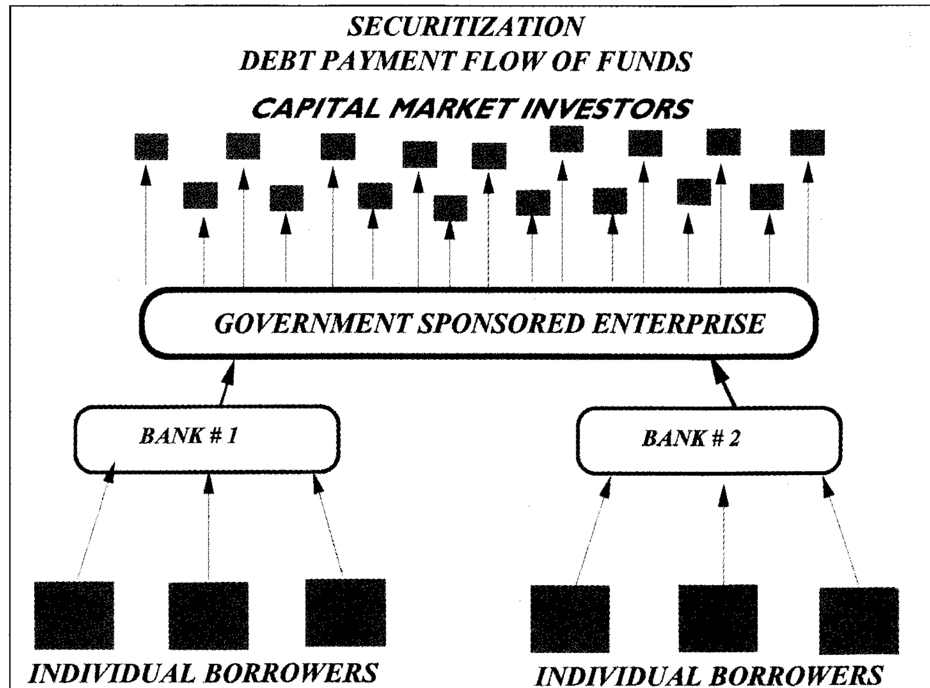
By Richard J. Lobron

Financing transit: Is "Dottie Fae" the answer?

Could private capital play a bigger role in financing needed investment in the nation's transportation infrastructure, including public transit? It could, through the medium of a new Government Sponsored Enterprise along the lines of "Fannie Mae" or "Freddie Mac" that might be called something like the "Domestic Transportation Infrastructure Financing Association" or "Dottie Fae," as the concept was informally known at the U.S. DOT.

In recent years, the U.S. government has begun to encourage private sector participation in infrastructure investment. This new federal policy direction was demonstrated with passage of the landmark 1991 Intermodal Surface Transportation Efficiency Act (ISTEA), which called for the development of innovative financing measures in support of both the highway and mass transit components of the transportation infrastructure.



A Government Sponsored Enterprise such as a Domestic Transportation Inrastructure Financing Association (DTIFA) could be chartered and capitalized to establish sector-wide credit and documentation standards and formation of a secondary market for debt related to all transportation infrastructure related activities.

Federal directions in private investment

The ISTEA provisions called for both the identification of innovative intermodal financing mechanisms and the development of greater levels of infrastructure awareness within the financial markets. Through ISTEA, government has expanded its efforts to encourage greater participation in the transportation sector by inviting direct investment in such activities as highway and transit development, operation and support.

More recently Executive Order No. 12893, issued by President Clinton in January 1994, encouraged private sector participation in infrastructure investment and management through the use of ". . . innovative public-private initiatives in the ownership, financing construction and operation of infrastructure projects. . ."

An earlier executive order (No. 12803) issued by President Bush in 1992 advocated the transfer of investment from the public to the private sector through an easing of regulatory interference in the privatization of infrastructure assets.

Unfortunately, private investor interest in infrastructure opportunities is still limited, owing largely to a lack of support and encouragement from the financial community. For despite its directives and policy initiatives, the federal government has still not resolved a basic ingredient of the economics of any infrastructure activity: Where does the money come from, if not from a loan or grant program from Uncle Sam?

Capitalizing private sector participation

The ability of the private sector to participate or invest in historically public sector activities, such as transit and highways, is hampered by an inability to obtain sufficient capital for such investment, regardless of the participant's credit-worthiness. New entrants into the field, who have little credit history, experience great difficulty in obtaining funds through existing capital sources. Likewise, many midsize participants have similar difficulty due to a lack of sufficient size, structure or financial acumen to approach capital markets with ease.

