all economic development funding and 64 percent of all funding for third-party loans.
- *Funded economic development every year.* This group accounted for 81 percent of all economic development funding and 84 percent of funding for third-party loans.

More populous jurisdictions (those that are more highly distressed) and central cities and urban counties are more likely to fund economic development lending with CDBG and Section 108 funds than are less populated jurisdictions, those that are less distressed, and suburban entitlement communities. However, smaller, less distressed suburban cities that do third-party lending are likely to spend a greater share of their economic development funds on such loans than are larger, more distressed central cities and urban counties.

Introduction

Since a defining characteristic of HUD's community development programs is the flexibility afforded to states and localities in determining how funds are to be spent and for what purposes, local officials engage in activities that address locally defined priorities—within the broad statutory national objectives and general program restrictions discussed in Chapter 1. The extent to which grantees use CDBG, Section 108, and EDI/BEDI to fund economic development, and the portion of total economic development funding devoted to third-party lending, is established in this chapter. This information is of value not only because it describes the national pattern that results from numerous local decisions about program usage, but also because it provides context for subsequent analyses—of the impact of program regulations, the characteristics of the national third-party loan portfolio, the performance and impacts of third-party loans, and the prospects for a third-party loan secondary market.

As indicated in Chapter 1, analysis of economic development funding uses is for a 10-year period that begins in 1990 and ends in 1999. Since third-party loans typically have terms of 10 years or less, those originated during this timeframe are responsible for a preponderance of the national portfolio that was in place at the time the study was undertaken. Moreover, this time period encompasses major regulatory and programmatic changes that influenced community decisions regarding possible program uses.

Explored in this chapter are questions regarding how many states and local communities used HUD's programs to fund economic development, in general, and third-party lending, in particular, and how much they spent. Funding allocations in the first half of the study period are compared to allocations during the second half to show the aggregate trend in economic development usage. The question of consistency of economic development usage is considered, both across grantees and over time. The types of economic development activities community officials decided to fund, grouped by national objectives and activity categories, are also reviewed. Finally, the kinds of communities that opted to fund economic development, which programs they used, and the extent to which economic development varies as a priority among entitlement communities—as evidenced by the share of their CDBG and Section 108 funds allocated to economic development and third-party lending—is assessed. Prior to presenting this material, however, it is appropriate to briefly address a key methodological issue that is important for understanding the connections (and distinctions) between the analysis presented here and later in the report—namely, the operational definition of "economic development" and "third-party lending" that is applied.

Sources and Uses of Information

While "economic development" is certainly not restricted to community investments that directly stimulate the economy by assisting businesses, enhancing the local labor force, or creating and retaining jobs, it was beyond the scope of this study to determine empirically the secondary economic impacts of CDBG- and Section 108-funded activities generally.[1] Therefore, it was necessary to adopt, *a priori*, an operational definition of economic development and third-party lending that was keyed to particular activity categories, national objectives, and other program-related information—as reported to HUD by grantees and entered into administrative databases. Even so, this approach is not straightforward given anomalies in HUD's administrative data files associated with CDBG, Section 108, and EDI/BEDI. For one thing, there is no single, comprehensive data source that can be used to characterize community spending under the three programs during the 1990s. In addition, there are gaps in the information for many grantees' activities due primarily to a transition between major data systems during the study period as well as other factors. The analysis, therefore, relies on data pieced together from different sources and, depending on the level of detail and coverage of the different data sources, uses varying definitions of economic development and third-party loans. These data sources, which vary by program and across program years, together comprise the study's Economic Development Funding Database (see Exhibit 2.1)[2].

As indicated in Chapter 1, the bulk of the data on the CDBG program come from three HUD administrative databases—the Integrated Disbursement and Information System (IDIS) that grantees use to draw down funds and record CDBG-funded activities, and two predecessor data systems: the Grantee Performance Report (GPR) database for entitlement grantees, and the Performance Evaluation Report (PER) database for states. Though there are numerous differences between these datasets, each contains basic information on the types of activities and national objectives funded with CDBG, which was then used to develop an operational definition of economic development.

[1] The latter, of course, include a very broad range of activities such as housing rehabilitation, street improvements, and childcare provision.

[2] Appendix B provides a detailed assessment of the coverage and quality of information from the different data sources, and the priority with which different sources were used for the study's Economic Development Funding Database.

Exhibit 2.1
Data Sources for the Economic Development Funding Database

Program/Data Source	Years Covered	Grantee Coverage
CDBG		
Integrated Disbursement and Information System	1996-99	All State and entitlement grantees, except New York
Grantee Performance Report	1990-95	All entitlement grantees
Site visit roster data*	1996-99	Site-visit sample (51 entitlement grantees)
Verified data	1990-99	Verification respondents
PER	1990-97	All states, except New York and Hawaii
Section 108		
Site visit roster data*	1994-99	Site-visit sample (51 entitlement grantees)
Grantee Performance Report*	1990-95	All entitlement grantees
Verified data*	1990-99	Verification respondents
Financial Management Division Database**	1990-99	All State and entitlement grantees receiving Section 108 awards
EDI/BEDI		
Site visit roster data*	1996-99	Site-visit sample (51 entitlement grantees)
Verified data*	1994-99	Verification Respondents
EDI/BEDI Database**	1994-99	All State and entitlement grantees receiving EDI/BEDI awards

*Third-party lending data only.
**Total and economic development data only.

To capture activities where the primary purpose was to stimulate economic development, the operational definition of economic development, as indicated in Exhibit 2.2, encompasses activities in three broad categories—business assistance, commercial/industrial improvements, and job training—plus any other activities qualified under the low- and moderate-income job creation and retention, or low- and moderate-income micro-enterprise benefit national objectives. HUD's administrative data frequently lack the information necessary to determine, easily, the exact financing structure of economic development assistance, whether it is a grant, a subsidy, a loan, or some combination of the above. Even assistance given in the form of loans can vary greatly, from direct loans to deferred payment loans, forgivable loans, partial grants and so on. Therefore, third-party lending initially was identified on GPR and IDIS as a subset of economic development, consisting of business assistance or commercial/ industrial improvement activities that also generated program income, or were flagged as revolving loan fund or direct business loans.

Exhibit 2.2
CDBG Program-Eligible Economic Development Activities*

Business Assistance
- Direct Financial Assistance to Non-Profit Business
- Technical Assistance to Business
- Micro-Enterprise Assistance

Commercial/Industrial Improvements
- C/I Rehabilitation
- C/I Land Acquisition/Disposition
- C/I Infrastructure Development
- C/I Building Acquisition, Construction, Rehabilitation
- Other C/I Improvements

Job Training

Other Activity Categories with Job Creation National Objective
- Housing
- Public Faciltities & Improvements
- Public Services
- Acquisition/Clearance

* Activity categories are compiled from the HUD expenditure classification system for economic development and other activities for which grantees use low-mod job creation as the national objective.

Two other important sources, grantee verification data and loan roster data, supplement data from HUD's administrative systems, filling gaps in the records and confirming the initial classification of activities (especially third-party loans). A broad effort was undertaken to verify selected data items directly with all grantees initially determined to have funded economic development.[3] Grantees were asked to verify the amounts spent on (or, for states, obligated to) economic development and third-party lending, by year. The verified data are only available at a summary level and do not provide any detail about specific activities but, for those grantees that responded, they offer a record of activities over the entire study period. In addition, the analysis uses loan roster data collected from grantee lending offices in the course of site visits. These data are the most reliable and accurate source of information on third-party loan expenditures; however, the roster data only cover the period 1996 to 1999, and are only available for the 51 high-loan-volume entitlement grantees visited on-site.

It was not possible to use the IDIS, GPR, and PER data systems to identify funding under the Section 108 or EDI/BEDI programs, since grantees do not report activities under these programs the same way as CDBG. Instead, Section 108 and EDI/BEDI funding was approximated using administrative data on award amounts and dates. Section 108 project descriptions in the Financial Management Division (FMD) database showed the intended use of the funds, allowing the determination of Section 108 economic development funding amounts; EDI/BEDI awards, by definition, involve economic development. However, neither data source provided enough detailed information on the use of funds to be able to estimate third-party lending. Therefore, to identify Section 108 and EDI/BEDI funding of third-party loans, the database draws on a mix of data sources similar to the mix used for the regular CDBG program, namely the loan roster data from site visits, verified economic development data from grantees, and (for Section 108 in the period 1990 to 1995) the GPR.

In sum, the study's Economic Development Funding Database provides the best estimate of economic development and third-party lending activities communities undertook during the 1990s using HUD's community development programs—pieced together from available sources. The patterns revealed by this information are examined next.

Economic Development Funding

The importance of HUD's community development programs as a resource for economic development and third-party lending is indicated by the extent to which state and local entitlement grantees use CDBG, Section 108, and EDI/BEDI for such initiatives. In the 1990s, these grantees almost universally used HUD's programs to conduct some amount of economic

[3] As described in Appendix C, data were culled from HUD's administrative systems and sent to 848 grantees for verification; 68 percent of entitlement jurisdictions and 70 percent of states responded.

development, and economic development accounted for approximately one-fifth of the programs' combined funding. The use of CDBG, Section 108, or EDI/BEDI for third-party lending was not as widespread, especially among entitlement grantees, with loan activity amounting to just one-fourth of total economic development funding. However, as detailed below, the allocation of funds to economic development and third-party loans varied considerably across the three programs.

Table 2.1
Number and Percentage of Local CDBG Entitlement Grantees and States Funding Economic Development and Third-Party Loans, 1990-99, by HUD Funding Source

HUD Funding Source	Number of Grantees	Number of Grantees Funding Economic Development	Percent of Grantees Funding Economic Development	Number of Grantees Funding Third-Party Loans	Percent of Grantees Funding Third-Party Loans	Percent of Economic Development Grantees*** Funding Third-Party Loans
Local Grantees						
CDBG	966	853	88 %	470	49 %	55 %
Section 108	337	232	69	86	26	37
EDI/BEDI	135	135	100	11	8	8
Any Program	966	859	89	482	50	56
States*						
CDBG**	49	49	100 %	41	84 %	84 %
Section 108	18	14	78	6	33	43
EDI/BEDI	9	9	100	0	0	0
Any Program	50	50	100	42	84	84

*Includes Puerto Rico.

**CDBG data not available for New York and Hawaii because HUD administers the CDBG programs in these states.

*** "Economic Development Grantee" is a grantee that funds economic development.

Source: Urban Institute Economic Development Funding Database--Third-Party Lending Study, 2002.

Out of a total of 966 local entitlement grantees that received CDBG funds in the 1990s, 859 of them funded economic development using CDBG, Section 108, or EDI/BEDI (see Table 2.1). CDBG was the most common source of funds for economic development. Almost all grantees that opted to fund economic development did so, at some point, using CDBG. A much smaller number of local grantees used Section 108 to fund economic development—232, or 24 percent of all grantees (not shown); however, this number represents 69 percent of the local grantees that participated in Section 108. In other words, more than two-thirds of all entitlement communities that successfully applied for Section 108 funding did so to support economic development. Since they provide grant funds tied to the use of Section 108, the EDI/BEDI

programs were used by a still smaller number of grantees. In total, 135 local grantees used EDI/BEDI, representing only 14 percent of all local grantees (not shown) but more than one-half (58 percent, not shown) of those that used Section 108 for economic development.

Table 2.1 also shows the extent to which local grantees opted to fund third-party loans as part of their economic development programs, or the pool of communities that were responsible for the lending examined in later chapters of this report. As indicated, one half of all local grantees used HUD funds to make third-party loans in the 1990s. Like economic development as a whole, the greatest number of local grantees funded third-party loans with CDBG (470 grantees, or 49 percent), while fewer used Section 108 and EDI/BEDI for third-party loans—only 9 percent and 1 percent of all grantees, respectively (not shown). The minimal use of EDI/BEDI for third-party loans is to be expected. These funds are granted to communities with the goal of increasing the feasibility of Section 108 economic development projects, which can be accomplished through over-collateralization, funding reserves, credit enhancement, or interest subsidies, rather than direct lending. Because grantees are required to repay Section 108 awards, third-party loans that generate a revenue stream might be expected to be an attractive use of funds. It is noteworthy, therefore, that the available data show that third-party loans were made by just 37 percent of the entitlement grantees that used Section 108 for economic development.[4]

States exhibit a similar pattern in the use of HUD's community development programs for economic development. As indicated in Table 2.1, all states used CDBG to fund economic development during the 1990s, and a majority (84 percent) used CDBG to fund third-party loans. Like local grantees, states were much less likely to use Section 108 and EDI/BEDI for the same purposes. Less than one-third of all states used Section 108 to fund economic development (27 percent), and a subset of these used Section 108 funds to make third-party loans.

States and local grantees, together, spent approximately $8.3 billion on economic development in the 1990s, which represents approximately one-fifth (18 percent) of the total $45.9 billion grantees spent on all activities under CDBG, Section 108, and EDI/BEDI (see

[4] The estimates of aggregate Section 108 third-party lending presented in Table 2.1 and the remainder of this chapter are conservative because the available data sources did not include every grantee that may have funded third-party lending with Section 108, especially in the period 1996 to 1999. Other than the loan rosters collected for site-visits, the only data source available for Section 108 third-party lending from 1996 to 1999 was the information that grantees provided through the data verification process. Of the 197 grantees that funded economic development with Section 108 in this period, roster or verification data were available for only 103 grantees (or 52 percent). It is therefore possible and quite likely that there exist a number of grantees that funded third-party lending with Section 108, but for which there are no data available.

Table 2.2).[5] States spent less on economic development than local grantees, which is not surprising since, under the allocation formula, states account for only 30 percent of CDBG awards. However, in proportional terms, states spent about as much as entitlement jurisdictions on economic development. Over the ten-year period, entitlement communities spent a total of $35.7 billion on all three programs, of which $6.2 billion (or 17 percent) went to economic development. States, by contrast, funded a total of just $10.2 billion in activities under the three programs, but they used about the same share (21 percent) of funds for economic development.

Table 2.2
Local CDBG Entitlement Grantee and State Economic Development Funding Levels, 1990-99, by HUD Funding Source

HUD Funding Source	Funding for all Activities	Economic Development Funding	Economic Development Funding as a Percent of Funding for all Activities	Third-Party Loan Funding	Third-Party Loan Funding as a Percent of Funding for all Activities	Third-Party Loan Funding as a Percent of Economic Development Funding
	(in millions)	(in millions)		(in millions)		
Local Grantees	**$35,745**	**$6,176**	**17**	**$1,591**	**4**	**26**
CDBG	$31,251	$2,717	9 %	$859	3 %	32 %
Section 108	3,976	2,941	74	715	18	24
EDI/BEDI	518	518	100	16	3	3
States*	**$10,167**	**$2,142**	**21**	**$628**	**6**	**29**
CDBG**	$9,808	$1,869	19 %	$566	6 %	30 %
Section 108	349	263	75	62	18	24
EDI/BEDI	10	10	100	0	0	0
Local Grantees and States	$45,912	$8,318	18 %	$2,218	5 %	27 %

*Includes Puerto Rico.
**CDBG data not available for New York and Hawaii.

Source: Urban Institute Economic Development Funding Database--Third-Party Lending Study, 2002.

While almost all entitlement grantees funded economic development with CDBG, and a smaller portion did so with Section 108, this pattern was reversed in terms of the dollar volume of funding. Economic development was a relatively modest share of total CDBG spending (just 9 percent) among entitlement communities, but a much greater share of spending under Section 108 (74 percent). The result is that CDBG and Section 108 accounted for roughly equivalent shares of the total economic development expenditures over the 10-year study period, at $2.7 billion and $2.9 billion, respectively.

[5] All funding estimates are in nominal dollars, not adjusted for inflation.

States, by contrast, relied more heavily on CDBG than Section 108 to fund economic development. States spent 19 percent of the CDBG funds they received in the 1990s on economic development, more than twice the share spent by entitlement communities. Like entitlement communities, states used Section 108 largely to fund economic development; 75 percent of all state Section 108 funding was used for this purpose. However, states received much less funding under Section 108 than entitlement communities, possibly due to a reluctance to commit futures years' grants as collateral for investments in particular non-entitled communities. Therefore, CDBG funding for economic development outstripped Section 108 among states.

Table 2.2 also indicates the approximate dollar volume of funding for third-party loans in the 1990s—$2.2 billion, in total. Several aspects of this funding are noteworthy. First, third-party lending was a relatively small share of total funding, just 5 percent among both entitlement grantees and states, or about a quarter of the funding for economic development. Second, among the entitlement grantees, CDBG and Section 108 accounted for roughly equivalent volumes of third-party lending—$859 million and $715 million, respectively. However, as with economic development as a whole, Section 108 funding for third-party loans among states was much smaller in dollar terms than funding under CDBG. Finally, it is worth noting that the EDI/BEDI programs account for a very small portion of third-party lending.

While EDI/BEDI was not widely employed for direct lending, the introduction of the program in 1994 coincided with an increase in the number and share of entitlement communities funding economic development and third-party loans. As discussed in Chapter 1, in the mid-1990s there also were regulatory changes intended to make it easier to qualify economic development activities under CDBG, including the addition of new national objectives. Table 2.3 illustrates some of the changes in economic development funding between the first half and the second half of the 10-year period, showing that a greater share of entitlement communities funded economic development in the last half of the decade (83 percent) than in the first half (77 percent). Among these grantees, however, the share that funded third-party loans barely shifted (from 49 percent to 51 percent). That is, more entitlement communities started to fund economic development in the late 1990s, but lending activity stayed proportionally about the same. This trend is reflected, also, in both of the individual programs—CDBG and Section 108.

While a larger number of entitlement communities began to use both CDBG and Section 108 to fund economic development in the late 1990s, the increase in the share of funding for economic development was driven by an increase in Section 108 awards. As a percent of total funding, economic development and third-party lending was constant for CDBG but increased greatly for Section 108. In the first half of the study period, entitlement grantees allocated 66 percent of total Section 108 funding for economic development, of which 11 percent was third-party lending. In the second half of the study period, these amounts grew: 76 percent of Section

108 funding was allocated to economic development activities, 28 percent of which was for third-party lending.

Table 2.3
Changes in Local CDBG Entitlement Grantee and State Economic Development Funding Between 1990-94 and 1995-99, by HUD Funding Source

HUD Funding Source	Years	Percent of Grantees Funding Economic Development*	Economic Development as a Percent of Funding for all Activities	Percent of Grantees Funding Third-Party Loans*	Third-Party Loan Funding as a Percent of Economic Development Funding
Entitlement Grantees					
CDBG					
	1990-94	76 %	9 %	49 %	32 %
	1995-99	83	9	50	31
Section 108					
	1990-94	65	66	36	11
	1995-99	68	76	36	28
Either Program					
	1990-94	77	12	49	25
	1995-99	83	19	51	29
States					
CDBG					
	1990-94	98 %	17 %	79 %	33 %
	1995-99	100	21	67	28
Section 108					
	1990-94	73	76	63	65
	1995-99	69	75	33	8
Either Program					
	1990-94	96	18	81	35
	1995-99	98	24	69	25

* These figures are lower than the decadal figures reported in Table 2.1.
Source: Urban Institute Economic Development Funding Database--Third-Party Lending Study, 2002.

There was a similar jump in state-level funding for economic development in the late 1990s. This was due, in part, to increased awards under Section 108 but, in contrast to entitlement communities, the increase among states also resulted from the commitment of more funds for economic development under CDBG. Furthermore, unlike entitlement communities, states did not increase the use of funds for third party lending. In fact, the states' use of CDBG

and Section 108 to fund third-party loans fell from 35 percent to 25 percent of combined economic development funding.[6]

Economic Development Funding Patterns

A majority of HUD's grantees fund economic development, but not all communities that use CDBG, Section 108, or EDI/BEDI to fund economic development do so to the same degree, or in the same way. This section examines several patterns in economic development funding that occurred among grantees that used HUD's community development programs to support economic development at some point during the 1990s—involving the distribution of spending across grantees, the degree to which grantees combined the different programs, the consistency of economic development funding over time, and the extent to which grantees pursued different types of economic development. The patterns revealed here have important implications for the issues to be explored later in the report, including the number and type of communities that could potentially participate in a secondary market for third-party loans and the strategies HUD could pursue if it wanted to increase the use of, or maximize the impacts from, CDBG, Section 108, and EDI/BEDI funding for economic development.

Concentration of funding. One of the main features of spending on economic development and third-party loans is that it is very concentrated: a relatively small number of grantees accounts for an overwhelming majority of total economic development spending. To a certain extent, this pattern is to be expected since CDBG allocation formulae ensure that larger, more distressed communities receive the largest CDBG grants. However, economic development and third-party loan funding was even more concentrated in the 1990s than spending as a whole.

Table 2.4 shows the degree to which funding for economic development and third-party lending in the 1990s was concentrated among the 10 percent of entitlement communities that spent the most on economic development under CDBG and Section 108, combined. While these top spending local grantees accounted for approximately one-half (54 percent) of total funding for all activities, they were responsible for more than three-quarters of the total funding for economic development and third-party loans (76 and 78 percent, respectively). Section 108 funding for economic development was more concentrated than funding under CDBG: top spenders accounted for 84 percent of total economic development funding and 92 percent of the funding for third-party loans under Section 108 compared to 66 percent for economic

[6] The decrease in Section 108 funding for third-party loans appears dramatic, but, nevertheless, is not a significant trend, due to the already low incidence of state third-party lending with Section 108. The large proportionate decline in the percent of funds reflects a very small absolute decline in the number of states funding third-party loans with Section 108.

development and third-party loans under CDBG. Even in the CDBG program, though, economic development and third-party lending was more concentrated than spending on all activities as a whole.

Table 2.4
Top Local CDBG Entitlement Grantee Funders of Economic Development: Share of Total Program Funding, 1990-99,* by HUD Funding Source

HUD Funding Source	Percent of Total Program Funding	Percent of Total Funding for Economic Development	Percent of Total Funding for Third-Party Loans
CDBG	50 %	66 %	66 %
Section 108	77	84	92
Combined**	54 %	76 %	78 %

*Top Grantee Funders are the 10% of grantees that spent the most on economic development under CDBG and Section 108, combined.

** Top 10% Grantee Funders = 97 grantees.

Source: Urban Institute Economic Development Funding Database--Third-Party Lending Study, 2002.

The distribution of economic development and third-party lending across local grantees is illustrated further by Exhibit 2.3, which shows how far funding levels drop after the 10 percent of entitlement communities that comprise the top spending group are considered. For example, the next 10 percent of entitlement communities (the 9th decile) accounted for only 12 percent of economic development funding and 11 percent of third-party loan funding. Therefore, communities outside the top-spending group account for a relatively small share of the national loan portfolio.

An analysis of the distribution of economic development and third-party loan funding among states also reveals a concentration of funding, although the pattern differs from entitlement communities in a number of important ways. Table 2.5 lists the top 10 states, ranked by total funding for economic development and by total funding for third-party loans. These top ten state grantees (or the top 20 percent of states) accounted for one half (51 percent) of all state economic development funding in the 1990s. Therefore, while it is concentrated, state funding for economic development and third-party lending is more evenly distributed than in the entitlement program, where 10 percent of the communities accounted for 76 percent of the economic development funding. Individual states, however, can represent a much greater proportion of total spending than individual entitlement communities due to the small number of state grantees. California, alone, for example, accounted for 14 percent of total state funding for third-party loans in the 1990s.

Exhibit 2.3
Distribution of Total Economic Development and Third-Party Loan Funding Across Local CDBG Entitlement Grantees Funding Economic Development, 1990-99

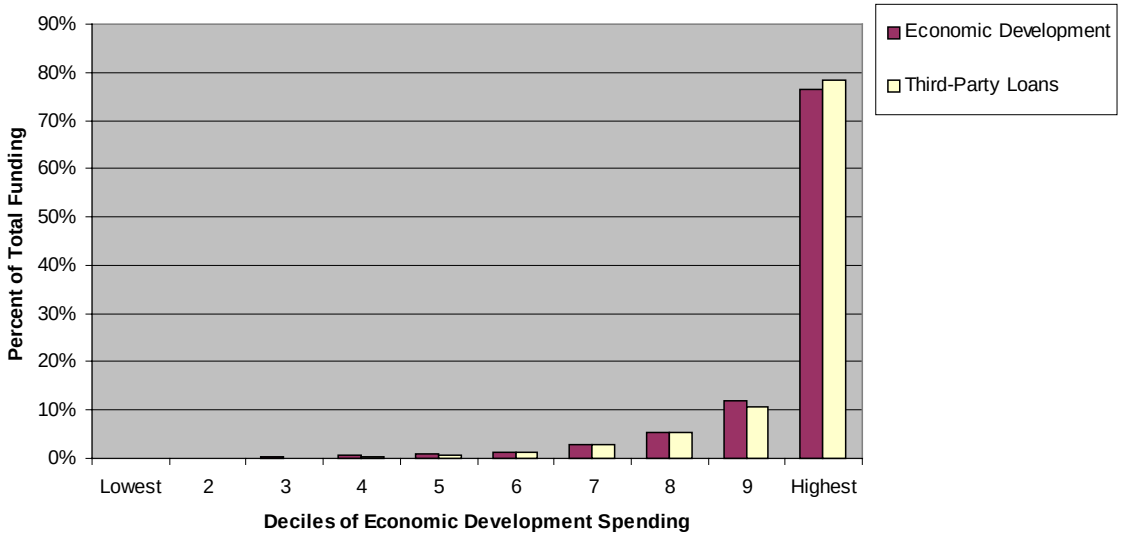


Table 2.5
Top Ten State Program Spenders on Economic Development and Third-Party Loans, 1990-99

Combined Economic Development Expenditure--using CDBG, Section 108, and EDI/BEDI

Rank*		Percent of Total CDBG/Section 108 Spending	Percent of CDBG/Section 108 Economic Development Spending
1	Michigan	3 %	8 %
2	Mississippi	4	7
3	Missouri	3	6
4	South Carolina	3	6
5	Indiana	4	5
6	California	3	5
7	North Carolina	4	4
8	Arkansas	2	4
9	Alabama	3	4
10	Texas	4	3
Top 10 Total		**35 %**	**51 %**

Combined Third Party Loan Expenditure--using CDBG, Section 108, and EDI/BEDI

Rank*		Percent of Total Expenditure for All Activities	Percent of Total Expenditure for Third-Party Loans
1	California	3 %	14 %
2	Missouri	3	8
3	Nebraska	1	8
4	Iowa	3	7
5	Kansas	2	7
6	Wisconsin	2	7
7	Arkansas	2	6
8	South Carolina	3	4
9	Ohio	4	4
10	Minnesota	2	4
Top 10 Total		**26 %**	**67 %**

*Rank for combined economic development expenditure, using CDBG, Section 108, and EDI/BEDI.
**Rank for combined third-party loan expenditure, using CDBG, Section 108, and EDI/BEDI.

Source: Urban Institute Economic Development Funding Database--Third-Party Lending Study, 2002.

Program combinations. Another dimension of the concentration of economic development and third-party loan funding is the degree to which entitlement communities combine CDBG, Section 108, and EDI/BEDI to pursue their economic development objectives. Among states, there was very little mixing of the programs due to low levels of participation in Section 108 and EDI/BEDI. Moreover, the combination of different programs did not influence aggregate state funding for economic development and third-party loans. In the entitlement program, by contrast, the combination of CDBG, Section 108 and EDI/BEDI was tied to much higher levels of spending.

Only 112 grantees, or 13 percent of the 859 local grantees that funded economic development during the 1990s, used a combination of CDBG, Section 108, and EDI/BEDI funds (see Table 2.6). However, these local grantees had a much higher level of investment per grantee than local communities using other program combinations, so they accounted for a higher share of total economic development funding—75 percent or $4.6 billion. By contrast, the largest single group of entitlement communities used CDBG alone (627 grantees, or 73 percent), but they accounted for just 12 percent of the total funding for economic development. Grantees that funded economic development with CDBG and Section 108 (without EDI/BEDI) represented 13 percent of the grantees and were responsible for an equivalent share of total economic development funding (13 percent).

Table 2.6
Local CDBG Entitlement Grantee Economic Development and Third-Party Loan Funding Combinations, 1990-99, by HUD Funding Sources Program Combinations

Economic Development

Program Combination	Number of Grantees	Percent of Grantees	Economic Development Funding (in millions)	Percent of Total Economic Development Funding	Grantee Average Economic Development Funding (in millions)
CDBG/Section 108/EDI	112	13 %	$4,613	75 %	$41.2
CDBG/Section 108	114	13	788	13	6.9
CDBG Only	627	73	767	12	1.2
Section 108/EDI	1	<1	2	<1	2.4
Section 108 Only	5	1	6	<1	1.2
All Combinations	**859**	**100 %**	**$6,176**	**100 %**	**$7.2**

Third-Party Loans

Program Combination	Number of Grantees	Percent of Grantees	Third-Party Loan Funding (in millions)	Percent of Total Third-Party Loan Funding	Grantee Average Third-Party Loan Funding (in millions)
CDBG/Section 108/EDI	48	10 %	$1,019	64 %	$21.2
CDBG/Section 108	26	5	80	5	3.1
CDBG Only	396	82	449	28	1.1
Section 108/EDI	9	2	39	2	4.4
Section 108 Only	3	1	2	<1	0.7
All Combinations	**482**	**100 %**	**$1,590**	**100 %**	**$3.3**

Source: Urban Institute Economic Development Funding Database--Third-Party Lending Study, 2002.

A similar pattern is exhibited by local grantees funding third-party loans. While those that used all three programs accounted for 64 percent of all third-party lending ($1 billion), local grantees that used CDBG alone accounted for 28 percent of all lending ($0.4 billion)—even though these groups consisted of 10 percent and 82 percent of the grantees funding loans, respectively. It also is noteworthy that among entitlement grantees that used CDBG and Section 108 for lending, almost twice as many received funding under EDI/BEDI (48, or 10 percent) than those that did not (26, or 5 percent). Furthermore, grantees that received EDI/BEDI funding conducted seven times more lending, on average, than those that did not.

These patterns indicate that the use of EDI/BEDI was related to higher volume funding for economic development and third-party loans. It is not clear, however, whether the introduction of EDI/BEDI facilitated the use of Section 108 and CDBG for economic development by a new group of grantees, or if those that were already funding economic development at high levels were able to use EDI/BEDI to extend the funds available for economic development. One way to examine the effect of the EDI/BEDI programs on economic development is to look at the change in funding patterns over time and the change in the distribution of grantees using different program combinations.

Although more entitlement communities used Section 108 funds for economic development and third-party loans after the introduction of the EDI/BEDI programs, the large increase in funding amount can mostly be attributed to those communities that already accounted for a large portion of total spending. In other words, grantees already funding economic development at the highest levels increased the amount they allocated to economic development and third-party loans. As shown by Table 2.7, the average economic development funding per grantee using CDBG, Section 108, and EDI/BEDI funds jumped from $13 million in 1990-94 to $28.2 million in 1995-99. An even greater increase occurred in funding for third-party loans, from $4.3 million to $17 million.

Average funding per grantee using other program combinations stayed roughly the same. As a result, local grantees using CDBG, Section 108, and EDI/BEDI accounted for an increasing percent of total economic development and third-party loan funding in the last half of the decade.[7]

[7] Much of this increase was due to a spike in EDI/BEDI awards in 1995, associated with a large increase in Section 108 funding. After 1995, there was still an increase over earlier funding levels, although at a fraction of the 1995 levels.

Table 2.7
Change in Local CDBG Entitlement Grantee Economic Development and Third-Party Loan Funding Combinations Between 1990-94 and 1995-99, by HUD Funding Source Program Combinations

	Economic Developent Funding			
	1990-94		1995-99	
Program Combination	Percent of Total Economic Development Funding	Average Economic Development Funding Per Grantee (in millions)	Percent of Total Economic Development Funding	Average Economic Development Funding Per Grantee (in millions)
CDBG/Section 108/EDI	69 %	$13.0	78 %	$28.2
CDBG/Section 108	15	2.9	11	4.1
CDBG Only	15	0.5	11	0.7
Section 108/EDI	0	0.0	<1	2.4
Section 108 Only	<1	1.2	0	0.0
All Combinations	**100 %**	**$2.5**	**100 %**	**$4.7**

	Third-Party Loans			
	1990-94		1995-99	
Program Combination	Percent of Total Third-Party Loan Funding	Average Third-Party Loan Funding Per Grantee (in millions)	Percent of Total Third-Party Loan Funding	Average Third-Party Loan Funding Per Grantee (in millions)
CDBG/Section 108/EDI	47 %	$4.30	70 %	$17.0
CDBG/Section 108	9	1.6	3	1.5
CDBG Only	44	0.5	24	0.6
Section 108/EDI	<1	0.1	3	4.2
Section 108 Only	<1	0.3	<1	0.4
All Combinations	**100 %**	**$0.9**	**100 %**	**$2.4**

Source: Urban Institute Economic Development Funding Database--Third-Party Lending Study, 2002.

Funding consistency. Economic development is, by its very nature, "lumpy:" development opportunities do not necessarily occur on a regular basis. In fact, some opportunities, as the term suggests, might require community officials to be opportunistic—using

CDBG, Section 108, or EDI/BEDI funds to take advantage of a particular set of possibly short-lived market circumstances. Other development projects might be many months or years in planning and implementation, but require a periodic or one-time injection of HUD funds as part of a larger funding package. Despite these characteristics, the record of funding under the CDBG program during the 1990s suggests that many grantees fund economic development on a consistent basis. Almost all states funded some economic development activity every year. There was greater variability in support among entitlement communities; however, those that did support economic development consistently provided funding at higher levels.

Table 2.8
Local CDBG Entitlement Grantee Funding for Economic Development and Third-Party Loans, 1990-99, by Consistency of Funding

Consistency of Funding	Number of Grantees	Percent of Grantees Funding Economic Development	Total CDBG Economic Development Funding (in millions)	Percent of Total CDBG Economic Development Funding	Total CDBG Third-Party Loan Funding (in millions)	Percent of Total CDBG Third-Party Loan Funding
Consistent Funders*	270	32 %	$2,223	81 %	$725	84 %
Episodic Funders**	583	68	495	19	133	16
Total	**853**	**100 %**	**2,717**	**100 %**	**859**	**100 %**

*Consistent funders are those grantees that funded economic development every year.

**Episodic funders are those grantees that funded economic development, but not every year.

Source: Urban Institute Economic Development Funding Database--Third-Party Lending Study, 2002.

Table 2.8 divides entitlement communities into two groups that used CDBG to fund economic development during the 1990s—"consistent funders" that funded economic development activities every year and "episodic funders" that did not fund economic development every year. This categorization further highlights the skewed distribution of economic development and third-party loan funding. While consistent funders represented about one-third of all grantees funding economic development (32 percent), they accounted for 81 percent of the total economic development funding and 84 percent of the total third-party loan funding. Consistent spending indicates that a community has made an ongoing commitment to fund economic development, rather than funding it on an opportunistic basis; however, the consistent spender category does not necessarily include every grantee that had a high (or regular) volume of economic development funding. For example, only 80 percent of grantees visited on-site for this study are consistent spenders, according to the definition used here, even though these grantees were selected for in-depth analysis because they spent more

on third-party loans. Furthermore, the consistent spender category does not include grantees that consistently fund lumpy, multi-year projects.[8]

Table 2.9
Distribution of Local CDBG Entitlement Grantee Economic Development and Third-Party Loan Funding, 1990-99, by Activity Category

	Average Percent of Economic Development and Third-Party Loan Funds Spent		
Activity Category	**1990-94**	**1995-99**	**1990-99**
Economic Development			
Business Assistance	68 %	59 %	64 %
Commercial/Industrial Improvements	22	22	22
Job Training	6	9	8
Acquisition/Clearance	3	2	2
Housing	1	1	1
Public Facilities & Improvements	1	4	3
Other	<1	2	1
Total	**100 %**	**100 %**	**100 %**
Third-Party Loans			
Business Assistance	86 %	82 %	84 %
Commercial/Industrial Improvements	14	18	16
Total	**100 %**	**100 %**	**100 %**

Source: Urban Institute Economic Development Funding Database--Third-Party Lending Study, 2002.

[8] Episodic spenders did not use CDBG to fund economic development every year, but many exhibited extended periods of support for economic development: 273 of those identified as episodic funders are communities that funded economic development for at least three years in a row during the last decade. These were the largest single group of episodic funders (47 percent). It is also noteworthy that there is a general pattern of grantees' reducing the proportion of CDBG funds spent on economic development in those years when Section 108 is used for that purpose.

Types of economic development. Given that communities have broad latitude to decide what types of economic development to support, this section examines the degree to which CDBG entitlement grantees funded different types of activity according to the two criteria used in the study's operational definition of economic development—eligible activities and national objectives. The resulting funding pattern indicates the degree to which grantees have been (or would be) sensitive to changes in program regulations, as well as the kinds of benefits that should be expected to accrue from grantees' support for economic development.

Table 2.9 indicates the average annual percent of economic development (and third-party loan) expenditures that were qualified under different categories of eligible activity between 1990 and 1999. To capture changes in the types of projects funded over the course of the decade, the table also shows the average annual percentages for two periods pivoted on the year when major changes were implemented in the regulation of economic development activities—1990 to 1994, and 1995 to 1999. A majority of CDBG funding for economic development (and third-party loans) fell under the rubric of business assistance for the duration of the 1990s. Between 1990 and 1999, an average 64 percent of all CDBG economic development funding was for business assistance, which includes technical assistance to businesses as well as financial assistance in the form of third-party loans and grants. The same activity category accounted for an average 84 percent of all third-party loan expenditures.

The next most common type of CDBG economic development activity category was commercial/industrial improvements, at 22 percent of the average annual expenditures. This category includes land acquisition, infrastructure development, facilities development, and other activities that might be undertaken directly by the grantee or a subrecipient. It also includes some assistance to businesses, for instance, for the exterior rehabilitation of private commercial or industrial facilities. The remaining activity categories each accounted for an average of less than 10 percent of the total economic development funding; however, it is worth noting that the funding for job training and activities classified as public facilities and improvements increased during the study period—from six and one percent, in 1990-94, to nine and four percent, in 1995-99, respectively—while funding for business assistance declined.

Table 2.10 provides a similar breakdown of economic development and third-party loan funding by broad national objective category. Over the 1990 to 1999 period, a majority of economic development (56 percent) and third-party loan (73 percent) funding qualified under a low- and moderate-income, job creation or retention national objective. The low- and moderate-income, area benefit national objective, which is often used to assist retail businesses, accounted for the next largest share of funding. An average 20 percent of economic development funding and 13 percent of third-party loans over the entire study period qualified under this objective; however, the share of total funding qualified on an area basis dropped considerably between the early and late 1990s. This decline mirrors an increase in the use of the low- and moderate-income, limited clientele national objective, from seven to 15 percent of

funding, which resulted from an increase in funding for job training and the introduction of a new objective under limited clientele—namely, the micro-enterprise benefit objective. The portion of third-party lending for low- and moderate-income, limited clientele benefit rose only slightly, which suggests that grantees may be offering micro-enterprises more flexible types of assistance in the form of soft loans and grants that do not need to be repaid. In third-party lending, the decline in low- and moderate-income, area benefit funding also reflects a modest increase in the use of the slum and blight elimination national objectives.

Table 2.10
Distribution of Local CDBG Entitlement Grantee Economic Development and Third-Party Loan Funding, 1990-99, by National Objective

	Average Percent of Economic Development and Third-Party Loan Funds Spent		
National Objective	**1990-94**	**1995-99**	**1990-99**
Economic Development			
Low-Mod National Objective	88 %	89 %	88 %
Low-Mod Job Creation	*57*	*55*	*56*
Low-Mod Area Benefit	*23*	*18*	*20*
Low-Mod Limited Clientele	*7*	*15*	*11*
Low-Mod Housing	*1*	*1*	*1*
Slums/Blight Elimination	12	11	11
Total	**100 %**	**100 %**	**100 %**
Third-Party Loans			
Low-Mod National Objective	90 %	86 %	88 %
Low-Mod Job Creation	*71*	*74*	*73*
Low-Mod Area Benefit	*18*	*9*	*13*
Low-Mod Limited Clientele	*1*	*3*	*2*
Low-Mod Housing*	*0*	*0*	*0*
Slums/Blight Elimination	10	13	12
Total	**100 %**	**100 %**	**100 %**

*Low-Mod Housing is not a valid national objective for Third-Party loans.

Source: Urban Institute Economic Development Funding Database--Third-Party Lending Study, 2002.

Grantees carry out a similar range of economic development activities with Section 108 funds. Table 2.11 shows the number of entitlement communities that used Section 108 during the 1990s for each of eight activity categories, as reported in the Community Development Administrators Phone Survey. The greatest number of local grantees (67 percent) used Section

108 to assist large commercial, retail, or industrial establishments. Other common economic development uses involved support for public infrastructure and small commercial, retail, or industrial establishments. These categories overlap with the activity categories in which grantees spent most of their CDBG funds (see Table 2.9).

Table 2.11
Local CDBG Entitlement Grantee Uses of Section 108 Economic Development Funds (1990's)

Section 108 Use	Number of Grantees	Percent of Grantees*
Larger Commercial/Retail/Independent Establishments	116	67 %
Public Infrastructure	66	38
Small Commercial/Retail/Independent Establishments	62	36
Publicly-owned Facilities	41	24
Facade Improvement Program	27	16
Micro-enterprises	26	15
Technical Assistance/Training	11	6
Job Training	11	6
Other Activities	38	22
Total Respondents	**174**	

*Total exceeds 100 percent as grantees gave multiple responses.

Source:Urban Institute Community Development Administrators Phone Survey--Third-Party Lending Study, 2002.

Table 2.12
Local CDBG Entitlement Grantee Uses of EDI/BEDI Funds (1990's)

EDI/BEDI Use:	Number of Grantees	Percent of Grantees*
Interest Subsidy or Other General Project Support	40	53 %
Environmental Remediation, or Brownfields Development	30	40
Public Infrastructure	24	32
Land Write-down	20	27
Other Purpose	29	39
Any Use	75	

*Total exceeds 100 percent as grantees gave multiple responses.
Source:Urban Institute Community Development Administrators Phone Survey--Third-Party Lending Study, 2002.

The Community Development Administrators Phone Survey also explored how entitlement communities have used EDI/BEDI funds. Table 2.12 shows that a majority of them

(53 percent) used EDI/BEDI as an "interest subsidy or for "other general project support," such as a loan loss reserve, although substantial numbers of grantees used the funds for other purposes. In addition, 39 percent used EDI/BEDI for another purpose not specified on the survey. Of the grantees responding in the "other" category, 38 percent can be classified as "Section 108 repayment," and 24 percent as "technical assistance." These uses reflect the intended role of EDI/BEDI funds: to leverage larger investment amounts and reduce the risk of using Section 108.

The phone survey also asked what financial arrangements grantees used to structure their use of EDI/BEDI funds. As Table 2.13 shows, a majority of jurisdictions used these funds as a grant to a Section 108 project, including uses of funds as "in-kind" assistance; e.g. situations where a jurisdiction would use EDI/BEDI to cover the public cost of infrastructure, project facilities or other publicly-owned project element. Other common EDI/BEDI uses include as a loan loss reserve (38 percent of grantees), to be used in case a third-party borrower defaults on a Section 108 loan, or as a below-market rate loan. (Eighteen of these loans were included in our third-party lending sample.)

Table 2.13
Distribution of Local Officials' Decisions on Structuing EDI/BEDI-funded Assistance*

EDI/BEDI Structuring	Percent of Communities Using EDI/BEDI
As a grant, including in-kind assistance	60 %
As loss reserves for a Section 108-funded loan	38 %
As a below-market rate loan	31 %
Number of Respondents = 75	

*Respondents include officials in jurisdictions that have used EDI/BEDI funds in conjunction with Section 108 funds for economic development activities since 1990.

Source: Urban Institute Community Development Administrators Survey--Third-Party Lending Study, 2002.

"Explaining" Differences in Economic Development Funding

Previous sections have described the spending patterns that result from local grantees' exercise of discretion over how CDBG, Section 108, and EDI/BEDI funds are used for economic development and third-party lending. Recall that grantees, themselves, decide whether to fund economic development and, if so, the level of funding they will provide, the source of that funding, the timing of that funding, and the types of economic development activities they intend to pursue. This section explores, in more depth, the types of communities that are likely to use CDBG and Section 108 for economic development and third-party lending purposes and the types of communities that are likely to spend more. It should be noted that, while the section highlights some of the factors involved in determining which grantees use different programs for economic development, there is no attempt to conclusively explain these differences.

Entitlement communities. Although a majority of entitlement grantees funded economic development and one-half of them funded third-party loans using CDBG in the 1990s, there were clear differences in the use of the program for these purposes. Table 2.14, which categorizes entitlement grantees according to three characteristics, illustrates these relationships. Grantee characteristics include: a measure of grantee size (grant size in 1999); a summary measure of community development need (1990 community "distress"); and grantee type (central city, suburban city, or urban county). By comparison to other types of communities, larger, more distressed central cities and urban counties are more likely to:

- *Fund economic development*—for example, 100 percent of grantees with grants over $10 million used CDBG to fund economic development compared to 75 percent of grantees with grants $750,000 or less (Column 3).
- *Dedicate a greater share of all CDBG expenditures to economic development*—for example, the most distressed cities on average spent 11 percent of their annual grant on economic development, compared to four percent for the least distressed cities (Column 4).
- *Fund economic development more consistently*—for example, central cities and urban counties on average funded economic development more than one in every three years (38 and 35 percent of years, respectively), compared to the less than one in every five years for suburban cities (19 percent) (Column 5).
- *Fund a greater range of economic development activity types*—for example, grantees with grants over $10 million funded an average 6.25 types of activity a year (see Table 2.9) compared to an average 3.45 activity types for grantees with grants $750,000 or less (Column 6).
- *Fund third-party loans*—for example, the 77 percent of the most distressed grantees that funded economic development also funded economic development loans, compared with just 26 percent of the least distressed grantees (Column 8).

All together, these findings paint a picture of the kinds of factors that are likely to drive a greater commitment to economic development. To start, highly distressed central cities and urban counties are more likely to have the kinds of community development needs that demand investments in economic development than less distressed, suburban cities—including higher unemployment, less business activity, and a lower skilled work force. On the supply-side, larger jurisdictions are likely to have more and larger economic development projects available more consistently. Moreover, larger and more distressed grantees are more likely to have large enough grants that they are able to spend on multiple types of activities every year.

Smaller, less distressed grantees may fund fewer categories either because their grant amounts are small, forcing them to choose between funding economic development and other

community development priorities—such as housing, public facilities, or public services. Small grant sizes may explain why smaller, less-distressed, suburban cities that opt to fund third-party loans are likely to spend a greater share of their economic development funds on loans—see Table 2.14, Column 9. Loans, when repaid, generate program income that offsets the cost to the community of funding economic development.

Finally, larger grantees are more likely to have a greater level of expertise in economic development and loan programs, giving them the capacity to fund such activities more efficiently, to fund a greater range of activities and, as the opportunities arise, to pursue additional funding opportunities (such as EDI/BEDI) more effectively.

Section 108 is one of the additional funding sources CDBG grantees can pursue and, not surprisingly, many of the patterns observed with the use of CDBG for economic development and third-party lending are also evident in the use of Section 108 (see Table 2.15). Officials of larger, more distressed central cities and urban counties are more likely than others to use Section 108 to fund economic development (Column 5) and third-party loans (Column 11). These grantees are likely to have more expertise with loan programs and may be indifferent to using Section 108 or CDBG—since they have large enough regular CDBG grants to fund most Section 108 projects. Larger grantees also have more large projects available in their jurisdictions, so they can absorb more Section 108 funds.

Smaller, less distressed suburban cities are, however, likely to spend a greater share of their Section 108 resources for economic development (Column 6) and third-party lending (Column 12), and Section 108 is likely to account for a greater percent of their combined economic development funding (from all sources) (Column 9). Unlike their large counterparts, small, less distressed suburban cities that use the Section 108 program may do so to fund projects that they would not be able to afford out of their regular CDBG grants.

States. States spent proportionately more on economic development than entitlement grantees and, overall, funded about the same proportion of economic development through third-party loans as did entitlement jurisdictions. However, with a smaller number of grantees and a more even distribution of spending in the state program, there is less overall variation in the economic development funding patterns of states. Still, a few significant trends deserve further discussion, inasmuch as they reinforce the patterns observed among the grantees in the entitlement program. For instance, the factors driving local grantees to fund economic development affect state grantees in a similar way. Covering large areas, states are likely to have many projects available to fund and a large enough grant to spend on multiple areas or activities every year. Therefore, in general, states also appear to exhibit funding patterns similar to larger, more distressed entitlement jurisdictions.

