

Community Development INVESTMENT REVIEW

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Foreword

December 2005

By Janet Yellen
President and CEO, Federal Reserve Bank of San Francisco

It is my pleasure to introduce the *Community Development Investment Review*, a new journal dedicated to the emerging field of community development investing. Our goal with this publication, like that of our Center for Community Development Investments, is to seek new ways to increase the flow of capital to low- and moderate-income communities. The *Review*, to be published three times a year, will bring together experts to debate new approaches, share knowledge, and promote effective public policy.

You may know the Federal Reserve System's mission is to implement sound monetary policy that ensures both price stability and maximum employment. Some pockets of persistent unemployment and poverty, however, may be beyond the reach of macroeconomic levers. We have created the Center and this publication to explore new approaches that ensure all segments of the economy, including low-income areas, enjoy the benefits of our shared economic growth.

This issue will focus on the New Markets Tax Credit program, which was enacted in 2000 to increase the flow of capital to communities that had been left out of the tremendous economic growth of the nation's longest economic expansion. Now, five years later, we believe it is an appropriate time to see how the program is working.

We hope you enjoy this inaugural issue of the *Review*, and that you will share your ideas with us for advancing the community development investment field.



The New Markets Tax Credit Program: A Midcourse Assessment

Julia Sass Rubin and Gregory M. Stankiewicz

On December 21, 2000, only weeks before he left office, President Bill Clinton signed into law the bipartisan Community Renewal Tax Relief Act. The Act included two “New Markets” initiatives originally proposed by the administration.¹ These initiatives were designed to address the continued presence of “places left behind,” which the administration identified as urban, older suburban, and rural areas of distress. These were locations whose residents had not shared in the strong economic growth of the mid-1990s (US Department of Housing & Urban Development 1999). At the ceremony, Clinton evidenced genuine pride in the bill, stating that it represented “the most significant effort ever” to help distressed communities by leveraging private investment (cited in Pappas 2001, p. 323).

The administration had considered a range of solutions to the problem of helping such communities, from traditional Democratic anti-poverty programs to more business-oriented policies that were designed to increase economic growth in the affected regions. The administration ultimately identified the problem of distressed communities as being driven by a lack of private capital. It thus crafted a solution of forming new public-private partnerships, which would help overcome barriers to investments in potentially lucrative “new markets” existing in the United States (Rubin and Stankiewicz 2001, p. 137). The resulting New Markets initiatives were good examples of President Clinton’s personal preference for “Third Way” policies, ones that used market forces to better people’s lives, while eschewing both traditional Democratic and Republican policy approaches.

The New Markets Tax Credit (NMTTC) program, one of the two initiatives, was designed to combine public and private sector resources in order to bring \$15 billion in new investments to impoverished rural and urban communities over a span of seven years. Passage of the legislation generated high hopes that this federal program would help create new jobs and community renewal in some of the nation’s most disadvantaged communities (Walker 2002, p. 28).

Five years later, the New Markets Tax Credit program has awarded slightly more than half of the available tax credits in three competitive rounds, with the remaining tax credits scheduled to be distributed by 2007. Moreover, the New Markets Tax Credit Coalition, a group composed of over 100 community development organizations and investors, is working to convince Congress to reauthorize the program in order to provide additional funding for future years (New Markets Tax Credit Coalition 2005a).

¹ The two initiatives were the New Markets Tax Credit and the New Markets Venture Capital programs. For more information about the New Markets Venture Capital program see Rubin and Stankiewicz (2003).

With the New Markets Tax Credit program at the midpoint of its implementation, this seems to be an opportune time to evaluate the program's impact to date. While a comprehensive data analysis is still premature, we believe that this is the right moment for a different type of evaluation.² In 2003, we conducted extensive interviews with individuals who had helped craft the NMTC legislation, lobbied for its passage, and applied for or received allocations of credits in the first round. We also conducted our own analysis of the program's content and implementation. Based on this analysis, we raised a number of concerns regarding how effective the program might be going forward (Rubin and Stankiewicz 2003). In particular, we were concerned that the program was vulnerable to excessive compensation of private investors at the expense of a greater community economic development impact. Now, after two more rounds of allocations, this article re-examines the program's implementation to date and we believe that this concern remains valid (see also Armistead 2005).

How the New Markets Tax Credit Program Works

The New Markets Tax Credit program builds on what the Clinton administration regarded as successful recent innovations in the federal government's approach to community economic development and poverty alleviation. These innovations include a reliance on financial intermediaries and the use of tax credits.

Financial intermediaries are organizations that broker deals between private sources of capital and the nonprofit and for-profit developers of housing and other community needs. By doing so, they help reduce private sector risk, and therefore encourage more private sector financing in distressed communities. Such institutions have come to play an increasingly important role in housing and community development (Vidal 2002; Walker 2002).³

The New Markets Tax Credit program relies on intermediaries to an even greater extent than previous initiatives, such as the Community Development Block Grant and the Low Income Housing Tax Credit (LIHTC) programs, which leave decisions regarding specific allocations to individual states and municipalities. In contrast, the New Markets Tax Credits are designed to go directly from the federal government to newly-created intermediaries, called community development entities (CDEs). Moreover, unlike intermediaries used in these other federal programs, CDEs are required by the legislation to be private and for-profit, though their parent entities can be public or nonprofit.

The New Markets Tax Credit program also uses tax credits rather than direct government funding to spur neighborhood revitalization. Tax credits are more palatable politically and

² The federal Office of Management and Budget also found in 2005 that the data was not yet available for a meaningful evaluation. See Government Accountability Office (GAO) (2005), *Government Performance and Accountability: Tax Expenditures Represent a Substantial Federal Commitment and Need to Be Reexamined*, GAO-05-690. Washington, DC: GAO, September, p. 71. To the degree that an analysis of this type can be undertaken, the Community Development Financial Institutions (CDFI) Fund of the U.S. Treasury Department has been facilitating this process by collecting data on individual transactions. The Fund, which administers the NMTC program, will make this data available to a vendor that its staff will select in order to conduct a multi-year evaluation of the program. This vendor selection process is currently in its early stages, and no evaluation is likely to be forthcoming for at least a year.

