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State of the Market 35: The last-mile counterparty

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As the CRA debate heats up, the most interesting question may be the one not asked: *When all is said and done, who needs whom more?*

Right now, both government and financial institutions take it as self-evident that the capital consumers (sponsors and owners) need money more than banks or governments need the sponsors. Yet if they stepped back from their position-based negotiating, the two groups would realize that in point of fact, each needs the other. A sponsor is the device by which a government delivers affordable housing to its constituents and a bank fulfills its CRA obligations – the last-mile counterparty without which the whole network is thwarted.

Government is a factory that produces only two products

Though government exists to create beneficial outcomes – lower poverty, a stronger economy, a safe and secure nation – it cannot create these directly. Instead, government is a factory that manufactures only two fundamental products:

Laws. Variations of 'thou shalt not' – rules, regulations, boundaries, and approvals required.

Money. Variations of 'we will pay you if' – grants, subsidies, incentives, and credit enhancement (which enables leverage).

(Hot air and political vaporware, both of which the government produces in bulk, are merely accidental byproducts for which no productive use has yet been found.)

The system fails without careful localized delivery

Because government can create *only* these two products, it tends first and foremost to see every problem in terms of those tools as the only potential solution: *What can we mandate or prohibit, and what must we pay for?* Passing laws is cheaper than spending money, and forcing someone to provide a service you don't feel like paying for seems like a smart solution – until the supposed providers deliver badly, hide, or leave the business, and no one is left to do your bidding.

After a while, government reluctantly turns away from its first product (laws) and manufactures its second product (money), at which point it runs into the next problem – lack of effective implementers who can turn laws and subsidy into outcomes.

Money does not flow at scale without counterparties

Every financial transaction matches two parties, a capital provider (the one who writes the check) and a capital consumer (the one who spends the check). Neither

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can exist without the other. Further, as business, finance, and programs become more complicated, considerations arise of *scale* (the need to move large amounts of money in a wholesale fashion) versus *complexity* (the need to customize results for particular situations). These two forces are inherently in tension – scale precludes complexity, and complexity resists scale – and the management of those tensions dictates governmental and business forms.

Programs are designed up but implemented down. In a country as large and diverse as ours, national government is invariably remote; it operates on generalities, broad principles, rules of thumb and stereotypes. So we design a program 'up' – intending it for national application with consistent administration – and then implement it 'down' – as the interpretation of rules is devolved downward to bodies with smaller geographic focus.

The heart needs the capillaries. To bridge the scale-complexity divide requires networks joined together among compatible scaled entities. Think of the power generation and distribution system, from the plant through the transformers to the substations, local lines, and your own home's circuit box. Or your own body: the heart at the center, moving blood in an entirely wholesale fashion through huge arteries down into normal blood vessels and eventually into capillaries.

Large-scale delivery requires a networked last-mile counterparty. Just as the heart needs the capillaries, any large-scale financial or governmental system, and especially any government delivery system, is predicated on a reliable last-link counterparty – a distributed and coordinated network that connects seamlessly, point to point, with a higher-level network of intermediaries, and they in turn with a higher level, and so on back to the center.

Your milk may be produced at a massive thousand-cow farm in the Midwest and transported in tanker cars, but if it doesn't appear on your local shelves, it's not much good to you.

When there is no capital-consuming counterparty, a government program cannot find expression and the money goes to waste. (We painfully experienced this with the LIHTC Exchange program, which was delayed more than a year through the necessity to create effective Federal-state counterparties for its delivery.)

Today, although there is a huge need to reposition and stabilize foreclosed homes, there is no reliable business doing this at scale, because we lack foreclosure redevelopers. The complexity of each foreclosure's unique facts and circumstances defeats any wholesale aggregator, and there aren't enough people trained in asset resolution to handle the massive surge.

Similarly, we have a national problem financing 5-to-50-apartment multifamily properties, because they are too small for the Federal programs and too big for the neighborhood non-subsidized sponsors.

Repurposing foreclosed homes and financing 5-50 apartments, in other words, are not *resource* problems, they're *counterparty* problems.

Requirements of the last-mile counterparty. Programs are no good unless they *actually get to* the people for whom they are intended. For a geographically distributed ecosystem of small entities (like developers) to work as an effective last-mile counterparty to larger capital providers, these member nodes must meet several criteria:

Covering the whole geography. Parts of the body that lack blood vessels die, no matter how much blood there is elsewhere.