Table 2.14
Local CDBG Entitlement Grantee Economic Development and Third-Party Loan Funding, 1990-99, by Selected Grantee Characteristics

Select Grantee Characteristics		(1) Total Number of Grantees	(2) Number of Grantees Funding Economic Development with CDBG	(3) Percent of Grantees Funding Economic Development with CDBG	(4) Average Percent of CDBG Spent on Economic Development	(5) Average Percent of Years with CDBG Funding for Economic Development	(6) Average Number of Economic Development Activity Types Funded by CDBG Per Year*	(7) Number of Grantees Funding Third-Party Loans with CDBG	(8) Percent of Grantees Funding Economic Development with CDBG	(9) Percent of Economic Development Grantees** Funding Third-Party Loans with CDBG
Grant Size 1999	$750,000 or Less	269	202	75 %	7 %	14 %	3.45	69	34 %	50 %
	$750,000 to $2,000,000	361	335	85	7	26	4.26	172	48	43
	$2,000,000 to $10,000,000	286	269	90	8	48	4.99	185	56	37
	Over $10,000,000	45	45	92	11	82	6.25	43	63	22
1990 Distress Quintile***	Least Distressed	118	96	81	4	8	3.66	23	24	44
	Quintile 2	127	116	91	7	28	4.37	67	58	37
	Quintile 3	125	119	95	8	36	4.68	83	70	40
	Quintile 4	127	121	95	8	43	4.73	76	63	35
	Most Distressed	123	120	98	11	56	5.24	95	79	35
Grantee Type	Central City	559	512	92	8	38	4.57	331	65	38
	Suburban City	261	208	80	6	19	3.68	66	32	43
	Urban County	146	133	91	6	35	4.60	73	55	42

*Maximum number of activity types is seven.

** "Economic Development Grantee" is a grantee that funds economic development.

*** Distress scores measure community distress based on three factors: poverty, age of housing and economic decline, and density.

Source: Urban Institute Economic Development Funding Database--Third-Party Lending Study, 2002, Distress Scores from HUD/PD&R.

3G Entitlement Grantee Section 108 Economic Development and Third-Party Loan Funding, 1990-99,
nd Grantee Characteristics

Select Grantee Characteristics		(1) Total Number of Grantees	(2) Number of Grantees with Section 108 Funding	(3) Percent of Grantees with Section 108 Funding	(4) Number of Grantees Funding Economic Development with Section 108	(5) Percent of Grantees Funding Economic Development with Section 108	(6) Average Percent of Section 108 Spent on Economic Development	(7) Number of Grantees Receiving EDI/BEDI Award	(8) Percent of Grantees Funding Economic Development with Section 108	(9) Average Percent of Combined Economic Development Funded with Section 108	(10) Number of Grantees Funding Third-Party Loans with Section 108	(11) Percent of Economic Development Grantees Funding Third-Party Loans with Section 108	(12) Average Percent of Section 108 Economic Development Funding Spent on Loans
1999	$750,000 or Less	237	67	28 %	16	24 %	100 %	6	38 %	66 %	10	63 %	92 %
	$750,000 to $2,000,000	236	68	26	75	69	87	28	44	65	10	29	40
	$2,000,000 to $10,000,000	229	95	41	106	69	84	64	61	55	23	35	50
	Over $10,000,000	242	104	43	35	80	80	37	76	47	39	47	41
ss Quintile*	Least Distressed	118	22	19	10	45	89	4	40	72	1	10	1
	Quintile 2	127	48	38	26	54	94	13	50	59	7	27	76
	Quintile 3	125	51	41	31	61	83	19	61	58	11	35	40
	Quintile 4	127	56	44	46	82	89	28	61	60	18	39	41
	Most Distressed	123	82	67	68	83	84	53	78	50	31	46	52
pe	Central City	559	233	42	163	70	86	104	64	55	63	39	51
	Suburban City	261	65	25	41	63	85	18	44	71	11	27	43
	Urban County	146	39	27	28	72	81	13	46	56	10	36	31

ores measure community distress based on three factors: poverty, age of housing and economic decline, and density.
n Institute Economic Development Funding Database--Third-Party Lending Study, 2002, Distress Scores from HUD/PD&R.

Table 2.16 considers the funding patterns of states by comparing grants that are above and below the median. There is little difference in the extent to which larger and smaller grantees allocate CDBG funds to economic development. However, as with smaller entitlement grantees, states with smaller grants display a greater reliance on third-party loans to fund economic development—with 40 percent of their economic development funding spent on loans versus 27 percent for larger grantees. States with smaller grants may face funding constraints that discourage more munificent forms of assistance.

As with the entitlement grantees, larger state grantees are more likely to participate in Section 108 projects. Furthermore, smaller state grantees that use Section 108 rely more heavily on the program; an average 41 percent of their total economic development funded through Section 108 compared to 24 percent for larger grantees. This may also be due to funding constraints; small states may use Section 108 funds to extend the funds available to support large economic development projects when there is not enough CDBG funding available to do so without reducing funding for other community development priorities.

Table 2.16
State CDBG Entitlement Grantee Economic Development and Third-Party Loan Funding, 1990-99, by Select Grantee Characteristics

Select Grantee Characteristics	Total Number of States**	Average Total CDBG, 1990-99 (in millions)	Number of States Funding Economic Development with CDBG	Average Percent of CDBG Spent on Economic Development	Number of States Funding Third-Party Loans with CDBG	Average Percent of CDBG Economic Development Funding Spent on Loans	Average Total Section 108 Amount 1990-99 (in millions)	Average Percent of Combined Economic Development Funded with Section 108
Grant Size, 1999*								
Less than Median Amount	24	$83	23	19 %	19	40 %	$8	41 %
More than Median Amount	25	321	25	19	22	27	18	24
Census Region								
Northeast	9	141	8	15 %	7	39 %	27	60 %
South	16	264	16	18	14	18	9	15
Midwest	12	233	12	28	10	63	28	27
West	13	97	12	16	10	29	5	23

*Median Grant Size in 1999 was $20,776,069.
**For grant size, number of States includes Puerto Rico, but data are unavailable for New York and Hawaii. For Census Region, number of States does not include Puerto Rico.
Source: Urban Institute Economic Development Funding Database--Third-Party Lending Study, 2002.

States' funding patterns also show variation by region. Those in the Midwest fund economic development at a much higher level (28 percent of total CDBG) than those in other regions, which diverge only slightly from one another. Midwest states also fund third-party loans with CDBG at the highest level, 63 percent, however, here with considerable difference among the other regions. States in the Midwest and the Northeast, the two regions with the greatest Section 108 award amounts, incorporate the Rust Belt. These areas may be more likely to contain highly distressed communities that are too small to qualify for CDBG funding in the entitlement community program. Greater distress in these regions corresponds to a greater

demand for economic development assistance, as seen in the entitlement communities with the highest distress scores.

Conclusion

This chapter has examined patterns and trends in community funding of economic development and third-party lending activities over the past decade with HUD's CDBG, Section 108, and EDI/BEDI programs. While nearly all entitlement and state grantees used CDBG for economic development purposes at some point or other over this period, varying levels of use reflect the diverse priorities of local communities and their respective capacities and needs for economic development funding. The program allocation formulae that result in CDBG funding levels to entitlement grantees provide greater amounts of money for larger, more distressed communities, and it is these communities that account for most of the CDBG-funded economic development activity that took place across the nation. Smaller communities with smaller grants were less likely to fund economic development with CDBG, but smaller communities funding third-party lending on economic development relied more heavily on loans. These patterns are also reflected in Section 108 usage patterns, where the largest grantees that funded economic development at high levels with CDBG funds are also more likely to have used Section 108, as well.

Having established how usage patterns and trends involving funding allocations for economic development and third-party lending are associated with grantee attributes, it is useful to turn next to consideration of how program usage is affected by HUD program requirements. This is the focus of Chapter 3.

CHAPTER 3: PROGRAM ADMINISTRATORS' PERSPECTIVES ON CDBG AND SECTION 108 PROGRAM REQUIREMENTS

Highlights

It is clear from the evidence in Chapter 2 that larger, more distressed cities and urban counties are the most frequent users of CDBG and Section 108 for third-party lending purposes—spending more money, more consistently, and in greater amounts than smaller, less distressed suburban communities. This implies that these federal programs not only allow localities to make choices, but that local conditions and needs, in fact, drive the creation of business lending as an appropriate programmatic response. Analysis of the effects of federal CDBG and Section 108 program requirements on local decisionmaking in the present chapter reinforces this general conclusion; the rules generally do not function to distort local choice.

None of the main federal requirements associated with the CDBG or Section 108 programs seem to pose a major hindrance to the majority of local officials charged with administering them. That notwithstanding, however, a substantial minority are concerned about the effects of low- and moderate-income job creation requirements on their loan programs, primarily because these are perceived to increase costs to businesses and to administering agencies. While some grantees see these and other rules as detrimental to their interest in carrying out third-party lending programs, it should be mentioned that some of this appears to be due to grantee misunderstandings about the range of options available to them. The confusion often centers on rules for qualifying expenditures as meeting national objectives, which, in the view of many local officials, requires them to qualify most expenditures in terms of low-income job creation. In reality, however, other options may be available that may be less burdensome to smaller business or to certain neighborhood programs, indicating a need for more guidance in this area.

With respect to Section 108, smaller users of the program (measured by the size of Section 108 lending programs) appear least willing to accept the special requirements that pertain to that program—including the long-standing requirement that a community's CDBG funding be pledged against loan repayment. In this regard, local community development officials attach considerable value to EDI and BEDI as tools to help them reduce what, to some, is a substantial risk: 16 percent of those who have used Section 108 for third-party lending purposes have had to use CDBG funds to make payments on loans for which businesses have defaulted on their obligations. Also, additional security requirements introduced in 1996 and the considerable time required to receive HUD approval of Section 108 applications are issues of concern to a broad spectrum of grantees.

State program administrators second the concerns raised by some local entitlement grantees concerning the difficulty of complying with the income and documentation requirements of the job creation national objective. They appear to be more risk-averse in response to Section 108 requirements than local grantees in that three of the four state Section 108 borrowers interviewed for this study reported they would not apply to the program in the future—largely because of disappointing loan repayment performance on the part of borrowers.

Introduction

For local governments to be in a position to promote economic development, they need to be able to respond to development opportunities as they arise. Response requires flexibility, and one of the considerable virtues of the federal CDBG and Section 108 programs is the flexibility they afford local officials wishing to pursue economic development aims. Some communities focus on large-scale industrial and commercial revitalization projects while others concentrate on lending to small business; some emphasize job creation while others devote attention to revitalization of commercial areas. This flexibility is the hallmark of the CDBG program, and local program administrators clearly value the economic development benefits that the program allows them to produce for their communities.

The broad embrace of the objectives and activities involved in lending to businesses is indicated by the fact that one-half of all entitlement jurisdictions and 86 percent of states use CDBG funding for this purpose. But equally true is the fact that not all states or entitlement communities do so, and Chapter 1 alluded to historical, situational, and perceptual differences across communities that may explain this. Moreover, Chapter 2 suggested that highly distressed central cities and urban counties are more likely to have the kind of community development needs that call for investments in economic development, including third-party lending, than less distressed suburban communities. Grantees with larger populations and CDBG entitlement amounts are likely to have more and larger economic development projects to fund more consistently, and the funding available to pursue a broad range of activities.

So long as disinclination to use CDBG and Section 108 for third-party lending purposes reflects local priorities and community development needs, use or non-use of these programs for third-party lending purposes has little policy import. Yet, in the past, some grantees complained that federal program requirements had made it unnecessarily difficult for them to use the programs for third-party lending purposes. Since then, as noted in Chapter 1, HUD revised its regulations to accord grantees more flexibility and regulatory clarity, as well as to respond to changes in statutes. As noted in Chapter 2, the introduction of EDI/BEDI shows that Section 108 use increased among grantees that took advantage of these new programs. Even so, regulatory hindrances are still a possibility. HUD's "statement of work" initiating this research, for example, describes the Section 108 program as historically "underused," while a 1997 U.S. General Accounting Office (GAO) study ascribed unwillingness to use it as due to community concerns over collateral requirements and a reluctance to pledge future CDBG program allocations against Section 108 borrowing.

This chapter examines whether federal program requirements are, indeed, perceived to hinder state and local third-party lending activities supported by CDBG and Section 108 funds and, if so, how. Considered are two types of unwanted effects that such requirements may impose: for some grantees or business borrowers, they could entail unacceptably high costs;

and, for a subset of them, these costs may lead to a disinclination to pursue specific types of third-party lending options or to discontinue such lending altogether. Finally, this chapter describes several aspects of state and local program administration that will be helpful in understanding some of the analyses presented subsequently in Chapters 4 and 5.

Sources and Uses of Information

To assess program administrators' perspectives regarding CDBG and Section 108 program requirements, information is drawn from three surveys:

- The Community Development Administrators Phone Survey;
- The Community Development Administrators On-Site Survey; and
- The State Community Development Administrators Phone Survey.

The first of these posed a series of closed-ended questions dealing with CDBG and Section 108 program administration to local officials, seeking their views on various federal requirements for the operation of local third-party lending programs.[1] One sub-group—administrators not currently operating such programs—was asked about the effects, if any, of federal requirements relative to other factors (such as local business demand for loans, loan repayment performance, and local economic development priorities) on their decision not to do third-party lending. Another sub-group—administrators currently operating third-party lending programs—was asked to evaluate the degree of "hindrance," if any, to their programs posed by various federal requirements. The second survey was more open-ended, collecting detailed information that was intended to both confirm areas of priority concern uncovered in the telephone survey and further explore how these areas affect local decision-making.[2] The third survey inquired about state officials' perspectives on program requirements.[3]

In collecting and using information about perceived program hindrances, an attempt was made to avoid uncritical acceptance of grantee complaints or the presumption that such complaints are indicative of regulatory burden, *ipso facto*. Administrators engaged in day-to-day program operations are obligated to structure and document their activities in ways that comply

[1] As noted in Chapter 1, this survey also asked about loan management and underwriting policies and practices. These results are discussed in Chapter 5.

[2] These involved hour-long, semi-structured interviews covering regulatory, underwriting, loan management, and secondary market issues as well as local program administration and the perceived effects of program requirements.

[3] The survey also asked about types of economic development activity (reported in Chapter 2), aspects of underwriting and loan management practices (reported in Chapter 5), and interest in secondary market sales (reported in Chapter 6).

with federal requirements—intended to ensure that public purposes are met and to justify past and future appropriations of funding for such programs. However valuable, in fact, this outcome is to local programs, programmatic and documentary efforts to ensure compliance convey no immediate rewards to administrators, who may, therefore, be inclined to exaggerate the costs and underplay the benefits of such obligations. To help to minimize these problems:

- The surveys inquired about the effects of program requirements only of staff currently operating programs, or of those who had some prior experience with them;
- The surveys asked about the relative weight of program requirements compared to local priorities only of officials who exercised a clear choice to enact or discontinue programs;
- The analysis considered only those who cited program requirements as "major" hindrances as indicative of potential problems (on the assumption that those reporting "minor" hindrance were reflecting "background" annoyance with program requirements);
- Credence was accorded to telephone survey results only if they were corroborated by on-site interview information on the breadth and depth of the effects of federal requirements on their programs; and
- The effects of any particular program requirement were examined only as they compared to other program requirements, not to an administrator's view that the requirements were, in themselves, burdensome or unwanted.

In addition, it should be noted, respondents to the Community Development Administrators Phone and On-Site surveys are an experienced group of administrators. The former had an average of seven years of experience in economic development and even more years in the administration of the CDBG program; the latter had five years and seven years of experience, respectively.

CDBG Program Administration and Program Requirements

In the CDBG program, local governments must designate agencies responsible for program design and implementation. Among program implementation responsibilities are verification and documentation of agency and borrower compliance with federal requirements. This section both describes the administrative arrangements local governments establish in their CDBG programs for operation of third-party lending programs, and examines some of the effects of CDBG program requirements on program operations.

Local administration of CDBG-funded third-party lending programs. As noted in Chapter 1, a major design option for third-party lending programs is where to lodge administrative responsibility. Each state or unit of general local government may select one or more agencies to operate CDBG and Section 108 programs, and may choose the type of agency or agencies it so designates. Earlier research on the entitlement community portion of the CDBG program indicated that most grantees designated a community development agency as the lead repository of programmatic responsibility, with the remainder consisting of staff departments, line agencies, or independent authorities. But, more than one-half of all entitlement communities also designated one or more additional agencies to handle portions of their program. In fact, about 43 percent of all economic development spending was allocated to so-called "sub-recipient" agencies. (Only public services expenditures—among acquisition and clearance, housing rehabilitation, and public facilities activities—exceeded this share.)

In Brief: Key Regulations and Requirements

As discussed in Chapter 1, the following HUD regulations and requirements apply when CDBG funds are used to originate loans to businesses:

Low-and moderate-income focus of job creation and retention activities—The primary beneficiaries of the jobs created or retained by third-party loans must be persons of low- and moderate-income—i.e., at least 51 percent of the permanent jobs (computed on a full time equivalent, FTE, basis) created or retained must be made available to or held by low- and moderate income persons.

Job creation and retention documentation— Jurisdictions must keep records as to the number of new jobs created by the business locating in the community and/or the number of existing jobs that were not lost because the business stayed in the area.

Level of public benefit standards—The jurisdiction must demonstrate that by originating the loan the community will profit from the business enterprise (typically in terms of the number of jobs that are created/retained or the number of low- and moderate-income persons receiving services). (See Exhibit 3.1 and Chapter 1 for more detail.) There are maximum caps in the HUD regulations as to the amount of CDBG funds that may be spent per job or per low- and moderate-income person getting services.

Public benefits standards documentation— Jurisdictions must produce paperwork to show that public benefits standards are being met.

Types of eligible economic development activities—HUD has promulgated rules regarding the types of economic development activities that can and cannot be funded using CDBG money.

Information collected for this study indicates that the general pattern of agency assignment and sub-recipient use for CDBG third-party lending resembles that found in the earlier study pertaining to economic development activities generally. For CDBG, 38 percent of local entitlement grantees (including both cities and urban counties) use more than one agency to administer their lending programs, and ten percent use more than two. Consistent with earlier findings, most of these (79 percent) are community development agencies, but communities rely relatively heavily on nonprofit agencies (33 percent), economic development departments (12 percent), and redevelopment authorities (16 percent).

Reliance on nonprofit agencies requires comment. Nonprofit organizations involved in third-party lending are generally sub-recipient agencies. They are accountable to the federal government at one step removed from the local jurisdictions that are the direct recipients of

federal funds. Previous research established that community development program administrators rate non-profits much less highly than public agency sub-recipients in their ability to carry out compliance activities related to eligibility determinations and financial management.[4] In this research, however, nonprofits were neither better nor less able to produce the documentary information requested by the study team of local loan program administrators.[5]

The effect of CDBG program requirements. Agencies administering CDBG programs are under an obligation to safeguard taxpayer interests, which include the assurance that key national objectives are being met, that funded activities correspond to eligible community development purposes, and that assistance is appropriate given the level of public benefit produced. Therefore, the Congress requires CDBG grantees and Section 108 borrowers to follow statutory program objectives, eligible activities, and other requirements. These legal prescriptions are given further definition by Agency regulations. Chapter 1 described these program requirements, which consist of three broad categories of prescribed actions or limits on program activity and the need to document compliance with these prescriptions (see Exhibit 3.1). Ideally, such laws and regulations would clearly specify what is required to accomplish national purposes but not be so vague or restrictive as to limit local ability to seize legitimate development opportunities. This tension between federal interests and local flexibility has waxed and waned over the years since the CDBG program's inception.

[4] *Federal Funds, Local Choices*, *op. cit.*, Table 6.11, pp. 6-37.

[5] In one instance, however, a nonprofit organization refused to grant the research team access to their files, and the CDBG recipient agency claimed to have no influence over their decision to do so. In another instance, a non-profit organization initially refused to cooperate and, for a time, the recipient agency was unsuccessful in encouraging participation. Ultimately, however, the non-profit organization agreed to participate.

Exhibit 3.1
CDBG and Section 108 Program Requirements

The following is a recap of HUD program requirements pertaining to national objectives, eligible activities, and public benefits, as outlined in Chapter 1:

National objectives requirements—each activity involving CDBG or Section 108 funds must meet one of three national objectives:

- *Benefit to low- and moderate-income (LMI) persons:* Although some economic development activities may be documented under the LMI area-benefit national objective (i.e. an activity that benefits all residents in a particular area where at least 51 percent of the residents are low- and moderate-income), most are documented under the LMI job creation/retention national objective, while the LMI limited clientele may be used with some micro-enterprise and job training activities.
- *Aid in the prevention or elimination of slums and blight:* To qualify under this national objective, activities must either prevent or eliminate slums and blights on an area basis, prevent or eliminate slum and blight on a spot basis, or be related to completing projects under the Urban Renewal program.
- *Meet other urgent community development needs*: To qualify as an urgent need, existing conditions must pose a serious and immediate threat to the health or welfare of the community; they must be of recent origin or recently have become urgent, and the community must be unable to finance the activity on its own. (Due to these requirements, this national objective is generally not used with economic development activities.)

Eligible activities requirements—economic development activities may involve the following:

- Special economic development activities;
- Micro-enterprise activities;
- Commercial rehabilitation;
- Special activities undertaken by CBDO's; or
- Public facility activities.

Public benefits requirements—*t*o ensure a sufficient return for CDBG or Section 108 investment in economic development projects, HUD developed and promulgated through regulation public benefit standards that are triggered for economic development activities qualified under: (a) the special economic development category; (b) public facility activities designed to create jobs where these jobs cost more than $10,000/FTE; and (c) economic development activities undertaken by a CBDO that would otherwise qualify under special economic development. These standards are:

- *For individual projects*, community grantees need either to spend no more than $50,000 of CDBG or Section 108 resources per FTE job created or retained ("jobs test") or to spend no more than $1,000 of CDBG or Section 108 resources per LMI person receiving goods or services ("goods-and-services test"); or
- *The aggregate rule:* For an entire program year, community grantees must add together their expenditures and benefits with respect to the types of activities noted above. The average of the projects under the "jobs" test can be no more than $35,000 of CDBG or Section 108 resources per FTE job created or retained. The average of the "goods-and-services" test can be no more than $350 of CDBG or Section 108 resources per LMI person receiving goods and services.

As noted above, CDBG program requirements may exert two kinds of unwanted effects on local programs: (1) they may unnecessarily impose costs on grantees or local businesses; and (2) as a result, they may deter grantees from pursuing legitimate community development activities because of community unwillingness or inability to absorb the costs involved. (These same costs apply to the Section 108 program, as well, and will be discussed in the next section.) To determine whether grantees, in fact, have rejected certain kinds of program activities as a result of federal requirements, a series of factors were identified—in addition to program requirements—that could influence these choices. Local officials were asked to comment on whether any of these factors influenced their decisions; they were offered the option of choosing from among both community-level and program-related factors (see Exhibit 3.2).

Exhibit 3.2
Possible Factors Influencing Local Decisionmakers

Local officials were asked to comment on whether any of the following several community-level or program-related factors influenced their decisions:

- **Local policy considerations, like:**
  - *Changing local priorities for the use of CDBG funds*—e.g., a shift in the relative importance of economic development and affordable housing on the local community development agenda; or
  - *A shift in local policy pertaining to aid to private business*—sometimes regarded by local political decision-makers as a less appropriate activity for government compared to investments in public works or government-provided services.
- **Market features, like:**
  - *Low business demand* for government-supplied loan funds, even at the discounted rates typically available, relative to other parties' demand for funds from other CDBG- or Section 108-funded programs; or
  - *Low economic development benefit from third-party lending*, compared to the benefits achieved through other development activities; e.g., grant programs to upgrade commercial facades, or public expenditures for infrastructure rehabilitation.
- **Poor repayment experience, like:**
  - *Poor loan repayment experience* (if the locality had been operating a CDBG or Section 108-funded third-party lending program.
- **Availability of other funds, like:**
  - *The availability of funds other than CDBG or Section 108* to carry out third-party lending activities.
- **Program requirements, like:**
  - *CDBG requirements for economic development,* including the income requirements for 51percent of persons hired, eligible activities, public benefits, and the need to document these; and
  - *Overall CDBG program requirements,* including Davis-Bacon, environmental review, relocation, and other requirements that pertain to CDBG and other federal programs.

It appears as if program requirements barriers induced only a relatively few, and mostly small entitlement grantees to discontinue using CDBG funds for third-party lending.[6] For instance, about 15 percent of grantees that administered third-party lending programs during the 1990s had no such program at the time of the survey in 2002. These "inactive" grantees spent about one-third the amount of money on economic development activities as did the grantees currently operating third-party lending programs. As shown in Table 3.1, about one-third of these inactive grantees report that CDBG requirements or rules for economic development were major factors in program discontinuation.[7] A similar proportion cites local policy factors, market circumstances, or poor experience with loan repayment. Only seven of the 48 grantees (15 percent) in this category cite regulatory requirements as their *only* reason for discontinuation of third-party lending activities.

Table 3.1

Decision Factors Influencing Local Officials' Decisions to Discontinue Using CDBG funds for Third-Party Loans, by Level of Importance*

	Level of Importance**		
Decision Factor	Very Important	Not Very Important	**Row Totals**
CDBG Rules/Program Requirements	36%	64	**100%**
Local Factors**	34%	66	**100%**
Poor Loan Repayment	31%	69	**100%**
Other Funds Available	25%	75	**100%**
Insufficient Staff Capacity	19%	81	**100%**
Market Demand***	19%	81	**100%**

Number of Communities = 43

*Respondents consist of entitlement community officials who are not currently using CDBG funds for third-party lending, but who have done so at some point during the last 10 years.

**Includes responses of "changing local priorities" and "local policy to assist businesses".

***Includes responses of "low demand from local businesses" and "low economic development benefit".

****Percentages exclude those responding "Don't Know" or who refused to answer.

Source: Urban Institute Community Development Administrators Survey--Third-Party Lending Study, 2002

[6] Source: Community Development Administrators Phone Survey.

[7] The reader should be aware that some of the tables used in this report focus on a specific sub-sample of a larger sample. Hence, the total number of cases may vary from table to table, as indicated in each table's nomenclature and notation.

Those currently operating third-party lending programs are in a position to comment on the effect these requirements have on program decision-making or operations. While it does not make sense to examine the overall effect of requirements in general (since most of these effects are considered desirable from a national perspective), it does make sense to ask grantees about the effects of specific requirements, relative to one another. If certain of them are viewed as a hindrance more than others, these become candidates for more aggressive HUD technical assistance and program monitoring (if not for efforts to revise regulations or policies to make compliance easier).

About one-half of all grantees report that *none* of the CDBG rules or program requirements identified in Table 3.2 poses a major hindrance to their programs. Most of those who cite any major hindrance identify only one requirement from the list of five available. The most often cited single hindrance is the obligation to meet and document compliance with the job creation national objective—reported both by those currently operating lending programs as well as those who discontinued their programs at least in part because of their wish to avoid certain program requirements. Relatively unimportant as program hindrances are requirements tied to eligible activities or public benefit. Difficulty complying with the jobs national objective appears to be general across all types of programs or grantees, while difficulty complying with eligible activities or public benefit requirements appears to be a problem only for smaller grantees. These results are confirmed by on-site interviews with local community development administrators and managers of third-party lending programs.

Table 3.2
Types of CDBG Legal and Regulatory Provisions that Local Officials Believe Hinder CDBG-funded Third-Party Lending Programs*

	Extent of Hindrance			
Nature of Hindrance	**Major Hindrance****	**Minor Hindrance****	**Not a Hindrance****	**Row Totals**
Job Creation Documentation	28%	38	33	**100%**
Income Requirements	23%	46	31	**100%**
Level of Benefits Documentation	16%	41	43	**100%**
Eligible Activities	11%	31	58	**100%**
Required Level of Benefits	9%	37	54	**100%**

Number of Respondents = 223

*Respondents include the 223 officials in jurisdictions that currently originate third-party loans to businesses using CDBG funds.

**Percentages exclude those responding "Don't Know" or who refused to answer.

Source: Urban Institute Community Development Administrators Survey--Third-Party Lending Study, 2002.

Judging by the types of comments recorded by the research team on-site, compliance with the income and documentary requirements tied to the job creation national objective is problematic primarily because of the costs in terms of staff time and aggravation they impose on development agencies and businesses. Further, borrowers sometimes resist the requirement to collect personal information from prospective employees whose jobs are created or retained as a result of third-party loans, and many administrators noted the challenge in getting such borrowers to comply with reporting requirements *after* they received a loan.

Compliance costs are one explanation for the "hit-or-miss" quality of local documentation of job creation. In both HUD's automated data systems and in grantee files, approximately 30 percent of loans lack information about jobs that are generated by business borrowers. Although not all grantees who were visited on-site could produce complete job information, documentary problems were especially concentrated in 13 of 51 sampled communities: in those places, information about jobs generated by third-party loans could not be obtained for 30 percent or more of sampled loans.[8]

Another obstacle to program implementation cited by some local officials pertains to federal Davis-Bacon requirements. Grantees identify two central concerns: Davis-Bacon increases their costs and it discourages some contractors, especially small and minority firms, from bidding on work. This perception has surfaced in many other studies, including the 1995 Urban Institute CDBG study where two-thirds of all grantees report Davis-Bacon as being a "large" or "somewhat large" obstacle.

In terms of actual program choices, the most serious effects of program requirements on grantee third-party lending activities appears to be in:

- *Lending to micro-enterprises and small businesses*—primarily due to the burden on these small businesses posed by the need to screen employees for income and document their income levels, which poses a further burden on grantees to provide technical assistance to these borrowers and to follow-up with them more thoroughly. This burden has led several grantees to discontinue funding micro-enterprise programs altogether.
- *Assistance to expand into the high-technology companies*—a way to attract both revenue and new jobs to their communities, because most of those with the skills to qualify for these jobs would be over the LMI limits. Several local officials valued the

[8] These data were sought and requested in all communities. In eight of them, the research team could not obtain these data even after diligent efforts to do so; in five others, these data may have been obtained if the research team could have devoted more extensive efforts to acquire them.

multiplier effect on lower wage businesses of attracting industries that employ higher skilled, higher-salary workers.[9]

- *The difficulty of qualifying façade improvement programs under a national objective*—believing that job creation was their only choice.

Given the nature of the comments made by community development administrators, however, it appears as if there is relatively widespread misunderstanding of the real flexibility available to them. Micro-enterprise lending need not entail the level of compliance burden that would be acceptable to larger projects. For example, if CDBG or Section 108 loan assistance is provided to a micro-enterprise that is *owned* by a low- or moderate-income individual, then the loan can qualify under the limited clientele national objective and not be subject to low-mod job creation requirements. Similarly, façade improvement programs need not be qualified under a job creation national objective: other communities qualify façade programs under the LMI area benefit national objective.

Special Section 108 Program Issues

As with the CDBG program, local governments must identify an implementing agency to both to carry out Section 108 programs and be responsible for compliance with applicable requirements. This section discusses Section 108 program administration and program requirements, in turn.

Local administration of Section 108-funded third-party lending programs. Unlike the responsibility for administering the CDBG program, which, not infrequently, is assigned to multiple agencies within a jurisdiction, Section 108 programs tend to fall under the purview of one local agency. Only 18 percent of local entitlement program grantees use more than one agency to administer Section 108. As a result, localities are far less likely to deliver Section 108 through nonprofit agencies. This may be because Section 108-funded third-party loans, compared to CDBG-funded loans, tend to be larger and more visible, and allocated as a single project rather than an ongoing program of smaller projects. Also, Section 108-funded loans represent a risk to the jurisdiction due to the pledge of CDBG funds for the security of the guaranteed loan. These features demand more, and more efficient administrative capacity than CDBG programs. Generally, nonprofit organizations tend to have less such capacity than local community development agencies, independent authorities, or economic development departments.

[9] This multiplier effect would be extremely difficult to document, requiring even more extensive record-keeping burdens on business to document their purchases, and on city staff to collect employment information from supplier businesses.

This program model of reliance on a single agency probably reflects the single-project character of many Section 108 programs, which makes multiple agency assignments infeasible or inefficient. Nearly all entitlement jurisdictions that apply for Section 108 funds have identified one or more projects for support in advance of their application to HUD. A typical application may request a Section 108 loan for support of one or several major downtown redevelopment projects, for which sites, project developers, intended uses, at least some private financing, and one or more tenants or operators is already known. In such applications, Section 108 uses are clearly specified, as are specific sources of collateral and repayment. However, a minority of entitlement jurisdictions—just over 40 percent—also have used Section 108 funds to establish loan programs for which the general character of eligible projects, types of financing available, and other program features may be known, but individual projects are not. This use of Section 108 resembles uses of funds under the CDBG program. As will be seen in the next chapter, these types of loans represent a relatively large share of Section 108-funded loans originated by entitlement grantees, but amount to a relatively small share of total loan volume.

Section 108 requirements. As noted above, the GAO issued a report in 1997 that attributed historical "under-utilization" of the Section 108 program to concerns about the collateral requirements of the program and to community reluctance to pledge CDBG funding as collateral for possible repayment of borrowed funds. Two questions follow from this: how widespread are these concerns, and has the expanding use of EDI/BEDI since 1994 alleviated them?

Smaller grantees appear less willing than others to accept the special requirements that the Section 108 program places on its users. These include the need to collateralize each Section 108 loan and to pledge future CDBG program funds as additional repayment security for the entire Section 108 loan. Local officials representing the small number of communities that opted to discontinue use of the Section 108 program for third-party lending (20 percent of users over the last decade) most often cite Section 108 program requirements, along with local policy, as the primary reasons for their choice (see Table 3.3). Just under one-half of those discontinuing use of Section 108 for third-party lending cite these requirements as the *only* reason for discontinuation. These are relatively few grantees (10 percent of users over the entire decade), and they devote less of their CDBG funding, on average, to economic development activities than do those who continue to use Section 108.

Table 3.3
Importance of Decision Factors Influencing Local Officials' Decisions Not to Apply for Future Section 108 Funds for Economic Development Activities*

Decision Factor	Level of Importance**** Very Important	Not Very Important	Row Totals
Local Factors**	44%	56	**100%**
CDBG Rules/Program Requirements	41%	59	**100%**
Other Funds Available	38%	62	**100%**
Unsatisfactory Loan Repayment Performance	21%	79	**100%**
Market Demand***	17%	83	**100%**
Insufficient Staff Capacity	3%	97	**100%**

Number of Respondents = 31

*Respondents include the 31 officials in jurisdictions that have used Section 108 for economic development activities since 1990, but who do not plan to apply for future Section 108 loans.

** Includes responses of "changing local priorities" and "local policy to assist businesses".

***Includes responses of "low demand from local businesses" and "low economic development benefit".

**** Percentages exclude those responding "Don't Know" or who refused to answer.

Source: Urban Institute Community Development Administrators Surve--Third-Party Lending Study, 2002.

In general, smaller Section 108 borrowers appear to be more heavily burdened than larger borrowers by Section 108 and CDBG program requirements—if burden is measured by the number of requirements that grantees cite as major hindrances (see Table 3.4). This same pattern was observed for CDBG program grantees.

The pledge of CDBG against Section 108 repayment is not, however, considered a major program hindrance to grantees that have operated, and plan to continue to operate, Section 108 third-party lending programs. But, collateral requirements imposed by the Credit Reform Act of 1990, which took effect in 1996, *are* regarded by grantees as a program hindrance. The collateral requirements can have the effect of limiting Section 108 loans to projects that pose small risks of default, particularly where few other sources of public collateral can be used to secure a Section 108 loan. In the view of several local officials interviewed, these collateral requirements run contrary to the spirit of the CDBG program—which is to further high-risk projects in areas where private capital is difficult to attract. This requirement may have particular force in cases where Section 108 is used to capitalize small business lending programs and where borrowers may have little security to offer.

Table 3.4

Number of Section 108 Legal and Regulatory Provisions Thought to Hinder Section 108 Third-Party Lending Programs, by Mean Average Annual Section 108 Expenditure on Economic Development Activities (1990-1999)

Number of Reported Major Hindrances	Mean Average Annual Section 108 Expenditure on Economic Development	Number of Communities*
0	$5,343,711	25
1	$1,797,019	21
2	$3,287,333	10
3	$1,081,783	11
4	$1,643,304	9
5	$0	2
6	$70,169	2
7	$87,121	2

Number of Respondents = 82

*Respondents include the 82 officials in jurisdictions that currently originate third-party loans to businesses using Section 108 funds.

Source: HUD IDIS Database and Urban Institute Community Development Administrators Survey--Third-Party Lending Study, 2002.

As shown in Table 3.5, relative to collateral requirements, the perceived level of hindrance of job documentation requirements is much less for grantees using Section 108 for third-party lending than for those using CDBG.[10] This is probably because of the greater salience of the Section 108 requirements, not because job documentation is any less burdensome for Section 108-funded projects—although these, on average, are larger than CDBG projects and might be expected to bear documentary burdens more easily. And, as with CDBG, requirements pertaining to eligible activities and public benefit appear not to be problematic for Section 108 program users.

Section 108 program application requirements engender nearly as much criticism as do the program's collateral requirements. These were often mentioned in the telephone survey and, in some instances, resented by officials contacted for on-site discussions. The effect of these requirements appears not to result from the amount of material required to be filed, but from the time HUD takes to approve or reject filed applications. Program managers in most jurisdictions doing Section 108-funded loans believe that HUD takes too long to process

[10]In some communities, these are the same, but ratings are reported separately for each program.

applications, which can be especially damaging in business lending situations where a quick response regarding availability of funds may be needed in order to take advantage of development opportunities. The dissatisfaction with the application process appears general across sizes of grantees.

Table 3.5
Types of Section 108 Legal and Regulatory Provisions That Local Officials Believe Hinder Section 108-funded Third-Party Lending Programs*

	Extent of Hindrance**			
Nature of Hindrance	**Major Hindrance**	**Minor Hindrance**	**Not a Hindrance**	**Row Totals (%)**
Section 108 Collateral Requirements	32%	26	39	**100%**
Section 108 Application Requirements	27%	34	38	**100%**
Pledge of CDBG Against Repayment	21%	37	42	**100%**
Jobs Documentation	21%	43	36	**100%**
Income Requirements	15%	39	45	**100%**
Level of Benefits Documentation	13%	37	49	**100%**
Eligible Activities	9%	28	62	**100%**
Required Level of Benefits	7%	39	50	**100%**

Number of Respondents = 82

*Respondents include the 82 officials in jurisdictions that currently originate third-party loans to businesses using Section 108 funds.

**Percentages exclude those responding "Don't Know/Refuses to Answer."

Source: Urban Institute Community Development Administrators Survey--Third-Party Lending Study.

Use of EDI and BEDI

As discussed in Chapter 2, the introduction of EDI in 1994 coincided with an increase in the number and share of grantees using Section 108 to fund economic development and third-party lending. But, most of the increase in funding for third-party lending can be attributed to previous program users who substantially increased their use of the program for lending. As noted in Table 3.6, local officials overwhelmingly credit EDI/BEDI funding as important in their decisions to seek program funding.

Table 3.6

The Reported Importance Community Officials Place on EDI/BEDI in Making Program Decisions

	Reported Effect of EDI/BEDI on:*	
EDI/BEDI Was:	**Decision to Seek Section 108 Funding**	**Decision to Fund Particular Types of Activities**
Very Important	85 %	70 %
Somewhat Important	10	15
Not Very Important	3	7
Not a Consideration	2	8
Total	**100 %**	**100 %**

Number of Respondents = 75

*This question was asked only of the 75 officials in jurisdictions that indicated that they have used EDI/BEDI funds in conjunction with Section 108 funds for economic development activities since 1990.

Source: Urban Institute Community Development Administrators Survey--Third-Party Lending Study

Given the salience of collateralization issues to local officials, as noted above, the importance of the additional funds provided by EDI/BEDI should be clear. As described in Chapter 1, these funds may be used as loan loss reserves and as other forms of credit enhancement. (Chapter 2 showed the percent of grantees using EDI/BEDI funding for these purposes.) In the event that borrowers of Section 108-funded loan cannot repay, EDI/BEDI funds can be used to partially repay the loans instead—thereby perhaps avoiding use of CDBG funds for that purpose. Credit enhancement means that loans that otherwise might pose unacceptable risk to local programs can be made more readily, as a portion of the risk is shared by EDI/BEDI. Local officials pointed to the risk reduction value of the loan loss reserves, gap financing, equity contributions, interest rate write-downs, and technical assistance programs provided to Section 108 borrowers.[11] EDI funds help to reduce risk to both local governments (and to their future CDBG allocations) and to private lenders, making it easier to attract private capital to Section 108-funded deals.

Local official apprehensiveness regarding the risk to a community's CDBG funding in the case of defaulted Section 108-funded loans is well-founded. As will be shown in Chapter 5, nearly one-half (45 percent) of grantees have, at one time or another, applied for Section 108

[11] Source: Community Development Administrators On-Site Survey.

loans with the intention of using their CDBG funds as the source of repayment. But, in part because of the collateral rules posed by the Credit Reform Act, which requires some security in addition to the CDBG pledge, nearly all grantees have used some form of project or other revenue as the repayment source in Section 108-funded projects. These revenues, however, have not always proven adequate to fully repay Section 108 loans. About one-quarter of grantees (24 percent) have experienced defaults on third-party loans, and two-thirds of those experiencing default (or 16 percent of all grantees) have, instead, used CDBG funds to repay their Section 108 loans.

State Programs

States represent 30% of all program funding under the CDBG program and about the same share of third-party lending activity. Because states are an intermediary between the federal funding source and local government project sponsors, issues of state administration of CDBG are very different from those of local entitlement jurisdictions. A most important variation in state administration of the program is the degree of administrative centralization and the amount of discretion accorded local, non-entitlement communities to design and operate their own third-party lending programs. The extent of this discretion, and the relative capacity of smaller local communities to carry out such programs, has some bearing on state interest in using Section 108 funding for third-party lending purposes.

Sources and methods. To protect the confidentiality of state administrators who responded to the State Community Development Administrators Phone Survey, given its small sample size (n=11), results in this section are presented in terms of the number of respondents who raised a particular program issue. These responses do not necessarily resemble the pattern of responses that would be obtained across all 50 states, but they do reflect the opinions of the heaviest users of the CDBG and Section 108 programs for third-party lending purposes, accounting for over 50 percent of all State CDBG funds used for third-party lending.

State CDBG and Section 108 program administration, and CDBG program requirements. There are two basic models of state program administration of CDBG- and Section 108-funded third-party lending programs. States may make grants to local jurisdictions to carry out single economic development projects, in which most project underwriting and loan management is retained at the state level, or states may grant funds to local units of government to run economic development programs and these units of general local government then take on the underwriting and loan management responsibilities. Of the 11 states included in this study, most adopted a middle path between centralized state administration and relatively complete local discretion:

- In the most centralized arrangements (two states), the state approves origination of loans to private borrowers, and repayments are used to form the basis for an

ongoing loan pool. The state also, then, approves subsequent originations from the pool. Application, underwriting, and loan management functions are shared between state agencies and local governments.

- In balanced "central-local" arrangements (five states), the states approve loan originations, and any repayments that flow to units of general local government may be re-lent according to general state guidelines. Within these guidelines, fund administrators at the local government level are responsible for application intake and review, financial underwriting, and loan management. Although they may be encouraged by state agency staff to foreclose on borrowers and recover on defaulted loans (where necessary), these policies are up to individual RLF administrators. (In one state in this category, program income was returned to the state and used to repay a Section 108 loan.)
- In the least centralized arrangements (three states), the states approve local applications for loans, and subsequent repayments are used to create a loan pool. Each local government applicant is free to set its own lending guidelines and to operate its program, as it sees fit. State agency staff may monitor in-person local RLF operations (four states) or merely accept annual reports of loan activity, job-creation data, and other compliance information (one state).

In terms of the programs that states have chosen to support with CDBG funding, the potential costs of compliance with program requirements appear not to have been a particularly important influence over this choice. The mix of development programs states operate (including lending programs) is driven primarily by state funding priorities and perceived demand for assistance. However, problems with loan repayment appear to influence state administrators to a degree not seen among their local entitlement counterparts, affecting their willingness to use CDBG funds, Section 108 funds, and funds from other agencies for lending purposes. In several states, repayment problems have led them to discontinue use of Department of Commerce funding for micro-enterprise lending.

Most state officials report no major hindrances to their lending programs as a result of federal program requirements. Even so, echoing the views of local program administrators, state officials most often cite the income requirements for low-and-moderate income jobs as the most significant hindrance to their program (among the requirements mentioned). In one way, compliance with this requirement should be more difficult for states, insofar as state administrators in most states—i.e., those not pursuing a centralized model—must rely on local program administrators to diligently collect and forward the jobs information supplied by local businesses.

Section 108 program use and responses to program requirements. States officials appear to be more risk averse than those of local entitlement grantees when it comes to using

the Section 108 program, primarily because they fear loss of future CDBG funding due to poor performance on loans. Three of the four current users of Section 108 for third-party lending purposes will not apply in the future because loan defaults have required them to use CDBG funds for repayment. One state administrator also discontinued doing third-party lending using the CDBG program because of repayment problems on a Section 108-funded deal.

Several state officials view the EDI/BEDI funds that are commonly used as hedges against Section 108 payment problems as difficult to obtain on a timely basis. But, for those who have used Section 108, availability of EDI/BEDI has been very important to their decision to do so: EDI/BEDI funds were used as grants or loss reserves to help reduce the risk of Section 108-funded loans.

Cross-cutting both the CDBG and Section 108 programs is a concern about states' abilities to fund larger projects of multi-county or statewide significance because of a local capacity to carry out these projects. This may be one part of the explanation for state reticence to use the Section 108 program: insofar as large projects, for which Section 108 is uniquely suited, require a local applicant under CDBG program requirements, capable-enough city or county governments may be difficult to find in rural areas.

As noted at the beginning of this chapter, both state and local program administrators value the economic development benefits that CDBG and Section 108 funding allow them to produce for their communities. The next chapter discusses those benefits for local CDBG and Section 108 third-party lending programs.

CHAPTER 4: AN ANALYSIS OF THE BENEFITS THAT DERIVE FROM HUD-SUPPORTED, LOCALLY ORIGINATED THIRD-PARTY LOANS

Highlights

This chapter assesses the benefits produced by CDBG- and Section 108-funded loans to business. The extent to which these benefits are created can be taken as indicators of overall program performance. Various performance tests are considered, including: (1) business survival rates; (2) rates of total and low-income job creation and retention relative to jobs planned at the time of loan origination; (3) the public costs of each job created; (4) the amount of private funding induced (or leveraged) by program loans; and (5) the rates at which public loan dollars substitute for private funds that would have otherwise been invested. The chapter's findings are briefly summarized below.

For CDBG-funded loans originated between 1996 and 1999, and for Section 108-funded loan originated between 1994 and 1999, the following is observed:

- Nearly 80 percent of all borrowers of CDBG funds, and 75 percent of borrowers of Section 108 funds were still in business at the time of data collection, meaning that 20 percent of CDBG-assisted business and 25 percent of Section 108-assisted businesses had failed between the time of loan origination in 2002.[1] This rate is closely comparable to the failure rate for all businesses.
- Program-wide, however, the 16,000 jobs created over the study period represented 107 percent of planned jobs. Of surviving businesses, 64 percent of CDBG borrowers and 57 percent of Section 108 borrowers that promised to create or retain low-income jobs as the condition of their loan met or exceeded their job targets.
- Each CDBG job costs the program $2,673, lower than the range of $3,652 to $6,250 for other federal economic development programs, while the Section 108 cost-per-job of $7,865 is slightly higher.[2]
- Each loaned CDBG dollar helps to induce an additional $1.83 in other public and private funding, and each Section 108-funded loan dollar helps to induce $1.75 in other funding. Put another way, 64 percent of the development project costs in both programs are covered from private and other public sources.
- Although local agency officials are not obliged to ensure that their CDBG- or Section 108-funded loans are essential to the job creation projects they support, 35 percent of CDBG-assisted businesses and 38 percent of Section 108-assisted businesses report that their projects would not have gone forward *at all* without these loans. But, 19 percent of CDBG borrowers and seven percent of Section 108 borrowers report that their projects would have

[1] About 20 percent of firms terminate in each of the first and second years after startup. The rate of dissolution decreases year by year; by the ninth or tenth year, only about seven or eight percent of the remaining firms fail. Fewer than half of all new firms are in operation after five years (*The State of Small Business: A Report of the President*. 1999. United States Government Printing Office, Washington).

[2] These figures are not loan principal per job. Loans are converted to their grant equivalents to permit a fair comparison. Figures include jobs in businesses that subsequently failed.

gone forward *on the same scale and timing*, even without this assistance.