³ The Enterprise Foundation and the Local Initiatives Support Corporation are examples of financial intermediaries operating nationally; other Community Development Financial Institutions serve in this role at the local and state levels.

easier to enact because they do not count as a direct budgetary expenditure. Instead, they are an opportunity cost to the federal government – revenues that would have been collected were it not for the tax credits (Burman 2003; Arnold 1990). The New Markets Tax Credits provide a 39 percent cumulative tax reduction to investors. The credits are designed to be used over seven years – allowing for a five percent reduction in taxes in each of the first three years, and a six percent reduction in each of the remaining four years (CDFI Fund 2005b). The credits are used as incentives to help attract private sector investors who, in exchange, provide the CDEs with capital that is used to finance projects designed to revitalize low-income communities.

The NMTC Selection Process

The U.S. Treasury Department's CDFI Fund certifies CDEs and determines which ones will receive tax credit allocations. To be certified, CDEs must be a for-profit entity that has a primary mission of community development. CDEs can demonstrate their commitment to such a mission in their organizational documents and by focusing at least 60 percent of their activities on low-income communities or people, either directly or through other entities. They also must be accountable to residents of the low-income communities they serve by having such residents represented on the CDEs' governing or advisory boards. As of September 1, 2005, the CDFI Fund had certified 1,953 organizations as CDEs. Of this total, 146 organizations had received one or more New Markets Tax Credit allocations (CDFI Fund 2005a; New Markets Tax Credit Coalition 2005b).

In addition to certifying CDEs, the CDFI Fund also allocates the tax credits. The Fund has conducted three rounds of NMTC allocations to date, awarding a total of \$8 billion in tax credits. The Fund currently is reviewing applications for a fourth round of allocations of \$3.5 billion, with the results due to be announced in 2006. The Fund will award a fifth round, consisting of an additional \$3.5 billion, in 2007. The selection process for these rounds has consisted of three reviewers independently reading and evaluating each application. The reviewers have included federal employees working on community development-related programs, along with individuals from the private sector who are knowledgeable about making investments of the kind allowed under the NMTC program.

CDEs apply for tax credits by submitting an application to the CDFI Fund that details their intended efforts in four areas: business strategy, capitalization strategy, management capacity, and community impact. Each of these four sections is rated on a scale of 0 to 25. Additionally, applicants can receive up to five extra points for having a track record of serving disadvantaged businesses or communities, and up to an additional five points for planning to invest substantially all the NMTC capital in unrelated entities.

The reviewers score the applications, tallying the four primary categories and the two extra categories, for a total of 110 points. The reviewers then recommend whether the applicants should receive an allocation and, if so, for how much. The scores of the three readers are added together and ranked. Fund staff review the applications with the highest scores to insure compliance in terms of program eligibility and regulatory matters. Those applications then are forwarded to the NMTC program manager for an allocation determination (CDFI Fund 2005b).

Recipients of NMTC allocations must sign an allocation agreement with the CDFI Fund, detailing the specific terms of their obligations. The allocation agreements utilize data from the applicants' proposed business plans to identify approved uses of the allocation and the geographic areas in which the funds must be invested. The agreements also incorporate those aspects of the business plan that likely increased the applicants' scores during the selection process (such as indicating that they will invest primarily in very distressed communities or in unrelated entities). The applicants are required to abide by the terms of the allocation agreement or risk losing any unused tax credits and being barred from participating in future rounds of NMTC allocations, or in any other programs managed by the CDFI Fund. All allocation recipients must invest at least 85 percent of their NMTC leveraged dollars in qualified low-income community investments.⁴

Program Objectives

Our analysis of the New Markets Tax Credit program is based on the assumption that the program's intent is one of poverty alleviation – to better the lives of residents of distressed communities – rather than general economic development. Many of the drafters of the New Markets Tax Credit legislation intended the program to focus on poverty alleviation, and hoped that the program would be designed in such a way as to maximize the developmental impact of the tax credits on low-income communities. However, the authorizing legislation did not explicitly state a focus on poverty alleviation.⁵ Congressional supporters of the NMTC legislation did indicate that “the program's goals are to direct new business capital to low-income communities, facilitate economic development in these communities, and encourage investment in high-risk areas” (GAO 2002, p. 1). Nevertheless, these goals are vague enough to leave open the question of whether the program is aimed at poverty alleviation or broader economic development.

The new Bush administration has been less interested in using community economic development as an avenue to address poverty alleviation, preferring instead to rely on faith-based organizations to take the lead on such issues while emphasizing overall economic growth objectives (Fletcher 2005). In 2004, the U.S. Treasury Department illustrated this shift in emphasis away from developmental goals by specifically identifying the New Markets Tax Credit program as an initiative useful for stimulating overall U.S. economic growth (quoted in Government Accountability Office 2005, p. 68).

While we feel it important to acknowledge this split over the goals of the New Markets Tax Credit program, we proceed under the assumption that the program's objectives are primarily anti-poverty. If that is to be the case, then New Markets Tax Credits should not be

⁴ Such investments include making loans or equity investments in a business that has at least 40 percent of its tangible property located in a low-income community; at least 40 percent of its employees' services performed in such communities; or at least 50 percent of its total gross income derived from a qualified business within a low-income community. Additional qualified investments include the purchase of qualified loans from another CDE; equity investments or loans made to another CDE; and financial counseling or other business assistance services to businesses located in, and to residents of, low-income communities (CDFI Fund 2005b).

⁵ Tax legislation does not generally include language regarding its purpose.

used to subsidize activities that have a limited community economic development impact. Furthermore, regardless of whether the goal is one of community economic development or of overall economic growth, we also assume that the NMTC program should not fund activities that would have occurred without the subsidy.

It is very difficult to determine if the program is in fact meeting these goals. First, the program is still new. Second, the individual deal data that the CDFI Fund is collecting are not yet available publicly. Third, even if such data were available, it is unlikely that the information would be sufficient to determine if specific deals would have occurred without a New Markets Tax Credit subsidy, or to allow for a true assessment of their community development impact. The former would require an ability to know what was inside the minds of the investors and the latter is always difficult at best to evaluate.⁶

In reviewing the available data and talking with participants, however, we stand by our original concern that the program likely is not meeting the objectives of maximizing the developmental impact of the NMTC dollars or of being utilized to subsidize only those deals that otherwise would not have been financially feasible. To understand why this is the case, it is important to review how the CDFI Fund implemented the NMTC selection process.