Lending institutions also have a general aversion towards exposure to risk in the infrastructure arena, which impedes the flow of capital to private ventures. This lender caution is largely due to the perceived levels of risk. The absence of reliable standards for determining an acceptable

level of credit quality limits a lender's ability to review a potential loan transaction in the context of the entire transportation industry. In addition, the lack of standard transaction documentation creates a situation in which issuance costs and lending conditions are disincentives to pursuing such loans.

The risks associated with private infrastructure debt which must be faced by a lending institution are usually greater than those experienced in other lines of business because of the relatively small number of such enterprises existing within the geographical service area of the individual lender. Accordingly, the capacity to minimize overall loan portfolio risk through diversification across a large number of borrowers is difficult for most banks to achieve.

A standard investment mechanism

These conditions are aggravated by the absence of a viable, widely accepted investment mechanism. The current use of funding methods unique to each project serves to undercut the success of federal government efforts to expand private investment in physical plant. A standardized method of obtaining funds would provide infrastructure project participants with access to new sources of capital from the general capital marketplace.

The easing of these limitations on capital movement into infrastructure investments was recognized by the ISTEA legislation, which noted a need to "... examine the existing impediments to efficient financing of intermodal transportation improvements."

A process is required through which the perception of risk associated with infrastructure activity can be clearly and objectively assessed. This effort would entail a design of standard loan documents, terms and conditions, as well as standard definition of acceptable credit quality levels. Such mechanisms would help to reduce the effort which must now be taken by lending institutions and borrowers to understand a transaction.

Standardization of lending activity can be used to provide a free flow of capital from a diversified group of investors to a diverse array of borrowers. A high quality investment instrument must be developed to meet the highest standards of investment prudence. Such an instrument would be sought eagerly by pension plans, mutual funds and other investors with high standards of quality.

ISTEA called for such an investment vehicle when it directed the creation of "... a type of infrastructure security to permit the investment of pension funds in funds used to design, plan and construct infrastructure facilities in the U.S."

These needs can be met through the use of securitization and secondary markets, implemented through the establishment of a Government Sponsored Enterprise (GSE).

Securitization described

Individual loans or leases generally use equipment, property, facilities or various expected receivables as collateral. "Securitization" represents the creation of marketable securities backed by receipts from a group, or pool, of these individual asset-backed loan or lease transactions. New capital for the origination of additional individual loan or lease transactions is provided by selling the pools of asset-backed securities to a broad range of investors with an extended geographic dispersion and a wide spectrum of portfolio risk diversification. Through this structured financing technique, the risks of late payments or repayment failures on the original individual loans and leases can be transferred from the original lender to the much larger security marketplace.

The single party which packages and "pools" the individual loans in this environment provides standardized risk analysis and documentation, and diversification of risk through the national scope of transactions. This issuing entity is the only guarantor of the debt visible to the investing community. Therefore, if the issuer holds a "AAA" rating, the debt instruments will also bear a "AAA." The credit quality of the individual loans is defined by their adherence to the standards established by the pooler.

The packaging and standardization of home mortgage loans by the Federal National Mortgage Association (FNMA or "Fannie Mae") and the Federal Home Loan Mortgage Corporation (FHLMC or "Freddie Mac") were early uses of this mechanism. Historically, the availability of money

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for home mortgages was affected by the economic health of the immediate region of the borrower. If the regional economy was poor, the local banking community also suffered and therefore had less money to lend for housing.

With the advent of FNMA and FHLMC, an infusion of capital from investors throughout the nation increased the availability of mortgage funds in all regions, avoiding these historic sensitivities to regional economic weaknesses. Since the inception of the practice for mortgages, secondary market acceptance and demand for asset-backed securities has grown tremendously over recent years, and has become increasingly global. In 1990, $180 billion of these securities were issued, in sharp contrast to a level of only $500 million of new issues in 1980. It is anticipated that by the year 2000, over 80% of all new loans in the U.S. will be securitized.

The success of these programs is largely owed to the standardization of loan applications processed by each agency. Due to the success of the securitization program, a person in Oregon completes essentially the same mortgage application as a borrower in Alabama. Each is required to meet essentially the same credit standards and file essentially the same loan documents, which have been developed to meet the standards established by FNMA or FHLMC. Since both loans meet the standards, both local banks will probably sell the mortgage loan to FNMA or FHLMC, and can then use the proceeds from the sale of the mortgages to lend money to other borrowers in Oregon and Alabama.

Securitization should also increase private sector involvement and awareness of infrastructure activity by providing a high quality investment vehicle to the investment community.

Having sold the mortgage loan, the local banker experiences no loss if the loan is not repaid. Instead, the risk is transferred to FNMA or FHLMC. These agencies, which purchase millions of similar mortgage loans from banks around the country, pool the loans and create securities which are repaid by the principal and interest received from the borrowers in Oregon and Alabama, as well as from other loans in the pool.