These performance levels vary across types of businesses assisted and locations. The following are among the more pronounced effects of the CDBG program:

- Larger loans and larger business borrowers (in terms of number of employees at the time of loan origination) tend to show better-than-average performance in terms of business survival rates and, among survivors, in the ratio of actual-to-planned jobs created.
- Larger businesses (in terms of both number of employees and annual sales) create jobs at less cost and leverage more public and private funding than others, but also tend to have higher rates of "substitution," as will be defined and discussed in this chapter.
- Borrowers in service industries create more jobs at lower cost than borrowers in other types of companies and, at the same time, are more dependent on CDBG-provided subsidies; i.e., they less frequently use CDBG loans to substitute for other sources of funding.
- Small businesses (in terms of jobs) and borrowers of small loan amounts tend to fail more frequently, create fewer jobs than planned and, in the case of small employers, create jobs at a higher cost than other firms. But these small businesses also are more likely to be minority businesses than other firms.
- Compared to others, businesses located in high-poverty and extreme-poverty tracts create fewer jobs and the jobs they create cost more than jobs created by firms in low-poverty tracts. For extreme poverty tracts, at least, part of the explanation may lie in the firms' inability to attract other public and private funding in the same amounts as firms in other neighborhoods.

Some of the findings for Section 108 program borrowers are similar:

- The relationship between business characteristics and the levels of benefits conveyed by projects is less clear than for CDBG, reflecting the smaller number of large projects carried out in the 38 jurisdictions included in the study that undertook Section 108-funded loan projects, and the unique circumstances that pertain to many of these large redevelopment efforts.
- Larger firms (in terms of sales and numbers of employees) create more jobs in relation to job targets than smaller firms and, for firms with large numbers of employees, these jobs are less expensive in terms of the face value of the loans than jobs created by smaller businesses.
- Firms with large annual sales, and those borrowing in large amounts, tend to leverage more public and private dollars than other firms—which tend to show below-average leveraging performance.

Reflecting the low-income community development purposes of the CDBG and Section 108 programs, about one-quarter of loans in both programs go to minority-owned businesses—substantially higher than their 15 percent share of the general business population. Assisted businesses also tend to be located in high-poverty neighborhoods: more than one-half of both CDBG- and Section 108-funded loan volume flows to businesses in census tracts where 20 percent or more of the population lives below the federal poverty level. In fact, more than one-third of Section 108 program loan funds are invested in businesses in "extreme poverty" neighborhoods—those with poverty rates of 40 percent or more.

Introduction

Localities can use CDBG and Section 108 funds in a variety of ways to create jobs, improve neighborhood commercial areas, increase the local tax base, encourage new business formation, and promote industrial areas and sectors—all of which constitute economic development benefits to the community. One such way is through third-party lending programs, which are often in the form of loan pools that revolve repayments from earlier loans into subsequent loans. As alluded to in Chapter 1, administrators conduct outreach to prospective applicants, accept applications from eligible businesses, underwrite and originate loans, and monitor the performance of loans and their resulting pubic benefits. Most CDBG- and Section 108-funded loans are originated through these kinds of ongoing programs. In addition, however, a substantial portion of Section 108 program funds are lent in large amounts as one-time investments in sizeable commercial and industrial enterprises. This chapter assesses the performance of these various types of loan activities, using the following measures: business survival rates; job creation and retention rates; job creation and retention costs; the amount of private funding induced (or leveraged); and the rates of substitution of public for private investment dollars.

Sources and Uses of Information

The analysis of benefits flowing from HUD-supported, third-party loans involves data from many sources. Beyond the description, in Chapter 1, of the study's samples and sub-samples and, in the Appendix, of the different weighting calculations required to make national estimates from the various samples, this section notes some of the special considerations involved in using and analyzing data collected for this study to estimate the results and performance of CDBG- and Section 108-funded loans. Of special importance are the inter-related levels of analysis used—loans, projects, and businesses—and the different samples employed.

The levels of analysis used in this chapter. The analysis in this chapter is carried out at four levels—individual loans, the projects these loans support, the businesses that carry out projects, and grantees:

- *Loans* are the individual notes executed between local jurisdictions or their subrecipients and business borrowers.[3] This chapter reports on how 976 individual loans and loan dollars were qualified with respect to the national objective they were intended to accomplish.

[3] The loans included in the study were selected for analysis based on the sampling procedure described in Chapter 1 and Appendix A.

- *Projects* are the economic activities supported by CDBG, Section 108, and other public and private funding. Multiple CDBG- or Section 108-funded loans (or notes) could be made to a single project, as when real estate loans and equipment loans are provided simultaneously through different local programs. These projects were identified based on analysis of the timing and purpose of sampled loans. The 930 projects are used in this chapter to report on job creation, leveraging, and uses of project funding.
- *Businesses* are the establishments that carry out projects. The 900 businesses included in the study are the basis for analysis of business termination rates. A subset of these businesses, consisting of 234 establishments that responded to the Business Survey (30 percent of surviving businesses), are the basis for an analysis of minority ownership and substitution issues.
- *Grantees* are the local entitlement cities and urban counties surveyed for this research, including 51 high-loan-volume communities as well as a sample of all other local entitlement jurisdictions. The total number of grantees surveyed was 460, of which 223 were identified as users of CDBG and Section 108 funds for third-party lending purposes.

Data sources. The sample of loans originated in the 51 high-loan-volume communities using CDBG, Section 108, CDBG float, and EDI/BEDI funds (from the Loan File Review Database) underpin most of the analyses in this chapter. The loan sample is weighted to reflect the universe of loans and total dollars lent in these communities over the time period of this analysis.[4] (Table 4.1 shows the relationship between numbers of loans and loan dollars sampled, and the universe of all loans awarded over this period.) Each level of analysis—loan, project, business, and grantee—requires data to be weighted differently to account for the fact that the probability of any project or business being included in the analysis is an artifact of the probability of any loan being sampled.[5]

Other sources of information used in the analysis are:

- The Community Development Administrators Phone Survey—which is the basis of program targeting information,

[4] For Section 108-funded, loans awarded between 1994 and 1999, were eligible to be included in the sample, and for CDBG, CDBG Floats, and EDI/BEDI, loans awarded between 1996 and 1999 were eligible for inclusion.

[5] How these weights were obtained is discussed in Appendix A.

- Dun and Bradstreet Market Indicators for 90 percent of the businesses in the Loan File Review Database—which is the basis of certain business establishment data such as sales volume and industry sector (SIC code); and
- Geo-coded business addresses corresponding to year 2000 Census tracts—which is the basis of information on the poverty levels and minority percentages of neighborhoods.

Table 4.1
Sampled Loans and Loan Volume in 51 High-loan Volume Communities, by HUD Funding Source

	HUD Funding Source			
Sampling Category	**CDBG/CDBG Float**	**Section 108**	**EDI/BEDI**	**Total**
Lending Volume Sampled (in millions)	$137.2	$520.5	$1.1	$658.8
Lending Volume Not Sampled (in millions)	42.4	25.6	0.5	68.5
Total Lending Volume (in millions)	**$179.6**	**$546.1**	**$1.6**	**$727.3**
Percent of Total Lending Volume Sampled	76 %	95 %	67 %	91 %
Total Number of Loans Sampled	756	201	19	976
Total Number of Loans Not Sampled	783	154	30	967
Total Number of Loans	**1,539**	**355**	**49**	**1,943**
Percent of Total Number of Loans Sampled	49 %	57 %	39 %	50 %

Note: There are 105 unsampled loans for which there are no origination dates. These have been excluded from the above calculations.
Source: Urban Institute Economic Development Funding Database--Third-Party Lending Study, 2002.

Missing-data issues. Because loan file data are maintained by differently from jurisdiction to jurisdiction, in widely varying formats, missing data are a problem for some of the analysis presented in this chapter—primarily affecting information on job creation, substitution, and leveraging. For example:

- *Job creation data are missing for about 30 percent of projects that had identified their national objective as low-mod job creation.*[6] As also noted in Chapter 3, at least eight of the 51 sampled communities lack jobs data for 30 percent or more of the sampled loans. (Another five communities did not have readily accessible jobs information, and the research team was unable to spend the time on site needed to track this information down.) For another 100 of the 976 sampled loans, local files or automated jobs data systems recorded "0" jobs created, meaning either that jobs were not created at all (perhaps because businesses failed to carry out their full investment program) or because program administrators did not record this information.

[6] This missing jobs data (i.e. more than 30% of projects that identified the national objective as low-mod job creation were missing job creation figures) is concentrated among approximately 15% of the entitlement grantees included in this study.

- *Analysis of leveraging is affected by missing data on the sources and uses of funds.* This information was recorded in data collection forms drawing on multiple sources—loan applications (where corroborated by other information), loan agreements, and other file-based information. These sources did not always agree with one another. Furthermore, the leveraging analysis in this chapter is based on sources of funds used in *projects,* which may have included multiple loans. Considerable effort was required to ensure that funding information was not double counted across multiple loan files. Leveraging information presented in this chapter is based on about 80 percent of all projects funded.
- *Analysis of substitution relies on data collected by the Business Survey*. Thirty percent of the businesses estimated to be still operating at the time of the survey were reached, and analysis shows no evident bias among non-respondents in whether they were aided by CDBG or Section 108, or the size of the loan they received.

Using the data discussed above, the reminder of this chapter examines the following topics, in turn: the national objectives, program purposes, and types of borrowers associated with CDBG- and Section 108-funded loans; the project benefits that derive from these loans; and the relationship between project benefits and the characteristics of business borrowers.

National Objectives, Program Purposes, and Types of Borrowers

This section describes characteristics of loans—including the numbers, dollar amounts, and sizes of loans made under the CDBG, CDBG Float, EDI/BEDI and Section 108 programs; reports the national objectives pursued by funded projects and some of the special purposes they pursued; and describes the types of businesses aided—including their size, start-up status, minority ownership, and location.

CDBG- and Section 108-funded loan characteristics. The tables in this chapter distinguish between loans originated using CDBG funds and those using Section 108 funds, with CDBG floats and EDI/BEDI included in the CDBG loan totals. The CDBG floats in the study represent a small proportion of total loans and loan volume and, therefore, do not influence the overall totals reported. Inclusion of a small number of EDI/BEDI loans in the CDBG totals (although tied to Section 108 program investments) is warranted because they resemble CDBG-funded loans in terms of size and purpose.

Section 108-funded loans are separately reported because of requirements pertaining to the program's operation—most notably the requirement that funds borrowed by localities be

repaid[7] and that these loans be secured by other forms of collateral in addition to future CDBG grant allocations. These requirements influence the financial characteristics of Section 108-funded loans, as well as the types of businesses assisted and the benefits conveyed by projects. In addition, because communities are able to borrow Section 108 funds in large amounts, they tend to use these funds to make larger loans and loans specifically tailored to the requirements of one or a few large borrowers.

Nearly all of the communities visited for this research created ongoing programs, usually revolving loan funds,[8] to make CDBG loan dollars available to business borrowers. Under a typical scenario, agency staff write program rules that define eligible applicants and projects, types of loans available and any limits on their size or cost, and any other program requirements that may encourage or discourage certain types of businesses to apply for loans. Businesses apply for program funds, and applications are underwritten within the parameters of loan size, interest rate, acceptable collateral, and other program requirements defined in advance of business applications. Loan funds are replenished each year from repayments of previous loans or from new allocations of funding from the annual CDBG formula grant.

As noted in Chapter 3, 40 percent of Section 108 program users report utilizing their Section 108 funds in this way—to capitalize loan pools for business lending. However, as previously discussed, nearly all Section 108 program users applied for program funding with specific projects in mind. Typically, these applications are for large, "project-based" loans and, as a result:

- Relatively few of the 51 high-loan-volume communities account for a sizeable percentage of all Section 108-funded lending—i.e., five communities account for 41 percent of all such lending by the 38 communities using Section 108 funds for third-party loans during the study period.
- Many of these and other communities using Section 108 do not establish ongoing programs, but apply for Section 108 in order to finance one or a few large redevelopment or industrial projects—a pattern followed in at least 16 of the 38 sampled communities using Section 108 for lending purposes during this period.
- Across communities, a relatively small number of projects account for a disproportionate share of program funding—i.e., the 10 largest loans in the study (all involving Section 108 funds) amount to $181 million, nearly 33 percent of a total $547 million in Section 108 lending done in the 38 communities using such funds for this purpose during the period.

[7] Grantees make repayments to a Fiscal Agent, under contract to HUD. The Agent remits their repayments to the private investors who fund, generally through public offerings, the grantees' notes guaranteed by HUD.

[8] See Chapter 1 for a definition of revolving loan funds.

These aspects of the Section 108 program will be invoked several times in this chapter to explain differences in the types of businesses assisted and, in Chapter 5, to explain the financial terms that are offered.

National objectives and program purposes. As previously discussed, each activity assisted with CDBG or Section 108 funds must meet one of three national objectives: they must benefit low- and moderate-income persons; help to eliminate slums and blight; or meet an urgent community need. Most CDBG and Section 108 usage qualifies under the national objective of benefit to low- and moderate-income persons. In turn, most loans (and loan dollars) that qualify as low-mod benefit do so under the job creation provision, as opposed to provisions allowing benefit to areas in which low-and moderate-income persons live. As shown in Table 4.2, 77 percent of CDBG-funded loan dollars and 76 percent of Section 108-funded loan dollars were qualified by local jurisdictions under the low-mod job creation national objective.

Table 4.2
National Objectives Under Which Third-Party Loans Are Qualified, by HUD Funding Source

	HUD Funding Source					
	CDBG/Float/EDI/BEDI			Section 108		
National Objective	Percent of Loans	Loan Dollars* (in millions)	Percent of Dollars	Percent of Loans	Loan Dollars* (in millions)	Percent of Dollars
Low-Mod Job Creation	76 %	$142.8	77 %	85 %	$416.0	76 %
Low-Mod Area Benefit	15	28.5	16	12	35.8	7
Slum/Blight	6	12.4	7	7	108.5	20
Other	3	2.4	1	5	2.4	0
Total	**100 %**	**$186.1**	**101 %***	**109 %***	**$562.7**	**103** %*
Number of Loans	775			201		

Note: Data are weighted to represent the universe of 1,943 loans in 51 high-loan volume communities.
*Percentage does not add to 100 as some communities list more than one national objective for a loan.
Source: Urban Institute Loan File Review Database--Third-Party Lending Study, 2002.

Worth special note are Section 108 project loan dollars that were qualified under the slum and blight national objective. These expenditures are intended to remove areas of deterioration that seriously undermine the economic prospects of neighborhoods or business districts. Dollars lent for this purpose represent nearly 20 percent of total lending using Section 108 funds, but only seven percent of all loans. In other words, these loans are substantially larger than the average Section 108-funded loan, and consist of the large, project-based loans—as described earlier.

If loans are used to fund low-mod job creation projects, the project sponsors are obliged to ensure that at least 51 percent of the jobs created or retained are either *held by*, or *available to* low- or moderate-income persons. Data collected by field researchers shows that in at least

87 percent of CDBG assisted projects and 89 percent of Section 108-assisted projects, a majority of jobs were held by low- and moderate-income persons. These figures represent jobs actually held by low- or moderate-income persons; the remaining 13 percent of CDBG-assisted projects and 11 percent of Section 108-assisted projects may have met their national objective by having jobs *available for* low- or moderate-income persons. This is not known from the data.

While all expenditures are required to meet one of the national objectives, most communities also pursue locally-adopted neighborhood revitalization or business development goals with their CDBG- and Section 108-funded lending programs. Jurisdictions do this by targeting funds to particular types of neighborhoods or businesses. This targeting refers to set-asides or special preferences that ensure that some or all of the loans are made to a particular kind of location or business. In the Community Development Administrators Phone Survey, local officials were asked whether or not CDBG- or Section 108-funded loans were targeted to particular types of businesses in their jurisdictions. As Table 4.3 demonstrates, the most common form of targeting used by grantees for both CDBG- and Section 108-funded loan programs is that involving neighborhood commercial areas: 52 percent of CDBG entitlement jurisdictions making third-party loans and 37 percent of jurisdictions making Section 108-funded program loans targeted neighborhood commercial areas. This finding echoes earlier research on the CDBG program, which found that neighborhood commercial area targeting was the primary form of business assistance targeting.[9] Business incubation or startups proved to be the next largest group targeted with CDBG money (36 percent of grantees).

Grantees use Section 108-funded loans more often than CDBG-funded loans to target specific industries or business sectors (28 percent of grantees for Section 108 versus 17 percent for CDBG), and 25 percent of grantees use Section 108 funds to target industrial areas. This preference for specific businesses or industries may reflect the fact that many communities use Section 108-funded loans for individual, large-scale projects, without pursuing an overall program of lending. Finally, approximately one-quarter of grantees use CDBG-funded loans (28 percent) and one-fifth of grantees use Section 108-funded loans (17 percent) to target specific types of business owners—e.g., minority business enterprises, women's business enterprises, those owned by disabled veterans, or other special groups.

[9] *Federal Funds, Local Choices, op. cit.*

Table 4.3

Local CDBG Entitlement Grantee Targeting of Third-Party Loans to Specific Businesses or Areas, by HUD Funding Source

	HUD Funding Source	
	CDBG	Section 108
Targeting Provisions	Percent of Communities*	Percent of Communities*
Neighborhood Commercial Areas	52 %	37 %
Business Incubation or Start-ups	36	16
MBE, WBE, 8(a), Disabled Vets	28	17
Industrial Areas	22	25
Brownfield Sites	21	18
Specific Industries or Business Sectors	17	28
Number of Entitlement Communities*	223	82

Note: Grantees are only those communities that currently originate third-party loans with CDBG or Section 108 funds.
*Percentages do not add to 100 as communities may target more than one type of business or area.
Source: Urban Institute Community Development Administrators Survey--Third-Party Lending Study, 2002.

Characteristics of assisted business. These neighborhood revitalization and small business development goals of the CDBG and Section 108 programs are reflected in the types of businesses that receive loans from either source. As Tables 4.4 through 4.7 show, one-half of all CDBG-assisted businesses have six employees or fewer, have average annual sales of $590,000, and are primarily in the retail or services sectors.[10] One quarter of businesses are minority-owned, and over one-half are in poverty neighborhoods. Section 108 tends to finance larger businesses, including a small number of very large enterprises, but even here, one-fifth of businesses are minority owned and most are in poverty neighborhoods.

Minority Status and Location of CDBG- and Section 108-funded Loans. Minority-owned businesses make up approximately one-quarter of both lending programs: 26 percent of CDBG-funded businesses and 25 percent of Section 108-funded businesses are minority owned.[11] This percentage is higher than the minority business percentage of the total U.S.

[10] This is not shown on any table.

[11] These are smaller percentages than found in the Urban Institute's earlier evaluation of the CDBG program. That study found that in 1989, 37 percent of all CDBG funds used to support for-profit business went to minority businesses. These funds included both loans and grants for facade improvements, technical assistance, facilities renovation and other activities. *Federal Funds, Local Choices, op. cit.*

business population—15 percent.[12] These minority-owned businesses have fewer employees and lower annual sales volumes than majority businesses. For example, 73 percent of minority-owned businesses receiving a CDBG loan have five or fewer employees compared to 43 percent of majority-owned business, and minority-owned businesses tend to receive smaller CDBG- and Section 108-funded loans than do other businesses.

Businesses aided by CDBG- and Section 108 funds are likely to be located in high-poverty neighborhoods—census tracts with 20 percent or more of their population in poverty. Compared to an average poverty rate of 14 percent in the 51 high-loan-volume communities, the poverty rate for neighborhoods in which businesses receiving CDBG funding are located averages 25 percent. As Table 4.4 shows, $97.9 million in CDBG funding (of a total $173.3 million), or 56 percent, flows to neighborhoods with poverty rates of 20 percent or more. The average poverty rate for neighborhoods in which a business receiving Section 108 funding is located is 29 percent, compared to an average poverty rate of 17 percent for communities with Section 108-funded loans. Of $505.5 million in Section 108-funded lending, $343.2 million (or 67 percent) goes to high-poverty neighborhoods, of which $195.2 million (or 39 percent of all funding) goes to extreme poverty neighborhoods (those having 40 percent or more of their population in poverty).

Table 4.4
Percent of Loans and Loan Dollars, by Neighborhood Poverty Categories and HUD Funding Source

	HUD Funding Source					
	CDBG/Float/EDI/BEDI			Section 108		
Neighborhood Percent of Persons in Poverty	Percent of Loans	Loan Dollars (in millions)	Percent of Loan Dollars	Percent of Loans	Loan Dollars (in millions)	Percent of Loan Dollars
Less than 20%	44 %	$75.3	43 %	33 %	$162.3	32 %
Between 20% to 39%	20	65.0	38	38	148.0	29
More than 40%	36	32.9	19	29	195.2	39
Total	**100 %**	**$173.3**	**100 %**	**100 %**	**$505.5**	**100 %**
Number of Loans	728 *			168 **		

Note: Data are weighted to represent the universe of borrowing businesses in 51 high-loan volume communities.
Percentages do not include responses of "Don't Know/Refuses to Answer".
*Due to missing data, this figure is less than the total 775 CDBG/Float/EDI/BEDI-funded loans.
**Due to missing data, this figure is less than the total 201 Section 108-funded loans.
Source: 2000 U.S. Census and Urban Institute Loan File Review Database--Third-Party Lending Study, 2002.

[12] U.S. Small Business Administration, 2001. *Minorities in Business, 2001*. Office of Advocacy. November.

Size, Start-up Status, Business Type, and Sector of CDBG-Aided Businesses. The role of CDBG as a source of small business lending funds is clear from basic descriptive data on the program. As shown in the sequence of tables to follow:

- The majority of businesses assisted by CDBG are independent, for-profit businesses (83 percent). Less than six percent are branches or franchises, and only 9 percent are nonprofit businesses.
- The majority of these companies are small firms.[13] The median business assisted with CDBG loan funds employs six persons and has annual sales of $590,000[14] (see Table 4.5). Firms with smaller sales volumes at the time of loan origination tend to receive smaller average CDBG-funded loans.
- The majority of CDBG-assisted businesses fall into three primary industry categories—services, retail, and manufacturing. The largest groups consist of services businesses, accounting for 33 percent of all firms assisted, and retail businesses, comprising 28 percent of all firms assisted (see Table 4.6).[15]
- Most CDBG-funded loans and loan dollars support expansion of existing business, but about one-fifth of loans in both programs support the start-up of new businesses (see Table 4.7). These start-up firms generally borrow small amounts of money and aim to create one or two jobs, on average—similar to the proportions found in earlier research on CDBG programs.[16] Most CDBG start-ups are in the retail sector.

[13] The Small Business Administration (SBA) assigns size standards, which define whether a business is small, by industry type under the North American Industry Classification System (NAICS). In determining size standards, the SBA considers the economic characteristics of an industry such as average firm size, distribution of firms by size, and start-up costs and entry barriers.

[14] The median sales figure exceeds that of an earlier study by the Urban Institute, which cited median revenues of the average business assisted with CDBG funds as $345,000 (The Urban Institute, 1995. *Federal Funds, Local Choices: op. cit.).* This was "revenues" not "sales" per se, and updated to 2002 dollars, would amount to some $430,000.

[15] The sectoral makeup of the CDBG portfolio is similar to lending done in years past. Previous research found that retail was the largest single group assisted, at 33 percent, with services at 18 percent and manufacturing at 15 percent. *Federal Funds, Local Choices, op. cit.*

[16] Twenty-three percent of the assisted businesses were also startups. See *Federal Funds, Local Choices, op. cit.*

Table 4.5
Mean Sales Volume and Mean Number of Permanent Employees at Year of Loan Origination, by Sales Volume Quartiles and HUD Funding Source

CDBG/Float/EDI/BEDI

Sales Volume Quartile	Mean Sales Volume	Mean Number of Permanent Employees
1: $0-$150,000	$59,721	6
2: $150,001-590,000	338,481	6
3: $590,001-$2,300,000	1,229,518	14
4: more than $2,300,000	9,429,653	61
Number of Businesses	498 *	

Section 108

Sales Volume Quartile	Mean Sales Volume	Mean Number of Permanent Employees*
1: 0-$247,477	$64,433	29
2: $247,778 - $1,249,835	686,474	34
3: $1,249,836 - $8,467,715	3,340,084	57
4: more than $8,467,715	67,579,072	116
Number of Businesses	108 **	

Note: Data are weighted to represent the universe of borrowing businesses in 51 high-loan volume communities.
*Due to missing data, this figure is less than the total 732 businesses receiving a CDBG/Float/EDI/BEDI-funded loan.
**Due to missing data, this figure is less than the total 168 businesses receiving a Section 108-funded loan.
Source: Dun and Bradstreet and Urban Institute Loan File Review Database--Third-Party Lending Study, 2002.

Table 4.6
Industry Sector for Businesses Receiving Third-Party Loans, by HUD Funding Source

	HUD Funding Source	
	CDBG/Float/EDI/BEDI	Section 108
Industry Sector (SIC Code)	Percent of Businesses	Percent of Businesses
Services	31 %	32 %
Retail Trade	28	18
Manufacturing	19	22
Wholesale Trade	9	10
Construction	6	3
FIRE*	4	8
Transportation	2	3
Agriculture	1	2
Public Administration	0	2
Total	**100 %**	**100 %**
Number of Businesses	732	168

Note: Data are weighted to represent the universe of borrowing businesses in 51 high-loan volume communities.
*FIRE="Finance, Insurance, and Real Estate."
Source: Dun and Bradstreet and Urban Institute Loan File Review Database--Third-Party Lending Study, 2002.

Table 4.7
Percent of Loans and Loan Dollars for Businesses Receiving Third-Party Loans, by Start-up Status and HUD Funding Source

	Loans	Loan Dollars	
Start-Up Status	Percent of Loans	Loan Dollars (in millions)	Percent of Dollars
CDBG/Float/EDI/BEDI			
Start-up	22 %	$42.6	25 %
Existing Business	78	129.5	75
Total	**100 %**	**$172.1**	**100 %**
Number of Loans = 696*			
Section 108			
Start-up	19 %	$202.6	40 %
Existing Business	81	298.4	60
Total	**100 %**	**$501.0**	**100 %**
Number of Loans = 155**			

Note: Data are weighted to represent the universe of all borrowing businesses in 51 high-loan volume communities. Percentages do not include responses of "Don't Know/Refuses to Answer."
*Due to missing data, this figure is less than the total 775 CDBG/Float/EDI/BEDI-funded loans.
**Due to missing data, this figure is less than the total 201 Section 108-funded loans.
Source: Urban Institute Loan File Review Database--Third-Party Lending Study, 2002.

Size, Start-up Status, Business Type, and Sector of Section 108-Assisted Businesses. The role of Section 108 as a lender to larger businesses also is clear from basic descriptive information. Businesses receiving Section 108-funded loans during the study period had a higher median sales volume at the time of loan origination than businesses receiving CDBG loans—$1,250,000 compared to $590,000 for CDBG (not shown on any table). In addition:

- A substantial minority of Section 108-funded start-ups consist of very large, urban renewal-type projects, borrowing large amounts of money, and aiming to create dozens (if not hundreds) of jobs. Of the largest 10 loans in the study, more than one-half are start-ups—including two shopping malls, two shipyards, a theme park, a newspaper company, and a hotel.

- Compared to CDBG-assisted businesses, a slightly greater proportion of Section 108-assisted businesses are in the manufacturing sector (19 percent compared to 22 percent, respectively). These manufacturing loans tend to be small, representing only 20 percent of loan dollars. Conversely, while the finance, insurance, and real estate sector (FIRE) represents only a small proportion of the total number of loans,

Section 108-assisted businesses have double the proportion compared to CDBG-assisted businesses (eight percent compared to four percent, respectively); however, the dollar amounts tend to be large, amounting to 16 percent of Section 108-funded lending. These are typically the large start-up companies just mentioned.

Program Benefits and Aspects of Program Performance

This section discusses CDBG- and Section 108-funded lending program accomplishments with respect to business development, job creation, leverage, and other community benefits. It should be noted that not all possible sources of benefit are measured; instead, the focus is on those sources that are readily measurable, have obvious community development significance and, for the most part, have been used in other studies—allowing for program comparisons. Five ways in which economic development lending can convey benefits to communities are analyzed. They are:

- *Business survival (or termination) rates*, or the percentage of businesses that survived from the time of loan origination to the time in 2002 when data were collected;
- *Job creation*, including the number of jobs created or retained as a result of third-party lending activities, and the percentage of planned jobs at the time of loan origination that were actually created or retained;
- *The cost of creating the total number of permanent jobs and low- and moderate-income jobs* associated with third-party lending activities;
- *Dollars leveraged*, including the amounts of private and other public funding used to support projects in which CDBG- or Section 108-funded loans are invested, and;
- *"Substitution,"* or the likelihood that private investment would have happened without the CDBG or Section 108 investments.

Following discussion of these basic program outcomes, features of the assisted businesses—including size, economic sector, or minority-ownership—are examined with respect to their effects on the outcomes achieved.

Business survival rates. One important reason to support community development through investments in business is because profitable businesses create a continuing stream of public benefits: they employ workers, pay taxes, and may provide neighborhood services. Businesses that do well create increasing levels of benefit over time, adding jobs, tax revenues and services. Some businesses, however, are not as profitable as expected at the time of loan origination, and some fail altogether. Indeed, businesses that seek public-sector assistance or operate in low-income neighborhoods may well be more fragile than other kinds of businesses. Therefore, to examine the extent of survival of businesses that carried out a CDBG- or Section

108-funded loan project during the study period, business termination data were collected from local loan files and Dun & Bradstreet records. Since it is likely that both sources fail to record business terminations occurring unbeknownst to local agency or Dun and Bradstreet representatives, the survival rates presented here may, if anything, be overstated.

Of the CDBG-funded loan borrowers included in this research, 80 percent were still in operation as of the summer of 2002 when information on business characteristics was collected.[17] A slightly lower proportion of businesses assisted with Section 108 dollars—75 percent—had survived through the time of data collection. Rates for CDBG-assisted businesses, adjusted for the age of businesses included in the sample, appear comparable to other studies of business assistance programs.[18] The pattern for Section 108-assisted business is less clear. Nearly one-half of businesses assisted in 1994 and 1995 had failed by 2002, but subsequent termination rates are substantially lower and do not fall predictably year after year.

Receipt of a CDBG- or Section 108-funded third-party loan is associated with increased survival chances of start-up businesses. Ample evidence shows that overall termination rates for all US start-up businesses are much higher than for existing business—50 percent of all firms are no longer in existence by the fifth year after start-up.[19] A comparison of start-up and existing businesses aided by CDBG or Section 108 shows that out-of-business rates of 19 percent and 23 percent, respectively, are much the same as existing businesses, and about one-half the expected rate if these firms failed at the same rate as all other start-ups. The previous Urban Institute study of the CDBG program came to the same conclusion.[20]

Job creation performance. As previously mentioned, two-thirds of all third-party loan dollars were qualified as meeting the CDBG national objective of creating low- and moderate-income jobs. This section examines whether projects (which can be aided by multiple loans) met their job-creation targets (i.e., did they create or retain as many jobs as had been planned

[17] This survival rate is slightly higher compared to other studies' findings of 72 percent (*Federal Funds, Local Choices, op. cit.,* and Ruth Alahydoian, 1995. *A Study of the Success Rates of State CDBG Economic Development Loans*. Office of Policy Development and Research, U.S. Department of Housing and Urban Development).

[18] Statistically, some fraction of all businesses fail each year. Fewer and fewer businesses will remain within any given cohort at each year after an observer chooses to begin recording survival rates. For CDBG loans, the percentage of surviving businesses declines each year after loan origination, at a rate similar to that of another study of business survivor rates in a government aid program. See Walker, Christopher and Kathy Pettit 1998 *Effective Aid to Trade-Impacted Manufacturers*. Economic Development Administration, Washington, DC.

[19] About 20 percent of firms terminate in each of the first and second years after startup. The rate of dissolution decreases year by year; by the ninth or tenth year only about 7 or 8 percent of the remaining firms fail. Fewer than half of all new firms are in operation after five years (*The State of Small Business: A Report of the President*. 1999. United States Government Printing Office, Washington).

[20] *Federal Funds, Local Choices, op. cit.*

at the time of loan origination), and how much these actual jobs cost the CDBG and Section 108 programs.

The CDBG regulations stipulate that all CDBG *activities* must qualify under a national objective. For CDBG- or Section 108-funded third-party lending qualified under the national objective of creating low- and moderate-income jobs, each jurisdiction is obliged to monitor and report to HUD the number of jobs that are, in fact, created or retained.[21] For purposes of this research, multiple loans have been bundled together into their respective *projects* for the purpose of counting jobs. This bundling corresponds to typical local practice in treating multiple loans as part of a single activity where the same business and economic activity is being funded. In the following discussions of job performance, costs-per-job, and funds leveraging, data are reported for a total of 930 projects funded by the 976 loans in the study sample.

Local agency staff continue their monitoring efforts after project start-up until they conclude that the borrowing business has completed the hiring (or job retention) activities required by their loan agreement with the city, county, or subrecipient agency. For 78 percent of the projects examined in this study, the latest jobs documentation in the files was dated a year or more after loan origination, by which time most firms would likely have reached whatever level of employment could be expected as a result of project investments.[22] Moreover, analysis suggests that most of the remaining 22 percent also had achieved their ultimate employment levels even though less than one year had elapsed since loan origination. A remaining pitfall of using local data, however, is variation in job documentation practices across communities—including differences in the timing of job documentation.

Table 4.8 summarizes the total number of jobs created or retained (including low-, moderate-, and high-income jobs) using CDBG and Section 108 funds for those projects that qualified under the low-mod national objective.[23] It distinguishes between the total number of jobs created or retained by all projects, on the one hand, and by only those projects carried out by businesses that survived, on the other. Projects aided by the CDBG and Section 108 programs, combined, created at least 93 percent of the jobs that had been planned at the time of loan origination.[24] Projects involving CDBG funds created or retained 107 percent of planned

[21] Activities that were not qualified under the job creation national objective are not obliged to track the number of jobs created or retained, although 31 percent of projects qualified under other national objectives collected jobs information nonetheless.

[22] In projects with multiple loans, researchers calculated the time elapsed between the date of the last loan origination to the date of the last recorded jobs documentation.

[23] All reported created jobs figures include both created and retained jobs. Although loan application files distinguished between created and retained jobs, local job creation documentation typically did not.

[24] Because some agencies stop counting job creation information once planned job targets are met, some portion of businesses probably created additional jobs not reported to agencies, and thus not included in these totals.

jobs while those involving Section 108 funds created or retained 82 percent of planned jobs. This comparison includes jobs in projects sponsored by terminated businesses, which may have been lost. Excluding jobs in projects carried out by terminated businesses reduces the CDBG job creation rate to 86 percent of planned jobs and the Section 108 rate to 60 percent of planned jobs.

Table 4.8
Created and Retained Jobs as a Percentage of Planned Jobs in Third-Party Loan Projects, by HUD Funding Source

	HUD Funding Source			
	CDBG/Float/EDI/BEDI	Section 108	Total	Number of Projects
Total Planned Jobs	11,703	15,925	27,628	695 *
Created or Retained Jobs				
All Businesses	12,501	13,079	25,580	495 *
Percent of Planned Jobs	107 %	82 %	93 %	
Surviving Businesses	10,070	9,499	19,569	410 **
Percent of Planned Jobs	86 %	60 %	71 %	

Note: Data are weighted to represent the universe of projects undertaken by all borrowing businesses in 51 high-loan volume communities. Total planned, created, and retained jobs include low-, moderate-, and high-income jobs: job figures are from only those projects qualifying under the low-mod national objective. Figures are corrected to account for missing jobs and subsidy data.

*Due to missing data, this figure is less than the total 720 projects qualifying under the low-mod national objective.

**Due to missing data, this figure is less than the total 577 projects qualifying under the low-mod national objective and undertaken by surviving businesses.

Source: Urban Institute Loan File Review Database--Third-Party Lending Study, 2002.

The average project did not fare as well as these program totals would indicate. Of projects sponsored by surviving businesses, and that were expenditures on the basis of low-mod job creation, 56 percent of CDBG-assisted projects and 52 percent of Section 108-assisted projects met or exceeded their total job-creation and retention targets (see Table 4.9). Performance in creating or retaining low-mod jobs is better than the job performance with respect to total jobs: 64 percent of CDBG-assisted projects and 57 percent of Section 108-assisted projects met or exceeded their low-mod job creation/retention targets (see Table 4.9). Put another way, 36 percent of projects with CDBG-funded loans and 44 percent of those with Section 108-funded loans failed to meet their low-mod job targets (see Table 4.9).

The cost per job created. Most economic development programs assess performance, at least in part, on the basis of the costs to them of the number of permanent jobs created. (Some few projects retained jobs, as well. For this study, job creation totals include both created and retained jobs.) This calculation is typically approximate, departing from precision where job counts are estimated or self-reported by businesses, where attribution of jobs to

public investment is uncertain, and where the period over which jobs slots are considered to be available is unknown. Such uncertainties necessarily apply to this study as well. Job counts are based on local business documentation and collected at varying points in time.

Table 4.9
Percent of Projects Meeting Total Jobs and Low-Mod Job Goals, by HUD Funding Source

	Percent of Projects that Met Job Goal				
HUD Funding Source	**Less than 100%**	**100%**	**Greater than 100%**	**Total**	**Number of Projects**
Total Jobs					
CDBG/Float/EDI/BEDI	44 %	20	36	100 %	316 *
Section 108	48 %	5	47	100 %	85 **
Total	**45 %**	**17**	**38**	**100 %**	**401**
Low-Mod Jobs					
CDBG/Float/EDI/BEDI	36 %	32	32	100 %	212 *
Section 108	44 %	9	48	100 %	65 **
Total	**38 %**	**26**	**36**	**100 %**	**277**

Note: Data are weighted to represent the universe of projects undertaken by all borrowing businesses in 51 high-loan volume communities. Total job performance includes low-, moderate-, and high-income jobs. Low-mod job performance only includes low-income jobs. Job figures for both total jobs and low-mod jobs are from only those projects qualifying under the low-mod national objective, and only include job data from businesses that survived.
*Due to missing data, this figure is less than the total 467 CDBG/Float/EDI/BEDI-funded projects.
**Due to missing data, this figure is less than the total 110 Section 108-funded projects.
Source: Urban Institute Loan File Review Database--Third-Party Lending Study, 2002.

Assisted businesses created a total of 30,303 jobs over the time period of the study,[25] 20,881 of which were low-and moderate-income jobs. These figures (and the cost per job figures recorded in the tables) include all of the jobs created by assisted businesses, even if their projects were not qualified under the low-mod job creation national objective or the sponsoring business had been terminated.[26] Since, overall, approximately $731.5 million of principal had been lent under both the CDBG and Section 108 programs over the same period, the creation of 30,303 total jobs results in an average loan principal cost-per-job of $24,138 (see Table 4.10). Average job costs are less expensive for CDBG-assisted, than for Section 108-assisted, businesses: $11,615 versus $37,957, respectively. Likewise, the creation of 20,881 low-mod jobs results in an average loan principal cost-per-low-mod-job of $35,030. Loan principal costs per each low- and moderate-income-job created are $18,946 for CDBG-funded projects and $49,107 for Section 108-funded projects.

[25] For CDBG-funded loans, the time period is 1996 to 1999, and for Section 108-funded loans, the time period is 1994 to 1999.

[26] This total jobs number differs from previous total jobs figures (i.e., Table 4.8) because this figure includes all businesses regardless of national objective.

Table 4.10
The Costs of Creating All Jobs and Low-Mod Jobs, by HUD Funding Source

	HUD Funding Source		
	CDBG/Float/EDI/BEDI	**Section 108**	**Total**
Total Lending Volume (in millions)	$184.6	$546.8	**$731.5**
Total created or retained jobs*	15,897	14,406	**30,303**
Principal cost per job**	$11,615	$37,957	**$24,138**
Created or retained low-mod jobs	9,746	11,135	**20,881**
Principal cost per low-mod job***	$18,946	$49,107	**$35,030**
Number of projects	455 ****	123 *****	**579**

Note: The figures are adjusted to account for missing job data; therefore, the principal loan amount in this table does not match Table 4.1. Data are weighted to represent the universe of projects undertaken by all borrowing businesses in 51 high-loan volume communities.

*Includes jobs counted by all projects, regardless of the national objective under which it was qualified.

**Principal cost per job does not include twelve cases with unusually high cost-per-job amounts.

***Principal cost per low-mod job does not include seven cases with unusually high cost-per-job amounts.

****Due to missing data, this figure is less than the total 756 CDBG/Float/EDI/BEDI-funded projets.

*****Due to missing data, this figure is less than the total 174 Section 108-funded projects.

Source: Urban Institute Loan File Review Database--Third-Party Lending Study, 2002.

Three factors seem to account for the larger cost-per-job recorded by the Section 108 program compared to CDBG. First, and as indicated in Table 4.8, the Section 108 program overall created fewer jobs than planned—82 percent of those projected at Section 108 loan application—compared to CDBG, which created more jobs than planned. Had Section 108-assisted businesses created jobs at the same rate as CDBG borrowers, Section 108 costs-per-job would have been about $31,000. Second, and as will be shown in a subsequent table, Section 108 pays a larger share of project costs than CDBG and, as shown in Chapter 5, more often occupies the first financial position in projects. If Section 108 funding leveraged the amounts of private sector funding that is typical for CDBG projects, costs-per-job would drop still further, approaching $20,000 - $25,000 per job, or roughly double the CDBG costs. Third, several very high cost-per-job Section 108 projects have substantial public benefits in addition to job creation, including a hotel parking garage, a public aquarium project, and several social services centers.

Programs that extend aid to businesses in the form of grants (like the U.S. Department of Commerce's Defense Adjustment Assistance Program or the Public Works Program, among others) convey a subsidy that amounts to 100 percent of the dollars granted. Because funds that must be repaid are "worth" less to businesses that borrow them than a similar amount in the form of a grant, it is appropriate to calculate a subsidy-dollars-per-job value by converting loan

dollars to their grant equivalents—thus allowing comparison of loan programs to grant programs.[27] The subsidy value of loaned funds must be estimated based on the difference between the interest rates and terms available under CDBG- and Section 108-funded third-party programs and those obtainable from market-rate lenders. While this is conceptually straightforward, such a subsidy value is difficult to calculate in practice. For some borrowers, for example, there may be no market-rate lender willing to accept the kind of risk that lenders using CDBG funds would absorb; in other words, there may be no market comparable. Further, private lenders underwrite business loans using multiple sources of information, not all of which could be collected for this study. Lenders assess this information in light of their own appetite for risk and profit, which varies considerably across firms and local markets. For these reasons, in the best of circumstances, comparable "market" rates can only be approximated.

Calculating the value of subsidies to borrowers—sometimes called the "asset value to the firm"—involves determining the net present value of the benefit to the firm of the interest subsidy on CDBG- and Section 108-funded loans.[28] To do so, the undiscounted stream of benefits is first calculated by subtracting each payment on a CDBG- or Section 108-funded loan from the payment that would have been made on a market-rate loan of the same term and amortization, with a rate equal to the yield of a Treasury obligation of comparable maturity sold on the day of origination plus 700 basis points.[29] This stream of benefits is then discounted

[27] These subsidy *value* figures are not subsidy *cost* figures. Subsidy value refers to the worth of subsidies to the assisted business. Subsidy cost refers to the cost to the *government* to provide these subsidies. The latter requires complex computations of the cost to the Federal Treasury of funds it borrows to support government operations and the opportunity cost of the funds granted to local governments relative to other uses. These calculations were not made for this report.

[28] This standard was chosen based on consultations with experts in "sub-prime" business lending. Note that this method estimates only the value of the interest subsidy. Any other subsidies, in the form of easier terms, deferral periods, matching grants, etc. are not included. Moreover, this method will also underestimate the subsidy for firms that would not have been able to secure a market loan at any price, since for them the 'market rate' would be infinite. For a discussion of this methodology, see: Rasmussen, et al. *A Methodology for Selecting Economic Development Incentives*, *Growth and Change*, 15(1) January 1984, pages 18-25.

[29] For nonstandard maturities or maturities for which no Treasury obligation was sold on the day of origination, a daily yield curve was constructed and the yield at the omitted comparable maturity was read off the curve. Note that, for purposes of this analysis, variable rate loans were treated as if they were fixed rate, using the interest rate applicable to the first payment. To the extent that lenders use risk-based pricing, this should tend to overestimate the value of the subsidy, since variable market-rate loans tend to have lower rates, but the comparison rate (Treasury obligation plus 700 basis points) was not adjusted for loan type. Note also that this 'comparable-maturities' method is not the current method used by HUD or the Office of Management and Budget (OMB) to calculate subsidy costs. The current method, known as the 'basket-of-zeroes' approach to discounting, is somewhat more accurate inasmuch as the comparable-maturities method may result in slightly smaller estimates of net present subsidy value. However, the differences between the two methods are, apparently, not large and, for purposes of this study, the basket-of- zeroes method was deemed not to be worth the additional time and effort--especially since the biggest source of uncertainty in the calculations is not the Treasury rate chosen but the 700 basis points margin

using the same ”market-rate” (Treasury obligation yield plus 700 basis points). Based on this calculation, the $732 million of loan principal in CDBG- and Section 108-funded projects conveyed an estimated subsidy value of $186 million. Broken down by program, the CDBG program’s estimated subsidy-dollars-per-job comes to $2,673, and that of the Section 108 equals $7,865. These subsidy-dollars-per-job compare favorably to other programs for which good information is available, even when the total public cost of jobs created is used as the point of comparison (see Table 4.11).

Table 4.11
Comparison of CDBG and Section 108 Job Creation Costs With Those of Other Federal Programs[30]

Grant Program, Description, and Source of Estimate	**Subsidy Dollars Per Job**
EDA Public Works Program—includes EDA and other public funding. Includes only new permanent jobs and not retained jobs (Burchell, 1997).	$5,157
Micro-enterprise assistance programs (non-loan portion, consisting of business development and program administration costs) (Servon, 1998).	$4,205—$6,250
CDBG grants and loans to business (Urban Institute, 1995).	$3,652
EDA Revolving Loan Fund program (Burchell, 2002), 1995 – 1998	$ 936
Third Party Lending Study of CDBG and Section 108, including total cost of public funds	$2,673 CDBG-only; $7,865 Section 108-only.
Loan Program, Description, and Source of Estimate	**Loan Principal Cost Per Job**
Average of Federal Revolving Loan Funds (CED, 1999). Urban Development Action Grant (1978 – 88) (HUD, 1989). Third Party Lending Study of CDBG and Section 108, principal amounts	$5,358 $10,478 $11,615 CDBG $37,957 Section 108

Note: Except for EDA revolving loan funds (1998 dollars), all job costs from federal programs are adjusted to 1999 dollars to allow comparison among figures compiled in different years. These figures are not loan principal per job. Loans are converted to their grant equivalents to permit a fair comparison.

that was added. For a discussion of the differences between the basket-of-zeroes and the comparable-maturities methods, see "The Basket-of-Zeroes Approach to Discounting," December 1, 1999, OMB Credit Subsidy Page: http://www.whitehouse.gov/omb/credit/c2.html (accessed June 2002).

[30] Table Sources: Robert W. Burchell, 1997. *Public Works Program: Performance Evaluation.* Center for Urban Policy Research, Rutgers University; Lisa J. Sevron, 1998. *Microenterprise Development as an Economic Adjustment Strategy*. Rutgers-The State University of New Jersey. December; The Urban Institute, 1995. *Federal Funds, Local Choices: An Evaluation of the Community Development Block Grant Program*, Vol 1; Robert W. Burchell, 2002. *EDA RLFs-Performance Evaluation.* Center for Urban Policy Research, Rutgers University; Corporation for Enterprise Development, 1997. *Counting on Local Capital: A Research Project on Revolving Loan Funds.* Washington, DC; and U.S. Department of Housing and Urban Development, 1989. *Consolidated Annual Report to Congress on Community Development Programs*. Office of the Assistant Secretary for Community Planning and Development, Office of Program Analysis and Evaluation. Washington, DC.

The top panels of Table 4.11 show the dollars-per-job-created for two grant-funded business-assistance activities for which subsidy dollars-per-job calculations are available: the EDA Public Works Program that provides grants to local development agencies for infrastructure projects supporting private investment; and micro-enterprise programs that receive funding from a variety of public and private sources for providing business development assistance to small, start-up businesses.[31] The subsidy value of these grants is the same as the grant amount.

The third panel reports the Urban Institute's earlier CDBG study that included both loans and grants to for-profit business. Because the study did not distinguish between loans and grants, the figure reported does not reflect a discount of loan principal to reflect the repayment requirement.