Implementation

The drafters of the original New Markets statutory language intentionally left the legislation vague, giving the CDFI Fund the critical role of interpreting the legislation and shaping the way the regulations would be designed to meet the program's objectives. The drafters selected the CDFI Fund for this purpose because of its focus on community development objectives and its experience in providing capital to, and monitoring the compliance of, organizations that invest in distressed communities. The drafters believed that it was more effective to give the Fund the responsibility of ensuring that NMTC allocation recipients were utilizing the money for appropriate community development purposes, rather than to write specific enforcement language into the legislation. Delegating these tasks to the CDFI Fund also provided for greater flexibility in program implementation.

However, the NMTC program's creators did not fully anticipate the very different political environment in which the program would be implemented. The Bush administration has been significantly less friendly than its predecessor towards community development in general and towards the CDFI Fund specifically. Under this administration's priorities, the CDFI Fund has received less than half of the budgetary resources it enjoyed during the last years of the Clinton administration. Moreover, President Bush's fiscal year 2006 budget proposal effectively would have eliminated the Fund by reducing its yearly budget from \$56 million to \$8 million, to be used solely for administering the NMTC program and the

⁶ For an excellent explanation of why an impact analysis of community economic development transactions is so challenging, see J. P. Caskey and R. Hollister, (2001), *Business Development Financial Institutions: Theory, Practice, and Impact*, Institute for Research on Poverty Discussion Paper no. 1240-01. Madison, Wisconsin: University of Wisconsin. Available at: <http://www.irp.wisc.edu/>

remaining portfolio of the Fund's other program awards (Congressional Budget Office 2005).⁷

Given a less supportive presidential administration, the CDFI Fund chose to minimize potential external criticism by limiting its own discretion in the selection process. This made a process like the one that the Fund uses for its other community development programs – e.g., first-round peer review, with subsequent site visits and additional due diligence by Fund staff – infeasible for the NMTC program.

The Fund's normal selection process had other limitations with regard to the New Markets Tax Credit. In an environment of dwindling budgetary resources, such an intensive approach was not cost effective for a program of this size. Moreover, the Fund did not have the staff necessary to conduct extensive due diligence. Finally, the Fund did not have experience dealing with many of the parent organizations that were applying for NMTC designation. These organizations were less concerned with, or knowledgeable about, community development issues and would have been more willing to use lawsuits to challenge unfavorable decisions.

As a result, the Fund implemented a selection process for the NMTC program that relies overwhelmingly on outside expert reviewers who evaluate the applicants utilizing a scoring system that the Fund created to facilitate the process. This scoring system has favored those applicants who are able to self-finance by relying on parent entities that can provide capital in exchange for the tax credits. It does so by allotting significant weight to those applicants who have the most solid capital commitments. A CDE's capitalization strategy section is worth 25 points, with the bulk of these points likely to be awarded to those applicants who have firm capital commitments in place, or a good plan for raising capital.⁸ Applicants with secure capital commitments also are more likely to receive larger allocations, as the allocation process factors in what percentage of an applicant's capital already is firmly committed.

Applicants capable of self-financing overwhelmingly are profit-driven organizations, such as commercial and investment banks.⁹ The NMTC legislation intentionally did not restrict participation in the program only to those organizations that had a community development mission because members of the Clinton administration believed that the amount of capital involved was too large to be managed exclusively by such entities. The administration also believed that opening the program to more traditional financial organizations would increase its impact and bring these financial sources into distressed communities on an ongoing basis.

⁷ Future funding for all CDFI programs except the NMTC, along with 17 other community development programs from throughout the federal government, would have been transferred to the Commerce Department, where these programs would have had to compete for a pool of capital that would have been 33 percent smaller than their 2005 allocations (CDFI Coalition 2005).

⁸ The CDFI Fund changed the NMTC scoring system for the third round of allocations to give greater weight to the business strategy and community impact sections. A CDE's capitalization strategy is still critical, however, as the score it receives on that section helps determine whether it will advance to the next stage of selection, during which the business strategy and community impact sections receive greater weighting.

⁹ Although a CDE must have a primary mission of community development, its parent entity does not need to have such a mission.

Profit-driven entities that do not have a community development mission, by definition, see the program as an opportunity to increase profits. As numerous studies comparing nonprofit and for-profit providers in other industries have documented, entities motivated primarily by profits make decisions based on that objective, often regardless of the social impact of those decisions (Devereaux, et al 2002; Cleveland and Hyatt 2002). In the case of the NMTC program, this means that profit-driven entities will try to increase profits by utilizing the credit to support investments that do not need the NMTC subsidy and by making investments with limited community development impacts.

Another concern is that the selection process allows CDEs to demonstrate their ability to raise capital via non-binding letters of intent from potential investors. These investors may withhold actual funding until they can review specific deals. Since investors also have the option of creating a CDE and applying directly for tax credits, they have an incentive to commit fully only to those deals likely to provide the highest financial returns, as opposed to those that would have the greatest community development impact. This may be forcing CDEs without a funding parent to offer potential investors more financially profitable deals than is prudent in order to attract their capital.

Our final concern about the NMTC program's impact on low-income communities and overall efficiency is due to the program's lack of restrictions with respect to "double-dipping." Double-dipping occurs when program funds are used in combination with other development incentives. The program's legislation does not allow the NMTC subsidy to be used with most other federal tax subsidies, such as the federal Low Income Housing Tax Credit (IRS 2004). However, applicants can combine New Markets Tax Credits with the Historic Tax Credit and all non-tax based federal economic development incentives, as well as with all state economic development incentives, in order to obtain an even larger total subsidy.

It can be argued that such double-dipping is necessary, given the relatively shallow amount of subsidy provided by the New Markets Tax Credits, and the fact that double-dipping is a regular part of most community development organizations' tool kits. However, if CDEs already are utilizing the NMTC program to maximize financial return on individual transactions, any further government subsidies will only enhance that return, generating little or no additional impact, whether developmental or broadly economic.