These mortgage-backed securities, which hold the AAA rating associated with FNMA or FHLMC, are then sold on the public markets and pay taxable interest to the investors. The funds received from investors are used by FNMA or FHLMC to purchase more loans from local banks, which in turn use the funds to create more loans. In the event loans are not repaid, FNMA or FHLMC guarantee to pay the investors certain levels of principal and interest, thus spreading the risk of loss across all investors across the nation.

Through securitization, investors on Wall Street provide funds for home mortgages without the need to investigate the credit quality of each individual loan, the individual banker or the strength of the regional economies in Oregon or Alabama. Instead, investors rely solely upon the credit quality of the Government Sponsored Enterprise—FNMA or FHLMC—to purchase, package and "securitize" only those loans which meet the credit quality standards established for the market.

Benefits of securitization

A similar securitization program could benefit the infrastructure needs of the nation, while the overall acceleration of infrastructure modernization that would come through an increased level of investment could expedite economic development, provide a stimulus for job creation and bring improvements to environmental and productivity performance.

By diversifying capital sources to private sector contractors, manufacturers and operators of infrastructure related activities, this infrastructure securitization could accelerate funding for developing technologies and private sector development initiatives. New investors, such as pension plans, which are currently precluded from infrastructure investment because of the tax-exempt nature of most related securities, would bring new moneys to the market through their purchase of GSE securities.

The attractiveness of private sector debt related to the development, operation and support of infrastructure activities will be enhanced as uniform criteria for credit assessment are established by the markets, as risk diversification expands, as low-risk operating returns are earned by primary lenders, and as investors become comfortable with the stability of the newly-formed market instruments. As the secondary market matures and liquidity is created, the cost of capital to the participants in the infrastructure process, including the transportation sector, should decrease.

Securitization should also increase private sector involvement and awareness of infrastructure activity by providing a high quality investment vehicle to the investment community. Risk-averse investors, such as pension funds or mutual funds, could provide financial support to infrastructure renewal without the need to analyze a vast array of individual transactions and borrowers. Instead, these investors could rely on the full faith and credit of the GSE as the issuer of the secondary market securities.

With an increased attractiveness of infrastructure-related debt to both lenders and prospective borrowers, the flow of non-government capital into the sector should increase. An expanded use and availability of private capital to transportation infrastructure activities, in turn, may make it possible to limit annual federal cash outlays to the levels necessary to cover annual debt service on loans or leases which are then securitized by the lenders. Such a reduction in annual federal cash outlays could create a "multiplier" effect on program funding, which would

eventually allow additional program initiations within the same level of budgetary authority.

The standardization of transaction formats and credit analysis protocols would provide the same benefits of expanded, cost-effective market access to related public sector entities. Furthermore, through special pass-throughs of tax exemptions on pools of tax-free debt instruments, public sector participants could be provided with levels of capital access equivalent to that available to private sector entities in the market.

Historic vehicles for securitization

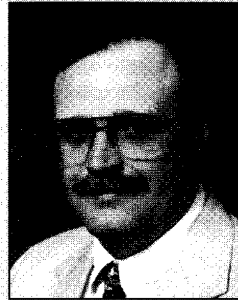
Securitization dedicated to infrastructure-related activities can be achieved though the establishment of a GSE, in the same fashion successfully applied to other domestic economic sectors when the need for private capital infusion was recognized.

The government initiated the practice of securitization in the mortgage loan arena through the formation of three GSE's, FNMA, FHLMC and the Government National Mortgage Association (GNMA). Approximately $1.3 trillion in mortgage-backed securities are currently outstanding through these GSE pooling programs. Through these programs some 83% of home mortgages now have some form of explicit or implicit federal support, and mortgage rates are approximately 1/4% to 1/2% lower than might otherwise be available.

The success of mortgage securitization has encouraged wider federal government use of the process. Currently, government securitization programs include multi-family home loans, school loans and farm loans. In addition, private financial institutions have also used these techniques to securitize many forms of consumer debt, such as auto loans, credit card debt and home equity loans.

A proposed mechanism for capitalization

To achieve the benefits of the suggested program, the government should charter a new Government Sponsored Enterprise with a mandate to develop and manage an Infrastructure Financing Securitization Program. This new entity might be called something like the Domestic Transportation Infrastructure Financing Association (DTIFA, or "Dottie Fae"), as the concept was informally known during 1992 discussions at the U.S. Department of Transportation. A DTIFA could be chartered and capitalized to establish sector-wide credit and documentation standards and formation of a secondary market for debt related to all transportation infrastructure related activities.



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