The fourth panel contains an estimate from an evaluation of the EDA revolving loan program, and includes only the estimated subsidy cost supplied by the original EDA grant to capitalize each fund and the interest foregone because loans were made over the years at discounted rates. Among the programs in the chart, the EDA revolving loan fund program is most similar to HUD's third party lending programs. The agency awards grants to local economic development agencies serving moderately distressed areas to create loan pools using EDA, other public, and private funding. Loans may then be originated to businesses for economic development projects, and repayments are recycled through the pools for use in future loans.

The fifth panel shows the cost of jobs created by businesses assisted in the 51 high-loan-volume communities, using the subsidy value calculation that was described above. It also shows total public costs per job (e.g., CDBG plus other public funds) that takes into account other CDBG, federal, state, or local public monies that are invested in loan-funded projects.[32]

The bottom panel shows the costs-per-job of other loan programs. The federal RLF figure is the mean of the average costs-per-job reported by local fund administrators in response to a survey of their financial and administrative characteristics carried out by the Corporation for Enterprise Development. The majority of these funds have been capitalized with funding from the US Department of Commerce. The UDAG program figure comes from HUD administrative systems, as reported in HUD's annual report to Congress on community development programs.

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[31] The cost figures shown were prepared for this study based on an analysis of information available on these programs.

[32] This figure assumes that other public funding included in loan-funded projects are grants, not loans. This may not be true in all projects, but researchers did not collect information on loan-grant status of these other public dollars.

The comparisons in the top panel show that average CDBG and Section 108 subsidy value per job is lower than the cost-per-job estimated for some other programs, and higher than that for the EDA revolving loan fund program, its closest counterpart in terms of program purpose and structure. For the latter comparison, the CDBG subsidy-value-per-job of $2,673 is nearly three times larger than the EDA figure of $936. At least three factors account for this difference. First, and by law, a portion of CDBG- and Section 108-assisted jobs must be held by or available to low-income persons; EDA-assisted businesses face no such requirements. Second, and related, local governments are required to document their compliance with CDBG job creation requirements, and the accuracy of this information is subject to verification by Federal monitors. Third, the EDA average is based on a large number of retained jobs, which other program experience shows are much less expensive (and much less reliably estimated) than new jobs.[33]

Project leverage. One desired effect of investing CDBG and Section 108 funds in economic development projects is encouragement of investment by other, especially private-sector funders. The rationale is that public funding helps to absorb risk that private-sector funders are unwilling to accept, thereby inducing their participation in pro jectfinance. In the best circumstances, such private funds would not be forthcoming “but for” the investment of CDBG or Section 108 dollars. This leveraging of private funding is an important benefit conveyed by community operation of economic development loan programs.

With respect to the various HUD-supported third-party lending programs, the best total leverage is achieved from CDBG-funded projects, in which CDBG funding averages 22 percent of total project costs (see Table 4.12). By comparison: Section 108-funded loan dollars average 31 percent of project costs; the small number of EDI/BEDI loan funds in the sample average 41 percent; and CDBG floats, which play a very different kind of role in project finance, pay the bulk of project costs (81 percent).[34] Other public and private sources pay the remainder of project costs not covered by HUD-supported third-party loans. Much of this remainder is paid by private funds—indicating that CDBG- and Section 108-funded loans are successful in attracting private capital to economic development projects. For example, the total value of CDBG-funded loan projects amounts to $735.5 million, of which $445.9 million (60 percent) is supplied by private lenders and equity investors. The $1.6 billion in Section 108 loan-funded projects includes $759.6 million in private funding, or 48 percent of funds. In both programs, investors of private equity provide 10 percent or more of funds, on average. Other state and local funding

[33] The analysis of EDA loan funds did not distinguish between retained and new jobs. A review of the loan profiles presented as appendices to the analysis strongly suggests that at least one-half of reported jobs are retained.

[34] This is the case because floats are short-term funds that are usually intended to bridge the period between project initiation and project completion on large redevelopment or industrial projects; this is a period where private-sector lenders make only high-cost funds available, pending completion of permanent financial arrangements.

sources (not including CDBG) are also important supporters of HUD-funded loan projects, contributing 11 percent of total funding, on average.

Table 4.12
Sources of Other Public and Private Funds in Third-Party Loan Projects, by HUD Funding Source

	HUD Funding Source							
	CDBG		CDBG Float		EDI/BEDI		Section 108	
	Dollars (in millions)	Percent	Dollars (in millions)	Percent	Dollars (in millions)	Percent	Dollars (in millions)	Percent
Loan Amount	**$165.5**	**22 %**	**$16.7**	**81 %**	**$2.3**	**41 %**	**$492.7**	**31 %**
Total Public Dollars	**128.1**	**17**	**0.9**	**4**	**0.7**	**13**	**335.3**	**21**
Section 108	13.7	2	0.0	0	0.7	12	105.5	7
EDI/BEDI	0.3	0	0.0	0	0.0	1	186.1	12
Other Fed Loans	26.0	4	0.0	0	0.0	0	7.6	0
State/Local	81.9	11	0.8	4	0.0	0	23.7	1
Other CDBG	6.2	1	0.0	0	0.0	0	12.3	1
Total Private Dollars	**445.9**	**60**	**3.1**	**15**	**2.5**	**45**	**759.6**	**48**
Private Lending	288.0	39	1.9	9	0.8	15	534.1	34
Equity	108.3	15	1.2	6	1.7	30	151.0	10
Stock	1.8	0	0.0	0	0.0	0	0.8	0
Personal borrowing	1.3	0	0.0	0	0.0	0	0.5	0
Other Funding	46.5	6	0.0	0	0.0	0	73.1	5
Total Investment	**739.5**	**99 %*******	**20.6**	**100 %**	**5.4**	**99 %*******	**1,587.7**	**100 %**
Number of Projects	685 *		14 **		18 ***		149 ***	

Note: Data are weighted to represent the universe of projects undertaken by all borrowing businesses in 51 high-loan volume communities. All 0% figures represent percentages that are less than one. Some subtotals do not add up to total public dollars or total private dollars due to rounding.

*Due to missing data, this figure is less than the total 723 CDBG-funded projects.

**Due to missing data, this figure is less than the total 15 CDBG Float-funded projects.

***There were 18 total EDI/BEDI-funded projects included in this study.

****Due to missing data, this figure is less than the total 174 Section 108-funded projects.

*****Percentage does not add to 100 due to rounding.

Source: Urban Institute Loan File Review Database--Third-Party Lending Study, 2002.

Put another way, each dollar of CDBG funding leverages $2.69 of private funding and another $0.77 of public money, for a total of $3.47 of other funds leveraged (see Table 4.13). Each Section 108 dollar leverages $1.54 in private funding and $0.68 in other public funding, for a total of $2.22 in other funds leveraged. For a recent` point of comparison, a study of revolving loan funds capitalized by the Economic Development Administration calculated a median leveraging ratio of $1.97 per RLF dollar for 3,988 loans originated between 1995 and 1998. This leveraging ratio is similar to the program-wide ratio for Section 108, and lower than the corresponding CDBG ratio. Most likely, this difference between CDBG and the other programs reflects the more frequent use of CDBG loan principal as “gap finance,” an inference supported by evidence in the next chapter showing the predominate use of CDBG funds as subordinate debt.

Table 4.13
Ratio of Public, Private, and Total Other Funding to Loan Principal, by HUD Funding Source

	HUD Funding Source							
	CDBG		CDBG Float		EDI/BEDI		Section 108	
	Dollars	Ratio to Loan Principal	Dollars	Ratio to Loan Principal	Dollars	Ratio to Loan Principal	Dollars	Ratio to Loan Principal
	(in millions)		(in millions)		(in millions)		(in millions)	
Loan Principal Amount	$165.5		$16.7		$2.3		$492.7	
Total Public Dollars	128.0	0.77:1	0.9	0.05:1	0.7	0.33:1	335.3	0.68:1
Total Private Dollars	445.9	2.69:1	3.1	0.18:1	2.5	1.09:1	759.6	1.54:1
Total Public and Private	**$574.0**	**3.47:1**	**$3.9**	**0.23:1**	**$3.2**	**1.42:1**	**$1,094.9**	**2.22:1**
Number of Projects	685 *		14 **		18 ***		149 ****	

Note: Data are weighted to represent the universe of projects undertaken by all borrowing businesses in 51 high-loan volume communities.
*Due to missing data, this figure is less than the totals 723 CDBG-funded projects.
**Due to missing data, this figure is less than the total 15 CDBG Float-funded projects.
***There were 18 total EDI/BEDI-funded projects included in this study.
****Due to missing data, this figure is less than the total 174 Section 108-funded projects.
Source: Urban Institute Loan File Review Database--Third-Party Lending Study, 2002.

Important to Section 108 projects are funds provided from EDI/BEDI and from other Section 108 funds that are not invested in the form of a loan. These other Section 108 funds contribute seven percent of total funding, and EDI/BEDI adds another 12 percent of funding—bringing their total contribution to 19 percent. Taken together with Section 108 loan principal, the total Section 108 or Section 108-related financial contribution comes to 50 percent of the total financing in Section 108-supported projects.

Substitution. The flip side of leveraging is "substitution"—the replacement of private dollars that ordinarily would be invested in projects if lower-cost public funding were not available. Other things equal, each public dollar that substitutes for a private dollar represents an inefficient use of public funds, and the loss of an opportunity to spend scarce public money on other worthwhile projects. All economic development programs that involve direct aid to for-profit firms risk substitution. Some programs have attempted to mitigate this risk by requiring "but-for" tests that use underwriting techniques to size public subsidies appropriately. However, even where these tests are aggressively applied, uncertainties surrounding the creditworthiness of projects and borrowers, private lender appetite for risk, availability of business owner capital, and other project financial characteristics render some substitution inevitable.

Although HUD publishes guidance to communities on how to ensure that the amount of funds provided to businesses is appropriate, neither the Section 108 nor the CDBG program requires a "but-for" test—in other words, evidence that a project would not have gone forward

"but for" the provision of Section 108 or CDBG funds.[35] Some grantees underwrite projects to limit the risk of substitution; others choose not to do so to avoid the demands this underwriting places on staff resources available for loan review and approval. Therefore, some amount of substitution is to be expected in both CDBG- and Section 108-funded third-party lending programs.

To determine the extent to which CDBG or Section 108 funds substitute for other forms of public assistance, the Business Survey included questions to business owners regarding whether they believed their investment involved: *no substitution*—it would not have happened at all without the loan; *partial substitution*—it would have happened on a smaller scale, over a longer time period, or with a delay had the loan not be made; or *full substitution*—it would have happened on about the same scale and same schedule in the absence of the third-party loan. Of the total number of businesses surveyed, 36 percent of CDBG-funded loan recipients and 39 percent of Section 108-funded loan recipients believed the investment activity supported by these funds would not have happened at all without the loan; an additional 40 percent of CDBG-funded loan recipients and 45 percent of Section 108-funded loan recipients reported that the investment activity would have happened without the loan, but on a smaller scale, over a longer period, or with a delay (see Table 4.14)[36]. Finally, 20 percent of CDBG-funded borrowers and nine percent of Section 108-funded borrowers (or 18 percent for both programs) claimed full substitution of public funding—i.e., that their projects would have happened on the same scale and schedule had no public money been involved. The dollar amounts involved in full substitution projects, however, are small in the Section 108 program, amounting to only 1.3 percent of funds invested. Taken together, "full substitution" projects account for four percent of all CDBG- and Section 108-funded loan dollars.[37] These figures mean that the smallest loans are most likely to involve substitution, which may be because local agencies are reluctant to incur the staff and other costs required to underwrite small loans aggressively enough to make substitution less likely.

[35] For example, HUD's previous Urban Development Action Grant (UDAG) program, which was established as part of the Housing and Community Development Act of 1977, required the HUD Secretary to determine that there was a strong probability that non-Federal investment in a project that also received UDAG funds would not have been made without the UDAG funds, and that the UDAG funds would not substitute for non-Federal funds that were otherwise available to the project. Consequently, substitution occurred when federal funds paid for some portion or all of an investment that the private sector or state or local governments would have paid for in the absence of UDAG funding. "But for" is a shorthand version of the statement, "But for UDAG, this project would not have gone forward."

[36] Note: the overall response rate for the business survey was 24 percent. However, after accounting for businesses that had terminated prior to conducting the survey, the overall response rate for *surviving businesses* was 31 percent.

[37] These findings suggest a slightly higher level of substitution for CDBG-assisted businesses than was found in the Urban Institute's earlier study of the CDBG program, where 50 percent of businesses reported that no project would have been undertaken without the CDBG funds. See *Federal Funds, Local Choices, op. cit.*

Table 4.14
Level of Substitution Reported by Owners of Assisted Businesses, by HUD Funding Source

	HUD Funding Source		
Degree of Substitution	**CDBG/Float/EDI/BEDI**	**Section 108**	**Total**
None: Would not have happened at all without the loan	36 %	39 %	36 %
Partial: Would have happened without the the loan, but on a smaller scale	40	45	41
Full: Would have happened on about the same scale and schedule	20	9	18
Would have had some other outcome	4	7	5
Total	**100 %**	**100 %**	**100 %**
Number of Businesses	188 *	39 **	227

Note: Data are weighted to represent the universe of borrowing businesses in 51 high-loan volume communities. Percentages do not include responses of "Don't Know/Refuses to Answer".

*Due to missing data, this figure is less than the total 193 CDBG/Float/EDI/BEDI-assisted businesses surveyed.

**Due to missing data, this figure is less than the total 41 Section 108-assisted businesses surveyed.

Source: Urban Institute Business Survey--Third-Party Lending Study, 2002.

Because these figures pertain to surviving businesses, true substitution percentages may be different from those reported here. If failed businesses were more heavily dependent on public subsidy to begin or continue operations, at least to the extent that they would not have gone forward with their projects at the same pace or scale, the full substitution figures reported here are somewhat overstated. If it is assumed that *none* of the failed businesses would have carried out their projects substantially as planned, the *full substitution* rates presented here would drop from 20 percent to 16 percent for CDBG, and from nine percent to seven percent for Section 108.

The Relationship Between Project Benefits and Business Characteristics

Not all CDBG- and Section 108-funded loans result in benefits at the same rate and, thus, program administrators have considerable interest in knowing what the tradeoffs are as they pursue certain kinds of job-creation and business-development objectives. For example, do small loans produce better results than larger ones? Does encouraging start-up businesses generate more jobs-per-dollar-invested than loans made to existing businesses? Do larger businesses leverage more funds than smaller businesses? This section answers these questions for the sample of 930 projects in the 51 high-loan-volume communities—using information about the borrowers, the amounts borrowed, and the locations of their businesses.

Anticipating that business characteristics might influence the subsequent performance of a project, the following characteristics were examined:

- **Loan amounts**: This variable consists of the principal amount of CDBG/CDBG Float/EDI/BEDI and Section 108-funded loans grouped into four equal categories on the basis of numbers of loans. For CDBG/Float/EDI/BEDI, these quartile cut-offs are 0-$97,000; $97,000-$179,543; $179, 543-297,778; and greater than $297,778. For Section 108, these cut-offs are 0-$614,400; $614,300-$1,200,000; $1,200,000-$3,000,000; and greater than $3,000,000.
- **Start-up status:** This variable indicates whether a firm had been in business for at least a year prior to loan origination.
- **Business sales volumes:** Taken from Dun & Bradstreet records, this variable consists of firm sales for the year prior to loan origination, divided into quartiles—defined separately for loans funded through the CDBG/CDBG Float/EDI/BEDI and Section 108 programs. The sales quartile cut-offs for CDBG/CDBG Float/EDI/BEDI are 0-$150,000; $150,000-$590,000; $590,000-$2,300,000; and above $2,300,000. For Section 108, these cut-offs are 0-$247,477; $247,477-$1,249,835; $1,249,835-$8,467,715; and above $8,467,715.
- **Business number of employees:** As recorded in loan application documents, this variable indicates the firm's employment at the time of loan origination, divided into quartiles. These quartiles for loans funded through both the CDBG/CDBG Float/EDI/BEDI and Section 108 programs are 0 to1 employee; two to five employees; six to 25 employees; and more than 25 employees.
- **Business sector:** This variable indicates the business sector that corresponds to the Standard Industrial Classification (SIC) code for the product made or service provided as a result of the CDBG- or Section 108-funded activity.
- **Business location:** This variable indicates the poverty rate in the year-2000 Census tract in which the borrowing business operates. That rate is divided into three categories—low poverty (less than 20 percent poverty); high-poverty (20 percent to 39 percent); and extreme poverty (40 percent or more poverty).

The remainder of this chapter discusses, in detail, the relationships between these six business characteristics and each of the five performance categories identified above. Anticipating that discussion, it is observed that for CDBG-assisted projects:

- Larger business borrowers tend to show better-than-average performance in terms of business survival rates and, among survivors, in the ratio of actual-to-planned jobs created. They also create jobs at less cost and leverage more public and private funding but, related to this, also tend to have higher rates of substitution.

- Smaller businesses tend to fail more frequently, create fewer jobs than planned and, in the case of small employers, create jobs at higher cost than other firms. But, these smaller businesses are also more likely than other firms to be minority-owned.
- Borrowers in services industries create more jobs, at lower cost than other companies and, at the same time, are more dependent on CDBG-provided subsidies—i.e., they less frequently use CDBG-funded loans to substitute for other sources of funding.
- Businesses located in high-poverty and extreme-poverty tracts create fewer jobs, and the jobs they create cost more than jobs created by firms in low-poverty tracts. For business establishments located in extreme poverty tracts, at least, part of the explanation may lie in their inability to attract other public and private funding in the same amounts as firms located in non-extreme poverty tract neighborhoods.

Because of the small number of respondents to the Business Survey sample who borrowed through the Section 108 program, the effects of business characteristics on substitution in Section 108-funded projects was not tested. And, overall, the relationship between business characteristics and the levels of benefits conveyed by such projects is less clear than for CDBG—perhaps reflecting the smaller number of projects and the unique circumstances that pertain to very large redevelopment efforts. But, in general, with respect to Section 108-funded projects:

- Larger firms create more jobs in relation to job targets than smaller firms, and these jobs cost less in terms of the face value of the loans than jobs created by smaller businesses.
- Firms with large annual sales volumes, and those that borrow large amounts of money, tend to leverage proportionately more public and private dollars than firms with smaller sales volumes or ones that borrow in smaller amounts—the latter tending to show below-average leveraging performance.

The effects of business characteristics on business survival rates. Whether smaller borrowers, smaller businesses, start-ups, service or retail enterprises, or those located in poorer neighborhoods went out of business at higher rates than larger borrowers, larger businesses, established businesses, manufacturing companies, or firms that are located in better-off neighborhoods was tested. For CDBG-assisted businesses, borrowers of small amounts of money and smaller firms (in terms of numbers of employees) do, in fact, terminate at higher rates than larger firms or those that borrow in larger amounts. (See Table 4.15, which shows termination rates by firm size.) Also, retail firms terminate at slightly higher rates than firms in other sectors (not shown on any table.)

Table 4.15
Percent of Loans, Loan Dollars, and Percent of Loan Dollars, by Business Status and Employee Quartile at Time of Loan Origination (CDBG/Float/EDI/BEDI-funded Third Party Loans)

	Loans				Loan Dollars					
	In Business	Out of Business	Total		In Business		Out of Business		Total	
Employee Quartiles	Percent of Loans	Percent of Loans	Percent of Loans	Number of Loans	Loan Dollars (in millions)	Percent of Dollars	Loan Dollars (in millions)	Percent of Dollars	Loan Dollars (in millions)	Percent of Dollars
1: 0-1 employees	77 %	23	100 %	136	$21.8	80 %	$5.3	20	$27.1	100 %
2: 2-5 employees	82 %	18	100 %	141	19.1	86 %	3.0	14	22.2	100 %
3: 6-25 employees	81 %	19	100 %	135	23.5	85 %	4.1	15	27.6	100 %
4: more than 25 employees	86 %	14	100 %	112	27.4	83 %	5.5	17	32.8	100 %
Total	**81 %**	**19**	**100 %**	**524** *	**$91.8**	**84 %**	**$17.9**	**16**	**$109.7**	**100** %

Note: Data are weighted to represent the universe of borrowing businesses in 51 high-loan volume communities. Percentages do not include responses of "Don't Know/Refuses to Answer."

*Due to missing data, this figure is less than the total 775 CDBG/Float/EDI/BEDI-funded loans.

Source: Urban Institute Loan File Review Database--Third-Party Lending Study, 2002.

As with CDBG-assisted businesses, Section 108-assisted establishments with smaller numbers of employees tend to fail at higher rates than larger establishments (see Table 4.16). This is partly explained by the losses experienced among manufacturing businesses receiving large Section 108-funded loans; such establishments went out of business at almost two times the rate of Section 108-assisted firms in other sectors. Finally, location in a high-poverty or extreme-poverty neighborhood has no effect on firm termination rates for either CDBG- or Section 108-assisted businesses. This is true even for retail firms located in high-poverty areas, which might be expected to depress firm sales relative to manufacturing or other enterprises that are producing for a non-neighborhood market.

Table 4.16
Percent of Loans, Loan Dollars, and Percent of Loan Dollars, by Business Status and Employee Quartile at Time of Loan Origination (Section 108-funded Third-Party Loans)

	Loans				Loan Dollars					
	In Business	Out of Business	Total		In Business		Out of Business		Total	
Employee Quartiles	Percent of Loans	Percent of Loans	Percent of Loans	Number of Loans	Loan Dollars (In millions)	Percent of Dollars	Loan Dollars* (In millions)	Percent of Dollars	Loan Dollars (In millions)	Percent of Dollars
1: 0-1 employees	81 %	19	100 %	39	$141.7	77 %	$42.8	23	$184.6	100 %
2: 2-5 employees	71 %	29	100 %	34	11.8	77 %	3.5	23	15.3	100 %
3: 6-25 employees	95 %	5	100 %	20	12.3	83 %	2.5	17	14.8	100 %
4: more than 25 employees	87 %	13	100 %	52	87.5	89 %	10.7	11	98.2	100 %
Total	**84 %**	**16**	**100 %**	**145** *	**$253.4**	**81 %**	**$59.6**	**19**	**$313.0**	**100** %

Note: Data are weighted to represent the universe of borrowing businesses in 51 high-loan volume communities. Percentages do not include responses of "Don't Know/Refuses to Answer."

* Due to missing data, this figure is less than the total 201 Section 108-funded loans.

Source: Urban Institute Loan File Review Database--Third-Party Lending Study, 2002.

The effect of business characteristics on job creation performance. The best CDBG job-creation performance—in terms of the percentage of projects meeting both overall and low-mod job targets as well as achieving a high ratio of created- and retained-to-planned jobs—is observed for smaller businesses (in terms of sales, but not number of employees).[38] (See Table 4.17.) Existing businesses, as compared to start-ups, do not show superior job performance. And, projects located in extreme-poverty tracts are less likely to reach job-creation targets than projects in high-poverty or low-poverty tracts: 58 percent of businesses in tracts with 40 percent poverty or more fail to reach job goals, compared to 42 percent for high-poverty tracts and 44 percent for low-poverty tracts (not shown on any table).

Table 4.17
Ratio of Actual to Planned Jobs, by Business Sales Volume, Employee Quartiles, Start-up Status, and HUD Funding Source

Selected Business Characteristics		HUD Funding Source: CDBG/Float/EDI/BEDI — Ratio of Actual to Planned Jobs*	HUD Funding Source: Section 108 — Ratio of Actual to Planned Jobs*
Start-up Status	Existing Business	1.26:1	1.22:1
	Start-up	1.20:1	0.79:1
Permanent Employees at Time of Loan Origination in Quartiles	1: 0-1 employees	1.03:1	0.97:1
	2: 2-5 employees	1.54:1	1.01:1
	3: 6-25 employees	1.02:1	1.13:1
	4: more than 25 employees	1.40:1	1.99:1
CDBG Sales Volume Quartiles (in year of loan origination)	1: $0-$150,000	1.90:1	N/A
	2: $150,001-590,000	1.14:1	N/A
	3: $590,0001-$2,300,000	0.80:1	N/A
	4: more than $2,300,000	1.09:1	N/A
Section 108 Sales Volume Quartiles (in year of loan origination)	1: 0-$247,477	N/A	1.55:1
	2: $247,778 - $1,249,835	N/A	1.29:1
	3: $1,249,836 - $8,467,715	N/A	1.34:1
	4: more than $8,467,715	N/A	1.72:1
Number of projects		316 **	85 ***

Note: Data are weighted to represent the universe of projects undertaken by all borrowing businesses in 51 high-loan volume communities.

*Job ratios are the proportion of total created or retained jobs to total planned jobs. Jobs data include low-, moderate-, and higher-income jobs, and come from projects qualifying under only the low-mod national objective. Figures also include jobs data only from businesses that survived.

**Due to missing data, this figure is less than the total 467 CDBG/Float/EDI/BEDI-funded projects qualifying under the low-mod national objective and undertaken by surviving businesses.

***Due to missing data, this figure is less than the total 110 Section 108-funded projects qualifying under the low-mod national objective and undertaken by surviving businesses.

Source: Urban Institute Loan File Review Database and Dun and Bradstreet--Third-Party Lending Study, 2002.

Section 108-funded projects carried out by business start-ups display markedly worse performance than those undertaken by existing businesses or by CDBG-funded projects carried out by either start-up or existing businesses. Further, those businesses that are in the services

[38] Note that these are averages of each project's job creation performance, treating all projects equally—regardless of their size.

sector fare worse than those in other sectors. In contrast, manufacturing firms perform better, on average, in terms of the percentage that reach their job targets and the degree to which actual jobs created exceed projected job-generation targets. These figures, however, include only survivor businesses, and it should be recalled that manufacturing firms fail at higher rates than those in other sectors.

The effect of business characteristics on costs per job. Some types of borrowing businesses appear to be more cost-effective job generators than others. With respect to the CDBG program, for example, jobs generated or retained by start-up companies, firms borrowing smaller loan amounts, and businesses with larger numbers of employees cost less than jobs created or retained by existing businesses, firms borrowing larger amounts, and smaller companies (see Table 4.18). With respect to Section 108, smaller companies and borrowers of larger amounts also are more cost-effective but, unlike the experience of CDBG-funded borrowers, existing firms create or retain jobs at lower cost than do start-ups.

Jobs created or retained in high-poverty or extreme-poverty neighborhoods appear to cost more than jobs created or retained in low-poverty neighborhoods. With respect to the CDBG program, the average principal cost-per-job in high poverty neighborhoods and extreme-poverty neighborhoods is $13,329 and $14,370, respectively, compared to $10,558 in low-poverty neighborhoods (see Table 4.19). Put another way, the average “premium” cost-per-job generated by establishments located in high-poverty neighborhoods amounts to $2,771—or 26 percent above the job-generation costs of firms located in low-poverty neighborhoods. Jobs created or retained as a result of Section 108-funded loans made to establishments in high-poverty neighborhoods also are more expensive—costing $37,929 compared to $30,394 for jobs generated by firms in low-poverty neighborhoods; this amounts to a 25 percent premium.

Table 4.18
Loan Principal Cost-Per-Job and Subsidy Value-Per-Job, by Select Business Characteristics and HUD Funding Source

Selected Business Characteristics		HUD Funding Source: CDBG/Float/EDI/BEDI — Principal cost per job*	CDBG/Float/EDI/BEDI — Subsidy value per job*	Section 108 — Principal cost per job*	Section 108 — Subsidy value per job*
Principal Amount Quartiles for CDBG/Float/EDI/BEDI	1: 0-$97,000	$13,054	$1,876	N/A	N/A
	2: $97,001-$179,542	7,388	1,482	N/A	N/A
	3: $179,543-$297,777	10,908	2,981	N/A	N/A
	4: more than $297,777	14,880	3,572	N/A	N/A
Principal Amount Quartiles for Section 108	1: 0-$614,399	N/A	N/A	$19,059	$4,036
	2: $614,400-$1,200,000	N/A	N/A	25,826	3,370
	3: $1,200,001-$3,000,000	N/A	N/A	35,813	4,746
	4: more than $3,000,000	N/A	N/A	44,409	13,505
Start-up Status	Existing Business	11,511	2,632	35,395	6,303
	Start-Up	11,483	2,682	42,357	14,078
Number of Employees (Quartiles)	1: 0-1 employees	13,646	3,099	41,074	10,886
	2: 2-5 employees	12,564	2,214	119,192	1,518
	3: 6-25 employees	14,383	3,156	42,186	9,636
	4: more than 25 employees	7,770	1,792	22,960	4,765
Sector	Manufacturing	10,273	2,182	42,248	3,684
	Retail	11,712	2,492	32,841	7,379
	Services	13,418	2,949	40,512	23,054
	Other	11,008	3,130	37,287	5,686
Number of projects		455 **	307 **	123 ***	44 ***

Note: Subsidy value is the financial benefit conveyed to borrowers. It is the difference between the value of payments at market rates minus the value of payments made at the discounted rates of most third-party loans. Data are weighted to represent the universe of projects undertaken by all borrowing businesses in 51 high-loan volume communities.

*The principal cost-per-job and subsidy value-per-job includes job data from all projects regardless of their national objective. Jobs referred to in these figures include low-, moderate-, and high-income jobs. Principal cost-per-job does not include twelve outliers. Subsidy cost per job does not include two outliers.

**Due to missing data, this figure is less than the total 750 CDBG/Float/EDI/BEDI-funded projects.

***Due to missing data, this figure is less than the total 168 Section 108-funded projects.

Source: Urban Institute Loan File Review Database and Dun and Bradstreet--Third-Party Lending Study, 2002.

Table 4.19
Loan Principal Cost Per Job and Subsidy Value Per Job, by Categories of Neighborhod Poverty and HUD Funding Source

	HUD Funding Source			
	CDBG/Float/EDI/BEDI		Section 108	
Neighborhood Percent of Persons in Poverty	Principal cost per job*	Subsidy value per job*	Principal cost per job*	Subsidy value per job*
Less than 20%	$10,558	$2,606	$30,394	$5,382
Between 20% and 39%	13,329	3,008	37,929	14,579
More than 40%	14,370	2,636	35,511	4,721
Number of projects	433 **	307 **	121 ***	44 ***

Note: Subsidy value is the financial benefit conveyed to borrowers. It is the difference between the value of payments at market rates minus the value of payments made at the discounted rates of most third-party loans. Data are weighted to represent universe of projects undertaken by all borrowing businesses in 51 high-loan volume communities.

*Principal cost-per-job and subsidy value-per-job includes job data from all projects regardless of their national objective. Jobs referred to in these figures include low-, moderate-, and high-income jobs. Principal cost-per-job does not include twelve outliers and subsidy value-per-job does not include two outliers.

**Due to missing data, this figure is less than the total 750 CDBG/Float/EDI/BEDI-funded projects.

***Due to missing data, this figure is less than the total 168 Section 108-funded projects.

Source: Urban Institute Loan File Review Database and 2000 U.S. Census--Third-Party Lending Study, 2002.

The effect of business characteristics on leveraging. The leveraging calculations presented here consider the investment of both private dollars as well as other public funds that support CDBG- or Section 108-funded projects. Two leverage figures are calculated: the ratio of private and other public funding amounts to the principal amounts of CDBG- or Section 108-funded loans; and the ratio of private funding to total public funding—the latter including CDBG- or Section 108-funded loan principal as well as funding from other state, federal, or local public-sector sources.

With respect to the CDBG program overall, each loan dollar leverages another $3.40 in public and private funding. Larger firms (in terms of sales and employees) tend to leverage more dollars, on average, than do firms with a smaller number of employees or those having a smaller volume of sales at the time of loan origination. Firms in the largest employee size quartile leverage $4.40 for each CDBG dollar lent and firms in the largest sales volume quartile leverage $4.50 for each CDBG dollar lent (see Tables 4.20 and 4.21). Consistent with the relatively poor leveraging ratios of firms employing the smallest number of workers ($1:$3.60) and those borrowing in the smallest amounts ($1:$1.90), retail firms, which tend to be smaller businesses and projects, leverage only $2.20 per-loan-dollar (not shown on any table).

Table 4.20
Leverage Amounts in Dollars and Ratio of Leverage to Principal Loan Amount for CDBG/Float/EDI/BEDI-funded Third-Party Loan Projects, by Census Tract Poverty Categories, Sales Volume Quartiles, and Employee Quartiles

Neighborhood Percent of Persons in Poverty	Loan Principal Dollars (in millions)	Other Public Dollars (in millions)	Ratio of all Other Public Dollars to Principal Amount	Private Dollars (in millions)	Ratio of all Private Dollars to Principal Amount	Total Other Public and Private Dollars (in millions)	Ratio of Total Other Public and Private Dollars to Principal Amount
Less than 20%	$80.3	$67.5	0.8:1	$220.5	2.7:1	$288.0	3.6:1
Between 20% and 39%	54.2	45.4	0.8:1	164.1	3.0:1	209.5	3.9:1
More than 40%	25.4	12.8	0.5:1	49.2	1.9:1	62.0	2.4:1
Total	**$159.9**	**$125.7**	0.8:1	**$433.8**	2.7:1	**$559.5**	3.5:1
Sales Volume Quartiles (Year of Loan Orgination)							
1: $0-$150,000	$21.5	$23.5	1.1:1	$40.0	1.9:1	$63.5	3.0:1
2: $150,001-590,000	18.0	15.7	0.9:1	48.1	2.7:1	63.8	3.5:1
3: $590,0001-$2,300,000	30.7	16.1	0.5:1	73.8	2.4:1	89.9	2.9:1
4: more than $2,300,000	37.5	32.3	0.9:1	135.8	3.6:1	168.1	4.5:1
Total	**$107.8**	**$87.7**	**0.8:1**	**$297.7**	**2.8:1**	**$385.3**	**3.6:1**
Employee Quartiles (Time of Loan Origination)							
1: 0-1 employees	$29.7	$25.8	0.9:1	$79.9	2.7:1	$105.7	3.6:1
2: 2-5 employees	21.8	4.7	0.2:1	45.4	2.1:1	50.1	2.3:1
3: 6-25 employees	23.8	7.6	0.3:1	64.2	2.7:1	71.8	3.0:1
4: more than 25 employees	31.2	24.7	0.8:1	112.1	3.6:1	136.8	4.4:1
Total	**$106.5**	**$62.8**	**0.6:1**	**$301.7**	**2.8:1**	**$364.5**	**3.4:1**
Number of Projects	731 *						

Note: Data are weighted to represent the universe of projects undertaken by all borrowing businesses in 51 high-loan volume communities.
*Due to missing data, this figure is less than the total 756 CDBG/Float/EDI/BEDI-funded projects.
Source: Dun and Bradstreet and Urban Institute Loan File Review Database--Third-Party Lending Study, 2002.

The poor job creation and principal cost-per-job performance of businesses located in extreme-poverty tracts may be explained, in part, by the weak leveraging performance of projects located in these tracts. Projects in tracts with 40 percent poverty or more leverage only $2.40 for each dollar lent. This weak leveraging performance is due primarily to lower levels of private investment—although these projects are not more dependent on other public funding than are projects located in census tracts with lower levels of poverty.

With respect to the Section 108 program, leveraging performance is best for borrowing companies that have larger annual sales volumes as compared to others. Firms above the median EDI/BEDI number of sales (the top two quartiles) leverage between $2.70 and $2.90 for each Section 108-funded dollar lent, compared to firms in the smaller quartiles. The smallest firms leverage only $1.60 in other funding. This Section 108 pattern, though, is driven by the inclusion of other public funds, which tend to be invested at higher rates in larger projects (see Table 4.21).

Table 4.21
All Leverage Amounts in Dollars and Ratio of Leverage to Principal Loan Amount for Section 108-funded Third-Party Loan Projects, by Census Tract Poverty Categories, Sales Volume Quartiles, and Employee Quartiles

Neighborhood Percent of Persons in Poverty	Loan Principal Dollars (in millions)	Other Public Dollars (in millions)	Ratio of all Other Public Dollars to Principal Amount	Private Dollars (in millions)	Ratio of all Private Dollars to Principal Amount	Total Other Public and Private Dollars (in millions)	Ratio of Total Other Public and Private Dollars to Principal Amount
Less than 20%	$132.8	$163.4	1.2:1	$215.0	1.6:1	$378.4	2.8:1
Between 20% and 39%	121.5	107.4	0.9:1	261.4	2.2:1	368.8	3.0:1
More than 40%	196.7	63.7	0.3:1	282.5	1.4:1	346.2	1.8:1
Total	**$451.1**	**$334.5**	**0.7:1**	**$759.0**	**1.7:1**	**$1,093.5**	**2.4:1**
Sales Volume Quartiles (Year of Loan Origination)							
1: 0-$247,477	$58.7	$22.7	0.4:1	$73.0	1.2:1	$95.8	1.6:1
2: $247,778 - $1,249,835	61.2	43.4	0.7:1	44.5	0.7:1	87.9	1.4:1
3: $1,249,836 - $8,467,715	37.0	62.5	1.7:1	36.0	1.0:1	98.5	2.7:1
4: more than $8,467,715	57.0	82.2	1.4:1	84.9	1.5:1	167.1	2.9:1
Total	**$213.7**	**$210.8**	**1.0:1**	**$238.4**	**1.1:1**	**$449.3**	**2.1:1**
Employee Quartiles (Time of Loan Origination)							
1: 0-1 employees	$164.1	$52.6	0.3:1	$234.7	1.4:1	$287.3	1.8:1
2: 2-5 employees	44.0	1.6	0.0:1	4.7	0.1:1	6.3	0.1:1
3: 6-25 employees	22.9	6.2	0.3:1	2.8	0.1:1	9.1	0.4:1
4: more than 25 employees	96.5	42.7	0.4:1	162.9	1.7:1	205.6	2.1:1
Total	**$327.6**	**$103.2**	**0.3:1**	**$405.1**	**1.2:1**	**$508.3**	**1.6:1**
Number of Projects	160 *						

Note: Data are weighted to represent the universe of projects undertaken by all borrowing businesses in 51 high-loan volume communities.
*Due to missing data, this figure is less than the total 174 Section 108-funded projects.
Source: Dun and Bradstreet and Urban Institute Loan File Review Database--Third-Party Lending Study, 2002.

The effect of business characteristics on substitution. Beyond establishing overall rates of self-reported substitution of CDBG or Section 108 dollars for other forms of funding, there is interest in determining whether certain types of businesses are more likely than others to be fully dependent on these programs—as indicated by a claim that the project would not have gone forward *at all* without a third-party loan. As is shown in Table 4.14, 36 percent of all CDBG-assisted business owners claim that their project would not have gone forward at all in the absence of their loan—indicating no substitution. Percentages of no-substitution are highest for: retail and services establishments (41 percent and 47 percent, respectively); smaller businesses in terms of sales volume (52 percent in the smallest sales quartile) and number of employees (51 percent of businesses with five or fewer employees); and minority-owned businesses (46 percent). (See Tables 4.22 and 4.23.)

Table 4.22
Number and Percent of Businesses Owners Reporting Substitution Effects, by Industry Type for Businesses Receiving Third-Party Loans (CDBG/Float/EDI/BEDI-funded Third-Party Loans)

	Effect of loan					
Industry Type	***No Substitution****	***Partial Substitution****	***Full Substitution****	***Some Other Outcome***	***Total***	**Number of Businesses**
Manufacturing	23 %	44	25	9	100 %	37
Retail	42 %	41	10	3	100 %	44
Services	47 %	37	0	0	100 %	65
Other	19 %	43	20	9	100 %	40
Total	**35 %**	**40**	**55**	**4**	**100 %**	**186 ****

Note: Data are weighted to represent the universe of borrowing businesses in 51 high-loan volume communities. Percentages do not include responses of "Don't Know/Refuses to Answer."
*"No Substitution" indicates a response of "the project would not have happened at all without the loan." "Partial Substitution" indicates a response of "this project would have happened without the loan, but on a smaller scale." "Full Substitution" indicates a response of "this project would have happened on
**Due to missing data, this figure is less than the total 193 CDBG/Float/EDI/BEDI-assisted businesses.
Source: Dun and Bradstreet and Urban Institute Business Survey--Third-Party Lending Study, 2002.

Table 4.23
Number and Percent of Businesses Reporting Substitution Effects, by Employee Quartiles for Businesses Receiving Third-Party Loans (CDBG/Float/EDI/BEDI-funded Third-Party Loans)

	Effect of loan					
Employee Quartiles	***No Substitution****	***Partial Substitution****	***Full Substitution****	***Some Other Outcome***	***Total***	**Number of Businesses**
1: 0-1 employees	38 %	41	16	5	100 %	29
2: 2-5 employees	51 %	34	15	0	100 %	41
3: 6-25 employees	28 %	39	29	4	100 %	36
4: more than 25 employees	17 %	52	26	5	100 %	27
Total	**34 %**	**41**	**21**	**4**	**100 %**	**133 ****

Note: Data are weighted to represent the universe of borrowing businesses in 51 high-loan volume communities. Percentages do not include responses of "Don't Know/Refuses to Answer."
*"No Substitution" indicates a response of "the project would not have happened at all without the loan." "Partial Substitution" indicates a response of "this project would have happened without the loan, but on a smaller scale." " Full Substitution" indicates a response of "this project would have happened on about the same scale and schedule."
**Due to missing data, this figure is less than the total 193 CDBG/Float/EDI/BEDI-assisted businesses.
Source: Dun and Bradstreet and Urban Institute Business Survey--Third-Party Lending Study, 2002.

Unlike businesses that received CDBG-funded loans, industry sector and number of employees seem to have little relationship to the perceived substitution impact of Section 108-funded loans. In other words, there is not one particular sector or a particular size of business (as measured by the number of permanent employees at the time of loan origination) where borrowers seem more inclined to allege that the investment activity would not have happened at all without their Section 108-funded loan. Again, however, manufacturing businesses seem least dependent on HUD-supported loans: 17 percent of borrowers claim that the investment activity funded by their Section 108-funded loan would have happened on about the same scale

and schedule even without the loan.[39] Business size, as measured by sales volume, also seems to be related to the perceived effect of Section 108-funded loans, with 67 percent of borrowers whose businesses are in the lowest sales volume quartile at the time of loan origination noting that their investment activity would not have happened without the loan.[40]

[39] This is not shown on any table.

[40] This is not shown on any table.

CHAPTER 5: THE FINANCIAL CHARACTERISTICS AND PERFORMANCE OF HUD-SUPPORTED THIRD-PARTY LOANS

Highlights

This chapter examines the financial characteristics and performance of CDBG- and Section 108-funded third-party loans. It describes the terms and underwriting characteristics of the loans, assesses their financial performance, and demonstrates how financial performance is related to loan terms, underwriting characteristics, and business and community characteristics. The analysis draws on data that were collected and classified according to the customary ways in which private-sector lenders underwrite small business loans.

There are differences among CDBG, Section 108, CDBG "float," and EDI/BEDI loans with respect to average loan size, financing terms, borrower characteristics, and lender underwriting practices. CDBG loans tend to be small, are heavily discounted, are made to smaller borrowers, and are less well collateralized than Section 108 loans. This is especially true compared to a group of Section 108 loans made for very large commercial and industrial projects, where large amounts of money are borrowed at near market rates. Generally speaking, more than two-thirds of CDBG and Section 108 loan files contain financial statements, *pro-formas*, and other underwriting information, and over 60 percent of loans are secured, at least in part, by real estate collateral.

The historical default rate of CDBG loans made between 1996 and 1999 is 23 percent, about the same as for the portfolio of loans outstanding at the time of data collection. As of 2002, 16 percent of outstanding CDBG loans had defaulted, and another eight percent were seriously delinquent (more than 90 days), bringing the total "problem" loan fraction to 24 percent (accounting for 19 percent of loan principal originated.) The historical default rate for Section 108 is higher than for CDBG, but is heavily concentrated among smaller loans. Excluding one community whose loan portfolio has an extremely high default rate, the historical default rate for Section 108-funded loans originated between 1994 and 1999 is 42 percent. For outstanding loans, 29 percent have defaulted and another four percent are seriously delinquent, bringing the problem loan rate to 33 percent (accounting for 11 percent of principal originated).

Multivariate analysis involving information on loan terms, financial underwriting, collateral, and business and community characteristics adds to the ability to predict the likelihood of default of a pool of loans over what would be estimated based only on program type (CDBG or Section 108), year of origination, and median MSA income. This means that information available to those conducting due diligence prior to secondary market purchases can be used to assess (to a degree) the underlying risks associated with a pool of economic development loans. Practically speaking, this means that the "due diligence" discount of loan sales prices that would apply to a loan pool in the absence of such information need not be applied.

Introduction

Economic development lending programs supported by CDBG and Section 108 have invested in a wide variety of businesses, pursuing a diverse range of economic activities. The programs that cities and urban counties have devised to support these businesses are similarly varied. No national program requirements limit the forms this lending can take and, as a result, localities have adopted various lending facilities ranging from deeply discounted loans to micro-enterprise borrowers to near-market-rate loans to large corporate enterprises. As an indication of the types of assistance communities have provided, consider the following examples:

- In a large Eastern city, one of two sub-recipients, an economic development authority, focuses mainly on large projects, using two CDBG revolving loan pools and several non-revolving loan pools funded by Section 108. One CDBG pool focuses on mortgages for mid-sized commercial and industrial projects for loans of up to $500,000. The other pool focuses on community projects, non-profits, and community supported businesses. Section 108 loans are typically in the millions.
- In a mid-sized Midwestern city, an urban redevelopment authority administers two active CDBG lending programs. Businesses meet the same eligibility criteria for each program (location in a targeted area, etc.), and both programs offer below-market interest rates. The programs differ in their allowable uses of funds and associated terms. One program is used only for real estate projects, and the other for machinery and equipment, operating capital, and related uses such as inventory. Applicants can apply for and receive loans from both programs in the same package, but they are required to sign two promissory notes and receive loans with different terms: real estate loans, following industry standards, are long term, while machinery and equipment or operating capital are provided for shorter periods.
- In a small Western city, program officials administer two CDBG programs, one for established businesses and one for those facing credit barriers, including new businesses, small women- or minority-owned firms, and non-profits. Applications and required documentation are the same, but the “emerging businesses” program has more flexible underwriting standards and tends to offer more favorable terms—including lower interest rates and longer amortization periods. Loans made under the emerging businesses program are also less likely to leverage a great deal of private funds, as is common under the standard program. In the standard program, businesses can borrow no more than 50 percent of project costs, and receive a substantially lower rate for loans which leverage more private funds.

Sources and Uses of Information

To investigate the character and performance of loans originated under these and other programs across the sample of 51 high-loan-volume communities, this chapter takes on three basic tasks, as discussed further below. They are to: (1) describe the loan terms and underwriting characteristics of CDBG- and Section 108-funded loans; (2) assess the financial performance of these loans; and (3) show how financial performance is related to loan terms, underwriting characteristics, and business, neighborhood, and community characteristics. An enormous amount of hitherto unavailable information was collected for these purposes—focusing on the loans, the projects they support, and their business borrowers—and special analyses were undertaken using this information.

First, to describe terms and underwriting characteristics, data were collected on loan terms (principal, interest, payments, term, etc.) and any collateral used to secure the loan (from the legal closing documents in local program or sub-recipient lender offices)—including the loan agreement, promissory note, and any mortgages or liens. Underwriting documentation (financial statements, tax returns, credit reports) and projected budgets (sources and uses of funds) were collected from loan application and approval packages, also in local program offices. Note that while loan terms were collected at the loan level—and, in some cases, varied between two loans in the same financing package—project budgets were collected at the project level and were identical for multiple public loans or, for that matter, for the public loan and a bank loan in the same project. This distinction was important in Chapter 4 for estimating job-creation numbers and leverage ratios, which were both collected and reported at the project level. In this chapter, because project sources and uses are discussed only in the context of the terms and performance of individual loans, all tables are presented at the loan level.

Loan Terminology

Underwriting refers to the process for deciding whether to approve a loan to a particular business.

Loan terms include the amount of money that will be loaned to the business, the interest the borrower will be charged, and the length of time the borrower has to repay the loan.

Loan servicing is the process of collecting payments from the borrower business and tracking these payments and balances due.

Loan delinquency refers to a situation where the business falls behind in making its payments.

Default occurs when the lender no longer believes that the business will make payments at all.

Note: There may or may not be defined conditions (such as the length of time in which payment has not been made) that distinguish a delinquent loan from one that is in default, and these conditions can vary from jurisdiction to jurisdiction and loan to loan.