A good example of this concern is the case of Advantage Capital, which received an NMTC allocation of \$110 million in the first round and an additional \$50 million allocation in the third round. Advantage intends to use its NMTC allocations for investments in nine states. In four of those states, Advantage also has the potential to qualify for 100 percent state tax credits for those same investments, through a state economic development effort called the Certified Capital Company (CAPCO) program.¹⁰ Therefore, if Advantage invests \$1 million in a qualified business, it could receive state CAPCO tax credits equal to \$1 million

¹⁰ The Certified Capital Company (CAPCO) program makes equity and debt investments in specific states in exchange for a 100 percent state tax subsidy (Barkley, Markley, and Rubin 2001). Advantage currently has CAPCO funds established in 4 of the 9 states in which it anticipates focusing its NMTC activities. These states are New York, Florida, Missouri, and Texas (New Markets Tax Credit Coalition 2005b).

and federal New Markets Tax Credits equal to \$390,000. The significant state subsidy via the CAPCO program makes it difficult to argue that these transactions would have been financially unattractive without the additional benefit of the NMTC subsidies.

Other analysts have addressed these concerns about the NMTC program by arguing that the combination of the strenuous selection process, the detailed nature of the allocation agreement, and the data being collected by the CDFI Fund to evaluate the program make it very difficult to utilize the credit for deals where the extra subsidy is not truly necessary, or where the community development impact is likely to be very limited (see, for example, Armistead 2005). As we have pointed out, however, the current CDFI Fund selection process advantages CDEs with profit-driven parent entities.

In addition, while the allocation agreement is important, it is not a guarantee that the tax credits will be used primarily to benefit low-income communities or to subsidize deals that would not have occurred otherwise. It may be very difficult for the CDFI Fund to determine if an organization maximized the community development impact of a particular deal or utilized the credits only when necessary. That information often is available only to those making the investments. Furthermore, violating an allocation agreement triggers a default rather than a recapture penalty. Recapture penalties are severe, including negation of tax credits that investors already have utilized. The less stringent default penalties, by contrast, consist of termination or reallocation of any unused portions of tax credit allocations and prohibition from applying for future NMTC allocations or any other CDFI Fund programs (CDFI Fund 2004). Given that CDEs have up to three years following an allocation round to attract investors and begin making deals, it is possible for a CDE to time its investments so as to utilize its allocation fully, and make a substantial profit, before the Fund can take any action against it.

Revising the New Markets Tax Credit Program

Given the possibility that the NMTC program is not being optimized developmentally or economically, and given the challenges we outlined regarding monitoring and enforcement, we argue that the program would be more effective if it required all CDE parents to be mission driven. Such a change would limit the profit-maximization incentive, thus providing greater assurance that the credit is being used primarily for poverty alleviation and only when a subsidy is necessary. This change would not meaningfully limit investors' interest in the program because investors who are currently setting up their own CDEs would still have the option to invest in unrelated, mission-driven CDEs.

This change could have been made when the NMTC program was first being proposed, and the NMTC Coalition advocated for just such a modification. However, the Clinton administration was concerned that this change might limit the magnitude of the program, and denied the Coalition's request. The NMTC Coalition subsequently asked the Clinton administration to allocate priority points to those CDEs that were unrelated to their investors. In the rush to pass the legislation prior to the end of President Clinton's second term, and in the frenetic environment that the end of an administration inevitably brings, this request was not incorporated into the legislation.

The significant challenge with implementing our proposal now lies in convincing those profit-oriented investors who already have set up their own CDEs to support this change. Since the NMTC Coalition currently is working to have the NMTC program reauthorized beyond its initial \$15 billion funding, it would not be prudent politically to divide the reauthorization coalition by changing the program in this manner at this time.¹¹ It can, however, be a goal for the program to work towards.

Conclusion

Compared to other federal community development initiatives, such as the Low Income Housing Tax Credit, the New Markets Tax Credit is a relatively modest program. Nevertheless, it represents a significant new source of capital for community economic development, and thus is greatly valued by many of those working to improve low-income communities.

In identifying what we see as potential limitations of the program in its current form, we do not want to lose sight of its many benefits. As case studies of NMTC investments and interviews with practitioners consistently demonstrate, the program has attracted new investors, and many of the NMTC transactions are being used to better the economic standing of distressed communities (New Markets Tax Credit Coalition 2005c; Armistead 2005; Rapoza Associates 2004). The NMTC Coalition also has been working to address some of the program's shortcomings, such as those that have favored real estate transactions over business equity (see Armistead 2005; Rubin & Stankiewicz 2003). Finally, the CDFI Fund has been responsive and flexible in revising procedures to reflect new knowledge and prior experience, as demonstrated by the numerous changes they have made to the application process.¹²

Ultimately, when evaluating the NMTC initiative, we must remember the critical lesson learned from the Low Income Housing Tax Credit program. Like the NMTC, the housing tax credit initially was authorized for a limited period of time. Despite opposition, supporters of the program were able to make the LIHTC permanent, in large part due to the political support generated by for-profit real estate developers and landlords who benefited from the credits (Weir 1999, pp. 150-151). In the current political environment, it may well be that the greatest potential limitations of the NMTC – its ability to be used for deals that are not optimal in terms of developmental impact as well as for those that would have occurred without the NMTC subsidy – will broaden the coalition fighting for the program's reauthorization and turn out to be critical to its continued existence. As one long-term community economic development practitioner said to us when discussing the NMTC program, “we must not let the perfect be the enemy of the good.”

¹¹ The original New Markets Tax Credit Coalition was composed primarily of mission-driven organizations. The Coalition has subsequently grown to include more investors.

¹² In addition to the changes to the selection process discussed earlier, other examples of changes made by the Fund include adding questions to the fourth round application intended to gauge how much profit a CDE plans to build into its deals.

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Community Perspective: Is the NMTC Program Making a Difference in Low-Income Communities?

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The New Markets Tax Credit (NMTC) program, which aims to attract \$15 billion of new investment to low-income communities over seven years, is generally considered to be the most important federal economic development subsidy for depressed areas in thirty years.¹ The program is not without its critics, however, and criticisms seem to center around four themes:

- These funds might be flowing to projects that do not really need them, such as projects that would have been built or businesses that would have received financing even without the subsidy provided by the credit.
- The program, which is targeted to low-income communities, defines low-income communities too broadly and so fails to concentrate investment in the neediest areas while also putting rural areas at a disadvantage.
- The program's tilt toward real estate limits its effectiveness as a tool for revitalizing low-income communities.
- Tax credits are being allocated and investment capital is flowing disproportionately to profit-motivated corporations at the expense of mission-driven organizations which better understand the needs of communities.