Similarity of nodes. Economies of scale require similar nodes; if they vary too much, larger-entity delivery becomes unreliable.

Expert across the whole system. As anyone knows who's ever strung serially connected Christmas lights, networks fail when they have dud nodes. For the capillary network to work, each outlet has to be sufficiently expert. Subsidies should pay for results, not procedures, but regulators tend to specify procedures as if they guarantee results. In the LIHTC, for instance, we have an unsatisfactory tension – a program with state-level administration (good!) but ludicrous national-level over-prescription in statute (bad!) which makes localized administration needlessly complicated.

Manageable intra-boundary friction. When there are intra-network boundaries (one peer node to another) the internal handoffs have to work smoothly and invisibly to the customer – such as the air traffic control system. Closer to home, Section 8 voucher portability clashes with place-based housing authority voucher contract administration, a problem as yet unsolved.

Nodes scaled to match the next level. Capillaries can't connect directly to the aorta. Localized nodes have to be small enough to handle customer specifics, yet big enough to make the next level's span of control manageable. When the scale differentials are huge, there will be *multiple* layers of networked intermediaries. In housing, we have the state housing finance agencies (state level), the public housing authorities (metropolitan or city level), and the CDCs (neighborhood level) – with spotty coverage in the lower-level networks.

Nodes self-repair or self-replace. If one node burns out, another must soon replace it, either consciously, through networked commitment, or unconsciously, through competition. In capitalism, red in tooth and claw, competition does this naturally (albeit not always satisfactorily); when housing affordability is involved, the market cannot be left entirely to its own devices. With properly structured subsidies, a new counterparty will always show up to take over from a failed one. However, proving the ability to consume subsidies is easy – providing the ability to provide the service is tougher.

Counterparties come in three types

Governmental program implementation is an endless search for reliable counterparties, choosing from among three basic types:

Public-entity counterparties – bodies created by state and local governments. Like seeking like, national governments confronted with a particularly gnarly policy challenge often give it first to state or local agencies (e.g. housing authorities). Unfortunately, these bodies have their own political imperatives, even the ability to reverse or nullify national government decisions; are seldom as entrepreneurial as the private sector; and are never as accountable as private counterparties.

Private purely for-profit counterparties – developers. Most government contracts are single-metric delivery (best value, cheapest cost), and their counterparties are for-profit. If the government wants new airplanes, computer systems, or highways, the best delivery is almost always a private contractor, because they are in business to deliver a product on time, on budget, and to specifications.

When the government is seeking quality affordable rental housing, the challenge is more complex, introducing not only the necessity for trading off between two distinct values (economics and affordability), but also across time domains (now and many years later).

Developing affordable housing is easy – just add enough sources, and stir! – but ribbon-cutting is not the principal measure of success. That requires a long-term partnership, which brings in the next ingredient.

Private mission-oriented counterparties. Some groups have an affordability mission embedded in their corporate DNA. Whether they are for-profit or non-profit, we call them Mission Entrepreneurial Entities and we wrote a whole book about them.[1] They're the growing species in this ecosystem, and, as I wrote in *State of the Market 34: What is an Industry?,* we think their emergence is a hallmark of an industry in formation.

Conclusion: capital providers need capital consumers

A hen, Samuel Butler wrote, is only an egg's device for making another egg. In the government world, private entities are the means whereby government turns its resources (laws, money) into outcomes. In the conventional world, banks need borrowers who turn capital into property and back into cash flows those borrowers use to repay loans. That's why loans are listed as bank assets, and deposits are bank liabilities – because a deposit does a bank no good unless it can be matched by a good loan to a good borrower.

A developer may be only a device for turning a bank's money into yield and CRA credits … but the bank has no other method for accomplishing the feat. Banks, government bodies, and other capital providers need smart organized developers, preferably Mission Entrepreneurial Entities, as capital consumers who deliver to them essential products and outcomes they are unable to synthesize for themselves.

The network of sponsors – assuming it becomes a network, a pack not a herd or a mob – is the true last-mile counterparty to banking and to government.

If banks and government understood this clearly, they would make the health of quality mission-oriented sponsor an essential priority, and shift their political negotiating posture to create a CRA-related ecosystem that increases aggregate capital flow and overall systemic efficiency.

[1] *Mission Entrepreneurial Entities, Essential Actors in Affordable Housing Delivery,* published 2010 by the Affordable Housing Institute, 256 pages, electronic copy available free at http://www.affordablehousinginstitute.org/AHI_MEE_report_order.php.