Second, to assess the financial performance of these loans, local data on the disposition of closed loans and the current status of those still open were collected. This typically required information collection from municipal offices responsible for loan servicing or legal affairs, which were often different from offices that maintained project application and loan agreement files. The definitions of “written-off,” “delinquency,” and “default” are somewhat dependent on local

definitions and the care with which program administrators record status information in public records. However, it is presumed that grantee definitions of default—the most serious indicator of non-performance—converge, in practice, around an implicit definition, presented later in this chapter. A payment status was determined for all but 31 of the 976 loans in the study sample. These data were used in two ways. To present information on loan performance in a fashion that allows for comparison with other economic and community development lending programs, loan performance was measured according to current status of loans at the time of data collection or as of the time that the loan was paid or written off. Episodes of delinquency or default that may have occurred sometime during the loan period, but which were subsequently cured prior to payoff or research data collection were ignored. To determine which factors influenced the likelihood that loans would encounter serious difficulty at some point over their lifetime, loan performance was measured according to whether a loan encountered serious problems at any point throughout its history.

Standard underwriting factors often used to determine whether a business borrower will receive a loan:

Maximum loan-to-value ratio: a requirement that the appraised value of property pledged as collateral against the loan be equal to or exceed a specified percentage of the amount of the loan.

Appraisal, inspection, or other valuation of collateral: a formal process for assessing the condition and value of the property or other holdings the businesses borrower pledges to surrender in the event it cannot pay off the loan. This value is used to calculate the loan-to-value ratio.

Review of applicant credit history: this could include the owner's personal credit history (amount of debt, previous experience in paying bills and loans, etc.) as well as that of the business.

Review of income tax returns: this could involve an inspection of both the owner's personal and corporate tax filings.

Financial statement analysis: considered are **historical and** projected earnings and profits of the business.

Owner expertise, capacity, or years in business: this indicates whether the owners has the knowledge and track record to establish or maintain the business venture to the point that he or she will be able to repay the loan.

Debt service coverage: the ratio of the income of the business to its loan payment, indicating the ability of the business borrower to pay off the loan from net business proceeds.

Third, to link loan performance to underwriting and other characteristics, categories of independent variables were specified based on discussions with local program staff and a review of the literature on private sector small business underwriting. Initial field investigations showed that the underwriting process used by public agencies resembled that of the private lenders involved in the projects, but with acceptance of greater levels of risk and lower returns, consistent with their public purpose. Unlike residential mortgage lending, however, there are no standards for private sector small business underwriting that can be used to guide data collection and classification.

Berger and Udell provide a helpful typology for describing the multiple types of underwriting conventionally used by lenders in assessing small business loans.[1] They distinguish among three types of *transaction-based underwriting*—financial statement, asset based, and credit-scoring—that are based on quantifiable information that is "relatively easily available at the time of loan origination,"[2] and a fourth, *relationship underwriting,* based on personal knowledge of the firm, its owners, and their prospects. As Table 5.1 indicates, business loan underwriters can evaluate either a firm or its principal(s), or both. Therefore, depending on a company's size, an underwriter may place greater emphasis on the financial condition of a principal rather than on his or her company. Moreover, a principal may place his or her own personal assets as collateral in order to supplement a firm's assets as collateral. The considerable amount of underwriting and other data collected on-site can be classified according to whether they indicate the use of one or more of the underwriting methods further described in Exhibit 5.1. The measures involved in each are as follows:

- *For financial statement underwriting*, they include information on whether loan files contain a *pro forma*, an income statement, a balance sheet, and personal or corporate tax returns;
- *For asset-based underwriting*, they include information on the type of collateral used to secure the loan;
- *For credit-scoring,* they include whether or not loan files contain a personal credit report and a personal tax return; and
- *For relationship underwriting*, they involve the presence of bank funding in a project's financing structure. The validity of this measure as an underwriting proxy presumes that most, if not all, private bank loans are sized and priced based, at least in part, on a relationship underwriter's assessment of a firm's creditworthiness. (By this standard, bank funding could serve as a proxy for other underwriting types, as well.)

[1] Berger, Allen and Gregory Udell. 2001. Small Business Credit Availability and Relationship Lending: The Importance of Bank Organizational Structure. Monograph prepared for the Board of Governors of the Federal Reserve System. April.

[2] Berger and Udell, 2001: pg. 6

Exhibit 5.1
A Description of Small Business Loan Underwriting Methods with Respect to Firms and Principals[3]

Underwriting Method	With Respect to the Firm	With Respect to the Firm's Principal
Financial Statement	Underwriter makes decision based mostly on information provided in a firm's balance sheet and income statements. This type of underwriting is most appropriate for companies with certified audited financial statements; such firms tend to be large companies. Lenders may underwrite small firms using this method, but only such firms that have strong audited statements and a history with the lender.	Underwriter makes decision based mostly in information provided in a principal's personal balance sheet and tax returns. This type of underwriting is most appropriate for small businesses that do not have audited financial statements.
Asset-Based	Underwriter makes decision based primarily on the quality of the collateral offered by the borrower. Accounts receivables and inventory are the most frequently used types of collateral. This type of underwriting is available to all types of firms, but is expensive for lenders to assess the quality of the collateral.	Underwriter makes decision based primarily on the quality of the collateral offered by the principal. These assets may include a personal guarantee, or the principal's personal assets.
Credit Scoring	Underwriter makes decision based on the creditworthiness and financial condition of a firm's principal. Lenders typically restrict this type of underwriting to small loans: those below $250,000 (some lenders restrict this amount to $100,000).	Underwriter makes decision based on the creditworthiness and financial condition of a firm's principal. Lenders typically restrict this type of underwriting to small loans: those below $250,000 (some lenders restrict this amount to $100,000).
Relationship	Underwriter makes decision mostly based on proprietary information about a firm and its principal that is gained over time through a business relationship. This business relationship may include previous loans, deposits and other financial products. Moreover, the underwriter may use other types of more informal information collected through contacts with local suppliers and customers. "Importantly, the information gathered over time has significant value beyond the firm's financial statements collateral and credit score, helping the relationship lender deal with informational opacity problems better than potential transaction lenders."[4]	Underwriter makes decision mostly based on proprietary information about a firm and its principal that is gained over time through a business relationship. This business relationship may include previous loans, deposits and other financial products.

Drawing on these factors, and including other variables hypothesized to influence business performance, five categories of variables were devised:

1. *Loan terms*—including loan amounts, interest rates, and terms.

[3] Adapted from Berger and Udell, 2001. p. 6.

[4] *Ibid*., p. 7.

2. *Underwriting information* tied to financial statement and credit-scoring underwriting—including whether any of the following—a tax return, credit report, *pro-forma*, and income statement information—are in the file, and how many pieces of this information are there.
3. *Collateral,* tied to collateral underwriting—including type of collateral (financial, machinery and equipment, inventory, real estate or other collateral), how many pieces of collateral there are, and in what position.
4. *Project financing structure* tied to relationship (and other) underwriting—including owner and other equity, other public funds, private funds, and the shares of the total transaction these represent.
5. *Business and community characteristics*—including whether the borrowing firm is a "start-up," the number of employees, and the neighborhood and city income levels in which the business is located.

In the analyses to follow, measures of distress are cross-tabulated with variables from the five categories listed above, and multivariate logistic regressions were conducted for each category. This "information content" analysis is intended to show how detailed information about the characteristics of a pool of loans could be used to indicate its risk relative to another pool of loans. For a loan pool consisting of CDBG and Section 108 loans, market participants ordinarily would rely on several "core" pieces of information to help assess risk: the program that contributed loans to the pool (CDBG or Section 108), the age of loans and the prevailing market conditions at time of origination (proxied by year of origination), and perhaps the economic circumstances of the communities in which loans were made (e.g., as reflected by median household incomes). These core variables would be easily observable for all loans offered for purchase on a secondary market. The information content analysis shows whether due diligence investigations of local loan files would yield to investors any new information that would improve their ability to assess risk over and above a core model. Variables within each of the five categories that predict loan performance also were used in a final, "integrated model" of loan performance.

The analysis in this chapter is based primarily on information drawn from local application, loan approval, and loan servicing files. The 976 loans sampled represented about 75 percent of total CDBG lending in these jurisdictions originated between 1996 and 1999, and 90 percent of Section 108 lending originated between 1994 and 1999. A complete documentation of sampling methods is contained in Appendix A.

Description of the Portfolio of CDBG and Section 108 Economic Development Loans

This section describes the financial terms of CDBG- and Section 108-funded third-party loans and the characteristics of their underwriting. The 51 cities and urban counties that were sampled originated $735 million in third-party loans during the study period, with funding provided from the following four sources, in order of the number of loans in this portfolio:

- *CDBG-funded loans account for the most loans originated in the study cities, but a comparatively modest share of lending volume.* Loan sizes average $103,000. The average interest rate on a CDBG-funded loan was 6.03 percent, well below market rates for business loans during the period, and carried an average term of just over 7 years (88 months).[5]
- *Section 108-funded loans account for the preponderance of combined CDBG and Section 108 loan volume.* The average Section 108-funded loan principal of more than $1.5 million is about eight times the CDBG average. Unlike CDBG-funded loans, those funded with Section 108 are originated at near-market rates, reflecting grantees obligation to repay Section 108 funds at an interest rate pegged at market auction. The average Section 108-funded loan with a single stated interest rate is 8.02 percent, though many are at variable rates—typically pegged to the rate of the bonds sold to fund federal Section 108 loan origination. The terms average 9.25 years (or 111 months).
- *EDI/BEDI funds are typically used as supplemental grants or loan loss reserves used to enhance the creditworthiness of Section 108-funded loans.* On rare occasions, however, EDI/BEDI funds are loaned to borrowers, some of whom are not involved in Section 108 projects.[6] EDI/BEDI-funded loans in the sample are the smallest, on average, with a mean principal amount of just under $31,000.
- *CDBG floats are a small portion of lending volume.*[7] They average about $855,000, or six times the CDBG average. The mean and median rates on CDBG float-funded loans are much lower than other CDBG loans, at 1.96 and 1.00, respectively.

[5] Calculations in Chapter 4 used as a market rate the Treasury obligation rate for issues of comparable maturity plus 700 basis points. This resulted in an average rate of 13 percent between 1994 and 1999.

[6] Note that EDI/BEDI funds may only be used independently from Section 108 projects where there is a special Congressional earmark or appropriation that makes an exception to program rules. The sampling methodology was not able to distinguish such special EDI/BEDI appropriations from the rest of the program.

[7] As indicated in Chapter 1, these are short-term loans used to provide interim financing to large economic development projects. Floats are funded from CDBG dollars already committed to other projects, but which are not needed immediately.

Table 5.1
Mean and Median Principal Amount, Interest Rate, and Term for Third-Party Loans by HUD Funding Source

Loan Terms	HUD Funding Source: *CDBG*			*CDBG Float*			*EDI/BEDI*			*Section 108*			*All Programs*		
	Mean	Median	Number of Loans	Mean	Median	Number of Loans	Mean	Median	Number of Loans	Mean	Median	Number of Loans	Mean	Median	Number of Loans
Principal	$103,373	$50,000	741	$855,597	$500,000	15	$30,567	$15,000	19	$1,508,776	$300,000	201	$361,712	$60,660	976
Interest	6.03	6.00	718	1.96	1.00	15	11.42	12.00	19	8.02	8.50	162	6.46	6.00	914
Term in months	88	64	733	40	22	15	65	60	19	111	85	188	91	66	955

Source: Urban Institute Loan File Review Database--Third-Party Lending Study, 2002.

The median and average interest rate figures for CDBG and Section 108 disguise variation in average rates across loans and across communities. For the CDBG program, and compared to a median interest rate of 6 percent, 25 percent of rates are at 4 percent or below, and 25 percent of rates are at 7.5 percent and above. The median average rate across *grantee portfolios* (the average rate of loans originated within each jurisdiction) is 5.71 percent, somewhat lower than the average rate of 6 percent for the entire national portfolio. Of the 42 communities using CDBG funds to make third party loans, the loans in 10 communities had average rates of 4 percent or less; the loans in ten other communities had rates of 7.3 percent or more.

For the Section 108 program, and compared to a median interest rate of 8.5 percent, 25 percent of interest rates are at 6.5 percent or below, and 25 percent of rates are at 8.75 percent or above. The median average rate across grantees is 7 percent, a full percentage point below the average rate for all Section 108 loans. Of the 37 communities using Section 108 funds to make third party loans, the loans in four communities are at 10 percent or above; the loans in four communities are at 4 percent or below. Unlike the CDBG program, average Section 108 interest rates vary across years, perhaps reflecting changes in interest rates charged to grantees. Between 1994 and 1999, average interest rates were lowest in 1996—6.4 percent—and highest in 1998, 9.33 percent.

The Relationship Between Loan Terms and Business Characteristics

As indicated in Chapter 4, entitlement grantees use CDBG-supplied loan funds by and large for small business lending. The median business aided by the program has six employees. As might be expected, these smaller businesses tend to borrow in small amounts—with the smallest loans going to businesses having one to five employees (see Table 5.2). The same pattern generally holds for firm size as measured by amount of annual sales. Larger businesses borrow larger amounts, with the largest loan amounts going to firms with the highest sales volumes. Finally, the largest loans went to nonprofit borrowers, averaging three times as much as those for private businesses. Nonprofit borrowers also receive the lowest rates, perhaps reflecting their preferential treatment by local agencies in view of the public and community purposes they serve.

Table 5.2
Third-Party Loan Amounts and Interest Rates, by HUD Funding Source and Selected Business Characteristics

	HUD Funding Source			
	CDBG		*Section 108*	
Business Characteristics	**Mean Loan Amount**	**Mean Interest Rate**	**Mean Loan Amount**	**Mean Interest Rate**
Number of Employees				
0	$110,295	6.0 %	$3,119,475	9.0 %
1-5	54,501	6.6	446,968	7.3
6-25	96,194	5.9	291,833	8.4
More than 25	200,911	5.2	1,794,884	8.2
Number of loans	**496**	**479**	**145**	**126**
CDBG Sales Volume Quartiles				
1: 0 - $150,000	$69,768	6.6 %	N/A	N/A
2: $150,001 - $590,000	70,674	6.1	N/A	N/A
3: $590,0001 - $2,300,000	108,000	5.6	N/A	N/A
4: greater than $2,300,000	222,650	4.9	N/A	N/A
Number of loans	**477**	**464**	N/A	N/A
Section 108 Sales Volume Quartiles				
1: 0 - $247,477	N/A	N/A	$1,142,869	7.9 %
2: $247,778 - $1,249,835	N/A	N/A	1,085,520	8.9
3: $1,249,836 - $8,467,715	N/A	N/A	624,231	8.7
4: Greater than $8,467,715	N/A	N/A	2,183,434	8.0
Number of loans	N/A	N/A	**108**	**95**
Start-up Status				
Existing Business	$104,784	6.0 %	$1,084,388	8.0 %
Start-up	92,874	6.2	3,252,326	7.5
Number of loans	**700**	**680**	**187**	**153**
Business Type				
Independent	$91,457	6.2 %	$1,233,593	8.1 %
Branch	(97,031)	(5.8)	(3,950,000)	(6.6)
Franchise	(111,934)	(4.2)	(1,216,055)	(8.2)
Non-Profit	(292,657)	(3.4)	1,666,082	7.5
Number of loans	**725**	**705**	**187**	**156**

Mean principal and interest estimated for all loans (n=1,943) originated in 51 high-loan volume communities for the years 1996-

Note: Percentages in parentheses are based on less than 10% of non-missing data.
Note: Because some borrowers received multiple loans, table includes double counting of businesses.
Source: Urban Institute Loan File Review Database, Dun & Bradstreet Data--Third-Party Lending Study, 2002.

The relationship between firm and loan characteristics is less clear for Section 108-funded loans. Unlike CDBG, loans for nonprofits are not substantially larger than for other classes of business, and are not offered at significantly lower rates—probably because grantee obligations to repay Section 108-funded loans at near-market interest rates limits the rate discounts community lenders can offer borrowers. In addition, there is no relationship between

firm sales volume and average principal borrowed or average interest rate. The smaller the number of Section 108-funded loans, the larger the average size; the presence of a significant number of very large Section 108 startups may account for this result.

At $3.3 million, the average Section 108 start-up loan is more than twice the size of the average for all Section 108-funded loans, and about 35 times the size of the average CDBG-funded start-up loan. These start-ups include a mix of business types—some representing small entrepreneurs (including micro-entrepreneurs) that are engaged in neighborhood-based retail or services businesses, and others that are large-scale enterprises. Indeed, the top 10 Section 108-funded loans, in terms of size, account for 20 percent of total Section 108 lending volume; six of these are start-up businesses that are well-capitalized, special-purpose entities, including limited liability companies formed specifically to own or develop large real estate projects.

Characteristics of Uses of Funds, Loan Underwriting, Collateral, and Financing Structure

The most common uses of loans made with CDBG and Section 108 funds involve provision of operating capital and acquisition of machinery and equipment. Forty-three percent of CDBG-funded loans are used to purchase machinery and equipment and 33 percent used for operating capital (see table 5.3). Forty-five percent of Section 108-funded loans are used for operating capital, and 37 percent for machinery and equipment. For both programs, about one-fourth of all projects involve acquisition of real estate (23 percent for CDBG-funded loans and 24 percent for Section 108-funded loans) or construction or renovation (21 percent for CDBG-funded loans and 26 percent for Section 108-funded loans). These uses of funds appear to be linked to the types of loan terms offered (i.e., longer terms for real estate) and the types of collateral used (i.e., real estate collateral for loans used, in part, for real estate acquisition). Each of these aspects of underwriting and financial structure is related to the size of loans and borrowers, which will become important in subsequent sections as loan distress rates and the correlates distress are examined.

Underwriting is the process by which lenders assess the risk of prospective loans and the value of the collateral proffered by borrowers as a hedge against loan default. Although program managers need not underwrite loans in order to originate them, most appear to do so. A review of loan origination files shows that financial statement underwriting, whether of the firm or of the principal, appears to be relatively widespread for communities that use both CDBG and Section 108 funds for third-party lending purposes. Nearly all officials contacted in the Community Development Administrators Phone Survey reported the use of financial statements, tax returns, balance sheets, and other forms of financial information to underwrite both CDBG- and Section 108-funded loans. And, roughly two-thirds of all CDBG loan files reviewed in the 51 high-loan-volume communities contain personal tax returns, income statements, balance

sheets, and *pro-formas*—evidence that local jurisdictions have taken steps to assess risk by examining the credit-worthiness of both borrowers and projects.

Table 5.3
Presence of Underwriting Documents, Collateral, and Uses of Third-Party Loan Funds, Percent of Loans and Percent of Dollars, by HUD Funding Source

	HUD Funding Source			
	CDBG		*Section 108*	
	Percent of Loans	Percent of Dollars	Percent of Loans	Percent of Dollars
Underwriting Documents in File				
Tax-Return	61 %	43 %	53 %	23 %
Income Statement	69	66	80	45
Credit Report	46	29	32	10
Balance Sheet	71	71	80	53
Pro Forma	67	68	70	76
Number of Loans	**640 to 678***		**176 to 183***	
Collateral Present in Any Position				
Financial	5 %	8 %	5 %	17 %
Machinery/Equipment/Inventory	53	46	44	32
Real Estate	62	70	61	80
Number of Loans	**664**		**190**	
Collateral Present in First Position				
Financial	1 %	1 %	2 %	8 %
Machinery/Equipment/Inventory	21	17	23	7
Real Estate	7	11	23	36
Number of Loans	**664**		**190**	
Uses of Loan Funds				
Acquisition of Real Estate	23 %	36 %	24 %	32 %
Renovation/Construction	21	32	26	46
Acquisition of Machinery/Equipment	43	40	37	22
Provision of Operating Capital	33	20	45	24
Inventory	13	8	26	19
Number of Loans	**733**		**194**	

*The number of loans varies for the category "Underwriting Documents in File" because each item was collected separately and, therefore, has a different missing data rate. The other variables in this table were multiple response items (e.g. check all that apply) and so were either all missing or nonmissing for a particular case.
Note: Because some businesses received multiple loans, table includes double counting.
Source: Urban Institute Loan File Review Database--Third-Party Lending Study, 2002.

Section 108-funded loan files are more likely to contain project underwriting information than CDBG-funded loan files, reflecting the need to satisfy the collateral requirements of the Credit Reform Act and the risk to grantees of pledging CDBG funding against their Section 108 program loan. Section 108-funded loan files also contain less of the kind of documentation

characteristic of principal (as opposed to firm) underwriting: they are less likely to have personal income tax returns (53 percent) or personal credit reports (32 percent) than are CDBG loan files. Because personal tax returns and personal credit reports represent a different type of underwriting (that of the principal rather than the firm), their relative absence from Section 108 files is indicative of the larger, and more than likely corporate character, of Section 108 borrowers.[8]

First position means that the lender is the first lien holder and, hence, is paid off first in the event of default.

Second and third position lenders, in the event of a default, are only paid after all first position lien holders are paid off. In deals that include both public and private lenders, typically private lenders are the first position lien holders.

Communities making use of both CDBG and Section 108 funds for third party lending typically collateralize their loans with borrower assets and, most of time, with real estate. This is important because such assets are fixed, more easily valued, more likely to appreciate, and unlikely to be discounted heavily on sale—as compared to equipment or inventory collateral. Over 60 percent of both CDBG- and Section 108-funded loans are secured, at least in part, by real estate collateral, although this most often was subordinate to other debt. For CDBG-funded loans, real estate liens securing the loan were in first position in only seven percent of loans, involving just 11 percent of CDBG loan volume.[9] By contrast, more than one-third of the Section 108-funded loan volume (36 percent) was secured, at least in part, by real estate in first position. This superior collateralization of Section 108-funded loans reflects the requirements of the Credit Reform Act and grantee reluctance to use local program funding or CDBG funds to repay defaulted loans.

Because the law specifies that Section 108-funded loans must be secured by assets beyond those involving future CDBG allocations to the community, the sources of these assets are of interest—as is the frequency with which communities have had to use CDBG funds to repay defaulted loans. While information on amounts and sources of recovery of individual defaulted loans was not collected, the Community Development Administrators Phone Survey included questions intended to identify the types of repayment sources that had been used in the past, and the sources of funds communities have used to repay defaulted loans. The results are shown in Table 5.4.

Fully 46 percent of grantees using Section 108 program funding for third-party loans planned, at the time of their loan application, to use CDBG funds to repay at least part of the

[8] Information was not collected regarding the legal form of borrower businesses (sole proprietorships and partnerships versus public corporations, for example), which likely effects whether individuals are underwritten as well as, or instead of the business.

[9] Although CDBG float loans are relatively rare, it is interesting to note that all 15 sampled had liquid financial collateral (such as letters of credit) that are, in nearly all cases, in first position.

money borrowed. This may be because local officials expected to experience defaults under the program, without full recovery of principal, or because they intended to use business repayments to replenish a revolving loan fund. As expected, most grantees (77 percent) expected to use business borrower repayments as a source of Section 108 loan repayment, but 56 percent of them intended to repay from some form of project proceeds (e.g., the sale of land acquired as part of project development). Further, for the 24 percent of communities that experienced defaults of third-party loans, two-thirds (67 percent) had, in fact, used CDBG funds to make repayments—more than had been able to make repayments from the collateral offered by borrowers (50 percent).

Table 5.4 Intended and Actual Sources of Section 108-funded Third Party Loan Repayment

Intended Sources of Section 108 Repayment at Time of Application*	**Percent that Planned to Use**
Project Proceeds	56 **%**
Payments from Third party Borrower	77
CDBG Entitlement	46
Other Public Revenues	14
Other Sources	6
Number of respondents = 82	

Sources of Section 108 Repayment After Business Default**	**Percent that Have Used**
Borrower Collateral	50 **%**
CDBG Entitlement	67
Other Public Revenues	24
Other Sources	16
Number of respondents = 20	

*Respondents include officials of all communities that reported having Section 108 loans.

**Respondents include only officals of those communities that reported having a business default.

Source: Urban Institute Community Development Administrators Phone Survey--Third-Party Lending Study, 2002.

To summarize, small loans are more likely than larger ones to: have been originated by underwriting the principals, not the firm; be relatively less well secured; and be used for operating capital and inventory. These smaller loans generally go to smaller, independent business borrowers. And, as will be shown below, these loans have higher rates of distress.

The Performance of the National Portfolio of CDBG- and Section 108-Funded Loans

It is important to determine the performance of CDBG- and Section 108-funded loans for two reasons. First, the price these loans could obtain in a secondary market is directly tied to their rates of delinquency and default and, to date, no information on the performance of these loans has been available. Second, defaults mean a loss of loan principal to the lender that cannot always be recovered by the sale of assets. Recall that for both CDBG and Section 108, only a minority of the loans have claims on collateral superior to those of other lenders, meaning that community lenders may not be able to recoup all of their losses.

This analysis of loan performance examines the status of third-party loans at the time of data collection—whether it was in default or seriously delinquent (90 days or more). Those that were seriously delinquent or in default are referred to as "problem" loans. A loan can be classified as "performing" or "problem" based on its payment status at a point in time during the life of the loan (active, or "open" loans) or at its final disposition ("closed" loans). In Table 5.5, these payment-status classes are as follows:

- *There are three categories of open loans:*
    - *Current loans*, which were paid up, or less than 90-days delinquent, at the time of data collection, even if they had been considered in default or had serious delinquencies in the past;
    - *Seriously delinquent loans*, which were more than 90-days delinquent at the time of data collection; and
    - *Defaulted loans,* which were classified as such only if the grantee (lender) had so-designated them at the time of data collection; although "default' was defined differently in different localities, loans listed by communities as defaulted typically included loans that were more than 90-days delinquent for which no further payments were expected (often because borrowers became unresponsive to requests for payment or work-out).
- *There are two categories of closed loans:*
    - *Paid-off loans,* even if they had been considered in default or had serious delinquencies in the past; and
    - *Written-off (or charged-off) loans*, for which the agency did not expect to make any further recoveries, including through foreclosure or on collateral.

The historical default rate of CDBG loans that were originated between 1996 and 1999 and either paid-off or written-off by 2002 comes to 23 percent. For the portfolio of open loans,

17 percent had defaulted and another 8 percent were seriously delinquent, bringing the "problem" loan percentage for the current portfolio to 25 percent.[10] Put another way, 25 percent of all CDBG-funded loans originated over the 1996-1999 period (including both closed and open loans) are non-performing, problem loans; 75 percent were performing. In terms of total volume of loan principal originated plus principal added in restructuring, 23 percent of closed loan volume consist of loans that had been written-off; and 16 percent of outstanding loan volume consist of loans that had defaulted or were seriously delinquent at the time of data collection. While some current loans that are in default or seriously delinquent may, in time, be paid off in full, a comparison of the percentage of open loans that are current to closed loans that are paid-off indicates that the current portfolio is performing about as well as CDBG loans have performed historically.[11]

Table 5.5
Performance of Third-Party Loans, by Closed and Open Status and HUD Funding Source

	Loan Status							
	Open			Closed			Total	
Program/Performance	Percent of Loans	Percent of Dollars*	Number of loans	Percent of Loans	Percent of Dollars*	Number of loans	Percent of Loans	Percent of Dollars*
CDBG								
Default / Written-off	17 %	9 %	72 %	23 %	21 %	48 %	19 %	12 %
Severely Delinquent	8	7	34	--	--	--	5	5
Current / Paid-off	75	84	395	77	79	176	76	83
Total	**100 %**	**100 %**	**501 %**	**100 %**	**100 %**	**224 %**	**100 %**	**100 %**
Section 108-funded								
Default / Written-off	37 %	18 %	41 %	59 %	22 %	20 %	43 %	19 %
Severely Delinquent	8	6	10	--	--	--	6	5
Current / Paid-off	55	75	91	41	78	24	51	76
Total	**100 %**	**100 %**	**142 %**	**100 %**	**100 %**	**44 %**	**100 %**	**100 %**
Section 108-funded (reduced sample)**								
Default / Written-off	32 %	9 %	15 %	42 %	13 %	6 %	34 %	9 %
Severely Delinquent	4	6	7	--	--	--	3	5
Current / Paid-off	64	85	75	58	87	14	63	86
Total	**100 %**	**100 %**	**97 %**	**100 %**	**100 %**	**20 %**	**100 %**	**100 %**

*Percent is of principal dollars at origination, not balance outstanding at time of delinquency, default, or write-off.

**One grantee with a large proportion of the Section 108 sample, and below average performance, was excluded from the reduced sample.
Source: Urban Institute Loan File Review Database--Third-Party Lending Study, 2002.

[10] By convention, many analysts would consider seriously delinquent loans (90 days or more) to be "defaulted."

[11] Analysis of loan cohorts shows that the composition of the pool of outstanding loans is unlikely to affect its comparative default performance relative to loans already closed.

Section 108-funded loans have performed less well than CDBG loans, although one community included in the study—with a large Section 108 program—considerably affects the results. For the full portfolio, the default rate for loans originated between 1994 and 1999, and written-off comes to 59 percent of loans, involving 25 percent of loan principal (as originated plus restructuring). In other words, defaults in the Section 108 program were highly concentrated among smaller loans. However, if the single community noted above is removed from the analysis, the historical default rate for the "reduced sample" portfolio drops to 42 percent of loans and 12 percent of loan volume. For currently outstanding Section 108-funded loans (and excluding the single community), 32 percent of loans had defaulted and another 4 percent were seriously delinquent—bringing the proportion of problem loans to 36 percent. These problem loans account for 15 percent of loan volume. However the universe of Section 108-funded loans is defined, smaller loans in the program are more often written-off, defaulted, or seriously delinquent than larger ones.

Table 5.6 shows, instead of the principal originated, the amount of principal outstanding for each category of loan performance. At the time of data collection, the CDBG program had $89 million in principal outstanding on an origination amount of $122 million. Of the principal outstanding, $9 million was in defaulted loans, and other $7 million was in seriously delinquent loans, for a total of $16 million in problem loan principal outstanding. Corresponding figures for Section 108 were $342 million in outstanding loans principal, of which $73 million was in default and $19 million was seriously delinquent, for a total of $92 million in problem loan principal outstanding. Taken together, the total amount of principal outstanding for both CDBG and Section 108 programs was $431 million, of which $107 million was in problem loans.

Table 5.6
Amount of Loan Principal Originated and Outstanding by Loan Status and Performance

	Loan Status			
	Open		Closed	
	Amount Originated	Amount Outstanding	Amount Originated	Amount Outstanding
	(in millions)	(in millions)	(in millions)	(in millions)
CDBG				
Default / Written-off	$11.3	$8.9	$9.6	$8.8
Severely Delinquent	8.3	6.8	--	--
Current / Paid-off	102.0	73.7	33.2	0
Total	**$121.6**	**$89.4**	**$42.8**	**$8.8**
Section 108-funded				
Default / Written-off	$80.2	$72.5	$19.0	$16.3
Severely Delinquent	23.9	18.8	--	--
Current / Paid-off	286.4	250.3	55.9	0
Total	**$390.5**	**$341.6**	**$74.9**	**$16.3**
Section 108-funded (reduced sample)*				
Default / Written-off	$27.5	$24.8	$3.4	$1.8
Severely Delinquent	17.5	15.4	--	--
Current / Paid-off	262.2	227.9	27.0	0
Total	**$307.2**	**$268.1**	**$30.4**	**$1.8**

* One grantee with a large proportion of the Section 108 sample, and below average performance, was excluded from the reduced sample.
Source: Urban Institute Loan File Review Database--Third-Party Lending Study, 2002.

Table 5.7 shows principal outstanding in problem loans as a percentage of total principal originated for open and closed loans in the CDBG and Section 108 program. In the CDBG program, the outstanding principal amounts for still-open problem loans came to 13 percent of principal originated. For closed loans, outstanding principal at the time of write-off came to 21 percent of total principal originated. In the Section 108 program, principal outstanding in problem loans came to 23 percent of total principal originated for open loans and 22 percent for closed loans. However, in the reduced sample of Section 108 program users, principal outstanding in problem loans came to only 13 percent of principal originated for open loans and 6 percent for closed loans. In other words, the percentage of principal outstanding in problem loans for both CDBG and Section 108 programs (reduced sample) is the same—13 percent.

Table 5.7
Percent of Loan Principal Originated and Outstanding by Loan Status and Performance

	HUD Program					
	CDBG		Section 108		Section 108 reduced sample	
	Open	Closed	Open	Closed	Open	Closed
	(in millions)	(in millions)	(in millions)	(in millions)	(in millions)	(in millions)
Principal Originated						
Total	**$121.6**	**$42.8**	**$390.5**	**$74.9**	**$307.2**	**$30.4**
Total Problem Loans	$19.6	$9.6	$104.1	$19.0	$45.0	$3.4
Default / Written-off	11.3	9.6	80.2	19.0	27.5	3.4
Severely Delinquent	8.3	--	23.9	--	17.5	--
Principal Outstanding						
Total Problem Loans	**$15.7**	**$8.8**	**$91.3**	**$16.3**	**$40.2**	**$1.8**
Default / Written-off	8.9	8.8	72.5	16.3	24.8	1.8
Severely Delinquent	6.8	--	18.8	--	15.4	--
Outstanding as Percent of Originated						
Total Problem Loans	**13%**	**21%**	**23%**	**22%**	**13%**	**6%**
Default / Written-off	7%	21%	19%	22%	8%	6%
Severely Delinquent	6%	--	5%	--	5%	--

* One grantee with a large proportion of the Section 108 sample, and below average performance, was excluded.
Source: Urban Institute Loan File Review Database--Third-Party Lending Study, 2002.

The loan principal outstanding at the time loans are declared in default is subject to recovery through seizure and eventual sale of assets. Analysts can only guess at the recovery rates for CDBG and Section 108 loans, as these data were seldom included in the loan files reviewed on site. The discussion in Chapter 6 on the structure of secondary market transactions suggests 40 percent as a plausible recovery rate, less than would be expected in standard small business lending. If this 40 percent figure is correct, then local program officials might expect to recover about $43 million of the total $107 million in principal outstanding in defaulted or seriously delinquent loans.

The analysis in Chapter 3 reported the concerns of local officials in putting CDBG funds at risk as they borrow Section 108 funds; they fear that unforeseen project difficulties would

require them to repay Section 108 with future grant allocations instead of project revenues. Although nearly one-half (45 percent) of grantees have, at one time or another, applied for Section 108 loans with the intention of using their CDBG funds as a source of repayment, grantees more often rely on project revenues as a repayment source. As this section shows, project revenues have not always proven adequate to fully repay Section 108 loans. If only 40 percent of outstanding principal in defaulted loans is recovered, (although it may be higher with Credit Reform Act collateral requirements and the relative frequency at which Section 108 loans are found in first position) then local officials will find it necessary to repay from sources other than project revenues for approximately $55 million of the $92 million in principal outstanding in problem loans. According to results from the telephone survey of local program administrators, about one-quarter of grantees (24 percent) have experienced defaults on third-party loans, and two-thirds of those experiencing default (or 16 percent of all grantees) have used CDBG funds to repay a part of their Section 108 loans. (See Table 5.8.)

Table 5.8
Distribution of Communities' Experience with Defaulted Section 108-Funded Third-Party Loans*

Community Experiences	Percent of Communities Using Section 108 for Third-Party Loans**
The Community Used Local or Other Funds to Repay Section 108 Loans Due to Inadequate Project Revenues	36%
A Businesses Defaulted on Section 108 loans (since 1997)	25%
The Community Used CDBG Entitlement funds to Pay Back Section 108-funded Loans	16%
Number of Respondents = 82	

*Respondents include the 82 officials in jurisdictions that currently originate third-party loans to businesses using Section 108 funds.

** Percentages exclude those responding "Don't Know" or who refused to answer.

Source: Urban Institute Community Development Administrators Survey--Third-Party Lending Study, 2002.

State Portfolios

As discussed in Chapter 1, 14 high-loan-volume states were contacted for purposes of collecting information about their use of CDBG and Section 108 funds for third-party lending purposes and representatives of 11 of them submitted loan rosters and responded to the State

Community Development Administrators Phone Survey. Nine of the 11 states made at least one CDBG-funded third-party loan during the 1996 to 1999 period, and two had discontinued CDBG economic development lending due to other policy priorities and high default rates on Section 108-funded loans. The average number of loans originated within each state was 52, and the total dollar amount was $98.4 million—between 1996 and1999.[12] The average loan was $211,520, considerably larger than the average loan originated by local entitlement communities ($115,000). For the seven states, 78 percent of their loans were current or paid-of, putting the "problem" loan percentage in the same range as that of the entitlement community portfolio.

Four states made 15 Section 108-funded loans during the 1994 to 1996 period, for a total dollar amount of $57.0 million, with the average loan equaling $3.8 million. Once again, the average third-party loan originated through the state component of CDBG (in these high-loan-volume states) was about twice as large as the average loan originated in the entitlement component (in high-loan-volume communities)—$1.5 million. State officials report that 67 percent of their loans are current or paid-off. Hence the proportion of problem loans (33 percent) is well under the overall rate of 49 percent for entitlement communities, and slightly less than the 37 percent rate obtained when one community's particularly troubled portfolio is removed from the analysis.

Three states reported using CDBG float loans, originating 10 of them for a total of $27.6 million. The average was about three times the entitlement community average.[13]

The Relationships Among Loan Performance and Underwriting, Collateral, Project Financing, and Business and Community Characteristics

In assessing the average risk of potential loan non-payment or default for a pool of loans offered for sale on secondary markets, public and private lenders may assume a relationship between the characteristics of loans, projects, businesses, and communities, on the one hand, and the financial performance of business loans, on the other. Of concern to local loan administrators as well as federal policy makers is whether a pool of loans with particular characteristics is likely to encounter more serious delinquency or default problems than a pool of loans with different characteristics.

This section examines the factors that influence whether loans experience serious payment difficulties at any time over their payment histories—referred to as "distressed" loans. Loan distress is the dependent variable in the multivariate analysis described later in this

[12] The picture that emerges of third-party lending patterns across the nine states is complicated because some of them included in their rosters loans made from RLFs as CDBG lending, and some did not.

[13] Details of the state portfolios were also discussed in Chapter 3.

chapter. Compared to the default and severely delinquent loans discussed in the preceding section, this definition of a distressed loan corresponds more closely to the interests of secondary market investors who are likely to be concerned, not about the ultimate disposition of a group of loans, but in whether payment problems occurred at any stage loans histories, which could affect the overall value of a pool of loans when purchased.

It is essential to point out that the analysis in this section is not intended to help secondary market participants predict the likelihood of distress for individual loans. The secondary market scenarios outlined in the next chapter do not assume that loan purchasers will "cherry pick" loans other than selecting only "performing" loans at the time of sale. Rather, the importance of the model presented in this section lies in identifying those features of loans that are associated with heightened risk of loan distress. Loan pools containing a higher proportion of loans with these risk factors can be expected to experience deeper price discounts than loan pools without these factors. In actual loan sales, secondary market will observe the performance of the initial issues to estimate the likely performance of subsequent issues. If subsequent issues have more or fewer of the characteristics shown to be associated with payment problems than earlier issues, buyers will pay a premium or demand discounts accordingly.

Distressed loans. A "distressed" loan, for purposes of this study, is one that: has been written off; was in default or foreclosure at the time of data collection or had been in default or foreclosure at some point in the past; was more than 90-days delinquent at time of data collection; or had cumulative delinquencies of 150 days or more since origination.[14] (The last category represented a relatively small portion of loans.) Therefore, a loan could be current at the time of data collection but still considered distressed on the basis of past delinquency or default status.

The rate of distress for all loans originated during the study period totals 30 percent of CDBG-funded loans and 50 percent of Section 108-funded loans, involving 22 percent of CDBG-funded loan volume and 21 percent of Section 108-funded loan volume (see Table 5.9). Figures for only those loans that were open as of the date of data collection—that is, excluding those paid-off or written-off—are the same; i.e., 30 percent of open CDBG-funded loans and 50 percent of open Section 108-funded loans, were distressed. This represented 22 percent of CDBG and 26 percent of Section 108, loan principal originated.[15]

[14] Information on total number of days delinquent since origination was available from payment histories for only a few communities. While this limits the ability to determine or predict the proportion of loans with delinquencies that are cured before ultimate default, it does not affect the measurement of the core outcome indicators of current status and ultimate write-off.

[15] Subsequent tables in this chapter use all loans originated during the period, rather than outstanding loans, in order to maximize cell sizes.

Table 5.9
Percent of Third-Party Loans and Principal Dollars by Non-Distressed and Distressed Status and HUD Funding Source

	HUD Funding Source			
	CDBG		*Section 108*	
Status	**Percent of Loans**	**Percent of Dollars***	**Percent of Loans**	**Percent of Dollars***
Non-Distressed	70 %	78 %	50 %	79 %
Distressed	30	22	50	21
Total	**100 %**	**100 %**	**100 %**	**100 %**

*Percent of dollars refers to loan principal at origination, not loan principal outstanding.

"Distressed" loans are those which were more than 90 days delinquent at time of review, or had been in default or more than 150 days cumulatively delinquent at any time since origination, or had been written-off.

Source: Urban Institute Loan File Review Database--Third-Party Lending Study, 2002.

Table 5.10

Mean and Median Principal Amount, Interest Rate, and Term, by Non-Distressed and Distressed Status and HUD Funding Source

	Principal*			Interest Rate			Term (in months)		
Program/ Performance	**Mean**	**Median**	**Number of Loans**	**Mean**	**Median**	**Number of Cases**	**Mean**	**Median**	**Number of Loans**
CDBG									
Non-Distressed	$114,481	$57,500	538	5.89	5.75	522	91	72	533
Distressed	$77,519	$40,369	203	6.36	6.00	196	82	60	200
Section 108									
Non-Distressed	$2,384,077	$600,000	124	7.57	7.51	95	140	120	120
Distressed	$634,694	$200,000	77	8.43	9.34	67	120	60	68

"Distressed" loans are those which were more than 90 days delinquent at time of review, or had been in default or more than 150 days cumulatively delinquent at any time since origination, or had been written-off.

*Principal refers to loan principal at origination, not loan principal outstanding.

Source: Urban Institute Loan File Review Database--Third-Party Lending Study, 2002.

For both programs, but especially for Section 108, the risk of loan distress is higher for smaller loans and those with higher interest rates (see table 5.10). For Section 108, the average distressed loan amount of $634,694 is only one-quarter the $2.4 million average size of performing loans. And, for both programs, distressed loans tend to have higher interest rates than performing loans—with a median interest rate that is 0.25 percent higher for CDBG-funded loans, and 0.83 percent higher for Section 108-funded loans.

Table 5.11

Percent of Third-Party Loans and Principal Dollars Distressed, by Presence of Underwriting Documents, Collateral Type, Project Source, Uses of Loan Funds, and HUD Funding Source

	HUD Funding Source							
	CDBG				*Section 108*			
	% Loans Distressed		% Dollars Distressed		% Loans Distressed		% Dollars Distressed	
Underwriting Documents	**In File**	**Not in File**	**In File**	**Not in File**	**In File**	**Not in File**	**In File**	**Not in File**
Tax-Return	30	31	25	19	60	44	29	26
Income Statement	29	34	23	22	59	33	41	13
Credit Report	34	27	31	19	61	48	43	22
Balance Sheet	27	38	23	21	58	36	38	13
Pro Forma	33	25	23	21	47	62	17	44
Collateral Type	**In 1st Position**	**Not in 1st Position**	**In 1st Position**	**Not in 1st Position**	**In 1st Position**	**Not in 1st Position**	**In 1st Position**	**Not in 1st Position**
Financial	(55)	29	(57)	22	(17)	52	(8)	24
Machinery/Equipment/Inventory	33	28	26	22	57	50	38	22
Real Estate	(26)	30	(27)	22	61	49	32	18
Collateral Type	**In Any Position**	**Absent**	**In Any Position**	**Absent**	**In Any Position**	**Absent**	**In Any Position**	Absent
Financial	(19)	30	(15)	23	(6)	54	(4)	27
Machinery/Equipment/Inventory	34	24	28	19	53	50	26	22
Real Estate	25	36	23	22	50	54	23	22
Project Source	**Present**	**Absent**	**Present**	**Absent**	**Present**	**Absent**	**Present**	**Absent**
CDBG	30	.	22	.	(12)	53	(17)	23
Section 108	(29)	30	(1)	23	51	.	22	.
EDI/BEDI	(0)	30	(0)	22	7	57	7	26
Other Federal	(25)	30	(16)	22	21	53	19	23
Other State/Local	22	31	19	23	20	55	25	22
Bank	23	37	20	26	46	53	13	29
Equity	29	31	24	21	18	72	16	32
Public/Private Sale of Stock	(33)	30	(49)	22	(0)	51	(0)	23
Personal Borrowing	(41)	29	(22)	22	(39)	51	(15)	23
Other Private	34	30	22	23	19	53	8	24
Use of Loan Funds for:	**Present**	**Absent**	**Present**	**Absent**	**Present**	**Absent**	**Present**	**Absent**
Acquisition of Real Estate	18	34	20	24	39	54	23	22
Renovation/Construction	24	32	19	24	39	55	15	28
Acquisition of Machinery/Equipment	33	28	23	22	41	56	22	22
Provision of Operating Capital	38	26	33	20	70	35	52	13
Inventory	46	28	39	21	72	43	46	16

Note: Percentages in parentheses are based on less than 10% of non-missing data.

"Distressed" loans are those which were more than 90 days delinquent at time of review, or had been in default or more than 150 days cumulatively delinquent at any time since origination, or had been written-off.

Source: Urban Institute Loan File Review Database--Third-Party Lending Study, 2002.

The effect of underwriting, collateral, and project financing on performance. Loans that are well underwritten and documented, that have good collateral, and that include financial contributions from project owners, developers, or private lenders would be expected to

display superior repayment performance compared to loans that are poorly underwritten or are unevenly documented, that have weak collateral, and that have no other project funding. Generally speaking, these assumptions are borne out by the data, although variations within and across underwriting, collateral, funds use, and financial structure variables, and across the CDBG and Section 108 programs, merit some discussion (see Table 5.11). In general, and for CDBG program loans:

- The presence of standard underwriting documents in the file appears *not* to be strongly related to performance. Although such loans are underwritten using these documents, loans may be originated for policy reasons despite the results of underwriting.
- Loans made in conjunction with private-sector financial participation in the form of bank loans are less likely to be distressed, even though they are likely to be in a subordinate position to bank loans or loans.
- Loans with financial or real estate collateral, even if subordinated, are less likely to be distressed (25 percent) compared to those with no real estate collateral (36 percent).
- Loans used to acquire real estate become distressed at lower rates than loans used for machinery and equipment or inventory—24 percent of renovation and construction loans and 18 percent of property acquisitions, compared to 33 percent of loans used for machinery and equipment and 38 percent used for operating capital.

For Section 108-funded loans:

- Those with application and approval packages containing tax returns, income statements, balance sheets, and credit reports are significantly *more* likely to be distressed than those with packages not containing these items. To the extent that this is related to underwriting of principal, and not of the firm, this may be indicative of small loans.
- Performance is strongly associated with the presence of owner equity, *which dramatically reduces the likelihood of distress in Section 108 loans—from 72 percent for loans to projects without owner equity to 18 percent for loans to projects with such equity*. *The p*resence of bank loans appears not to affect loan performance.
- Seventy percent of loans that are used, at least in part, for operating capital and 72 percent of those used for inventory (a closely related expense) are distressed—nearly twice the rate of distress of loans involving estate (at 39 percent).
- The presence of collateral, of whatever type, appears not to be related to distress.

These relationships generally conform to expectations, but are not clear-cut. The types of businesses and neighborhoods involved in CDBG- and Section 108-funded loans may, as well, exert an influence over loan performance. This is examined below.

Business and community characteristics. As previously observed, smaller loans, compared to larger ones, tend to be: the result of principal underwriting; relatively less well secured; and used for operating capital and inventory. Such loans also are more likely to become distressed.

Among borrowers of CDBG funds, loans to businesses with fewer than 25 employees have a greater likelihood of loan distress—with distress rates ranging from 33 to 37 percent—while loans to businesses with more than 25 employees have a distress rate of 25 percent. This pattern of loan distress is similar for CDBG sales volume quartiles. Loans to start-up businesses—which, in the CDBG program, tend to be small, independent, retail and services businesses—are much more likely to become distressed than loans to existing businesses (37 percent and 28 percent, respectively). CDBG loans to non-profit organizations are the least likely to be distressed, perhaps because of larger loan sizes and easier terms, as noted in a preceding section.

The relationship between business size and the performance of Section 108-funded loans is even more pronounced than that observed for CDBG-funded loans. Section 108-funded loans to small businesses are much more likely to be distressed than loans to similarly sized, CDBG-funded businesses—with loans to 60 percent of all zero-to-one-employee businesses and 86 percent of all two-to-five-employee businesses becoming distressed. (Note that although these distress rates are high, they actually make up only three percent of the dollar volume of distressed loans). In contrast, businesses in the highest sales volume quartiles are much less likely to have had repayment problems—24 percent of such loans became distressed, representing just seven percent of all distressed Section108-funded loans.