This article addresses each of these criticisms, highlighting the ways in which the NMTC program has responded to them and how the program has evolved over the last four years.

What Do We Know about the Program's Effectiveness?

The U.S. Department of the Treasury's Community Development Financial Institutions (CDFI) Fund has awarded tax credits that will generate \$8 billion of investment to 170 Community Development Entities (CDEs) in three competitive rounds. More than two years after the first allocations were announced, there are finally some significant data that permit

¹ This statement was made to the author by a number of people interviewed for this and an earlier article, for example, by Robert Rapoza, President and Principal of Rapoza Associates and Manager of the New Markets Tax Credit Coalition, in an interview on October 14, 2004.

an initial analysis of what is actually happening as a result of the NMTC.² Because there is some lag time in reporting the transactions to the Fund, and because the great majority of the reported transactions were recent, the CDFI Fund has not yet had the opportunity to analyze them. It has therefore not yet been possible to use hard data about the characteristics of actual transactions to respond to the criticisms or to draw definitive conclusions about the program's effect on low-income communities.

Despite incomplete data, a significant amount of information about the program's effectiveness has been assembled in case studies, reports, and articles in the popular press. Case studies on a number of projects financed by the NMTC are described in *New Markets Tax Credits: Issues and Opportunities* published by the Pratt Center (Armistead 2005) and *New Markets Tax Credits: A Progress Report* published by the New Markets Tax Credit Coalition (New Markets Tax Credit Coalition 2005). CDEs such as the National Trust for Historic Preservation have released portfolio descriptions and reports. In addition, industry conferences sponsored by Novogradac and Company, the Reznick Group and others have proven to be a rich source of information about the implementation of the NMTC program. Finally, information available from the CDFI Fund, including an analysis of the way that the competitive process has changed over three application rounds, has allowed some insight into the program's implementation.

This article builds on the information outlined above. In addition, the author conducted 26 interviews with participants in the NMTC program, surveying a variety of community development practitioners—intermediaries, investors, lenders, consultants, government bureaucrats, advocates, lawyers, accountants and others.³ The interviews and case studies also provide important insights into how this program is working on the ground.

Are the Credits Being Used for Projects that Would Have Been Done Without It?

The NMTC is a shallow subsidy. According to former Treasury Department official Cliff Kellogg, it expands “the range of what’s ‘investable’ by providing slightly more return when investors are balancing the risk-return tradeoff.” Kellogg said that the program was designed to “overcome false perceptions of market risk. The NMTC should encourage investors to ‘take a second look’ when they might otherwise decline a viable deal.”⁴ The potential short-

² The CDFI Fund is the unit of the U.S. Department of the Treasury designated to administer the NMTC program, in conjunction with the Internal Revenue Service. A Community Development Entity (CDE) is an organization – a kind of community bank – that applies to the Fund for an allocation of tax credits. If awarded an allocation, tax credits flow to taxpayer entities such as banks that make equity investments in the CDE. To date, \$8 billion in NMTC have been awarded by the CDFI Fund (the Fund) to 170 Community Development Entities in three competitive rounds, with awards announced in March 2003, May 2004 and May 2005. See CDFI Fund website, <http://www.cdfifund.gov>. [Linda G. Davenport, Deputy Director for Policy and Programs, CDFI Fund, U.S. Department of the Treasury, Remarks at National Housing and Rehabilitation Association's Conference on New Markets Tax Credit Program, August 10, 2005.]

³ The author conducted most of the interviews for the publication cited above between October 2004 and March 2005 and some additional interviews for this article in August and September 2005.

⁴ Cliff Kellogg's Keynote Address to Novogradac & Company LLP's New Markets Tax Credit Conference, June 7, 2002, http://www.novoco.com/NMTC/Resources/kellogg_keynote.doc.

coming of this shallow subsidy strategy is that, in theory, instead of making “undoable” or “marginal” deals possible, the credits could be used to “sweeten” deals that were feasible without it. Although skeptics are right to point out that this could happen with the NMTC in theory, the critical question is whether this is happening in practice. In other words, are there signs that the subsidy really is sweetening deals rather than making undoable deals doable? And if so, are program administrators taking steps to limit this outcome?

A wide variety of community development practitioners claim that the NMTC program is successful in its mission of bringing capital to communities where it was in short supply (see Armistead 2005). Interviewees with this view included individuals with a broad view of the community development industry, including: Bart Harvey, CEO of the Enterprise Foundation; Michael Rubinger, CEO of the Local Initiatives Support Corporation (LISC); Evelyn Kenvin, Director of Community Investments, Citigroup; and Frederick Copeman, National Director of Tax Credit Investment and Advisory Services, Ernst and Young.

When asked to discuss whether they thought the credit was being directed to projects that couldn’t have been done in its absence, respondents overwhelmingly said they believed on the basis of their experience that it was. Mr. Copeman made the point that he was initially concerned about this issue, but had been pleased with the way it has worked out. He credited the CDFI Fund with doing a good job of allocating credit authority to CDEs that are financing what he called “but for” projects—ones that would not have been done without NMTC subsidy.⁵ Several interviewees focused on the fact that they only consider investments that are made financially feasible with the addition of NMTC. Many said they would not finance a project that could be done with conventional unsubsidized financing.⁶

In part, this pressure to ensure that the NMTC provides “but for” financing is the work of the CDFI Fund, which implements the tax credit allocation process. The Fund has modified the application process and is attempting to give greater weight to applications that target more highly distressed communities with more than the statutorily required minimum amounts of subsidy. The Fund is relying on competition to induce applicants to promise more, using the allocation agreement to require performance consistent with the application, and linking subsequent allocations to the achievement of required milestones.