The large start-up companies that represent such a high proportion of Section 108-funded lending volume appear less likely to become distressed than existing businesses. (Recall that average Section 108-funded start-up loans are large, have close to market rates, and tend to be well-capitalized, special-purpose entities formed specifically to own or develop large real estate projects.) Loans to these start-ups are less likely to become distressed (37 percent of the time) than are loans to existing businesses (54 percent of the time). And, as in the CDBG program, loans to non-profit organizations are less likely to become distressed (20 percent of the time) than were loans to other business categories.

Table 5.12
Percent of Loans and Dollars Distressed, by Funding Source and Selected Business Characteristics

	Federal Funding Source			
	CDBG		*Section 108*	
	Percent of Loans Distressed	**Percent of Dollars Distressed**	**Percent of Loans Distressed**	**Percent of Dollars Distressed**
Number of Employees				
0	33	28	46	8
1-5	35	28	86	83
6-25	37	25	35	51
More than 25 employees	25	16	31	27
Average Overall	**31**	**24**	**55**	**24**
Number of loans	**496**		**145**	
CDBG Sales Volume Quartiles				
1: 0 - $150,000	32	25	N/A	N/A
2: $150,001 - $590,000	30	27	N/A	N/A
3: $590,0001 - $2,300,000	35	28	N/A	N/A
4: greater than $2,300,000	22	11	N/A	N/A
Average Overall	**30**	**21**	N/A	N/A
Number of loans	**477**		**N/A**	
Section 108 Sales Volume Quartiles				
1: 0 - $247,477	N/A	N/A	53	12
2: $247,778 - $1,249,835	N/A	N/A	50	64
3: $1,249,836 - $8,467,715	N/A	N/A	61	63
4: Greater than $8,467,715	N/A	N/A	24	25
Average Overall	N/A	N/A	**51**	**37**
Number of loans	**N/A**		**108**	
Start-up				
Existing Business	28	22	54	33
Start-up	37	26	37	4
Average Overall	**31**	**23**	**51**	**22**
Number of loans	**700**		**187**	
Business Type				
Independent	31	24	56	29
Branch	(22.9)	(20.8)	(0.0)	(0.0)
Franchise	(34.5)	(16.8)	(41.0)	(18.5)
Non-Profit	(13.6)	(17.3)	20	4
Average Overall	**30**	**22**	**51**	**22**
Number of loans	**725**		**190**	

Note: Percentages in parentheses are based on less than 10% of non-missing data.
"Distressed" loans are those which were more than 90 days delinquent at time of review, or had been in default or more than 150 days cumulatively delinquent at any time since origination, or had been written-off.
Source: Urban Institute Loan File Review Database, Dun & Bradstreet Sales Data--Third-Party Lending Study, 2002.

Most loans originated using CDBG and Section 108 funds are intended to create low- and moderate-income jobs as their rationale for meeting a national objective under the law. These businesses can be located anywhere within a jurisdiction, but a majority of CDBG grantees target at least some of their loan programs to lower-income neighborhoods. Indeed, a majority of both CDBG- and Section 108-funded loans are made to businesses that operate in poor neighborhoods (see Table 5.13). It is likely, therefore, that these neighborhoods also benefit from the investments supported by CDBG loans, but it is also likely that neighborhood location may influence the performance of these loans—in view of the difficulties that may attend business operations in poor neighborhoods.

Table 5.13
Percent of Third-Party Loans and Principal Dollars Distressed, by Poverty Rate of Neighborhood and HUD Funding Source

	HUD Funding Source					
	CDBG			*Section 108*		
Poverty Rate	Percent of Loans Distressed	Percent of Dollars	Number of Loans	Percent of Loans Distressed	Percent of Dollars	Number of Loans
Less than 20 Percent	28 %	38 %	323	59 %	38 %	58
20 - 39 Percent	31	43	253	42	43	68
40 Percent or Greater	36	20	137	53	20	69

"Distressed" loans are those which were more than 90 days delinquent at time of review, or had been in default or more than 150 days cumulatively delinquent at any time since origination, or had been written-off.

Source: Urban Institute Loan File Review Database and 2000 Decenial Census--Third-Party Lending Study, 2002.

In fact, loan distress *is* related to neighborhood poverty, but the effect is not a strong one. The percentage of CDBG-funded loans that are distressed rises in small increments as the poverty percentage of the census tracts in which business are located rises. Just over one-third (36 percent) of CDBG-funded loans to businesses located in extremely high poverty tracts—i.e., greater than 40 percent poor—are distressed, compared to 31 percent of businesses located in medium poverty neighborhoods—i.e., 20 to 39 percent poor—and 28 percent in neighborhoods with less than 20 percent poor. For Section 108-funded loans, no such simple relationship exists: 53 percent of such loans in tracts with 40 percent or greater poverty are distressed, but the rate is even higher—59 percent—in tracts in which less than 20 percent of the population is poor.

The probability of loans being distressed does not seem to be tied to the poverty rate of the community, the city or county unemployment rate, or the community minority percentage, for either the CDBG or Section 108 programs.

Multivariate relationships between loan characteristics and loan performance. As will be more fully discussed in Chapter 6, economic development loans have, to date, sold at a discount on the secondary market, meaning that the seller did not receive the full value of the unpaid principal balance of the loan pools. Two classes of factors—related to the public policy

goals of the CDBG and Section 108 programs, and uncertainty surrounding loan performance—account for this discount.

CDBG- and Section 108-funded third-party loans should not be expected to perform as well as other loans, for they are originated to serve a public purpose. Most borrowers do not appear to meet normal small business underwriting standards used to evaluate applicants for conventional or Small Business Administration (SBA) loans, and these loans become distressed more frequently. Loans are more often in subordinate positions underneath private loans, making outstanding principal more difficult to recover. And while risky borrowers in other credit markets typically obtain loans with higher interest rates compared to less risky borrowers, CDBG- and Section 108-funded loans are offered at below-market interest rates. Therefore, no secondary market purchaser of a pool of CDBG- or Section 108-funded loans will offer par value (for the entire pool). As Chapter 6 estimates, a pool of such loans would sell to investors at a substantial discount, perhaps as high as 35 percent. Such a discount is difficult to avoid, and results from an explicit policy decision to provide subsidized credit to establishments that further local economic development interests in low- and moderate-income neighborhoods.

Sellers will suffer even larger discounts in the sale of loans if markets lack information about the performance of loans and the characteristics of their underwriting. If due diligence reveals that loans are not well documented or that underwriting practices did not adequately evaluate risk, discounts will likely be steep for those reasons alone.[16] Therefore, an important question to answer about third-party lending programs is whether the underwriting information found in local or state loan files generally helps to predict loan performance. If it does, this would lend confidence to secondary market participants that they would have the information necessary to assess the performance of a pool of loans—and likely result in a reduction in the size of an eventual discount.

[16] Securitizers and rating agencies conduct due diligence for such transactions, which means that they examine loan file documentation in order to assess the quality of the assets offered for sale.

A series of "informational content analyses" were conducted to determine whether several categories of independent variables related to third-party loans improve the predictive power of a "core" model. Based on these analyses, an integrated model of loan performance was then constructed, which includes the most influential variables from each of the independent variable categories. Each type of analysis involves logistic regression, in which the dependent variable—loan distress—is a dichotomous measure of whether on not a loan has had a problematic payment history.[17]

Informational content analysis. The question asked in this section is whether each of several categories of independent variables provides "informational content" to a core predictive model of loan performance. The core model contains only information on the origination year of each loan, whether or not it is funded by Section 108[18] (rather than CDBG), and the median household income of the Metropolitan Statistical Area (MSA) in which the loan was originated. These variables capture some information about the possible performance of loans—the program, their vintage and economic circumstances at the time of origination, and the underlying strength of local markets (as reflected in median incomes). They do not contain specific loan-level information that an underwriter might use to assess the risk of loan distress, but which would require retrieval of extensive information from loan files. In sum, the analysis determines whether or not loan-level data collected from files improves the predictive power of a model that only uses this minimal information. The variable categories are described in Exhibit 5.2, with the core regression analyzing the following function:

Probability (Distressed) = f(Origination Year, Section 108 Status, Median Household Income)

Each of several subsequent regression analyses, then, augments the core analysis with variables from each category.

[17] A logistic regression is an appropriate statistical method to use when the dependent variable is categorical. The underlying assumption of the method is that there is an underlying latent variable that is a linear function of the explanatory variables. The probability of observing a 1 or 0 (a dichotomous result) equals the assumed cumulative probability distribution function evaluated at the value of the latent variable. Because loan-level data were drawn from a non-random sample, we used weights that represent the probability of a loan being included in the sample.

[18] The Section 108 loan indicator is included in the core regression because we did not have a sufficient number of observations to run separate analysis for CDBG and Section 108 loans. There are 82 Section 108 loan observations that have no missing values for any variables used in the integrated model. This is not a sufficient number to provide accurate parameter estimates.

Exhibit 5.2
Regression Functions for Variable Categories

Variable Category	Dependent Variables Added to the Core Model
Loan Terms	*Loan Amount, Interest Rate, Term*
Underwriting Information	*Tax Return in File, Credit Report in File, Pro Forma in File, Income Statement in File, Total Number of Underwriting Pieces in File*
Collateral	*Financial Collateral, Machinery, Equipment and Inventory Collateral, Real Estate Collateral, Other Collateral, Number of Pieces of Collateral*
Collateral in First Position	*Financial Collateral in First Position, Machinery, Equipment and Inventory Collateral in First Position, Real Estate Collateral in First Position, Other Collateral in First Position, Number of Pieces of Collateral in First Position*
Project Financing Structure Dummy Variables	*Owner Equity Dummy, Private Non Owner Equity Dummy, Other Public Funds Dummy*
Project Financing Structure Proportion Variables	*Total Transaction Amount, Owner Equity Proportion of Total Transaction, Private Non Owner Equity Proportion of Total Transaction, Other Public Funds Proportion of Total Transaction*
Business Characteristics	*Business Start-up, Number of Employees.*

The informational content analysis shows that all five categories of variables—loan terms, underwriting information, collateral (including collateral in the first position), financing structure and business characteristics—improve the predictive ability of a core model that only includes year of origination, whether the loan is Section 108, and median household income in the MSA.[19] In other words, the types of information contained in loan files and used by underwriters to assess loan applications can be used to help predict the performance of a pool of loans. Table 5.14 shows a significant difference (and p-value) between the value of the likelihood function with the core variables and added category variables.[20] It reports the results of both un-weighted and weighted regressions (where weights reflect the probability of a loan's inclusion in the sample). The change in the value of the core likelihood function for each regression is significant at the 0.10 level, except for one category in the weighted regression.

[19] As noted earlier, we also ran most tests using a broader definition of troubled loans (i.e. one that included loans that were restructured—even without any other evidence of a problem—and those that were delinquent more than 30 but less than 90 days) as a sensitivity analysis. Because the regression results were essentially the same, we decided to use the definition that more closely resembled most the common conception of default.

[20] In the actual calculation, we multiplied the difference between the value of the likelihood function by two, and used a Chi square statistic to assess whether the difference was significantly different from 0.

Each category adds a significant amount of predictive power to the logit performance model, with all Chi-square tests significant at the 0.01 level.

Table 5.14
Informational Content Analysis of Category Variables -- Distressed Loans

	Unweighted						Weighted			
	Log Likelihood	DF	Log Likelihood Difference	Chi Square	DF	P > Chi Square	Log Likelihood Difference	Chi Square	DF	P > Chi Square
Core Model	464.75535	7								
Loan Terms	414.79496	10	-49.96039	99.92078	3	<0.0001	-17.22398	88	3	<0.0001
Underwriting Information	458.69917	12	-6.05618	12.11236	5	0.0333	-3.44712	6.89424	5	0.2286
Collateral	404.07567	12	-60.67968	121.35936	5	<0.0001	-13.89638	27.79276	5	<0.0001
Collateral in 1st Position Dummy Variables	405.83641	11	-58.91894	117.83788	4	<0.0001	-7.89501	15.79002	4	0.0033
Financing Structure Dummy Variables	437.3277	10	-27.42765	54.8553	3	<0.0001	-7.78409	15.56818	3	0.0014
Financing Structure Proportion Variables	431.84705	11	-32.9083	65.8166	4	<0.0001	-15.10349	30.20698	4	<0.0001
Business Characteristics	373.74441	9	-91.01094	182.02188	2	<0.0001	-2.62553	5.25106	2	0.0724

Integrated model analysis. As a second step in the empirical analysis, each statistically significant variable from each category regression was included in an integrated model.[21] This is akin to the creation of a rudimentary credit-scoring model of small business loan performance, which can predict the likelihood that a given loan will remain current. Ordinarily, this task requires having a relatively large database of information on both current and delinquent or defaulted loans. Even so, one of the best proprietary models, the Dun and

[21] The integrated model of loan performance was developed by analyzing the statistically significant variables from each of the weighted category regressions, which are presented in the Appendix. Weighted regressions were chosen because they are a better reflection of the overall population of loans available for securitization. Some variables, however, were statistically significant in the individual category regressions but were not when other variables were added to the model. Therefore, we had to analyze the extent to which variables remained significant given different specifications of potential integrated models. Also, some of the variables, such as interest rate at origination, are included in the integrated model because of their importance in empirical analyses of other forms of lending. For the most part, though, the variables in the integrated model are those that are statistically significant in the category regression and also after variables from other category regressions were added.

Bradstreet Credit Scoring Report, does not improve predictive power by very much over a simple guess based on average loan performance—thus illustrating the challenge associated with identifying factors that influence small business loan performance.[22]

For this analysis, some of the variables have an effect that is consistent with expectations, as presented in Appendix D-1. From the core model, lower median household income in the community means that loans are more likely to be distressed. This is not surprising: such communities are likely to have a higher level of economic and social problems, which create a more risky business environment. The effect of the origination year dummy variables is somewhat ambiguous. The year dummy parameter estimates are significant at the 0.10 level for 1995, 1996, 1997 and 1998, but not for 1994. The expectation was that all of the year dummy variables would be significant and positive, because older loans are more likely to have some form of payment issue than newer loans.

The integrated loan performance model includes variables from each of the variable categories. In finalizing the model, variables were chosen that remained stable over different model specifications. From this analysis, the following can be concluded:

- The most predictive variable from the "loan terms" category is the loan term in months at origination: it is positively related to the probability of a "distressed" loan, perhaps indicating that long and short loan terms are associated with different types of projects, with different risks—e.g., loans for real estate acquisition are likely to be longer than those for short-term needs such as operating capital or inventory.
- The presence of a credit report in the file is the most influential variable from the underwriting category, and is positively related to a loan being "distressed." This finding may be consistent with loan underwriters requiring more information for loans they believe to be more risky and, therefore, underwriting the principal in addition to the business. This finding, however, should be interpreted with caution: clearly, it is unlikely that the presence of a credit report *creates* more risky loans; rather, more risky loans may require more extensive documentation.
- From the "financing structure" category, it is observed that loans for projects with larger shares of borrower equity financing are less likely to become "distressed." This may reflect an effect in which more highly capitalized borrowers have the

[22] The model predicts the likelihood of a company paying a loan in a delinquent manner (90+ days past terms) during the first 12 months after origination. In a sample Credit Scoring Report, the company indicates that 16.6 percent of all companies in their files have a delinquent payment. This average is the 50th percentile, and the probability of a delinquency of a hypothetical company in the high-risk 15th percentile is 19.8 percent, only 3.2 percentage points higher. This means is that a firm in a very high percentile of risk is only slightly more likely to default than the average firm.

wherewithal to remain current on their loans or because paid-off loans are not included in the definition of distress. It may also reflect the fact that borrowers with greater equity are better able to sell the financed assets for enough money to pay off their loan if they get into financial trouble.

- No significant collateral variable emerged from the integrated model. This may reflect the type of information collected: although the value of the collateral, in cases where it was documented in the file, was collected, such cases are, in fact, fairly rare and, therefore, result in an unacceptably high level of missing data. Consequently, the model uses only the presence of collateral by type, rather than its quality or value. It is difficult for an experienced underwriter to value collateral, particularly for non-real estate loans, and so it is not surprising that it apparently was not it valued in many cases.
- Finally, the most predictive borrower business characteristic is whether the establishment is a start-up, which is consistent with expectations.

Other variables—interest rate at origination, total project size, and number of underwriting pieces—are not statistically significant, a finding that may be further evidence that some of the explanatory variables are endogenous. That is, some loan programs may use inverse risk-based pricing in which loans with lower interest rates are originated to more risky borrowers, thereby creating a negative relationship between interest rate at origination and the probability of a "distressed" loan. Similarly, some underwriters may require more documentation for risky loans while others may not approve loans at any risk level without the documentation. Therefore, the effect of the total number of underwriting pieces may be, in the aggregate, not significantly different from zero.

Summary and implications of the model. Inasmuch as the analysis presented above represents an initial effort to predict or explain the performance of CDBG- and Section 108-funded third-party loans, the results can only be considered a first, albeit very important step in understanding how such loans perform. The integrated model cannot be considered definitive; instead, it can be taken as a reliable *preliminary* indication of the factors that influence loan performance. It is important for two reasons: categories of variables that influence whether a loan becomes distressed are identified; and this information would likely aid secondary market actors in structuring transactions.

The integrated model is somewhat predictive of loan performance, and several variables included in it improve the predictive power of the core model. This is a significant outcome given that there are no other predictive models of CDBG- and Section 108-funded loans that have been developed. Further, the integrated model's predicted probability of a loan becoming distressed changes when compared to a model that does not include any predictive variables. The median estimated probability of a "distressed" loan from the integrated model is 27.6

percent. This probability increases dramatically across percentiles of rank-ordered predicted loan values: the 85th percentile estimated probability of a "distressed" loan is about 48 percent. This compares favorably to Dun and Bradstreet's observations that the predicted probability of its model at the 85th percentile for a serious delinquency is only 3.2 percentage points higher than the median predicted probability.

Table 5.15
Integrated Loan Performance Model

		Distressed Loans			
Variables		**Parameter Estimate**	**Odds Ratio**	**Marginal Effect on Probability**	**P-Value**
Intercept		14.1922834	n/a		0.0114
Log of Median Household Income		-1.3637889	0.32463402	-0.32227	0.0136
Originated in 1994		1.48609712	4.41981184	n/a	0.3906
Originated in 1995		1.51677268	4.55749296	0.35735	0.0273
Originated in 1996		0.69033621	1.99438596	0.16264	0.0303
Originated in 1997		0.93145716	2.53820507	0.21945	0.003
Originated in 1998		1.02600937	2.78991008	0.24173	0.0009
Section 108		1.45788068	4.29684349	0.34348	<0.0001
Term at Origination (in months)		-0.0058952	0.05903159	-0.00139	0.0113
Interest Rate at Origination		-0.0005707	0.9928914	n/a	0.9894
Number of Underwriting Pieces in File		0.04313023	1.60710201	n/a	0.4352
Credit Report in File		0.36107649	1.43487321	0.08507	0.0909
Log of Total Project Financing		-0.1178124	0.2985967	n/a	0.1129
Owner Equity Proportion of Total Financing		-0.8768605	0.49172315	n/a	0.1624
Startup		0.30394813	1.35519875	n/a	0.2007
Statistics					
Observations (Sum of Weights)	562.971				
Log Likelihood Full	323.23273				
Log Likelihood Reduced	362.32366				
Difference	39.09093				
Chi –Square	78.18187				
P Chi-Square	<0.0001				
Pseudo R-square	0.1079				

But, more important from a secondary market perspective, results show that the information in loan files is useful for establishing which loans have the potential to be problematic. It suggests that the underwriting documentation available in local loan files captures, to a certain extent, the underlying risks associated with a given applicant—even if the predicted risk was not always used in pricing the loan because of a loan program's public purpose. Documentation, therefore, can provide reassurance to potential transaction participants regarding the benefits of conducting due diligence—i.e., that data in loan files are in good enough condition to analyze, to assess risk, to structure credit enhancements, to price transactions, and to assist in structuring successful secondary market securitizations.[23]

In sum, the fact that the information in local loan files is somewhat predictive of loan performance is a crucial finding from the perspective of potential secondary market participants. However, it is also the case that many local loan files are not complete and, therefore, the type of underwriting that was undertaken is not easily determined from them. Without improving documentation procedures in some communities, CDBG- and Section 108-funded third-party loan sales will continue to be executed with discounts over and above the policy discount associated with the specific risks and interest rates associated with the loans. The model suggests that this is an unnecessary outcome: data similar to that which was collected for this study can be used by sellers and prospective buyers to model performance and provide information regarding appropriate loan pricing.

[23] This, of course, is a much better outcome than would have been the case if the informational content analysis did not show that the variable categories improved the predictive power of the core model. In such a case, potential secondary market participants would have little confidence in the quality of the loan-level data available for due diligence, or the type of underwriting used by CDBG and Section 108 third-party loan originators.

CHAPTER 6: CONSIDERATION OF THE FEASIBILITY OF SECONDARY MARKET SALES OF THIRD-PARTY LOANS

Highlights

This assessment of the feasibility of establishing a secondary market for HUD-supported third-party loans is based on: a review of existing third-party loan pool characteristics; the observation that such loans are underwritten in a way that helps to predict risk; discussions with economic development secondary market participants; and interviews with local officials.

Any asset generating a cash flow can be placed in a secondary market. A common way to sell financial assets is through asset-backed securities (ABSs), which offer investors a range of maturities and yields based on the different risk levels of the underlying assets. Nearly all ABSs have some form of credit enhancement to reduce risks to buyers. Common enhancements include over-collateralization (in which the volume of securities issued is less than the value of the underlying assets), creation of loan-loss reserves using some of the interest payments or proceeds from bond sales, and creation of structured transactions that include senior and subordinate debt. Such structured transactions contain an A-rated, low-risk senior tranche, a higher-risk subordinate tranche, and an unrated, high-risk, residual tranche. As cash flow is generated by financial assets, holders of the senior tranche get paid first, holders of the subordinate tranche get paid next and, if any cash flow remains, holders of the residual get paid last.

Previous small business and economic development loan transactions that have used all of these forms of enhancement demonstrate the importance, to investors, of having information on both loan performance and underwriting characteristics. They also suggest a transaction structure that, based on the amounts of private equity and market-rate loans associated with HUD-supported loans, apportions about 23 percent of a CDBG/Section 108 ABS to a senior tranche, 57 percent to a subordinate tranche, and 20 percent to a residual retained by the sellers. Because the senior tranche is small relative to standard small-business ABSs, and the residual is large, sellers of a CDBG/Section 108 ABS may expect to receive about 66 cents on the dollar. To illustrate, in high-loan-volume communities, the $324 million of loan principal outstanding for performing loans in 2002 would yield approximately $207 million in sales proceeds—the full loan principal less the 20 percent residual, and an seventeen percent discount because most of the public debt sold is subordinate to that of private lenders.

Although certainly feasible, creation of a secondary market requires resolution of issues raised by potential buyers and sellers. Data on loan performance and underwriting characteristics of the kind presented in this report would be needed in future transactions. Lack of standardized underwriting and servicing guidelines would lead investors to apply steep discounts to the prices they offer. And, although about one-half of local officials express interest in potential sales, they are concerned that investors would want to cream only high-performing loans, would require sharp discounts, and would demand standard underwriting—all of which might undermine agency relationships with borrowers, limit flexibility to pursue high-risk and high-payoff projects, and not necessarily produce sufficient financial benefits.

Introduction

In principle, any asset—including an economic development loan—generating a cash flow may be placed in a secondary market, which means that the cash flow from the assets can be sold to investors in the form of financial securities. Indeed, increasingly sophisticated financial techniques have been used to facilitate secondary markets for a wide variety of assets, including home mortgages, automobile loans, credit card receivables, and equipment leases.[1] Even non-performing loans can be sold in secondary markets, as shown by sales of loans owned by the Resolution Trust Corporation that was charged with assuming and disposing of bad loans originated by failed savings and loan institutions.

Some local community development officials express interest in selling the rights to future cash flows from their third-party economic development loans in order to expand their economic development efforts beyond current levels or in anticipation of the possibility of future cutbacks in external funding. To date, however, secondary markets for economic development loan, in general, have been very limited, and those that have been established have been crude and inefficient. As a result, loan sales have entailed both deep discounts from the unpaid principal loan balances (par values)—even for loans that loan program administrators consider to be of high quality.

To assess the feasibility of establishing a specialized secondary market for HUD-supported third-party loans, this chapter proceeds in three stages. First, asset-backed securities are described generically and in terms of how they might work with respect to third-party loans—based on previous secondary market experiences involving small business and economic development loans. Second, the possible market structure and pricing of securities for CDBG- and Section 108-funded loans are considered. Finally, the interests and concerns expressed by market participants in previous secondary market transactions and by local community development officials regarding possible development of a secondary market for their loans are reported.

[1] Bushaw, Amy. 1998. "Small Business Loans: Testing the Waters." *The Journal of Small & Emerging Business Law,* Vol. 2(1): 197-257.

A Description of Secondary Market Securitization Transaction Structures

To create an ongoing secondary market for CDBG- and Section 108-funded third-party loans, intermediaries (such as investment bankers) would have to securitize these loans into ABSs,[2] after which rating agencies would evaluate their credit quality. Prior to the 1980s, securitizations were designed as simple "pass-through" securities. The proceeds generated by the assets forming the underlying collateral were "passed through" to investors. Because these asset backed securities could only reflect the underlying assets,[3] they had limited appeal to investors interested in a broader range of maturities and yields than these assets possessed. This changed dramatically in the 1980s as collateralized mortgage obligations (CMOs) were developed and used in the mortgage backed securities market. In these transactions, the underlying cash flow generated from the underlying assets is structured in order to create multiple certificates (or bonds) with different maturities and risks (and therefore, prices and yields). This structure allows both low-risk and high-risk investors to purchase portions of a single issuance.

Almost all ABSs have some form of credit enhancement, which provides investors with confidence that they will receive payment even if the underlying assets fail to perform. There are two types of credit enhancement available for such securities: external and internal. External credit enhancements are provided by third parties, such as those who insure bonds; internal credit enhancements are supplied by the assets themselves.[4] There are three common internal credit enhancements: senior-subordinate structure; overcollateralization; and excess spread accounts.

- **Senior-subordinate structure:** Certificates or bonds that represent the lowest credit risk to investors are included in the senior tranche, while other certificates that are more risky are issued as part of subordinate tranches.[5] The proceeds generated from the underlying mortgages are applied sequentially to each tranche: the senior certificate holders are paid first until all payments owed those investors are met.

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[2] In securitization transactions, cash flows generated by assets are used to pay investors which is why such securities are referred to as asset backed securities. See Schwarcz, Steven L. 1994. "The Alchemy of Asset Securitization." *The Financier* Vol. 1(5):53-64; and SG ABS Research. 2000. *Asset Backed Securities: Practical Guide for Investors* May 15.

[3] Robinson, Kelly. 2001. *Expanding Capital Resources for Economic Development: An RLF Demonstration*. Washington, D.C.: Research and National Technical Assistance, Economic Development Administration.

[4] Kohler, Kenneth E. 1998. "Collateralized Loan Obligations: A Powerful New Portfolio Management Tool for Banks." *The Securitization Conduit* Vol. 1(2):5-19.

[5] Tranches within a CMO (now called Real Estate Mortgage Investment Conduits (REMICs) represent separate financial instruments that are created from the underlying cash flow provided by the mortgages used as collateral. Tranches are designed to provide investment opportunities that differ by credit risk, yield, and maturity date.

After the senior tranche is paid in full, the remaining funds are used to pay the investors in subordinate tranches. The holders of the residual or unrated tranche receive any payments left over after these more senior tranches have been paid in full. As a result, the residual tranche's payment to the investors is most likely to be affected by defaults, while the senior tranche is the most insulated from credit risk.[6] The subordinate debt can be thought of as acting as a loan loss reserve for the senior debt, thereby allowing the senior debt to receive an investment grade rating. Higher risk investments (with high expected losses) require more subordinate debt and residual than lower-risk investments if the senior tranche is to receive an AAA rating.

- **Overcolleralization:** In this type of credit enhancement, the total unpaid principal balance of assets used as underlying collateral is greater than the value of the security issued. As an example, assume a loan portfolio with mortgages totaling $10 million in unpaid principal balance. An over-collateralized issuance may consist of an investment grade ABSs worth only $9 million. In effect, the excess collateral acts as a loan loss reserve, and so provides a credit enhancement to investors.

- **Loan loss reserves:** This type of credit enhancement assures securities buyers that their losses would be covered by payments from a reserve account established for that purpose. These are known as *excess spread accounts* if they are funded from the difference between the payments received from loans originated to borrowers and the payments to investors. This payment difference is the spread between interest rates charged to borrowers and the rates paid to investors. For example, the weighted average interest rate for a pool of mortgages may be 9 percent, while the average interest rate of the ABS issued to investors may be only 8 percent. These loss reserves are sometimes capitalized initially by using a portion of the proceeds of securities sales. *Recourse* is a kind of loss reserve-equivalent, in which loan originators make cash payments to investors to cover losses in the event of default. *Substitution* is a similar procedure, by which performing loans are substituted for non-performing loans.

Many transactions use a combination of internal credit enhancements. An ABS may have a senior-subordinate structure combined with overcollateralization and an excess spread account. The issuer may decide to use an external credit enhancement, as well, in order to provide even more assurance to investors. A transaction's structure, ultimately, is a function of: the relative costs associated with different types of credit enhancements; the quality of the

[6] DeLiban, Nancy and Brian P. Lancaster. 1995. "Understanding Nonagency Mortgage Security Debt." *Journal of Housing Research*. Vol. 6(2):197-216.

underlying collateral; and investors' trade-offs of risk and return. In general, the amount of credit enhancement required for a particular transaction is directly related to the risk and volatility of the underlying collateral. For instance, an ABS that uses prime conforming mortgages as collateral will require much less credit enhancement to receive a given price than an ABS that uses mortgages that do not meet conforming underwriting criteria. Investors in such more risky ABSs will demand a higher level of assurance that they will be paid in the event of loan delinquencies and defaults, or will offer a lower price for the ABSs to offset the higher level of risk.

Previous secondary market transactions involving public or business loans. Increasingly widespread use of credit enhancements has boosted investor comfort with ABSs across a wide range of risk classes. Previous transactions—including market sales of small business loans, HUD CDBG loan securitizations, and the Economic Development Administration's (EDA's) Revolving Loan Fund (RLF) demonstration—show the feasibility of a secondary market for CDBG and Section 108 third-party loans, even though investors remain wary of such transactions.

A 1995 survey of CDBG revolving loan funds identified 12 sales involving 548 housing rehabilitation loans that generated $4.6 million in proceeds.[7] Like the third-party loans described in Chapter 5, these were often originated with below-market interest rates to high-risk borrowers—usually in second position to private bank financing—with highly variable underwriting and documentation.[8] Such loan sales were not "plain vanilla" transactions: partly because of poor loan documentation, initial transactions took 14 months to complete, although subsequent transactions—usually with investors participating in the first round of sales—took only eight months to complete. The loans sold at an average discount of 19.1 percent, which resulted from both the loans' relatively low interest rate (6.2 percent) compared to market rates for similarly rated securities and a lack of information about their expected performance. The transactions used a variety of techniques to reduce risks to investors—including reserve accounts, repurchase, and substitution agreements—as follows:.

- Loan loss reserve funds were included in three transactions involving a set-aside of 12 percent of the purchase proceeds (Washington, DC), a letter of credit from a local bank and a reserve fund equal to 10 percent of the unpaid principal balance of the loans at the time of sale (St. Paul, MN), and a state-supplied $100,000 grant to capitalize a loan loss reserve (Kalamazoo, MI).

[7] Dommel, Paul. 1995. *Secondary Markets for City-Owned CDBG Loans*. Prepared for the U.S. Department of Housing and Urban Development: Cleveland OH, Cleveland State University.

[8] Robinson, 2001, p. 9.

- Other cities agreed to repurchase non-performing loans or to substitute a performing loan for one that was in arrears.
- Sellers in substitution transactions were required to have performing loans equal to 50 percent of the loans sold: in effect providing a 50 percent loan loss reserve.

A few municipalities have sold CDBG-funded economic development loans to secondary market investors. In the largest such transaction, the MacArthur Foundation in 1994 purchased a security issued by the South Carolina Jobs-Economic Development Authority (JEDA) that used economic development loans as collateral. The transaction had a relatively large amount of credit enhancement: $7 million of an $11 million loan pool was sold as a senior security, while a $4 million subordinate security was retained by JEDA.[9] In effect, this provided a 36 percent loss reserve to the senior tranche, which sold at par at a rate similar to comparable Treasury securities. This level of credit enhancement is not unusual, given the volatility and risk associated with the underlying collateral.

The Economic Development Administration has capitalized hundreds of RLFs since the 1970s and, in 1999, initiated a demonstration to facilitate securitization transactions for these portfolios. It awarded $900,000 in grants to four entities to cover transaction costs—including staffing, legal fees, and rating agency fees.[10] Their experience is as follows:

- The Racine County Economic Development Corporation (RCEDC) used RLF loans to collateralize a $1 million line of credit provided by a local bank consortium. A portfolio of 22 business loans with an unpaid principal balance of $1.2 million was valued at $1,1 million. Borrowed at 5 percent, the LOC funds were used to originate loans at 6 percent; the 100 basis point excess spread covered RCEDC operating costs. Credit enhancement included a slight over-collateralization (a $1 million LOC collateralized by loans valued at $1,1 million) and a loan volume cap of $700,000 from the LOC—in effect, providing a 30 percent loan loss reserve (a level of credit enhancement similar to the JEDA transaction).
- South Dakota Rural Enterprise, Inc, implemented a transaction in which investors provided an unsecured, low-interest, ten-year bank loan subordinated to senior debt—a model previously implemented successfully by the National Community Capital Association and Citibank, supported by the Ford Foundation. Lenders provided SDREI with funds at 3 percent and SDREI made the capital available to participating RLFs at 5 percent. Investors received CRA credit for the loans originated.

[9] Robinson, 2001. p. 11.

[10] *Ibid*., p.17; and interview with Kelly Robinson, August 2, 2002.

- The Community Reinvestment Funds and Commonwealth Development Associates executed a more typical form of securitization transaction. As part of the EDA demonstration, CFF purchased 27 loans from 3 RLFs with an unpaid principal balance of $1.3 million and an average coupon rate of 8.5 percent. The capital raised through the transaction was $1.2—an overcollateralization of 7.5 percent. The loans were pooled with other funds into a single transaction of $14.4 million, containing four classes of securities: a Class A, senior security for $7.6 million; a Class B, junior security for $3.5 million; and a subordinated security for $0.6 million and a residual security for $2.9 million, both held by CRF. Credit enhancement for the senior security was over 47 percent: $7.6 million out of a total pool of $14.4 million. Relatively well capitalized, CRF provided warehouse financing, buying RLF loans and holding them until it accumulated sufficient volume to execute a transaction. Even though CRF bore the risks that the rate investors would demand from the ABS would exceed the rates of the underlying loans, CRF officials believed that "cash on the barrel" would induce RLFs to sell their loans readily. This warehouse line and the retention of $3.5 million of subordinated and residual debt conveyed a significant subsidy to RLFs, improving the price they received for their loans despite the relatively risky and volatile collateral used for the ABS.

While small, there is a secondary market for conventional small business loans. Feldman reports that $900 million of small business loans were securitized through 1994, which is about 0.5 percent of the total $155 billion of such loans that were outstanding at that time.[11] There are a number of factors that account for this low securitization volume, like the fact that small business lenders do not adhere to standardized underwriting guidelines. This makes it difficult for potential investors to evaluate small business loan pools in order to price the risks associated with the underlying collateral. Moreover, potential securitizers cannot use standard pricing models, which help to reduce transactions costs associated with structuring asset backed securities.[12] While the lack of standardized underwriting in small business lending is, perhaps, the most important factor in explaining the low volume of securitization in this market, it is also the case that some segments of the small business loan market have high prepayment speeds and also exhibit higher credit losses.[13]

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[11] Feldman, Ron. 1995. "Will the Securitization Revolution Spread?" *The Region*. http://minneapolisfed.org.pubs/region95-09/reg959b.html.

[12] Zhang, Zhongcai and Ziona Austria. 1996. *Small Business Lending: Barriers and Trends*. Report prepared for the U.S. Environmental Protection Agency, Office of Pollution Prevention and Toxics. Cleveland: The Great Lakes Environmental Finance Center, Maxine Goodman Levin College of Urban Affairs, Cleveland State University. Report.

[13] Faulk, Donna. 1999. Prepared Testimony of Ms. Donna Faulk, Chair, Government Business and Loan Committee, Bond Market Association, New York, New York. <http://www.house.gov.smbiz/hearings.106th/1999/990624/faulk.htm>

Despite these challenges, investors are purchasing ABSs using small business loans as collateral. Between 1995 and 1997, Feldman estimates that $1.1 billion in small business loans were securitized.[14] More recently, AMRESCO and First Union securitized relatively large small business loan portfolios—$221 million and $589 million, respectively. These two deals were motivated by a change in regulation that eased certain restrictions, and an increase in competition for small business loans.[15] This securitization activity also may be the result of increased use of credit scoring by small business loan originators. Credit scores provide objective and easily analyzed information about the credit quality of a borrower, which makes it easier for investors and securitizers to assess and price the risks associated with a given loan pool. In addition, some lenders are using a relatively consistent set of underwriting guidelines for portions of the small business loan market, thereby creating a potentially larger pool of loans suitable for securitization.[16]

These trends, if they continue, may help to increase the secondary market for small business loans beyond the relatively strong market for guaranteed mortgages originated as part of the SBA's 7(a) program. Moreover, investment banks and other secondary market participants are using more diverse methods to structure asset backed securities to make them more attractive to potential investors. These techniques may be suitable for small business ABSs, since these loans have higher credit risks and faster prepayment speeds. For example, Feldman points out that a lender must provide a credit enhancement of between 11 percent and 20 percent of the total amount of loan pools sold to the secondary market. In most cases, lenders provide this credit guarantee by assuming the entire potential loss liability, and so do not reduce their risk exposure even after selling the loans.

Lessons learned from previous transactions. The following lessons follow from the secondary market transactions involving economic development or similar loans that have occurred to date. Investors will find it difficult to price (and will, therefore, conservatively price) securities backed by loans that are not documented according to industry standards and for which loan performance and, more importantly, loan loss information is lacking. Investors will require substantial amounts of credit enhancement, requiring any securitization to be structured with a combination of overcollateralization, subordinate debt, and other enhancements to cover a loan pool's expected losses. Loan sellers will have to retain a high proportion of the pool's credit risk by retaining the residual piece of the transaction, capitalizing a loan loss reserve, or including repurchase or substitution plans in the sale terms agreement. Initial transactions will

[14] Feldman, *op. cit.,* 1999.

[15] Friend, Janin. "A Jump Start for Cheap Loans." *Business Week*. Sept. 13, 1999.

[16] Feldman, Ron. 1997. "Small Business Loans, Small Banks and a Big Change in Technology Called Credit Scoring." The Region <http://www.minneapolisfed.org/pubs/region/97-09/credit_score>

require a credit-risk discount that exceeds a reasonable estimate of expected losses. Moreover, discounts will be increased if interest rates of the underlying assets are below those of similarly rated securities. Subsequent issues, however, can benefit from the observed performance of initial offerings. As market participants observe actual payments and losses, required credit enhancements will come to be based on more objective and reliable estimates.

Financial Economic Analysis of a Secondary Market for CDBG and Section 108 Third-Party Loans

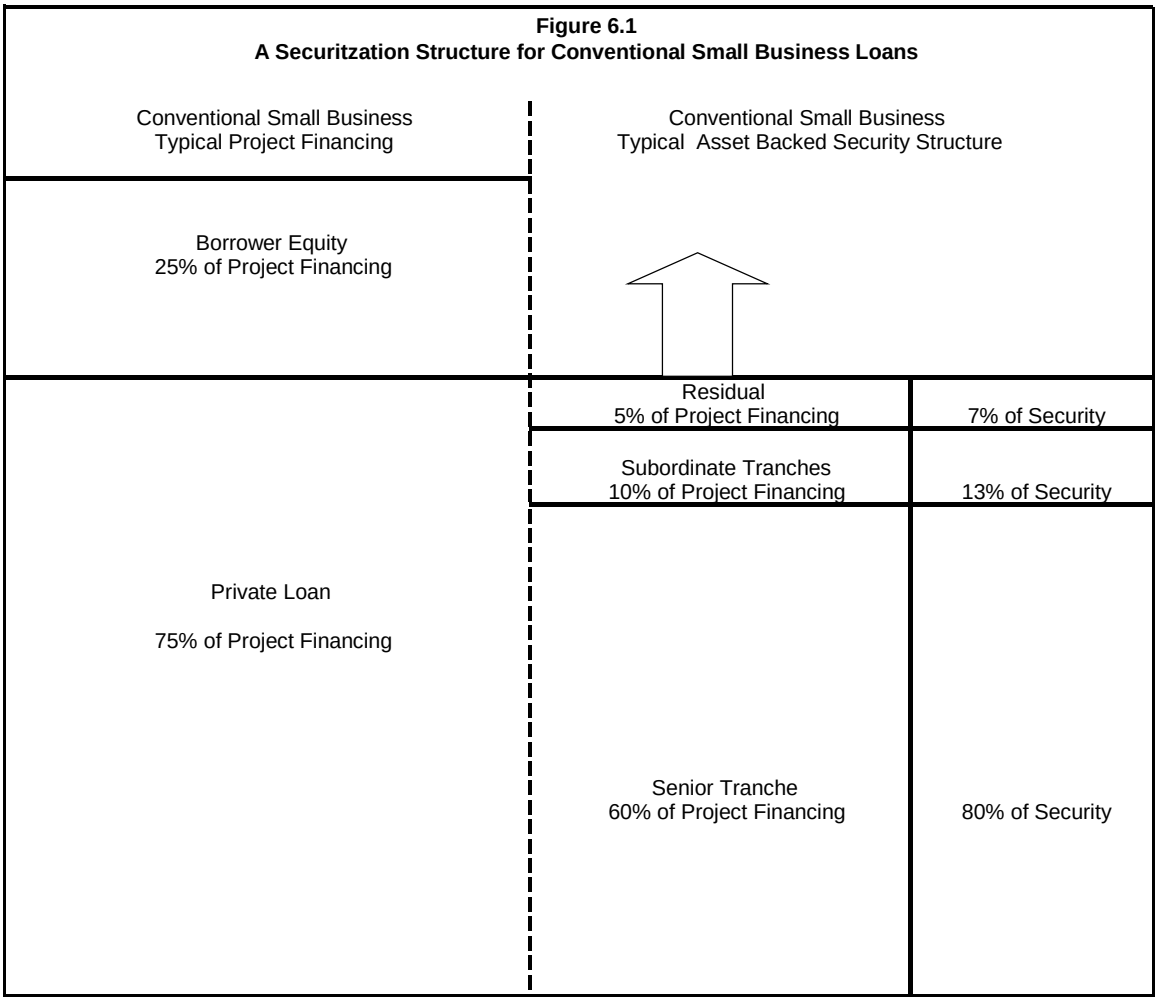
The structure of a potential secondary market for CDBG- and Section 108-funded loans is dependent on the potential size of a senior tranche and the expected losses from a pool of HUD-supported third-party loans. In the discussion below, standard small business loan securitizations are used as a model for possible securitization of CDBG and Section 108-funded loans. These securities typically rely on the senior-subordinate structure described above, and this form of credit enhancement is likely to produced the best "execution" or command the best price compared to other forms of securitization. That said, any form of credit enhancement could be used to bring these loans to a secondary market. Most important is to create some form of first-loss account that would absorb much of the risk that investors would otherwise incur. Such a first-loss account could come from the residual and subordinate tranches, from a loss reserve, from over-collateralization, or most likely, combinations of these methods. The account could be capitalized from internal sources, from grants made by third parties, or from both.

A securitization structure for conventional small business loans. Similar to other forms of lending, conventional small business loans are originated to borrowers who place their own equity into a transaction, and demand additional collateral. Figure 6.1 is a schematic diagram of such a transaction. As indicated, conventional small business lenders typically require a borrower to place a minimum of 25 percent equity in the transaction. This serves two purposes: the borrower's equity contribution makes it less likely that he or she will default on the loan; and the lender is more likely to recover the unpaid principal balance of the loan in the event of a default. In effect, the borrower assumes the first loss position and, therefore, provides security to the lender beyond that in the underlying value of the assets used as collateral.

The figure shows how each type of financing is exposed to potential loss; sources of funds lower down on the diagram are exposed to less risk. Therefore, private loans are shielded from losses by the borrower equity "sitting" above them. In the event of a default, private lenders can recover any unpaid principal from the sale of assets used as collateral. The figure also depicts how loans can be securitized using a structure already employed in the small existing secondary market for conventional small business loans. For example, AMRESCO and Business Loan Express, two non-depository lenders that issue ABSs with small business loans

as collateral, have an AAA-rated tranche that accounts for approximately 80 percent of the security, with the remaining 20 percent consisting of subordinate debt and a residual—usually retained by the seller. The figure shows the 80-percent senior tranche "below" the subordinate tranche and a residual that absorbs losses resulting from delinquencies and defaults of the underlying loans. Put another way, the relatively risk-free senior tranche represents 60 percent of total project financing.

Figure 6.1
A Securitzation Structure for Conventional Small Business Loans



A possible securitization structure for CDBG- and Section 108-funded loans. Because transactions involving CDBG and Section 108 financing appear riskier than those involving only standard small business loans,[17] it is estimated that the senior tranche for

[17] As discussed in Chapter 4, 81 percent of third-party loan borrowers claim they did not meet bank standards in that their project would not have been possible, on the same sale and during the same time period, absent their CDBG- or Section 108-funded loan.

transactions with CDBG- and Section 108-funded loans is only 80 percent as large as for conventional small business loans. As total debt (public and private) amounts to 85 percent of project financing (as in Figure 6.1), then the senior position for a pool of CDBG- and Section 108-funded loans is 48 percent of the total, with the remaining 37 percent consisting of the subordinate tranche and a residual.[18]

Figure 6.2
A Possible Securitization Structure for
CDBG- and Section 108-Funded Loans

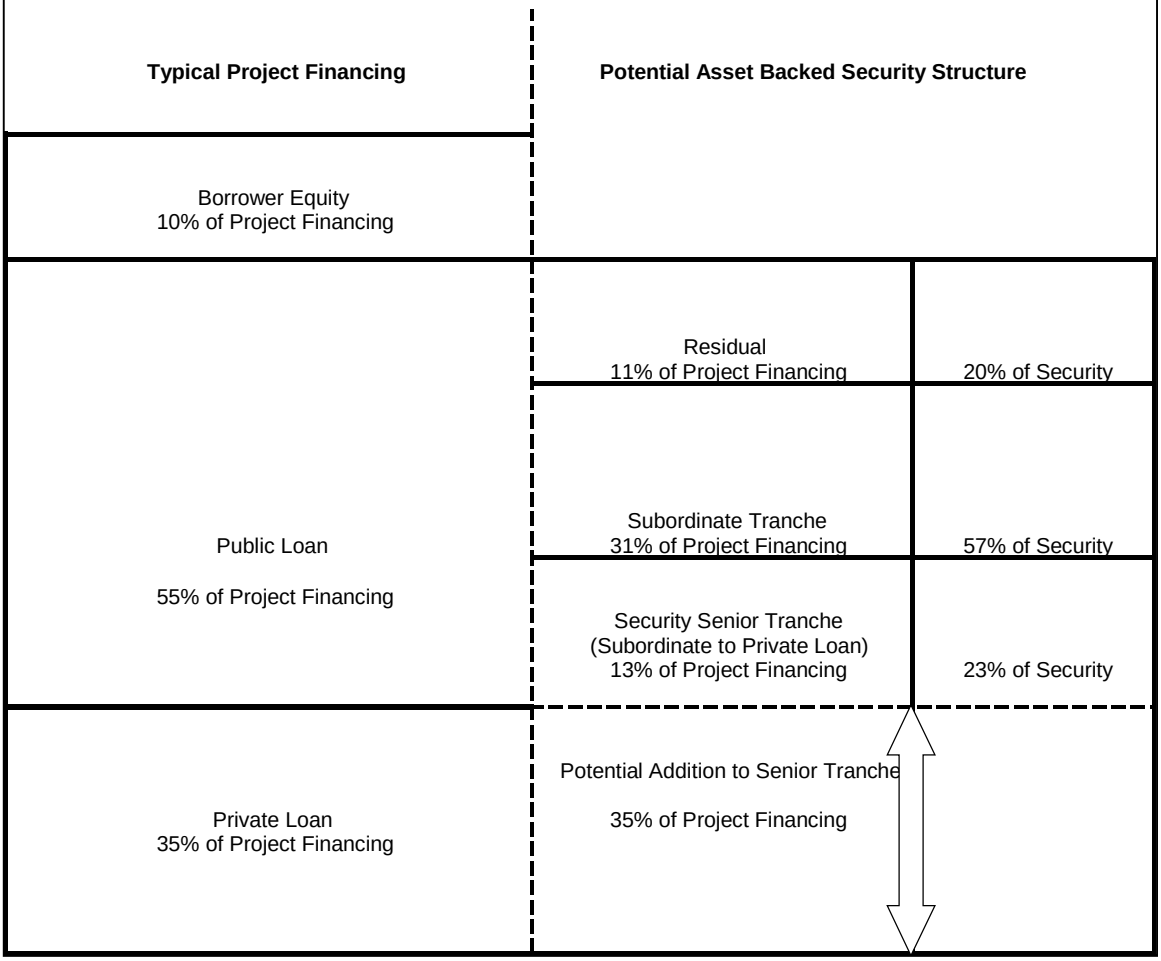


Figure 6.2 shows the financing structure specific to CDBG- and Section 108-related transactions and how it corresponds to the structure of a potential asset backed security. Borrower equity accounts for around 10 percent of project financing and, on average, private

[18] In the conventional small business lending scenario, the senior tranche was 60 percent out of 85 percent; 80 percent of 60 percent is 48 percent.

loans are 35 percent of project financing—a smaller percentage of total financing compared to conventional small business loans—while public loans, at 55 percent of project financing, provide the remainder. As in Figure 6.1, the financing "sitting under" other forms of capital is more insulated from risk, which places private loans in the most senior position protected by borrower equity and the CDBG- or Section 108-funded loans. The CDBG- or Section 108-funded loans, in a subordinate position, are protected only by borrower equity. As the figure indicates, 48 percent of the total project financing is in senior position and 35 percent is taken up by the private debt, leaving 13 percent of the senior position for CDBG- or Section 108-funded loans. The size of the residual piece is estimated at 11 percent—a residual slightly larger than expected losses, as explained below. This leaves 31 percent of total project financing in the subordinate tranche. In other words, the 85 percent of project financing provided by private and public loans can be carved up a as follows: 30 percent, private loan senior tranche; 13 percent, public loan senior tranche; 31 percent public loan, subordinate tranche; and 11 percent residual.

Assume that the securitization involves only the public sector loans. Figure 6.2 shows that 23 percent of the security will consist of a senior tranche, 57 percent will consist of a subordinate tranche, and 20 will consist of a residual. To illustrate, assume that the entire volume of performing CDBG- and Section 108-funded loans in early 2002 (the time of data collection) are securitized in a single transaction. Table 5.7 showed this volume to be $324 million—of which $74 million is CDBG funding and $250 million is Section 108 funding. Applying the percentages from Figure 6.2, $75 million would form the senior tranche and command an investment grade rating, $185 million would form the subordinate tranche and be discounted accordingly, and $65 million would form the residual—and in all likelihood be held by the originating jurisdictions. As noted above, these figures would change if other forms of credit enhancement were used; for instance, a portion of the first-loss account could come from over-collateralization—e.g., if only $280 million of securities were issued on the total $324 million of assets—thereby reducing the size of the residual tranche.[19]

The estimated price of CDBG and Section 108 securitizations. Asset-backed securities will sell at a discount from the principal value of the underlying assets. Chapter 5 discussed the two sources of this discount: a "policy" discount that stems from the public purposes served and which results in third-party loans that are of higher risk than other small business loans, are subordinate to private debt, and are made at below-market rates; and an "uncertainty" discount that stems from a lack of standardized underwriting (including standards, servicing and documentation) and an absence of historical information on loan performance.

[19] Note that intermediaries would charge fees for arranging the transaction, perhaps amounting to $1 million or so of the face value of the ABS.

Both of these sources of discount are reflected in the relative sizes of the residual and the senior tranches, which, in turn, drive the price of the issuance. The residual is estimated based on the size of expected losses—estimated to be 15 percent of the pool. This estimate is based on the roughly 21 percent of principal outstanding for CDBG- and Section 108-funded loans in default or seriously distressed and, further, on the presumption that only 40 percent of the unpaid principal balance at the time of default is recovered through sale of assets.[20] Therefore, the required residual portion of the securitization in Figure 6.2 is 20 percent—slightly larger than the expected losses in order to provide investors with enough confidence to purchase the subordinate and senior tranches. The small senior tranche, at 18 percent of total financing, will not be viewed by an uncertain market as a full senior tranche because of the private loan that sits in the first position and, therefore, investors are not likely to pay par for the senior and subordinate debt. A conservative estimate places the discount below par at 18 percent.

Based on the relatively small size of the senior tranche and the large size of the residual, the price of CDBG- and Section 108-funded loans can be estimated to be about two-thirds of the unpaid principal balance. This estimate assumes that a seller will retain the residual of 20 percent, leaving 80 percent of the unpaid principal balance within the senior and subordinate tranches. The price can, then, be estimated at 82 percent of this balance (i.e., after a 16 percent discount), or 66 percent. This 16 percent discount reflects the unusual structure of CDBG and Section 108 deals compared to those more typical in small business lending, in which only private and not public debt is involved. Investors accustomed to seeing a senior tranche consisting only of private debt will be wary of a senior tranche that includes public debt that is behind private debt in the individual transactions. As a result, they are unlikely to pay par for this senior tranche. This estimate does not include any discount or premium for the difference between the weighted average coupon of the discounted loans and the yield from alternative market-rate investments.

There is a potential alternative for jurisdictions that want to sell CDBG and Section 108-funded loans, but do not want to receive an up-front discount on the realized sales price. Rather than sell such loans, a municipality can pledge the unpaid principal balance for a new Section 108 trust, which would sell bonds to investors at par, given an additional Section 108 guarantee from HUD. In such a transaction, HUD would guarantee a new trust up to the full unpaid principal balance of the pledged loans. However, the municipalities would still be required to repay HUD as the pledged loans defaulted.

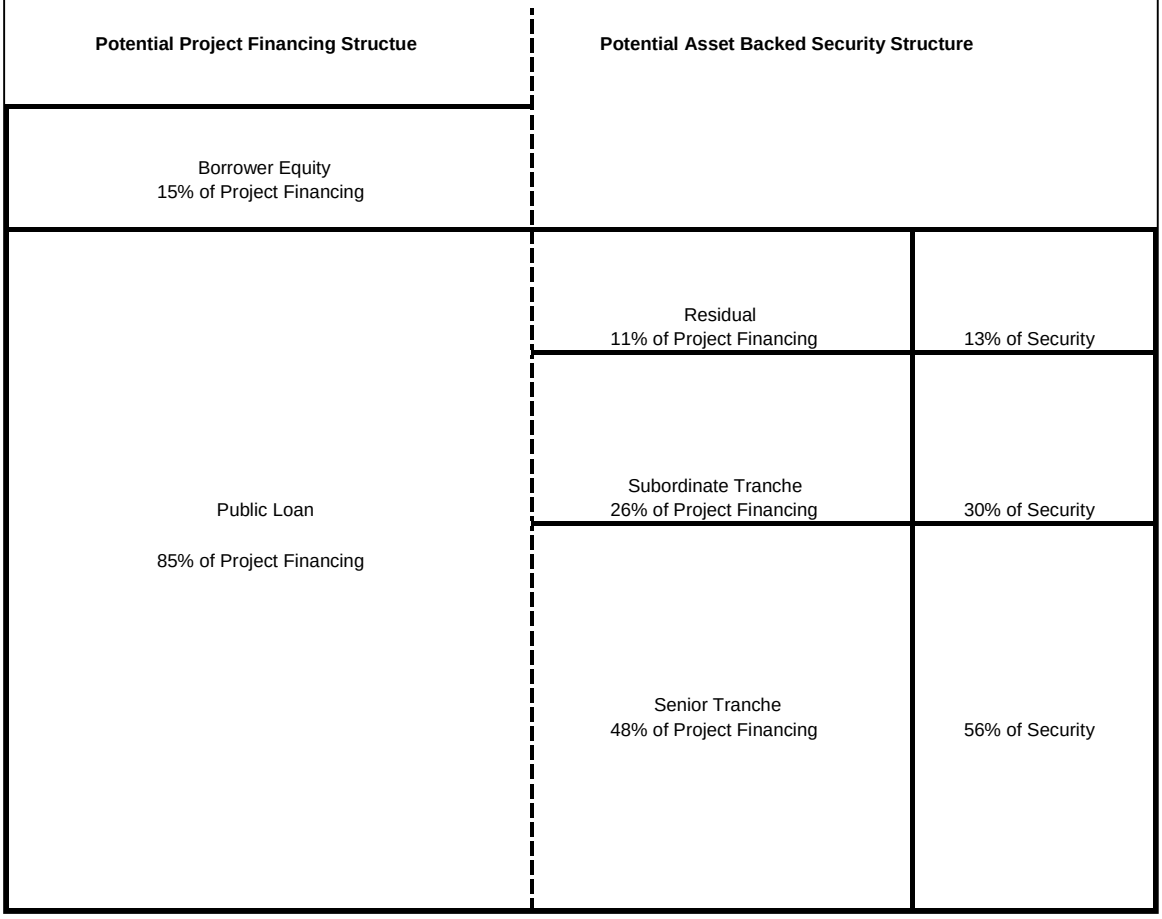
[20]If 21 percent of loan principal is in defaulted or seriously delinquent loans and 60 percent of principal is not recovered, then roughly 15 percent of the total pool is lost (60 percent times 21 percent is 13 percent, plus a two percentage point margin).

An alternative securitization structure for private and public (CDBG and Section 108) loans. The execution (or price) received by a seller in the securitization structure depicted in Figure 6.2 can likely be improved by incorporating all of the senior tranche in the securitized loan pool, not just the portion that is funded by public loans. This simplified security structure would correspond more closely to those typical of other ABSs already found in the marketplace, and would reduce the 16 percent discount estimated in the illustration in Figure 6.2. Also in contrast to the structure presented above, the "public" loan in an alternative securitization structure could be provided entirely by private funding, with a loss reserve capitalized by CDBG or Section 108 funding. Use of public funds in this way would probably leverage more in total project financing than if CDBG or Section 108 funding is lent out directly. Certainly, borrowers would find it easier to work with only one source of debt finance, thereby avoiding the additional costs tied to multiple loan applications, documentation, and closings.

Figure 6.3 presents a likely market structure for such a transaction. In contrast to Figure 6.2, which has both public and private loans, the secondary market provides an outlet for a combined loan that accounts for 85 percent of project financing. This structure incorporates the need for many CDBG- and Section 108-funded loan borrowers to access capital without a substantial amount of equity. The securities issued will have a senior tranche that accounts for 56 percent of the total issuance, and 48 percent of the total project financing. This senior tranche is consistent with the estimate that CDBG- and Section 108-funded loans are more risky than conventional small business loans; therefore, the senior tranche in CDBG- and Section 108-backed loan securities is 80 percent of the total project financing of conventional small business loans. In addition, the 13 percent residual portion is consistent with an expected loss rate of 60 percent for 21 percent of the outstanding principal in problem loans.

The security in Figure 6.3 presents a potential secondary market structure that would become feasible after potential market participants have had an opportunity to evaluate loan performance and losses over time. The relative size of the senior tranche to the subordinate debt and residual piece is similar to that of other ABSs. Moreover, the residual and subordinate debt, which accounts for 43 percent of the issuance, should pro-vide a sufficient credit enhancement to the senior tranche. The execution under such a secondary market should approach 85 percent, assuming that the residual continues to be retained by the seller.

Figure 6.3
And Alternative Securitization Structure for
CDBG- and Section 108-Funded Loans



Noteworthy Issues in the Establishment of an Ongoing Secondary Market for CDBG- and Section 108-Funded Loans

While a secondary market for CDBG- and Section 108-funded loans is certainly feasible,[21] there are issues that must be addressed before it can function in a manner that is implied by Figure 6.3. This section identifies such challenges—as conveyed by both industry

[21] Any sale of Section 108-funded loans would have to accommodate the fact that many such loans are pledged as additional collateral against Section 108 trusts that issue bonds to investors. Therefore, HUD would have to develop a mechanism, such as another trust, that would allow for the sale of the Section 108-funded loans that are pledged as collateral against existing Section 108 trusts. This is not an insurmountable obstacle, but would complicate any such transaction.

participants (buyers, sellers, and intermediaries) in previous transactions and local community development officials who would constitute the sellers in subsequent transactions. With respect to the former, informal discussions were held with persons who had participated in earlier transactions that involved CDBG- and Section 108-funded loans or similar collateral in order to identify issues that make it difficult to bring such ABSs to market. With those who had previously been involved as buyers, or intermediaries between buyers and sellers, discussions were based on actual data on loan performance and project financing structure, as reported in Chapter 5, and the specific securitization structures presented in this chapter (Figures 6.2 and 6.3). To identify issues related to potential sellers of loans, formal on-site and telephone interviews with a large sample of community development administrators focused on their past experience with, and understanding and perceptions of, secondary market issues. Collectively, these discussions revealed three issues that make a secondary market for CDBG and Section 108 third-party loans problematic: data availability; lack of standardization in underwriting and servicing; and reluctance of potential sellers.

Data availability. Inasmuch as previous secondary market transactions have used similar types of collateral, nothing precludes the creation of a secondary market for CDBG- and Section 108-funded loans. Because there have been so few such transactions, however, there is little public data to show what potential market participants might expect with respect to market acceptance of these securities on the part of both buyers and sellers.

Relevant and reliable data are, unquestionably, necessary for efficient operation of secondary markets. Investors, rating agencies, and sellers can assess fair prices for loans only when they have historical information relating to asset performance through different economic environments, loss rates in the event of defaults, and prepayment probabilities.[22] Unlike the residential and commercial mortgage markets, there is considerably less information available on the performance of economic development loans. Robinson identifies only four studies published between 1987 and 2000 that report on the performance of RLF loan portfolios.[23] Understandably, then, lack of data was an issue raised by nearly all of the industry participants contacted for this study, and it is very likely that such persons will only increase their investments after participating in, and observing demonstration transactions. This is the pattern observed in the conventional small business loan secondary market: potential investors observe

[22] For an example of a study related to the factors that predict residential loan performance, see Capozza, Dennis, Dick Kazarian and Thomas Thomson. 1998. "The Conditional Probability of Mortgage Default." *Real Estate Economics* 26(3): 359-389. For a study on commercial mortgage performance, see Vandell, Kerry, Walter Barnes, David Hartzell, Dennis Kraft, and William Wendt. 1993. "Commercial Mortgage Defaults: Proportional Hazards Estimation Using Individual Loan Histories." *Journal of the American Real Estate and Urban Economics Association* 21:451-480.

[23] Robinson, *op. cit.,* p. 47.

demonstration transactions and monitor loan performance, losses, prepayments, and other types of variables that affect the feasibility of subsequent transactions. It appears as if the primary way to overcome the hesitancy of potential future market participants in CDBG- and Section 108-funded loan sales is to provide them with sound information—such as of the sort collected for this study—and information from actual transactions that use these loans as collateral.

Lack of industry standardized underwriting and servicing. A second theme that emerged from discussions with market participants involves the lack of industry standardized of underwriting and servicing associated with CDBG- and Section 108-funded loans. Even if there were more data available, it appears, it is unclear how applicable such data would be from community to community, or lender to lender. This is because there are very few standard underwriting and servicing guidelines that apply across jurisdictions and third-party lending programs. Industry participants point to the fact that an efficient and liquid secondary market for a particular asset class is comprised of assets from more than one company. For example, Fannie Mae and Freddie Mac mortgage backed securities include loans originated by hundreds of originating financial institutions, yet investors know that these loans conform to an industry-wide set of underwriting guidelines—relating to such factors as borrower credit quality and loan-to-value ratio—as well as loan servicing standards. Further, seller and loan servicers are obliged to provide a standard documentation package. This combination—standard underwriting, servicing, and documentation—means that residential mortgages that adhere to Fannie Mae and Freddie Mac standards are very similar, irrespective of the originating lenders.

Since CDBG- and Section 108-funded third-party loans are originated with little standardization in underwriting, documentation, and servicing across municipalities, potential investors will find it costly to assess a loan portfolio, a particular originating agency, or both. This cost will increase the discount buyers will insist upon for the loans they buy. But as an analogue to the now-standard practice in the secondary market for housing loans, application of standards for underwriting, servicing and documentation could be devised and implemented for economic development loans as well. Except for loan documentation standards, which local agencies could adhere to without compromising local policy goals, underwriting and servicing standards could constrain local lending choices, unless they are tailored to permit higher-risk lending and more relaxed servicing policies than is typical in other business lending.

Seller concerns about secondary market participation. Fully one-half of all Community and Economic Development Department Directors across the country express some interest in selling economic development loans to investors, citing potential for obtaining relief from time-consuming servicing responsibilities and for accelerated receipt of income to expand their lending programs. However, only a small fraction (four percent) of them have ever participated in a secondary market and, of the five high-loan-volume communities included in this study that have sold economic development loans, experiences have been mixed. Most of

the five either are not interested in future loan sales or are only conditionally interested: officials in one community hope to expand their program; those in two others would continue to sell loans only if (a) the income were exempt from HUD program-income requirements or (b) the discounts applied are lower than those they previously experienced; and officials in two communities are not at all interested in additional sales.[24] In brief:

- One community works with a national non-profit organization, a licensed SBA lender that does all underwriting, loan closings, and servicing for one of its economic development lending programs. The non-profit organization uses CDBG dollars to leverage additional funds, either by borrowing against the city's CDBG contribution or by selling loans made using CDBG funds on the secondary market. The non-profit retains a two to three percent return to cover costs, and the remaining program income (regardless of the community's initial CDBG contribution, which typically ranges between 20 percent and 25 percent of the entire principal amount) is returned to the community for future loans. Officials in this community entered the secondary market hoping to expand their ability to provide additional resources to the local business community, and will continue to sell loans through this non-profit.
- A second community sold loans originated under the now-expired Urban Development Action Grant Program to generate new "clean" dollars—i.e. those not subject to HUD regulations regarding program income.[25] They were able to reclassify these dollars as "miscellaneous income" and use them for new lending. and would be interested in CDBG secondary market sales if they could continue to similarly reclassify this income.
- A third community sold loans to a national fund that wanted to buy the least risky loans in the portfolio at a substantial discount. This community received approximately 40 cents on the dollar, and would only be interested in making further sales if the discounts could be reduced.
- Another community sold a portion of performing loans to a local nonprofit to secure capital to originate new loans. According to a key community development official, these sales did not benefit the community. Buyers wanted only the "best" loans, and the community still had to complete substantial monitoring tasks and incur administrative costs to prepare loans for purchase. The community is not interested in making further loan sales.

[24] Source: Community Development Administrators On-Site Survey.

[25] Under UDAG program rules, program income from loan repayments or sales could be spent at any time for any purpose, so long as the activities funded were eligible under Title I of the Housing and Community Act of 1974.

- A fifth community hired a consultant to evaluate their portfolio, choose loans that would be most likely to sell on the secondary market, and then sold "all their best portfolio pieces" for 70 cents on the dollar. However, they did not receive the proceeds from the sales for two full years and, then, had a large amount of program income that they had to spend "right away." Local officials do not believe the experience was ultimately beneficial to their community and would recommend against further secondary market sales.

The experiences of these communities echo several of the major themes raised by industry participants and others who have engaged in secondary market transactions, as well as many community and economic development officials across the nation who have no prior experience with loan sales. Notwithstanding their level of interest in secondary market possibilities, many were quite guarded in their assessment of market prospects.[26] Sources of concern include: (1) potential for investor "creaming" of high-performing loans; (2) potential for deep price discounts; (3) inability to standardize, or lack of interest in, standardizing, underwriting practices, (4) perceived adverse effects of loan sales on community relationships with borrowers; (5) potential for adverse effects on job creation or business development; and (6) doubts about the adequacy of the financial benefits to be derived.

Many local officials assume that investors would be inclined to purchase only the highest performing loans within their program portfolios—"creaming" the best and leaving the remainder. This was confirmed for one official who asked asking several local financial institutions to examine his community's portfolio for the possibility of secondary market sales. Based on their assessment, he concluded that sales were not feasible: investors wanted to "cherry pick the good ones", while the city also wanted to "sell the bad ones." As indicated in the analysis above, potential asset-based securities would be backed only by performing loans, and the communities would have to retain a substantial residual (estimated, in the previous example, to be 20 percent of the total security).

There is also a widespread perception among local officials that secondary market sales would involve substantial discounts. Respondents rightly point to the "high-risk nature of third-party loans," lack of standardized underwriting, absence of historical information on loan performance, the second or third security positions their loans occupy, and their below-market interest rates. Many believe that in view of these sources of discount, secondary market investors would not be willing to pay what local officials believe would be necessary to trigger local sales.

Some local officials believe that it is not possible, nor even necessarily desirable to move toward the standardization of underwriting that they sense is required to prevent deep

[26] Source: Community Development Administrators Phone Survey.

discounts. On local official notes that, as a "lender of last resort" for low-income business owners, the loans he originates "defy standardization." Another official notes that decisions to issue economic development loans are inherently political and often informal, preventing standardized approaches. Yet another official worries that any attempt to standardize lending practices would "crush the creativity" associated with economic development lending and would ultimately hurt the communities they are trying to serve. Agencies are lenders of last resort, with public policy incentives structure terms and workouts that best meet borrower's needs. One local official, for example, notes that loans in his community are made to high-risk borrowers who require special attention they might not get from secondary-market investors.

Local officials from a large number of communities believe that third-party loan sales would affect their relationships with borrowers. One official worried that if loan sales strained relationships with their businesses (due, for example, to an outside servicing agent's persistence in attempts to collect debt or in threats of foreclose due to delinquency or default), they would be even less likely to supply job creation documentation than currently. Likewise, one official believes his community would not necessarily want to give loans to "a stranger" to service because they, the community agency, are used to dealing one-on-one and "flexibly" with their clients. One official expresses concern that if "something were to go wrong" with loan sales, and borrowers concluded they were not being well-cared for, the agency itself would feel the negative impacts of a community perception that they were "not running a good program."

Many local officials worry about the impact that loan sales would have on the benefits communities derive from originating such loans. Several of them point out that, even where a business defaults on a loan, the creation of low- or moderate-income jobs is a desirable benefit that goes beyond the need simply to pay back the debt. Secondary market investors, they fear, would put debt repayment ahead of such a broader community benefits. Going farther, one community official is convinced that selling loans on the secondary market would result in an increase in defaults and, consequently, lost potential to create new jobs.

Finally, local officials expressed the belief that secondary market sales provide no long-term financial benefit. One official, for example, worried that loans sales would result in a decrease in program funds over the long haul, because the community would spend the accelerated sales proceeds in the short term. Several officials note that, if they are not able to quickly re-loan proceeds from secondary market sales, they could lose the opportunity to apply for additional grant funds. A "big lump sum" of program income, observes one community official, is a problem because of HUD's requirements that it be spent before any new allocations are made. Equally troubling to others is the potential for local executive or legislative bodies reducing allocations for third-party lending purposes as a direct consequence of the infusion of loan sales proceeds. To paraphrase one economic development official, "If I were to receive a large amount of money from the sale of my loans, the City Council will simply reduce my funding by that amount."

Conclusion

The fact that there have been relatively few secondary market transactions involving economic development loans creates a vicious circle. Lack of transactions means a lack of information on loan performance, which means that investors would demand a return in excess of the objective risk premium; that is, they will heavily discount the price of securities that use these loans as collateral. Potential sellers of loans believe that investors' uncertainty will result in an unfair price for their loans, which induces them to hold loans off the market. In other words, this dynamic makes it difficult for participants to arrive at a market clearing price: sellers do not want their loans sold at too steep a discount while investors will only enter the market if they receive returns that adequately compensate them for the risk and uncertainty inherent in a market with little information. Uncertainty is exacerbated by the lack of standard lending and servicing practices followed by loan originators.

Uncertainty and limited experience generally translate into high perceived risk, restricted interest and competition, and higher discounting—especially in the early phases of the establishment of new markets. A primary way to reduce uncertainty is to make information available to potential market participants through the publication of data and demonstration transactions. This study is, itself, an important first step to informing potential market participants about the terms and performance of CDBG- and Section 108-funded loans. Alone, however, it is unlikely that these data will be enough to motivate a large increase in investor interest in these loans. Secondary markets for other similar forms of collateral (i.e. conventional small business loans) remain small, despite some executed transactions. Since potential market participants would likely benefit from observing the performance of new transactions that use CDBG and Section 108 third-party loans as collateral, HUD may want to consider subsidizing such transactions through the provision of credit enhancements or transaction fees in order to provide incentives to potential participants, including originators, to structure such transactions.

APPENDIX A:

SAMPLING PROCEDURES AND WEIGHTS

APPENDIX A: SAMPLING PROCEDURES AND WEIGHTS

Both the sample of loans originated in high-loan-volume communities and the sample of business owners who received those loans are complex, and require description beyond that provided in Chapter 1. This appendix discusses the sampling and weighting procedures for these samples.

Sample of Loans Originated in High-Loan-Volume Communities

The sample of third-party loans originated in high-volume communities was drawn from loan rosters maintained by local Community Development Departments and/or their subrecipients. Officials of these agencies were asked to provide complete rosters of all of the loans they originated for economic development purposes during the study period—1994 to 1999 for Section 108 and EDI/BEDI, and 1996 to1999 for CDBG—including loans made from program income or from pools capitalized with CDBG, EDI/BEDI or Section 108, regardless of the Fiscal Year of the capitalization. Loans made under the CDBG 'float' provisions were also included.

Loans made exclusively for housing or social services were excluded, although mixed-use projects involving, for example, both commercial space and housing were included, with no effort made to split out the costs of the economic development and non-economic development activities. Because it was not feasible to distinguish between *forgivable loans* and the closely-related *recoverable grants*, all loans with forgiveness provisions were excluded. Finally, loans made to capitalize community banks or credit unions were excluded, unless the money was used for direct lending and therefore reported to HUD as a subrecipient activity.

Some communities, in some projects, mixed CDBG, EDI/BEDI or Section 108 funds with other sources of funds—such as UDAG repayments or local funds. Where there was only one loan agreement, loans were sampled based on total loan amount, not the portion that was attributable to the programs of interest. However, where a community had signed multiple loan agreements in the same financing package, only the CDBG, Section 108, or EDI/BEDI loans were sampled, with data collected on the other loans on a "Sources and Uses" form for that project.

Rosters provided by the 51 high-loan-volume communities contained a total of 2,253 loans.[1] Of these, 205 were determined not to be eligible for the sample for several reasons, including the fact that they were originated outside of the study period or were not economic

[1] We attempted to obtain data from 55 cities but four refused, for reasons discussed in a footnote to Chapter 1. Also, our data in Washington, D.C. is incomplete as we were not able to obtain data from a large sub-recipient.

development loans. The remainder, therefore, consisted of 2,048 loans, of which about one-half were sampled for the purpose of a file review to cull a variety of administrative data on their characteristics and performance.

Table A-1
Samples of Loans for Administrative Data Collection

Loan Source	Size in Dollars	Population	Fraction Sampled	Fraction Obtained
CDBG	1: <=60,000	947	0.280	0.275
	2: > 60,000-<=100,000	289	0.509	0.509
	3: >100,000-<=150,000	137	0.693	0.693
	4: >150,000-<=250,000	104	0.740	0.740
	5: >250,000	162	0.981	0.981
	6: Changers	38	0.895	0.895
	7: New Loans	4	1.000	1.000
Section 108	1: <=195,000	135	0.207	0.207
	2:>195,000-<=500,000	82	0.341	0.341
	3:>500,000-<=650,000	12	0.750	0.750
	4:>650,000-<1,000,000	14	1.000	1.000
	5:>=1,000,000	108	0.991	0.991
	6: Changers	14	0.857	0.857
	7: New Loans	2	1.000	1.000
Total		**2,048**	**0.479**	**0.477**

The sampling procedure involved purposeful over-sampling of particularly large loans and sampling in proportion to the dollar volume of remaining loans. It also involved an effort to sample an even distribution of both CDBG and Section-108 funded loans. To accomplish these objectives, the universe of loans was separated into five strata, as follows:

- What was referred to as Category “5” consisted of loans over $1 million for Section 108 and over $250,000 for CDBG. These were sampled with certainty.

- All remaining loans were divided into four groups based on loan amount—going from lowest to highest-value. Although the intention was to divide these loans evenly into quartiles based on loan volume, because the cutoffs were defined before all of the loan rosters had been received the distribution was not, ultimately, perfectly balanced. Loans in quartiles "1" though "4," then, were randomly ordered within each category, and a sequence number was assigned by taking the first loan in each category, then the second in each category, etc. Because the categories were designed to have approximately equal total dollar volumes, but rising average loan sizes, selecting loans in turn from each category had the desired effect of making the sampling probability increase with the size of the loan. As Table A-1 shows, the fraction sampled ranged from less than one-quarter of the smallest loans to almost all of the largest ones.

The samples were random within each community, inasmuch as field team data collectors processed the loans within each quartile in a random order.[2] No specific sample size was set in advance for each community because of an expectation that some communities' files would require more time than others to find, review, and extract relevant information. (Files and loan documentation are non-standard and maintained differently from community to community and, sometimes, across agencies or organizations within a single community.) The field teams' visits were arranged and staffed with a goal of collecting data on all "certainty" loans (category "5") and a random sample consisting of at least 50 percent of the remaining dollar volume of loans in each community.

If field teams arrived on site and found additional loans beyond those reported in loan rosters that had been received prior to the visits, before beginning the file review process they followed the sampling procedure described above. However, several scenarios occurred that required procedures for mid-review and modification of the sample. They are as follows:

- If new eligible loans were discovered after file reviews had begun, teams were instructed to add the loans to the category ("1" through "5") that they belonged to, based on size and funding source. Then, data collection teams were to determine whether they were likely to have time to review at least the same proportion of new loans as they had of the loans in the same quartile that were known when the sampling sequence was established. For example, if they had already sampled six out of 10 "old loans" in category "2", and they were adding five "new loans," then they would need to decide if they had time to sample at least three of the new loans.
- If sufficient time remained to sample the same proportion of loans, then the teams were instructed to assign a random number to each new loan, insert each loan into its

[2] This process resulted in over-sampling of loans from communities where loans could be processed relatively quickly. Weights are used in the analysis to adjust for this variation across cities.

appropriate place within its category based on the assigned random number. Any loans assigned sampling sequence numbers below the most recently sampled/reviewed file were to be reviewed immediately, and then the modified sequence was to be followed in its new order until time had run out.

- If sufficient time did not remain to sample the new loans at their original sampling proportion, then the teams were instructed to put them in the "new" category (category "7" in the table above) and to review them until time ran out or until they were completed, before returning to the original sampling sequence. This happened very rarely and, as noted above, all such loans were sampled.
- If, upon review, loans were found to have any values or funding sources that were different than what was listed on the roster used to derive the original sample, either of which would have affected their probability of being sampled if known, the new information was recorded but the loans were not re-sampled, and their probabilities of selection remained at the probabilities for the size of loan they were originally thought to be (i.e. their sampling strata are determined by the original loan information). These loans are represented in category "6", in Table A-1, labeled "Changers."
- Finally, if a loan was determined to be ineligible for sampling, under the criteria described above, they were removed from the working roster and the sampling number of the purged loan was assigned to the next highest-numbered loan in the category; the number of that loan was assigned to the next-highest number loan, and so on. This preserved the balance between categories and retained the random order of the sampling sequence within each stratum.

  Ultimately, 976 loans were sampled from the 51 communities.

Sampling Weights

Two sets of weights were calculated, one to sum to the total number of loans and another to sum to the total dollar value of the loans. To do this, the population was divided into the appropriate strata, and the number of loans and dollars in the population and the number of loans and dollars sampled in each stratum was calculated. The weights for the administrative data are the number of loans or dollars in the population divided by the number of loans or dollars successfully sampled. This incorporates both the probability of being sampled and the "response rate", or probability of data being successfully collected given that the loan was in the

sample.[3] The "response rate" for each category was also calculated in order to do analyses to see if loans with lower response rates appear to differ from those with higher response rates.

The sub-groups are those identified in Table A-1 for each community, with the following exception. "Changers" were assigned to their original (incorrect) loan amount, since this determined their probability of being sampled.[4]

Table A-2 shows the number of loans sampled and not sampled and the sampling percentages, by year of origination. Table A-3 shows the dollar volume of loans sampled and not sampled and the percentage of the total dollar volume of loans in the 51 communities that was sampled.

Table A-2
Percentage of Loans Sampled, by Year of Origination

Loan Type	Year of Origination	# Loans Sampled	# Loans Not Sampled	Total # Loans	Percentage of Loans Sampled
CDBG/	1996	206	221	427	48.24
CDBG FLOAT	1997	204	206	410	49.76
	1998	190	192	382	49.74
	1999	156	164	320	48.75
subtotals		***756***	***783***	***1539***	
Section 108	1994	9	5	14	64.29
	1995	16	9	25	64.00
	1996	34	19	53	64.15
	1997	49	50	99	49.49
	1998	40	29	69	57.97
	1999	53	42	95	55.79
subtotals		***201***	***154***	***355***	
EDI	1994	0	0	0	0.00
	1995	0	0	0	0.00
	1996	0	0	0	-
	1997	3	5	8	37.50
	1998	7	11	18	38.89
	1999	9	14	23	39.13
subtotals		***19***	***30***	***49***	
Totals:		**976**	**967**	**1943**	**50.23**

Note: There were 105 unsampled loans for which there is no origination date. Therefore, they have been excluded from the above calculations.

[3] The response rate is calculated as the number of loans successfully sampled divided by the total in the sample.

[4] An exception was made for those loans discovered to be in Category "5" that were not there originally. Those loans remained in the Category "5" bin and not the "6" (Changers) bin, since they were supposed to be sampled with certainty.

Table A-3
Percentage of Dollar Volume Sampled, by Year of Origination

Loan Type	Year of Origination	Lending Volume Sampled	Lending Volume Not Sampled	Total Lending Volume	Percentage of Total Lending Volume Sampled
CDBG/	1996	$36,379,704	$10,772,026	$47,151,730	77.15
CDBG FLOAT	1997	30,999,177	9,986,869	40,986,047	75.63
	1998	35,423,725	11,775,797	47,199,522	75.05
	1999	34,406,455	9,851,632	44,258,087	77.74
subtotals		***137,209,062***	***42,386,324***	***179,595,385***	***76.40***
Section 108	1994	$26,505,000	$2,325,000	$28,830,000	91.94
	1995	38,090,000	212,320	38,302,320	99.45
	1996	123,880,670	1,811,413	125,692,083	98.56
	1997	107,775,776	9,816,220	117,591,996	91.65
	1998	111,295,666	4,388,683	115,684,349	96.21
	1999	112,989,356	7,010,896	120,000,252	94.16
subtotals		***520,536,468***	***25,564,532***	***546,101,000***	***95.32***
EDI	1994	$0	$0	$0	
	1995	0	0	0	
	1996	0	0	0	
	1997	59,500	108,000	167,500	35.52
	1998	273,800	180,900	454,700	60.22
	1999	761,000	241,500	1,002,500	75.91
subtotals		***1,094,300***	***530,400***	***1,624,700***	***67.35***
Totals:		**658,839,830**	**68,481,255**	**727,321,085**	**90.58**

Note: There were 105 unsampled loans for which there is no origination date. Therefore, they have been excluded from the above calculations.

Businesses Receiving Loans in High-Volume Communities

For the business survey, all loans for which administrative data were collected were sampled, and interviews were attempted with the owners of all sampled establishments. However, as discussed in Chapter 4, about 20 percent of the businesses for which administrative data were obtained appeared to have gone out of business as of the time of data collection. Interviews were completed with 30 percent of the owners of surviving businesses.

Sampling Weights

Weights for the business survey were calculated using the probability of the loans sampled from the high-loan-volume communities, divided by the probability of being sampled in the business survey. Two separate weights were created for the business survey--one to estimate total businesses (based on the loan weight to total loans) and another to apply to total dollars (based on the loan weight to total dollars). (If a business had more than one loan the weights for only one loan were used.) The probabilities are the sum of businesses (or dollars) successfully sampled, divided by the sum of businesses (or dollars) unsuccessfully sampled. Each weight was multiplied by the response rate of the business survey (30 percent).

APPENDIX B:

THE ECONOMIC DEVELOPMENT FUNDING DATABASE

APPENDIX B: THE ECONOMIC DEVELOPMENT FUNDING DATABASE

The Economic Development Funding Database is a collection of data gathered from a variety of sources and compiled in such a way to assist the research team in describing grantees' spending patterns for economic development and third-party loans. The original research plan called for an analysis of program level data to determine which grantees were spending HUD program funds on economic development and how much, and an analysis of activity level data to determine what types of economic development the communities were funding. However, issues with data quality, incomplete or missing records, varying definitions of dates, and even varying definitions of economic development and third-party lending complicated the task of creating the database.

This appendix describes the coverage and quality of data from the different sources, and the priority with which different sources were used for the study's Economic Development Funding Database. First, it assesses how the various data sources met the needs of the research objectives and describes how the detail, accuracy, and comprehensiveness of each source determine the priority with which a particular source contributes to the database. It then the method of data collection and processing that led to the final product—a database that is as accurate and complete as possible at the summary level, and an internally consistent, although incomplete, activity level dataset.

Table B.1
Data Coverage by Source

Data Source	Years	Grantees	Program	Expenditure Category
IDIS	1996-99	All States and Entitlement Grantees	CDBG	Total, ED, TPL
GPR	1990-95	All Entitlement Grantees	CDBG & Section 108	Total, ED, TPL
PER**	1990-97	All States	CDBG	Total, ED, TPL
FMD Database**	1990-99	All Grantees	Section 108	Total & ED
EDI/BEDI Database**	1994-99	All Grantees	EDI/BEDI	Total & ED*
Roster	1996-99****	51***	All	TPL
Verified Data	1990-99	478***	All	All

Notes:
*All EDI/BEDI is assumed to be economic development.
**Data from PER, FMD and EDI/BEDI databases are obligated/award amounts, not expenditure data.
***Out of a total of 966 grantees during the study period.
****1994-99 for Section 108.

Summary Level Dataset

The summary level dataset in the Economic Development Funding Database consists of annual expenditure data for each grantee in three categories: total expenditure, economic development, and third-party lending by program (CDBG, Section 108, or EDI/BEDI). The database draws on several different sources for the summary level annual expenditure amounts (see Table B.1), relying heavily on HUD's Integrated Drawdown and Disbursement System (IDIS), Grantee Performance Report (GPR),

and Performance Evaluation Report (PER) databases. This section describes the unique attributes of each source and evaluates its contribution to the database.

HUD database sources (IDIS, GPR and PER). The three HUD database sources, IDIS, GPR and PER, are the most comprehensive sources available; covering between them the entire set of grantees over the 10-year period, 1990 to 1999—see Table B.1. The GPR database supplies entitlement grantee data from 1990-95 and IDIS supplies data for entitlement and state grantees from 1996-99. The research team obtained IDIS data from a download from the mainframe system files in May 2002. The PER database supplies state CDBG data only from 1990-97. These data are reported as amounts that states obligated to units of local government, not the amount actually spent.

In the PER, GPR and IDIS databases, economic development was identified as activities qualified under certain eligible activity types and national objectives. Economic development activities were those qualified as business assistance and commercial/industrial improvement or any activity that was intended to create jobs, that is, it qualified under the Low/Moderate Income Individuals Jobs Creation National Objective. Table B.2 gives a complete list of economic development activity types. On IDIS, the activity description data, from the *Activity* table, correspond to expenditure amounts, found in the *Drawdown Transaction* table. A third-party loan was identified as a subset of economic development activities, limited to the financial assistance to business, microenterprise assistance, and acquisition/rehabilitation activity categories. A third-party loan was any activity in these categories that generated program income or was funded by a revolving loan fund, as evidenced on IDIS by flag variables in the *Activity* table, or that specifies a direct or deferred payment loan amount, on IDIS in the *Economic Development: Business* table.

Table B.2
Economic Development Activities in the CDBG Program

Business Assistance
- Direct Financial Assistance to Non-Profit Business
- Technical Assistance to Business
- Micro-Enterprise Assistance

Commercial/Industrial Improvements
- C/I Rehabilitation
- C/I Land Acquisition/Disposition
- C/I Infrastructure Development
- C/I Building Acquisition, Construction, Rehabilitation
- Other C/I Improvements

Job Training

Other Activity Categories with Job Creation National Objective
- Housing
- Public Faciltities & Improvements
- Public Services
- Acquisition/Clearance

HUD's databases provided a good foundation, but there was the problem that in many instances GPR and IDIS were missing expenditure data for a significant number of grantees, with either entire years missing or only partial year data. Table B.3 shows the percent of grantees reporting expenditures on GPR, from 1990 to 1995, and on IDIS, from 1996 to 1999. The first year IDIS was operational, 1996, many grantees (only 29 percent reporting) did not report their expenditures on IDIS, and of those that did, many only reported partial year expenditures. For some earlier years, some grantees did not report on GPR, as well.

Site Visit Loan Rosters. The loan rosters that the research teams collected from their site visits offer a highly accurate and detailed report of the extent of third-party lending; however, rosters are only available for 51 grantees where site visits were conducted.[1] Since the site visit grantees were selected from the top lenders, they account for almost half of the CDBG lending activity in the study period (calendar years 1996-99), and over 95 percent of the Section 108 lending (calendar years 1994-99).

The loan rosters introduce inconsistency, however, in determining the date an activity occurred. In GPR and IDIS, the date was consistently defined within the source, across all grantees. With the loan rosters, the date given as the loan origination date could be the date the loan agreement was signed, the date funds were disbursed, the date the loan was approved, or even the date the application was submitted. Since the Economic Development Funding Database may, simultaneously, draw on the loan roster data for third-party lending amounts and another source for economic development and total spending amounts, the different sources may record different dates for the same activity. As a result, although third-party lending is defined as a subset of all economic development activities, the third-party lending amount that appears in the database for a given year might be greater than the amount reported for economic development.

Additionally the loan rosters list loans according to a stricter definition than how GPR and IDIS would characterize the activity. For instance, the loans on the loan roster are those which have to be paid in full, that is there are no forgiveness provisions in the loan agreement, while the activities characterized as loans in GPR and IDIS are those which require repayment, but whether in full or partially forgivable is unidentified in the data. Ultimately, the loan rosters collected from the grantees provide an authoritative source for third-party lending amounts; however, the third-party lending amounts compiled from other sources still offer a good picture of this activity. A regression through the origin of the amounts reported on IDIS and GPR on the roster amounts shows the strong agreement between the roster data and the GPR/IDIS data. The coefficient of

Table B.3
Number of Grantees Reporting Expenditure on HUD Data System*

Year	Number of Grantees	Number of Grantees Reporting	Percent of Grantees Reporting
1990	846	797	94%
1991	858	847	99
1992	866	857	99
1993	871	797	92
1994	915	750	82
1995	923	728	79
1996	930	271	29
1997	947	887	94
1998	957	952	99
1999	960	959	99.9

Notes:
*GPR for 1990-95, IDIS for 1996-99

[1] See Appendix A for a more detailed discussion of the loan roster data collection process.

the regression is 1.18, significant at a 0.01 level, indicating that the different data sets are in close accord. The coefficient is also greater than one, which shows that the GPR/IDIS data sources are not complete (due primarily to missing years).

Administrative sources for Section 108 and EDI/BEDI awards. To capture Section 108 total and economic development amounts and EDI/BEDI amounts, the Economic Development Funding Database draws on an administrative record source for each program, the FMD Database for Section 108 and a database of awards for EDI/BEDI, since grantees did not report these funds on IDIS and GPR the same way as CDBG. These sources, however, did not have enough information to determine when grantees fund economic development through third-party loans with Section 108 and EDI/BEDI. The Financial Management Division of HUD maintains a database of all Section 108 funds awarded during the study period. A database for EDI/BEDI awards was compiled from lists of every EDI/BEDI grant that was awarded during the study period. Since the data are available for awards only, not expenditures, these figures may overestimate the extent of Section 108 and EDI/BEDI spending. Furthermore, the only date available is the award date and the funds may not actually be spent until more than two years later.

Verified data. Because data were not available from other sources, a broad effort was undertaken to verify selected data items directly with all grantees initially determined to have funded economic development.[2] Grantees were asked to verify the funds spent on (or, for states, obligated to) economic development and economic development lending, by year. The verified data are only available at a summary level and do not provide any detail about specific activities, but, for those grantees that responded, they offer a record of activities over the entire study period. Economic development and economic development loans take many forms, and since grantees may have varying definitions of economic development and third-party loans, there could be some inconsistency in the reporting, with certain types of economic development included and other types omitted from the verification sheets.

Prioritizing Data Sources

After compiling data from the sources mentioned above, the research team had to determine the priority with which each source would contribute to the Economic Development Funding Database. Since there were cases where several sources might contain overlapping, and possibly conflicting or duplicate data, each source was assigned a priority to ensure maximum data coverage, accuracy, and consistent reporting, and minimize double counting.

Table B.4 shows the ranking of data sources by the priority with which they contributed to the Economic Development Funding Database. The priority of a source may vary by

[2] See Appendix C for a more detailed discussion of the data verification process.

program, year, and activity type. A high priority source is one that was considered over other lower priority sources. A lower priority source was used only if there were no data available from a higher priority source. If a source covered all grantees and all activities over the study period, it would be the sole contributing source.

For the CDBG entitlement program data, GPR and IDIS have the same priority, but each source covers only half of the study period, 1990-95 for GPR and 1996-99 for CDBG, without overlapping. Both GPR and IDIS contain many of the same data, however, there are some important distinctions. GPR contains both CDBG and Section 108 expenditures, but only for entitlement grantees, while IDIS contains only CDBG expenditures, for states as well as entitlement grantees.

Table B.4
Data Source in Order of Priority, by Year and Program

Program	Priority by Years 1990-1995	1996-1999
CDBG-Entitlement Grantees		
Total Funding	G, V	I, V
Economic Development	G, V	I, V
Third-Party Loans	G, V	R, I, V
CDBG-States		
Total Funding	P, V	I, V
Economic Development	P, V	I, V
Third-Party Loans	P, V	I, V
Section 108		
Total Funding	F	F
Economic Development	F	F
Third-Party Loans	R*, G, V	R, V
EDI/BEDI**		
Total Funding	E	E
Third-Party Loans	R, V	R, V

G = GPR V = Verified Data
I = IDIS F = FMD Database
R = Roster E = EDI/BEDI Database
P = PER

Notes:
*Roster data covers 1994-99 for Section 108
**EDI/BEDI program began 1994

The state grantees did not report expenditures on GPR, so a different source, PER was used in place of GPR, from 1990 to 1997, after which IDIS was the priority source. States used PER to report obligated amounts, however, not actual expenditures, so this source may overestimate the extent of CDBG activity by state grantees in the years before they used IDIS to report expenditures.

The FMD and EDI/BEDI databases provide Section 108 total and economic development expenditure amounts, and EDI/BEDI total expenditure amounts for every grantee receiving a Section 108 or EDI/BEDI award during the study period. For these data items, there were significant differences in the date used to mark the receipt of funds. Therefore, one source contributes all data for Section 108 total and economic development expenditure amounts and

EDI/BEDI total expenditure amounts, in order to eliminate the possibility of double-counting a Section 108 or EDI/BEDI award.

The verified data is used in those cases where the other sources are missing data for a particular year. Since the verified data is only available at the summary level, it is not possible to fill in a partial year's worth of data. This source contributes most heavily to the Section 108 and EDI/BEDI economic development loan category, where it is the only source available for the vast majority of grantees where no site visit was conducted.

Weighting

Even after compiling data from different sources, including HUD's databases and the verification data, there still remained the problem of missing or incomplete data for the CDBG program. Therefore, in order to provide better program-wide estimates, we weighted the CDBG amounts to account for the non-reporting grantees. Using annual grant amounts that were available for all grantees, we calculated a separate weight for each year equal to the ratio of the total grant amount to the grant amount for those grantees that reported expenditures for that year. Assuming that the grantees that did not report expenditures were not significantly different than those that did report expenditures, the final weighted figures show an accurate picture of the full extent of economic development and third-party lending with CDBG.

Activity Level Dataset

In addition to the summary level data that report annual economic development and third-party lending amounts for each program, the activity level dataset shows funding amounts in each of the subcategories of economic development. The activity level dataset shows annual expenditure data by activity category (see Table 2.13) and national objective category (see Table 2.14). Unlike the summary level dataset, the activity level dataset only covers entitlement grantee CDBG expenditures and has only two sources, the GPR and IDIS systems. These two data sources together cover the entire study period, GPR from 1990 to 1995 and IDIS from 1996 to 1999, and include all entitlement grantees; however, some grantees did not report in some years—see Table B.3. Since there is only one data source used for each half of the decade, the reporting does not overlap or contradict. However, there was a period of time for which data were mostly unavailable as grantees switched from one system to the other.