The goal of deeper targeting of the tax credits is reflected in successive rounds of the allocation applications. Consider the following changes in the NMTC application:⁷

- In the third allocation round, the CDFI Fund introduced a new question (# 36) to focus more attention on the issue of where the subsidy provided by the tax credit is going, asking applicants “how will the economic benefits of the NMTC allocation be

⁵ Interview with Bart Harvey, October 26, 2004; interview with Michael Rubinger, October 25, 2004; interview with Evelyn Kenvin, August 9, 2004; e-mail correspondence with Frederick Copeman, March, 2005.

⁶ They included the following: LISC’s Robert Poznanski, President of the New Markets Support Corporation; James Walker, Managing Director of Enterprise Social Investment Corporation’s ESIC Realty Partners; and John Leith-Tetrault, Director of the Community Partners Program of the National Trust for Historic Preservation.

⁷ The NMTC application can be found on the CDFI Fund website: <http://www.cdfifund.gov/docs/NMTC/2005/2006NMTCApplication.pdf>.

apportioned amongst: the investors, through economic returns; the Qualified Low-Income Community Investment (QLICI) investees/borrowers, through lower costs of capital; and the applicant, through fees or economic returns?” In other words, who is getting the subsidy—investor, CDE, or community project?⁸

- In both rounds two and three, all allocatees indicated that at least 75 percent of Qualified Equity Investment (QEI) proceeds would be used to provide products with more favorable rates and terms than those available in the market. In round three, 88 percent of allocatees (36 of 41) indicated that 100 percent of their loans and investments would have flexible or nontraditional features.⁹ In the 2006 application, a new question (# 19) asks if the applicant will “commit that all of its QLICI-related debt financing will have interest rates that are at least 25 percent lower than the prevailing market rates for the particular product . . . or for every QLICI, meet at least three of the criteria for flexible or non-traditional features.”¹⁰
- In round two, 67 percent of allocatees (42 of the 63) indicated that they would invest at least 95 percent of NMTC proceeds into low-income communities, rather than the required 85 percent. In round three, 85 percent (35 of the 41) said they would invest 95 percent; and 22 percent (9 organizations) indicated they will invest 100 percent in low-income communities.

These increasingly higher thresholds and benchmarks give some indication of the Fund’s intention to use its administrative powers to maximize the extent to which the subsidy goes to the deal. Creating a competitive process that encourages applicants to “bid” these objectives in their application is a good first step. However, a strong compliance system is necessary in order to tie outcomes to bids. The Fund has created and begun implementation of a Community Investment Impact System (CIIS) with this capability.

CIIS is designed to allow the Fund to measure the impact of CDE investments on low-income communities using a variety of metrics to compare CDEs’ performance with their benchmarks in the allocation agreements, and to use the results to inform future allocation decisions. The Fund intends to use the data to further refine the fourth round competition (\$3.5 billion of allocations), but it remains to be seen whether they will be able to do this given recent budget and staff cuts.

Is the Targeting Too Broad and Does it Give Short Shrift to Rural Areas?

Targeting Economically Distressed Areas. To be eligible for NMTC, an investment must be located in a census tract that has at least 20 percent poverty or where the median family

⁸ 2005 NMTC Allocation Application, p. 20. <http://www.cdfifund.gov/docs/nmtc/2005/2005NMTCApplication.pdf>.

⁹ The Fund did not report the corresponding number for round two.

¹⁰ According to the application, flexible or nontraditional features include: “Equity Investments, Equity Equivalent terms and conditions, Debt with equity features (e.g., debt with royalties; debt with warrants; convertible debt), Subordinated debt, Below market interest rates, Lower than standard origination fees, Longer than standard period of interest-only loan payments, Higher than standard loan to value ratio, Longer than standard amortization period, More flexible borrower credit standards, Non-traditional forms of collateral, Lower than standard debt service coverage ratio, Loan loss reserve requirements that are less than standard.” (NMTC program 2006 Application, p. 10.)

income does not exceed 80 percent of statewide median family income or the metropolitan area median family income. Nearly 39 percent of the census tracts in the country are eligible for the NMTC program (GAO 2004, p. 4). This broad targeting, rather than a focus on geographies with higher distress indicators, has been a source of some criticism. In practice, however, this has been offset to a certain extent by factors in the competitive application process which allow applicants to score additional points for committing to make investments in areas of greater economic distress. It appears that incentives such as these in the competitive allocation process are having some effect. In round two, 70 percent of allocatees (44 out of 63) indicated that at least 70 percent of their investment dollars would be made in communities of higher economic distress. In round three, 90 percent (37 out of 41) made this statement. Nearly half (20) indicated that 100 percent of their activities will be provided in such areas. In addition, in the 2006 application, the Fund asks applicants to commit to providing at least 75 percent of their QLICIs in areas that meet an even higher standard of economic distress than in prior years.¹¹

Allocations to Rural Areas. On average, only about 17 percent of allocations in the first three rounds—about \$1.35 billion out of \$8 billion—have been to CDCs whose target communities are rural areas. This has been a disappointment to rural community development practitioners and their supporters. These groups have been frustrated that they have received fewer tax credits (17 percent) relative to their share of the population (21 percent). Concern over this disparity, particularly over the drop from a 20 percent allocation to rural areas in the first round to 15 percent in the second, led the New Markets Tax Credit Coalition and others to advocate for a legislative change, passed in October 2004, which expanded the definition of low-income community applicable to rural areas. Advocates for rural community development are seeking additional legislative changes as they campaign to reauthorize the NMTC program.

Is this a major flaw? It might be, but it is too early to draw conclusions. The concern that has been raised is about the allocation of credits to CDEs serving rural areas, but it may be the case that there are fewer NMTC-eligible investments in QALICBs in rural areas. This is an area where we need more information. For example, we do not yet know how the \$1.35 billion allocated to date for rural areas compares to the effective demand for QLICIs in those areas. There just may not be enough potential investments.

Another potential NMTC financing problem for rural projects is that they may be too small. As discussed in the next section, one characteristic of the NMTC program is that high transaction costs make it difficult for CDEs to make loans/investments in projects smaller than about \$3 million. If rural deals that seek tax credit financing turn out in general to be significantly smaller, it will be difficult to craft a solution for rural areas.

¹¹ NMTC program 2006 Application, Question 29, p. 17.

Does the Tilt toward Real Estate Limit the Program's Effectiveness as a Tool for Revitalizing Low-Income Communities?