Conclusion

The process by which the data sources were evaluated and then combined to form the final database was intended to compare the available sources and select the most detailed and accurate source, while minimizing double counting of expenditures. There may be inaccuracies and over- or under-estimation of certain data items but, on balance, the Economic Development

Funding Database gives the best estimate for analyzing states' and entitlement communities' use of CDBG, Section 108, and EDI/BEDI to fund economic development.

APPENDIX C:

DATA COLLECTION METHODOLOGIES

APPENDIX C: DATA COLLECTION METHODOLOGIES

The following describes the data collection methodology for five sources of data used in the report, "Public-Sector Loans to Private-Sector Businesses: An assessment of HUD-Supported Local Economic Development Lending Activities." The data sources are:

- Economic Development Expenditures Verification,
- Telephone Survey of Community Development (CD) Directors,
- On-site Surveys of CD Directors and Program Managers,
- On-Site Loan File Reviews, and
- Telephone Survey of Businesses Receiving Loans in High-Volume Communities.

Economic Development Expenditures Verification

The Economic Development Expenditures Verification conducted in Phase I requested that CD Directors confirm summary data on economic development spending under the CDBG, Section 108 and EDI programs. Entitlement grantees (n=878) and states (n=50) were asked to verify the results from the preliminary analysis of HUD's administrative data systems. The verification process was not intended to confirm every detail of a grantee's economic development spending over the study period but to ask local program managers to review and, if necessary, correct summary program data on total spending, economic development spending, and spending on economic development loans. This process was used to produce reliable order-of-magnitude data for sampling and analysis of program expenditure patterns.

The verification was conducted for two classes of grantees:

- Those (n=848) found to have used CDBG, Section 108, or EDI to fund economic development activities any year between 1990 and 1999, and
- A random sample of grantees (n=30) that according to HUD's databases did not fund any economic development activities over the same time period.

The verification process comprised of four sequential steps:

- Advance notification to grantees regarding the verification process;
- Mail-out of a verification package to each grantee with summary information on program data, and, where practical, backup data;
- Follow-up with grantees to encourage response to the verification request; and

- Tracking of grantees' response and modifications to the summary economic development database.

Verification Package

Each grantee was sent an economic development spending verification package. Grantees were asked to review information on their economic development spending derived from the GPR, PER, and IDIS databases, verify its contents, make corrections as necessary, and return a sheet with verified data.

The verification package contained a personalized cover letter co-signed by Richard Kennedy, Director of the Office of Block Grant Assistance, and Paul Webster, Director of the Financial Management Division, economic development spending sheets with instructions, and a business reply mail (BRM) envelope.

The verification activities results in the following response rates:

- 68% of Sampled Entitlement Jurisdictions with ED spending (n=580)
- 70% of States (n=35)
- 60% of Sampled Entitlement Jurisdictions with no ED spending (n=18).

Telephone Survey of Community Development (CD) Directors

The Telephone Survey of CD Directors was conducted during the fall and winter of 2001/2002. The jurisdictions contacted for the survey were city and county governments that reported using Community Development Block Grant (CDBG) or Section 108 funds for economic development at some time between 1990 and 1999, whether in HUD's monitoring databases or in response to the verification effort.

Each piece of sample was initially identified as either a site-visit or a non-site-visit jurisdiction, depending on whether or not it had also been chosen as a location where in-depth interviews and reviews of loan files would be conducted. Therefore, the sample included the 55 site-visit jurisdictions and 445 randomly selected non-site-visit jurisdictions. For the most part, the discussion that follows look at the sample as a whole.

Prior to the start of calling, each jurisdiction was sent a pre-survey notification letter. In addition to the usual elements of such letters, there was a form enclosed that allowed the recipient to identify the correct respondent(s) to the survey and specify one or more times when this person/these people would be available to participate in the telephone interview. If the form was completed and returned (by fax), the information was entered into Aspen's CATI (computer-assisted telephone interviewing) system. Site-visits jurisdictions were e-mailed reminders asking them to establish a date and time for the interview. Non-site-visit jurisdictions that did

not response to our initial written request were contacted by telephone to set-up a data and time for the interview.

The Urban Institute developed the questionnaire for the Survey of CD Directors with input from Aspen Systems staff regarding question structure and format. A single survey instrument was developed with branching and skip patterns to account for whether the jurisdiction used funds from CDBG, from Section 108, from both, or from neither for economic development purposes.

The Survey of CD Directors was conducted using CATI technology to ensure the consistent administration of the questionnaire. There was only one variation in the survey methodology, depending on whether the jurisdiction was selected for a site visit. In such cases, if it was determined that there were different people who needed to answer questions concerning the jurisdiction's CDBG-funded versus Section 108-funded economic development activities, each potential respondent was pursued and interviewed individually. If this situation occurred in a non-site-visit jurisdiction, interviewing the CDBG person was given priority.

The number of attempts to secure a completed interview ranged from 1 to 32, with an average of 4.5 attempts overall and 4.4 attempts per completed survey. Of the three records attempted more than 17 times, all were site-visit jurisdictions, where obtaining a completed interview was mandatory. Likewise, interviews with site-visit jurisdictions tended to take longer to conduct (approximately 28.8 minutes per interview versus approximately 12.9 minutes per interview for non-site-visit jurisdictions) because a greater proportion required asking the full battery of both CDBG and Section 108 questions.

In all, a total of 463 interviews were conducted, representing 460 individual jurisdictions.[1] After removing those jurisdictions that indicated—either verbally or in writing—that they had used neither CDBG nor Section 108 for economic development activities since 1990 (n=13), the overall response rate for the survey was 94.3 percent.

Refusal reasons. When an interviewer encountered a potential respondent who did not want to participate in the survey, he/she tried to determine the person's reason for refusing. Where possible, the interviewer tried to address the respondent's concerns and solicit their cooperation. If this was not possible, the interviewer recorded the respondent's reason(s) for non-participation. Of the six respondents in this category:[2]

- Two indicated the survey was too long;

[1] In three instances, separate interviews had to be administered to different people for the same jurisdiction to obtain information about both CDBG and Section 108.

[2] Multiple answers were allowed.

- Two indicated they were too busy—that they did not have the time;
- One indicated he/she was new to the job and did not know the programs well enough to answer;
- One indicated the jurisdiction does too little economic development to make their answers worthwhile or to take the time; and
- Two indicated they were just not interested or did not give any particular reason.

Data editing. Completed interviews were periodically removed from the CATI system for a final quality control review. The review consisted of looking for inconsistencies in the responses, questionable/illogical data, and/or re-coding information as indicated by the interviewers on a problem sheet. Survey-specific problem sheets were used to make changes in the survey data due to respondent or interviewer error. In a few cases, respondents were re-contacted for clarification and/or confirmation of the data, and the information was corrected as necessary.

In addition, responses to open-ended questions were examined. Typographical errors and inconsistencies in abbreviations were corrected, and an effort was made to ensure that all such responses were presented as complete and coherent thoughts. For the "Other [SPECIFY]" questions, the responses were reviewed and recoded into existing answer choice categories, if the answer choices had not been read to the respondent during the interview. Again, where necessary, respondents were re-contacted for clarification and/or additional information, and the file was corrected.

On-site Surveys of Community Development (CD) Directors and Program Managers

On-site surveys of Community Development (CD) Directors, or their designated representatives, were designed to collect more detail on the grantees' use of CDBG, Section 108 and EDI/BEDI funds for economic development than was practical to collect in the prior telephone survey. Because the grantees survey represented the largest, most active users of the program for third-party lending, we believed that their insights into the program were worth additional attention.

The survey instruments used on-site included a large number of open-ended questions, at times with probes. Several questions were explicit follow-ups to questions asked in the telephone survey and were merged with the answers the specific respondent had given in the telephone interview in order to solicit additional explanation or expansion.

The survey of CD Directors was focused on policy trends and the communities' experience with economic development and third-party lending over time. The survey of

program managers focused on underwriting standards, program characteristics, and default experiences.

On-Site Loan File Reviews

Loan file reviews were carried out by site teams consisting of mid-level and junior staff from the Urban Institute and its subcontractors, ICF Consulting and KRA Corporation. Site team leaders were assigned to make arrangements for the visit, supervise on-site work, and complete the on-site surveys. Each team was staffed at a level sufficient to collect data on all loans sampled with certainty and at least 50 percent of the remaining dollar volume of loans.

Staff training was held in December 2001, covering basic understanding of the programs, familiarization with data collection instruments and confidentiality procedures and practice reviews of several redacted files supplied by reconnaissance sites.

All field team members were provided with laptop computers preloaded with a Microsoft Access database consisting of data entry forms and underlying tables, in order to reduce transcription errors and costs and to facilitate aggregation of the data when teams returned from the field. Information was collected on loan terms, underwriting data (including sources and uses budgets, and collateral and underwriting documentation found in the files), national objectives and job creation, business characteristics, and loan performance. Often these were in multiple files or grantee databases, but teams were responsible for arranging access to all relevant files either before arriving or once in the field.

Identifying information, such as name of business or borrower, address and phone number, grantee ID and grantee's loan number were not recorded in the database, but instead were recorded separately on paper forms which field staff were instructed to carry in separate bags. Data and surveys were transmitted only by secure means (FedEx or courier) in separate packages from identifiers forms. Tracking numbers created on site were then used to link the file data to the identifiers solely for the purpose of preparing the sample of businesses receiving loans. Physical and electronic security was maintained at the Urban Institute and subcontractor offices using locked file drawers and secure, password protected network drives, in accordance with the Urban Institute human subject rules.

Telephone Survey of Businesses Receiving Loans in High-Volume Communities

The database produced from the loan file review formed the basis for generating the sample of businesses selected to participate in the Survey of Businesses Receiving Loans in High-Volume Communities. Because in many communities more than one loan had been made to the same business, the number of businesses represented was 900, rather than 976.

Each loan record was assigned to one of five groups, in two stages.

- At stage one, the sample was divided into two categories—"early" or "late"—depending on when the site visit to that community was to have been conducted. Because interviewing for the Business Survey began before the all of the site visits were completed, this was done to ensure that there was adequate representation of business loans in the "late" category.
- At stage two, within the "early" sample group, sample records were divided into three subcategories—representing different levels of effort that would be devoted to securing an interview: "high," "medium," and "low." Essentially, the larger the loan, the greater the effort that was to have been made to ensure an interview with the loan recipient. Within the "late" sample group, records were associated with two level-of-effort categories: "high" and "medium."

The resulting sample was as follows:

Business Lending Survey—Distribution of Records by Sample Group and Level of Effort

	SAMPLE GROUP		
LEVEL OF EFFORT	**EARLY**	**LATE**	**TOTAL**
HIGH	34	40	74
MEDIUM	130	541	671
LOW	124	---	124
TOTAL	288*	581*	869

*Of the original records received from the Urban Institute, 14 from the "early" group and seven from the "late" group were never loaded into CATI because there was incomplete mail and/or telephone information, because it was determined the business that received the loan no longer existed, or because the same business received multiple loans.

Prior to the start of calling, each business was sent a pre-survey notification letter explaining the purpose of the survey and instructing them to expect a call from an Aspen interviewer. For the "early" group, the letters were sent to the addresses that appeared in the loan files. For the "late" group, the addresses were first checked against Dun and Bradstreet database. This resulted in substantially fewer letters being returned by the post office for the "late" group.

As with the CD Directors Survey, the questionnaire for the Business Survey was developed by the Urban Institute, with input from Aspen staff regarding question structure and format. A single survey instrument was developed that accounted for differences in the types of businesses, their current operational status, and their current loan status. In addition, where certain information had not been available from the loan file (i.e., interest rate and loan term), the respondent was asked for these data during the interview or was sent a worksheet to complete and return by fax.

The Business Survey was conducted using CATI (Computer Assisted Telephone Interviewing) technology. For the "early" sample group, interviewing began on May 9, 2002 and continued through May 30, 2002. Once the "early" sample had been "exhausted"—either by reaching a terminal disposition or a maximum number of attempts, these records were deactivated to prevent further calling, and work on the "late" sample group began. Those interviews were conducted between June 17 and July 16, 2002. Calls were made from Monday through Friday between the hours of 9:00 a.m. and 5:30 p.m., respondent's time.

As noted above, the number of attempts to secure a completed interview was dictated by the level-of-effort subcategory to which any given record was assigned. (For the "early" group, specific upper limits were 12 for the "high" category, 10 for the "medium" category, and two for the "low" category.) In addition, no businesses were assigned to the "low" effort category in the "late" sample group because it was determined that relatively few interviews could be completed with only two contacts with businesses. Table C-2 shows the range and average number of attempts for each sample and effort-group combination, both overall and for completed interviews only.

Table C-2
Business Survey—Range and Average Number of Attempts by Level of Effort and Sample Group

Level of effort/ sample group	ALL RECORDS		COMPLETES ONLY	
	Range	Average	Range	Average
High				
Early	1-13	6.8	1-9	4.4
Late	1-15	7.5	1-11	5.5
Medium				
Early	1-11	5.7	1-10	3.6
Late	1-15	5.1	1-14	4.7
Low				
Early	1-4	2.0	1-3	2.0
Total	1-15	4.9	1-14	4.4

One difference in procedures was instituted between the "high/medium" and the "low" level-of-effort subcategories. Because the "high" and "medium" groups were called repeatedly over a consecutive number of days, interviewers were instructed not to leave messages for these contacts unless they were given no other choice. On the other hand, since the "low" group was to be called only a few times, with a long interval in between, leaving messages for the contact was encouraged.

A total of 238 Business Lending interviews were conducted. Removing those businesses or organizations that indicated they had not received a loan from the specified jurisdiction (n=4), the overall response rate for the study was 28.6 percent. As expected, the greater the level of effort to obtain a completed interview, the better the response rate—with the individual rates by level of effort ranging from a high of 40.6 percent ("early/high") to a low of 9.6 percent ("early/low"). The breakdown of sample by last disposition is presented in Table C-3 below.

Refusal reasons. As with the Survey of CD Directors, when an interviewer encountered a potential respondent who did not want to participate in the survey, he/she tried to determine the person's reason for refusing. Where possible, the interviewer tried to address the respondent's concerns and solicit their cooperation. If this was not possible, the interviewer recorded the respondent's reason(s) for non-participation. They are as follows:

Table C-3
Business Lending Survey—Distribution of Reasons for Refusing to Participate*

REFUSAL REASON	EARLY MEDIUM	EARLY LOW	LATE MEDIUM	TOTAL
Too busy; doesn't have time	2	2	19	23
Survey too long	0	1	2	3
Doesn't participate in any surveys	0	1	4	5
New to job; doesn't know loans well enough	0	0	1	1
Confidentiality concerns	0	0	3	3
Doesn't discuss finances with outsiders	1	0	5	6
Just not interested; no particular reason	3	0	7	10
Other reason	2	3	11	16
Refused to give reason	1	1	4	6
TOTAL ANSWERS	9	8	56	73

*Multiple answers were allowed.

"Other" refusal reasons were:

- Doesn't participate in phone surveys or wouldn't participate unless a paper questionnaire could be provided (n=6);
- Business no longer in existence or business closed (n=3);
- Wasn't aware funds came from HUD and wouldn't participate unless contacted by HUD (n=1);
- Wouldn't participate in voluntary survey (n=1);

- Potential language barrier (n=1);
- Couldn't talk because at work (n=1);
- Won't discuss business activities over phone (n=1);
- Wouldn't participate without introductory letter, but refused to provide name/fax number (n=1);
- Indicated it was the worst loan they ever had (n=1).

Data editing. Completed interviews were periodically removed from the CATI system for a final quality control review. The review consisted of looking for inconsistencies in the responses, questionable/illogical data, and/or re-coding information as indicated by the interviewers on a problem sheet. Survey-specific problem sheets were used to make changes in the survey data due to respondent or interviewer error. In a few cases, respondents were re-contacted for clarification and/or confirmation of the data, and the information was corrected as necessary.

In addition, responses to "Other [SPECIFY]" and open-ended questions were examined. Typographical errors and inconsistencies in abbreviations were corrected, and an effort was made to ensure that all such responses were presented as complete and coherent thoughts. For the "Other [SPECIFY]" questions, the responses were reviewed and recoded into existing answer choice categories, if the answer choices had not been read to the respondent during the interview. Again, where necessary, respondents were re-contacted for clarification and/or additional information, and the file was corrected.

APPENDIX D:

REGRESSION MODEL RESULTS

APPENDIX D: REGRESSION MODEL RESULTS

This appendix provides the core regression and category variables that were used in the model discussed in Chapter 5, and reports detailed regression model results. Included are:

- The core regression and category variables;
- Unweighted ”problem loan” regression results;
- Weighted “problem loan” regression results;
- Unweighted “distressed loan” regression results; and
- Weighted “distressed loan” regression results.

Appendix Table D-1 presents the core regression and category variables used in the logistic regression mode—forming the basis of the “informational content analysis” presented in Chapter 5—as well as the hypothesized relationships between the variables included in the model and the likelihood of loan distress. The table distinguishes between variables in the “core regression” and each of categories of independent variables. The core regression includes variables that are readily observable—median household income, whether the loan uses CDBG or Section 2108 funding, and year of origination. The five categories of independent variables consist of loan terms, underwriting information, collateral, project financing structure, and business characteristics.

The remaining tables show the regression results from the informational content analysis for each of the five categories of variables. The results show the probability that the observed relationship is due to chance (P Value) as well as the size of the predicted effect (Odds Ratio). The latter is the likelihood that a variable will have an effect on the value of the dependent variable relative to some other variable. For example, the unweighted regression results indicate that a loan originated in 1997 is 2.087 times more likely to become distressed than a loan originated in 1999.

Appendix Table D-1. Core Regression and Category Variables		
	Variable Description	Expected Effect on Loan Performance
Core Regression		
Median Household Income	Log of City median household income in 1999.	- Higher income cities are likely to be less economically distressed
Section 108	Dummy variable =1 when loan is Section 108	? No a priori expectation regarding Section 108 status and performance
Origination Year	Separate dummy variables =1 when origination year is 1994, 1995, 1996, 1997 or 1998. 1999 is the omitted category	? No a priori expectation regarding origination year and performance
Loan Terms		
Loan Amount	Original Principal Balance of CDBG/Section 108 loan. The empirical analyses used the log of the loan amount.	? Unclear how loan amount will affect performance. Larger loans may be underwritten with more care, therefore there may be a negative relationship. However, larger loans may be originated to borrowers who are unable to secure private financing, thereby creating a negative relationship between loan size and performance.
Interest Rate	Original note rate of CDBG/Section 108 loan.	+ Loans with higher interest rates should be more likely to default, since higher rates indicate a lower subsidy
Term	Original term of the loan, measured in months.	? Longer term loans may be originated to less risky borrowers, thereby showing a negative relationship. Shorter term loans, however, have less time to experience poor payment performance
Underwriting Information		

Appendix Table D-1. Core Regression and Category Variables		
	Variable Description	Expected Effect on Loan Performance
Tax Return in File	Dummy variable that takes the value of 1 if loan file had a tax return	? Negative if the presence of this information indicates a more careful review of a loan. May be positive, though, if underwriters require more rigorous documentation for more risky loans
Credit Report in File	Dummy variable that takes the value of 1 if loan file had a credit report	
Pro Forma in File	Dummy variable that takes the value of 1 if loan file had a Pro Forma	
Income Statement in File	Dummy variable that takes the value of 1 if loan file had an income statement	
Total Number of Pieces of Underwriting Information in File	Total number of underwriting pieces of information in file	
Collateral		
Financial	Dummy variable that =1 when loan had financial collateral, such as a letter of credit	? There is no a priori expectation regarding the relationship between loan performance and type of collateral
Machinery, Equipment and Inventory	Dummy variable that =1 when loan had machinery, equipment, and inventory collateral	
Real Estate	Dummy variable that =1 when loan had real estate collateral	
Other	Dummy variable that =1 when loan had other collateral, such as a personal guarantee	
Number of Collateral Pieces	Total types of collateral	- Expectation is that loans with more types of collateral reflect the borrower's ability to bring more resources to a project
Financial in First Position	Dummy variable that =1 when loan had financial collateral, such as a letter of credit in the first position	?

Appendix Table D-1. Core Regression and Category Variables		
	Variable Description	Expected Effect on Loan Performance
Machinery, Equipment and Inventory in First Position	Dummy variable that =1 when loan had machinery, equipment, and inventory collateral in the first position	There is no a priori expectation regarding the relationship between loan performance and type of collateral in the first position
Real Estate in First Position	Dummy variable that =1 when loan had real estate collateral in the first position	
Other in First Position	Dummy variable that =1 when loan had other collateral, such as a personal guarantee in the first position	
Number of Collateral Pieces in First Position	Total types of collateral in the first position	- Expectation is that loans with more types of collateral in the first position reflect the borrower's ability to bring more resources to a project
Project Financing Structure		
Owner Equity	Dummy variable =1 when project has owner equity funding	- Presence of owner equity indicates that the borrower has a personal investment in the overall project financing
Private Non Owner Equity	Dummy variable=1 when project has private non owner equity funding	- Presence of private non owner equity funds signals that a private lender believed that the project was creditworthy
Other Public Funds	Dummy variable =1 when project has other public funds	? Other public funds may be an indication that another agency believed that the project was creditworthy. Conversely, may be a signal that borrower equity and private debt was not sufficient to finance transaction

Appendix Table D-1. Core Regression and Category Variables		
	Variable Description	Expected Effect on Loan Performance
Total Project Size	Total of all project financing	? Larger projects may be underwritten with more care by lenders and initiated by more experienced companies. Conversely, larger projects may be more exposed to economic factors that are beyond the control of an individual firm
Owner Equity Proportion of Total Project Size	Owner equity share of total project financing	- A larger share of owner equity funding may signal a more sound borrower
Private Non Owner Equity Proportion of Total Project Size	Private non owner equity share of total project financing	- Large share of private non owner equity funding may signal a private lender's confidence regarding the overall financial soundness of a project
Other Public Funds Proportion of Total Project Size	Other public funds as a share of total project financing	? A larger share of other public funds may signal a project that could not attract private financing, or it may be that another agency wanted to participate in a sound project
Business Characteristics		
Business Start-up	Dummy variable =1 when year loan originated is the same as the year business started	- Start-up firms are more likely to experience hardship
Number of Employees when loan was originated	Number of employees with firm in 1999	- Larger firms may have a more mature management structure

Unweighted Problem Loan Regression Results

Loan Terms	Parameter Estimate	Standard Error	P Value	Odds Ratio
Intercept	8.9472	4.4443	0.0441	
1994	0.4624	0.8907	0.6307	1.5879
1995	0.0072	0.6470	0.9912	1.0072
1996	0.4285	0.2446	0.0798	1.5349
1997	0.4203	0.2397	0.0796	1.5224
1998	0.6104	0.2453	0.0128	1.8412
Section 108	0.8953	0.3067	0.0035	2.4481
Log of Median Household Income	-0.8331	0.4323	0.0540	0.4347
Log of Principal Amount	-0.1406	0.0752	0.0614	0.8688
Term at Origination (in months)	-0.0033	0.0015	0.0277	0.9967
Interest Rate at Origination	0.1103	0.0347	0.0015	1.1166
Chi Square	57.7578			
Prob > Chi Square	<0.0001			
N	725.0000			

Underwriting Quality	Parameter Estimate	Standard Error	P Value	Odds Ratio
Intercept	5.4824	4.2746	0.1996	
1994	0.2406	0.8682	0.7817	1.2720
1995	-0.0627	0.5734	0.9129	0.9392
1996	0.3940	0.2362	0.0952	1.4829
1997	0.4419	0.2290	0.0536	1.5556
1998	0.6040	0.2314	0.0091	1.8294
Section 108	0.7059	0.2153	0.0010	2.0256
Log of Median Household Income	-0.6338	0.4120	0.1240	0.5306
Tax Return in File	-0.1413	0.2763	0.6092	0.8683
Credit Report in File	0.2681	0.2628	0.3075	1.3075
Balance Sheet in File	-0.6202	0.3475	0.0743	0.5378
Pro Forma in File	-0.1766	0.2448	0.4707	0.8381
Total Underwriting Pieces	0.2426	0.1955	0.2148	1.2745
Chi Square	34.5340			
Prob > Chi Square	0.0006			
N	766.0000			

Collateral	Parameter Estimate	Standard Error	P Value	Odds Ratio
Intercept	2.5188	4.6495	0.5880	
1994	0.2931	0.8832	0.7400	1.3406
1995	-0.1891	0.5779	0.7434	0.8277
1996	0.2453	0.2464	0.3195	1.2780
1997	0.3505	0.2418	0.1472	1.4197
1998	0.5821	0.2390	0.0149	1.7898
Section 108	0.9203	0.2325	<0.0001	2.5102
Log of Median Household Income	-0.3527	0.4429	0.4257	0.7028
Finance	-0.9436	0.3810	0.0132	0.3892
Machinary, Equipment or Inventory	0.2076	0.1907	0.2764	1.2307
Real Estate	-0.3631	0.2029	0.0736	0.6955
Other	0.3086	0.2335	0.1863	1.3615
Total Collateral Pieces	0.0910	0.0632	0.1498	1.0953
Chi Square	43.7497			
Prob > Chi Square	<0.0001			
N	691.0000			

Collateral in First Position	Parameter Estimate	Standard Error	P Value	Odds Ratio
Intercept	4.9314	4.6282	0.2866	
1994	0.5665	0.8705	0.5152	1.7621
1995	0.0507	0.5919	0.9318	1.0520
1996	0.3343	0.2477	0.1770	1.3970
1997	0.3728	0.2430	0.1250	1.4517
1998	0.6727	0.2409	0.0052	1.9596
Section 108	0.4406	0.2328	0.0585	1.5536
Log of Median Household Income	-0.5870	0.4451	0.1872	0.5560
Finance in First Position	0.2518	0.5889	0.6690	1.2863
Machinary, Equipment or Inventory in First Position	0.1728	0.2147	0.4208	1.1886
Real Estate in First Position	0.2503	0.2677	0.3498	1.2844
Other in First Positon	0.8380	0.1893	<0.0001	2.3119
Chi Square	45.0895			
Prob > Chi Square	<0.0001			
N	691.0000			

Financing Structure with Dummy Variables	Parameter Estimate	Standard Error	P Value	Odds Ratio
Intercept	9.3575	4.4661	0.0362	
1994	0.0949	0.8716	0.9133	1.0996
1995	-0.0391	0.5788	0.9461	0.9616
1996	0.2725	0.2384	0.2529	1.3133
1997	0.2972	0.2324	0.2010	1.3461
1998	0.5699	0.2336	0.0147	1.7680
Section 108	0.4943	0.2195	0.0243	1.6393
Log of Median Household Income	-0.9309	0.4261		0.3942
Owner Equity Greater Than 0	-0.2110	0.1744	0.2262	0.8098
Private Non Owner Equity Greater Than 0	-0.5183	0.1679	0.0020	0.5955
Other Public Funds Greater Than 0	-0.4449	0.2224	0.0455	0.6409
Chi Square	37.4342			
Prob > Chi Square	<0.0001			
N	740.0000			

Financing Structure with Proportion Variables	Parameter Estimate	Standard Error	P Value	Odds Ratio
Intercept	9.7498	4.4211	0.0274	
1994	0.0866	0.8715	0.9208	1.0905
1995	-0.0769	0.5848	0.8954	0.9260
1996	0.2609	0.2405	0.2780	1.2981
1997	0.2896	0.2348	0.2174	1.3359
1998	0.5508	0.2360	0.0196	1.7347
Section 108	0.9091	0.2789	0.0011	2.4822
Log of Median Household Income	-0.7756	0.4280	0.0700	0.4604
Log of Total Transaction Amount	-0.1807	0.0687	0.0085	0.8347
Owner Equity Proportion of Transaction	-1.0306	0.5621	0.0667	0.3568
Private Non Owner Equity Proportion of Transaction	-0.4652	0.3612	0.1978	0.6280
Other Public Funds Proportion of Transaction	-0.4757	0.6041	0.4310	0.6214
Chi Square	50.7210			
Prob > Chi Square	<0.0001			
N	740.0000			

Business Characteristics	Parameter Estimate	Standard Error	P Value	Odds Ratio
Intercept	9.0677	4.7094	0.0542	
1994	0.5275	1.2000	0.6602	1.6947
1995	-0.5466	0.6623	0.4092	0.5789
1996	0.2249	0.2581	0.3835	1.2522
1997	0.3312	0.2527	0.1900	1.3926
1998	0.5526	0.2517	0.0281	1.7377
Section 108	1.3007	0.2581	<0.0001	3.6720
Log of Median Household Income	-0.9565	0.4522	0.0344	0.3843
Startup	0.3626	0.2130	0.0887	1.4371
Total Employees	-0.0028	0.0012	0.0219	0.9972
Chi Square	43.9445			
Prob > Chi Square	<0.0001			
N	634.0000			

Weighted Problem Loan Regression Results

Loan Terms	Parameter Estimate	Standard Error	P Value	Odds Ratio
Intercept	11.5239	4.6100	0.0124	
1994	0.5719	1.1648	0.6234	1.7717
1995	0.6493	0.6857	0.3437	1.9143
1996	0.6402	0.2484	0.0100	1.8969
1997	0.6770	0.2490	0.0066	1.9679
1998	0.9173	0.2521	0.0003	2.5026
Section 108	1.3218	0.2873	<0.0001	3.7502
Log of Median Household Income	-0.9780	0.4510	0.0301	0.3760
Log of Principal Amount	-0.2132	0.0779	0.0062	0.8080
Term at Origination (in months)	-0.0043	0.0018	0.0162	0.9957
Interest Rate at Origination	0.0447	0.0345	0.1952	1.0457
Chi Square	76.8643			
Prob > Chi Square	<0.0001			
N	721.5900			

Underwriting Quality	Parameter Estimate	Standard Error	P Value	Odds Ratio
Intercept	771050597.0000	4.3346		
1994	-0.3526	1.2172	0.7720	0.7028
1995	0.4724	0.6181	0.4446	1.6039
1996	0.5950	0.2419	0.0139	1.8130
1997	0.6949	0.2389	0.0036	2.0036
1998	0.8487	0.2415	0.0004	2.3365
Section 108	0.9727	0.2161	<0.0001	2.6452
Log of Median Household Income	-0.8248	0.4177	0.0483	0.4383
Tax Return in File	-0.2032	0.2691	0.4501	0.8161
Credit Report in File	0.3721	0.2633	0.1576	1.4508
Balance Sheet in File	-0.6607	0.3416	0.0531	0.5165
Pro Forma in File	0.1562	0.2472	0.5275	1.1690
Total Underwriting Pieces	0.0534	0.1938	0.7830	1.0548
Chi Square	55.8553			
Prob > Chi Square	<0.0001			
N	760.6580			

Collateral	Parameter Estimate	Standard Error	P Value	Odds Ratio
Intercept	4.2365	4.7416	0.3716	
1994	0.2081	0.1223	0.8672	1.2314
1995	1.1453	0.5959	0.0546	3.1433
1996	0.5760	0.2579	0.0255	1.7790
1997	0.6666	0.2582	0.0098	1.9476
1998	0.9091	0.2587	0.0004	2.4821
Section 108	0.9203	0.2325	<0.0001	2.5102
Log of Median Household Income	-0.5460	0.4539	0.2290	0.5793
Finance	-1.0771	0.4612	0.0195	0.3406
Machinary, Equipment or Inventory	0.5686	0.1957	0.0037	1.7659
Real Estate	-0.5503	0.2020	0.0064	0.5767
Other	0.5766	0.2446	0.0184	1.7799
Total Collateral Pieces	0.0066	0.0643	0.9176	1.0067
Chi Square	76.5943			
Prob > Chi Square	<0.0001			
N	685.2900			

Collateral in First Positon	Parameter Estimate	Standard Error	P Value	Odds Ratio
Intercept	9.5182	4.7133	0.0434	
1994	0.2734	1.1929	0.8187	1.3145
1995	1.3250	0.6001	0.0272	3.7624
1996	0.6201	0.2571	0.0159	1.8591
1997	0.6184	0.2553	0.0154	1.8559
1998	0.9971	0.2575	0.0001	2.7104
Section 108	0.7246	0.2320	0.0018	2.0640
Log of Median Household Income	-1.0531	0.4561	0.0210	0.3488
Finance in First Position	0.1543	0.6686	0.8175	1.1669
Machinary, Equipment or Inventory in First Position	0.5524	0.2083	0.0080	1.7375
Real Estate in First Position	-0.0420	0.3080	0.8914	0.9588
Other in First Position	0.9103	0.1864	<0.0001	2.4852
Chi Square	67.6266			
Prob > Chi Square	<0.0001			
N	685.2900			

Financing Structure with Dummy Variables	Parameter Estimate	Standard Error	P Value	Odds Ratio
Intercept	11.5476	4.6420	0.0129	
1994	-0.1788	1.2388	0.8852	0.8363
1995	0.5849	0.6209	0.3462	1.7948
1996	0.5119	0.2434	0.0354	1.6684
1997	0.5354	0.2407	0.0261	1.7081
1998	0.8146	0.2422	0.0008	2.2584
Section 108	0.7175	0.2197	0.0011	2.0494
Log of Median Household Income	-1.1571	0.4436	0.0091	0.3144
Owner Equity Greater Than 0	-0.1691	0.1782	0.3428	0.8444
Private Non Owner Equity Greater Than 0	-0.4681	0.1689	0.0056	0.6262
Other Public Funds Greater Than 0	-0.5935	0.2448	0.0153	0.5524
Chi Square	52.8372			
Prob > Chi Square	<0.0001			
N	734.5320			

Financing Structure with Proportion Variables	Parameter Estimate	Standard Error	P Value	Odds Ratio
Intercept	11.4577	4.5585	0.0120	
1994	0.0928	1.2256	0.9396	1.0973
1995	0.5322	0.6396	0.4053	1.7027
1996	0.5529	0.2477	0.0256	1.7384
1997	0.5492	0.2450	0.0250	1.7319
1998	0.8551	0.2464	0.0005	2.3516
Section 108	1.2553	0.2684	<0.0001	3.5088
Log of Median Household Income	-0.8899	0.4397	0.0430	0.4107
Log of Total Transaction Amount	-0.2631	0.0662	<0.0001	0.7687
Owner Equity Proportion of Transaction	0.0240	0.5317	0.9639	1.0243
Private Non Owner Equity Proportion of Transaction	-0.2100	0.3544	0.5536	0.8106
Other Public Funds Proportion of Transaction	-0.3201	0.6533	0.6241	0.7261
Chi Square	72.7658			
Prob > Chi Square	<0.0001			
N	734.5320			

Business Characteristics	Parameter Estimate	Standard Error	P Value	Odds Ratio
Intercept	13.1496	4.8338	0.0065	
1994	0.7879	1.1919	0.6814	2.1988
1995	-0.4018	0.8048	0.6176	0.6691
1996	0.2867	0.2653	0.2798	1.3321
1997	0.5620	0.2631	0.0327	1.7541
1998	0.6099	0.2633	0.0205	1.8402
Section 108	1.5577	0.2552	<0.0001	4.7479
Log of Median Household Income	-1.3520	0.4657	0.0037	0.2587
Startup	0.2581	0.2108	0.2208	1.2945
Total Employees	-0.0030	0.0014	0.0344	0.9970
Chi Square	63.3447			
Prob > Chi Square	<0.0001			
N	628.4620			

Unweighted Distressed Loan Regression Results

Loan Terms	Parameter Estimate	Standard Error	P Value	Odds Ratio
Intercept	14.4649	4.7100	0.0021	
1994	0.0184	0.9387	0.9843	1.0186
1995	0.0085	0.6885	0.9902	1.0085
1996	0.5410	0.2666	0.0425	1.7177
1997	0.4925	0.2615	0.0597	1.6364
1998	0.7358	0.2654	0.0056	2.0871
Section 108	1.0973	0.3166	0.0005	2.9962
Log of Median Household Income	-1.3306	0.4578	0.0037	0.2643
Log of Principal Amount	-0.2207	0.0793	0.0054	0.8019
Term at Origination (in months)	-0.0020	0.0016	0.1963	0.9980
Interest Rate at Origination	0.1065	0.0364	0.0034	1.1124
Chi Square	62.0142			
Prob > Chi Square	<0.0001			
N	725.0000			

Underwriting Quality	Parameter Estimate	Standard Error	P Value	Odds Ratio
Intercept	10.6057	4.5138	0.0188	
1994	-0.1333	0.9204	0.8848	0.8752
1995	0.0218	0.6031	0.9712	1.0220
1996	0.5042	0.2544	0.0475	1.6556
1997	0.5137	0.2465	0.0371	1.6714
1998	0.7350	0.2476	0.0030	2.0854
Section 108	0.8234	0.2207	0.0002	2.2783
Log of Median Household Income	-1.1703	0.4357	0.0072	0.3103
Tax Return in File	0.0825	0.2911	0.7769	1.0860
Credit Report in File	0.2754	0.2774	0.3209	1.3170
Balance Sheet in File	-0.2389	0.3652	0.5131	0.7875
Pro Forma in File	-0.2921	0.2573	0.2562	0.7467
Total Underwriting Pieces	0.1431	0.2058	0.4868	1.1539
Chi Square	36.6525			
Prob > Chi Square	0.0003			
N	766.0000			

Collateral	Parameter Estimate	Standard Error	P Value	Odds Ratio
Intercept	8.0245	4.9236	0.1031	
1994	-0.2526	0.9423	0.7886	0.7768
1995	-0.1879	0.6096	0.7579	0.8287
1996	0.3432	0.2662	0.1973	1.4094
1997	0.3584	0.2618	0.1710	1.4310
1998	0.7335	0.2557	0.0041	2.0824
Section 108	0.7898	0.2314	0.0006	2.2031
Log of Median Household Income	-0.9289	0.4694	0.0478	0.3950
Finance	-0.9158	0.4258	0.0315	0.4002
Machinary, Equipment or Inventory	0.3017	0.2000	0.1314	1.3522
Real Estate	-0.3092	0.2123	0.1453	0.7340
Other	0.4660	0.2494	0.0617	1.5936
Total Collateral Pieces	0.0351	0.0641	0.5835	1.0357
Chi Square	48.7058			
Prob > Chi Square	<0.0001			
N	691.0000			

Collateral in First Position	Parameter Estimate	Standard Error	P Value	Odds Ratio
Intercept	10.3767	4.9197	0.0349	
1994	0.0136	0.9245	0.9883	1.0137
1995	0.0569	0.6208	0.9270	1.0586
1996	0.4237	0.2668	0.1123	1.5276
1997	0.3912	0.2621	0.1355	1.4787
1998	0.8101	0.2565	0.0016	2.2482
Section 108	0.6003	0.2380	0.0117	1.8226
Log of Median Household Income	-1.1514	0.4738	0.0151	0.3162
Finance in First Position	0.0070	0.6085	0.9908	1.0070
Machinary, Equipment or Inventory in First Position	0.2433	0.2240	0.2775	1.2755
Real Estate in First Position	0.2095	0.2751	0.4463	1.2331
Other in First Positon	0.7287	0.1958	0.0002	2.0725
Chi Square	45.1843			
Prob > Chi Square	<0.0001			
N	691.0000			

Financing Structure with Dummy Variables	Parameter Estimate	Standard Error	P Value	Odds Ratio
Intercept	14.8750	4.7236	0.0016	
1994	-0.4069	0.9280	0.6610	0.6657
1995	0.0240	0.6127	0.9688	1.0243
1996	0.3625	0.2580	0.1601	1.4369
1997	0.3708	0.2511	0.1398	1.4489
1998	0.6631	0.2507	0.0082	1.9408
Section 108	0.5941	0.2248	0.0082	1.8113
Log of Median Household Income	-1.4981	0.4512	0.0009	0.2235
Owner Equity Greater Than 0	-0.2147	0.1844	0.2443	0.8068
Private Non Owner Equity Greater Than 0	-0.5884	0.1774	0.0009	0.5552
Other Public Funds Greater Than 0	-0.5362	0.2425	0.0270	0.5850
Chi Square	47.2928			
Prob > Chi Square	<0.0001			
N	740.0000			

Financing Structure with Proportion Variables	Parameter Estimate	Standard Error	P Value	Odds Ratio
Intercept	14.9568	4.6590	0.0013	
1994	-0.3932	0.9262	0.6712	0.6749
1995	-0.0175	0.6194	0.9775	0.9827
1996	0.3578	0.2601	0.1689	1.4302
1997	0.3613	0.2535	0.1541	1.4352
1998	0.6512	0.2531	0.0101	1.9178
Section 108	1.0490	0.2882	0.0003	2.8547
Log of Median Household Income	-1.2980	0.4511	0.0040	0.2731
Log of Total Transaction Amount	-0.1987	0.0720	0.0058	0.8198
Owner Equity Proportion of Transaction	-0.9534	0.6010	0.1127	0.3854
Private Non Owner Equity Proportion of Transaction	-0.5179	0.3816	0.1747	0.5957
Other Public Funds Proportion of Transaction	-0.3587	0.6397	0.5750	0.6986
Chi Square	58.2541			
Prob > Chi Square	<0.0001			
N	740.0000			

Business Characteristics	Parameter Estimate	Standard Error	P Value	Odds Ratio
Intercept	13.8545	4.9743	0.0053	
1994	-0.0225	1.0615	0.8322	0.9778
1995	-0.4432	0.7005	0.5269	0.6420
1996	0.4694	0.2780	0.0913	1.5990
1997	0.4824	0.2735	0.0778	1.6200
1998	0.7057	0.2709	0.0092	2.0252
Section 108	1.3148	0.2579	<0.0001	3.7242
Log of Median Household Income	-1.4610	0.4784	0.0023	0.2320
Startup	0.2619	0.2219	0.2378	1.2994
Total Employees	-0.0030	0.0014	0.0310	0.9970
Chi Square	46.0494			
Prob > Chi Square	<0.0001			
N	634.0000			

Weighted Distressed Loan Regression Results

Loan Terms	Parameter Estimate	Standard Error	P Value	Odds Ratio
Intercept	18.3213	4.8535	0.0002	
1994	0.2830	1.1902	0.8121	1.3271
1995	0.7354	0.6920	0.2879	2.0863
1996	0.6729	0.2700	0.0127	1.9600
1997	0.8083	0.2682	0.0026	2.2442
1998	1.0299	0.2704	0.0001	2.8008
Section 108	1.3004	0.2843	<0.0001	3.6707
Log of Median Household Income	-1.6530	0.4750	0.0005	0.1915
Log of Principal Amount	-0.2619	0.0809	0.0012	0.7696
Term at Origination (in months)	-0.0015	0.0019	0.4063	0.9985
Interest Rate at Origination	0.0511	0.0361	0.1567	1.0524
Chi Square	74.1052			
Prob > Chi Square	<0.0001			
N	721.5900			

Underwriting Quality	Parameter Estimate	Standard Error	P Value	Odds Ratio
Intercept	13.9813	4.5244	0.0020	
1994	-0.4854	1.2797	0.7044	0.6154
1995	0.6968	0.6227	0.2631	2.0074
1996	0.6721	0.2605	0.0099	1.9584
1997	0.8300	0.2555	0.0012	2.2932
1998	1.0205	0.2573	<0.0001	2.7746
Section 108	0.9094	0.2145	<0.0001	2.4829
Log of Median Household Income	-1.4997	0.4370	0.0006	0.2232
Tax Return in File	-0.2735	0.2801	0.3288	0.7607
Credit Report in File	0.1770	0.2746	0.5191	1.1937
Balance Sheet in File	-0.4381	0.3553	0.2177	0.6453
Pro Forma in File	0.0305	0.2577	0.9057	1.0310
Total Underwriting Pieces	0.1651	0.2024	0.4146	1.1795
Chi Square	51.9903			
Prob > Chi Square	<0.0001			
N	760.6580			

Collateral	Parameter Estimate	Standard Error	P Value	Odds Ratio
Intercept	11.2777	4.9138	0.0218	
1994	-0.0977	1.2914	0.9397	0.9069
1995	1.3636	0.5958	0.0221	3.9104
1996	0.6508	0.2777	0.0191	1.9171
1997	0.7943	0.2767	0.0041	2.2129
1998	1.1813	0.2757	<0.0001	3.2585
Section 108	0.8935	0.2305	0.0001	2.4437
Log of Median Household Income	-1.2527	0.4715	0.0079	0.2857
Finance	-1.1160	0.5060	0.0274	0.3276
Machinary, Equipment or Inventory	0.4891	0.2009	0.0149	1.6309
Real Estate	-0.4616	0.2088	0.0271	0.6303
Other	0.3862	0.2540	0.1283	1.4714
Total Collateral Pieces	-0.0048	0.0651	0.9414	0.9952
Chi Square	70.9767			
Prob > Chi Square	<0.0001			
N	685.2900			

Collateral in First Positon	Parameter Estimate	Standard Error	P Value	Odds Ratio
Intercept	15.0996	4.9146	0.0021	
1994	-0.0190	1.2621	0.9880	0.9812
1995	1.4888	0.6020	0.0134	4.4318
1996	0.6676	0.2756	0.0154	1.9495
1997	0.7423	0.2726	0.0065	2.1008
1998	1.2279	0.2727	<0.0001	3.4142
Section 108	0.6997	0.2303	0.0024	2.0132
Log of Median Household Income	-1.6236	0.4764	0.0007	0.1972
Finance in First Position	0.1207	0.6807	0.8593	1.1282
Machinary, Equipment or Inventory in First Position	0.4485	0.2122	0.0345	1.5660
Real Estate in First Position	0.1315	0.3103	0.6716	1.1406
Other in First Position	0.5860	0.1902	0.0021	1.7969
Chi Square	58.9740			
Prob > Chi Square	<0.0001			
N	685.2900			

Financing Structure with Dummy Variables	Parameter Estimate	Standard Error	P Value	Odds Ratio
Intercept	18.2020	4.8837	0.0002	
1994	-0.4409	1.3090	0.7362	0.6434
1995	0.7672	0.6332	0.2257	2.1537
1996	0.5289	0.2637	0.0449	1.6970
1997	0.6676	0.2588	0.0099	1.9496
1998	0.9413	0.2594	0.0003	2.5634
Section 108	0.6996	0.2195	0.0014	2.0129
Log of Median Household Income	-1.8405	0.4674	<0.0001	0.1587
Owner Equity Greater Than 0	-0.2568	0.1866	0.1687	0.7735
Private Non Owner Equity Greater Than 0	-0.3930	0.1763	0.0258	0.6750
Other Public Funds Greater Than 0	-0.5221	0.2613	0.0457	0.5933
Chi Square	57.2747			
Prob > Chi Square	<0.0001			
N	734.5320			

Financing Structure with Proportion Variables	Parameter Estimate	Standard Error	P Value	Odds Ratio
Intercept	17.9066	4.7654	0.0002	
1994	-0.1762	1.3032	0.8924	0.8384
1995	0.7274	0.6507	0.2636	2.0697
1996	0.5705	0.2678	0.0332	1.7691
1997	0.6888	0.2627	0.0087	1.9914
1998	0.9945	0.2638	0.0002	2.7033
Section 108	1.1394	0.2667	<0.0001	3.1249
Log of Median Household Income	-1.5889	0.4601	0.0006	0.2042
Log of Total Transaction Amount	-0.2277	0.0682	0.0008	0.7964
Owner Equity Proportion of Transaction	-0.4293	0.5627	0.4456	0.6510
Private Non Owner Equity Proportion of Transaction	-0.2302	0.3691	0.5329	0.7944
Other Public Funds Proportion of Transaction	-0.1932	0.6831	0.7773	0.8243
Chi Square	71.9135			
Prob > Chi Square	<0.0001			
N	734.5320			

Business Characteristics	Parameter Estimate	Standard Error	P Value	Odds Ratio
Intercept	15.4838	4.9993	0.0020	
1994	0.4912	1.5206	0.7467	1.6342
1995	-0.1247	0.8291	0.8805	0.8828
1996	0.6207	0.2836	0.0286	1.8603
1997	0.8366	0.2810	0.0029	2.3085
1998	0.7947	0.2820	0.0048	2.2138
Section 108	1.3653	0.2493	<0.0001	3.9168
Log of Median Household Income	-1.6217	0.4824	0.0001	0.1976
Startup	0.0715	0.2190	0.7441	1.0741
Total Employees	-0.0029	0.0015	0.0610	0.9971
Chi Square	59.2511			
Prob > Chi Square	<0.0001			
N	628.4620			