The NMTC program favors real estate investments. CDFI Fund data report that the likely use of funds from the second and third rounds combined is \$3.1 billion (56 percent) for real estate projects and \$1.8 billion (33 percent) for businesses. The remaining 11 percent is for capitalization of other CDEs (Rapoza 2005). The percentage likely to be invested in real estate grew to 61 percent in the third round from 54 percent in round two. This outcome is driven in part by the program's penalties for investments that move out of qualified census tracts or cease to serve a public purpose. These penalties are known as "recapture" by the IRS. This outcome is particularly disappointing to the community development venture capital sector and to others working to facilitate investments in businesses in low-income areas.

Those who wanted to see NMTC investment in businesses and entrepreneurs were encouraged by the Clinton administration's New Markets Tours of 1999 and 2000. The President, along with business leaders, toured a number of high-profile poor communities and the language of the speeches and media coverage focused on making capital available to businesses in poor communities. That led supporters of business lending and investing to have high hopes that the NMTC would be a tool for them. The New Markets Initiatives advocated by the President also included other features which might have been more effective in facilitating business lending and investing, such as the American Private Investment Companies. Those features were not included when the New Markets Tax Credit was passed in December 2000.

Despite some disappointments, it is hard to draw the conclusion that the NMTC program has not turned out to be what its designers intended. The program appears to work well for real estate projects, generating an important economic boost in targeted communities. At the same time, however, the NMTC Coalition is currently working with its community development venture capital and business lending members to decide what legislative changes to pursue that would promote business investment. No decisions have yet been made on a lobbying strategy, according to Alison Feighan, vice president and partner at Rapoza Associates.¹²

Are Tax Credits Being Allocated Disproportionately to For-Profit CDEs at the Expense of Mission-Driven Organizations?

Kevin Kelly, Grants Management Director for the National Congress for Community Economic Development, Robert Brandwein, president of Policy and Management Associates, Inc., a community economic development consulting firm, and many others have asked if mission-driven organizations are getting their fair share of funds under the NMTC program.¹³ To fairly evaluate this concern, we need to distinguish between the distribution

¹² Interview with Alison Feighan, Vice President and Partner, Rapoza Associates, August 29, 2005. Rapoza Associates is the manager of the New Markets Tax Credit Coalition.

¹³ Interview with Kevin Kelly, Grants Manager Director, National Congress for Community Economic Development, August 30, 2005. Interview with Robert Brandwein, Policy and Management Associates, August 30, 2005.

of allocations among different types of CDEs, and the distribution of investments by CDEs among different types of QALICBs. We also need to understand the standard against which the share going to community-based development organizations is measured.

CDEs can be classified into three groups:

- *for-profit* – those with profit-driven parents, like banks and investment banks;
- *mission-driven* – those with mission-driven parents like nonprofit CDCs and intermediaries, CDFIs and related organizations; and
- *public* – those with governmental parents such as housing finance agencies or public economic development agencies.

Over the course of three rounds, about 47 percent of the funds have gone to for-profit CDEs, about 41 percent to mission-driven CDEs, and about 12 percent to public CDEs. The share to for-profit CDEs has been as low as 44 percent in the first round and as high as 51 percent in the second round. The share to nonprofit CDEs has been as low as 36 percent in the second round and as high as 44 percent in the third round. The share to public CDEs has ranged from eight percent to 16 percent.

Does the disparity between the shares going to for-profit CDEs (47 percent) and mission-driven CDEs (41 percent) matter? Does it presage a negative outcome for low-income communities? It is not immediately apparent that there is a problem here. First, it is important to note that the disparity is small. Second, the important question for advocates of community-based development is not who gets the allocation, but whether or not their constituents' projects receive capital investment. We do not know how much of a correlation, if any, there is between the for-profit/mission-driven nature of the CDE and the for-profit/nonprofit ownership of the project receiving the investment. Examples of various different combinations abound—for-profit CDEs investing in nonprofit QALICBs, nonprofit CDEs investing in for-profit QALICBs, etc. Third, there also may not be a problem in the long run because some nonprofit developers such as CDCs seem to have taken steps to partner with a for-profit CDE at the time that the CDE applies for an allocation, providing the CDE with more community support in the application process and reserving a place in the pipeline for the CDC.

If it turns out that projects of nonprofit CDCs are having difficulty in getting NMTC financing, it may be a problem of size. Staff at a number of CDEs suggested that because of high transaction costs, the minimum loan or investment they could reasonably make is in the range of \$3 million to \$5 million. This would exclude many CDC deals.

Community development practitioners are working to find ways around this small-investment problem. James Walker, managing director of ESIC Realty Partners' (ERP's) CDE, notes that ERP is supplying the Enterprise Foundation's lending arm with financing subsidized by the NMTC, which they are lending in amounts as small as \$100,000. Robert Poznanski, President of LISC's New Markets Support Corporation, says that LISC is also working on the problem of originating smaller loans subsidized by the NMTC and expects to be rolling out a program soon. According to Mary Tingerthal, Chief Credit Officer of the Community Reinvestment Fund, her organization is approaching this problem by creating a secondary market for community development loans, including business loans, averaging about \$300,000.

Strategies like the ones mentioned above are important because the nature of the NMTC program seems to be driving a trend toward larger allocations from the CDFI Fund. The median allocation has steadily increased from \$21 million to \$47 million to \$50 million over the last three rounds. The smallest allocation increased from \$500,000 to \$5 million. Allocatees, applicants and the Fund have learned that operating a CDE is a complex, expensive operation with high transaction costs, and the inefficiency of operating with a very small allocation has become apparent. Although it may be overstated, one interviewee said it does not make sense to try to operate a CDE unless you expected to obtain and use an allocation of \$100 million a year.

Conclusion

The NMTC, passed into law nearly five years ago, has shown significant promise in achieving its objective of attracting at least \$15 billion of new capital into targeted communities where investment capital has been scarce. It appears that the subsidy is being used to make marginal projects doable, putting them over the top in terms of their ability to obtain financing. Although a broad definition is used to designate eligible low-income communities, competitive pressures for allocations appear to be working to target the funds more narrowly to areas of greater economic distress. Program structure, particularly with regard to recapture provisions, is causing a significant tilt towards real estate projects, which has been disappointing to proponents of increased business investment, but which is nonetheless consistent with the objectives of the program's design. Finally, the distribution of allocations among for-profit, mission-driven and public CDEs does not appear to be causing undesirable outcomes with respect to the availability of capital to different types of low-income community businesses. It does appear that the difficulty of using the NMTC to make small loans and investments will be an enduring one.

In light of these positive results to date, supporters of community economic development are in a strong position to advocate for a reauthorization of the NMTC, which is proving to be a powerful and effective tool for the economic development of distressed communities.

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The Political History of and Prospects for Reauthorizing New Markets

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Introduction

The federal New Markets Tax Credit is generating \$15 billion in private investment for struggling communities through 2007. It was the centerpiece of a broader community development bill in 2000 that Republican Congressman (now Senator) Jim Talent (R-MO) called “the most important anti-poverty program in decades,” representing “a true bipartisan consensus” (*Congressional Record*, p. H6821).

Achieving bipartisan support was no mean feat in these highly partisan times. But New Markets’ appeal is actually more than bipartisan; it has managed to span the ideological and policy differences within both parties. Within the Republican Party, New Markets appealed to both “opportunity society” and business-oriented members, and to both rural and urban representatives. Among Democrats, both traditional liberals and more centrist “New Democrats” supported New Markets. Its popularity across the political spectrum bodes well for the future of the program.

Authority for New Markets, however, will expire after the funding competition that is expected to open in the summer of 2006 and end with awards in winter or spring of 2007. That means Congress will have to extend authority for New Markets in 2006 to avoid interrupting the program. Many issues, including possibly far-reaching income tax reform, are potential political killers for the still young New Markets. This article explores the politics surrounding New Markets: how this federal anti-poverty program could appeal so broadly, who supported it and why, and prospects for legislative renewal.

The New Markets Idea

To get a better sense of where this tax incentive is going, it might help to look at where it came from. The origins of the New Market Tax Credit are in the 1990s, when the extraordinary success of the Low Income Housing Tax Credit prompted policy makers and advocates to consider how that model could be applied to other community development activities.

The political environment became receptive to the New Markets concepts in the late 1990s. Because of the historic economic prosperity, leaders from across the political spectrum wanted to bring the power of capitalism to bear on the pockets of poverty that were left behind during the decade’s unprecedented economic growth. For example, Reverend Jesse Jackson was working on his Wall Street Project, an effort to open access to capital and corporate governance

to minorities and low-income people. Meanwhile, conservative “opportunity society” leaders like former HUD Secretary Jack Kemp – the 1996 Republican Vice-Presidential candidate – and Republican Congressmen J.C. Watts and Jim Talent wanted to broaden the conservative movement by applying its principles to inner cities and rural areas. These two strands were mindful, and sometimes even supportive, of each other. Kemp, for instance, was fond of quoting Jackson to the effect that “capitalism without capital is just another ‘ism.’”

Kemp and Jackson were making not just an economic argument, but also a moral one. For the United States to accept communities of chronic poverty and economic isolation at the moment of its greatest prosperity seemed to mock the American promise of universal opportunity. Kemp was especially sensitive to how the international community, and especially budding democracies in the former Soviet Union and elsewhere, saw the United States. American capitalism would have to prove it could work for all Americans to become more acceptable in the often frightening new era of globalization.

Further knitting together diverse ideological strands, you had Jackson, the liberal, teaming up with President Bill Clinton, the centrist. Clinton embarked on several trips to poor urban and rural areas in 1999 and 2000 to promote the idea that the federal government could stimulate investment in areas that had been left out of the economic boom. In a 1999 interview, Jackson asked Clinton why he thought the idea was so popular with liberals and conservatives. Clinton answered, “It’s not charity. It’s a hand up and not a hand out.” The plan openly embraced capitalism: “We’re not asking anybody to do anything that isn’t a good business decision” (Jackson interview 1999).

In a second dynamic, targeting these pockets seemed to be a viable way to keep the already hot economy growing without sparking inflation and higher interest rates. The rationale here was that tapping underutilized productive capacity in inner cities and economically distressed rural areas would simultaneously bring new workers into the labor market and expand domestic consumer demand. “I would argue the only way to keep the growth going without inflation is to find both new businesses and new employees and new customers at the same time,” Clinton said (Clinton 2000).

This idea was reinforced by the research of the highly regarded Harvard Business School Professor Michael Porter. He argued that well-conceived businesses could thrive in economically isolated areas if they utilized the proximity to business customers, workforce, and consumers that traditional business analysts overlooked, a phenomenon Porter called the “competitive advantage of the inner city” (Cowan 1994). A 1999 HUD report picked up the theme with respect to retailing: “the higher population density in most inner-cities more than balances out the higher income in the spread-out suburban areas.” The report also concluded that low-income consumers spent \$331 billion outside their neighborhoods in 1998 because there were too few shopping options locally (HUD 1999, p. vi).

Of course, underdeveloped pockets of poverty were not simply an inner city problem. New Markets would also target rural areas that lagged in growth. For example, L. Ray Moncrief, an executive with the nonprofit Kentucky Highlands Investment Corporation, said he needed the New Markets initiative because “Wall Street venture capital is not coming to central Kentucky” (Babington 1999b, p. A2).

As diverse perspectives converged on the need and opportunity for a government intervention, a consensus also emerged about how to structure the policy. Any new economic development strategy would involve the private sector and local government. To make these partnerships work, conservatives and liberals had embraced the importance of community accountability, decentralized decision-making, and tax incentives. Conservatives and liberals could see tax incentives and public-private partnerships as anti-bureaucratic and market-driven approaches that gave more power to local communities and investors.

A revitalization approach rooted in public-private partnerships might not have been so feasible a decade or so ago, according to a Brookings Institution report on nonprofit community development corporations (CDCs) prepared by Carol Steinbach. “But today, the presence of a strong and capable network of thousands of community development corporations in low and moderate income areas—and allied intermediary organizations that support them—helps ensure the [low income housing] tax credits will be used well and attract maximum leverage” (Steinbach 1998, p. 23). The growth of CDCs had been phenomenal. By the mid-1970s, there were only about 200 CDCs operating nationwide (National Congress for Community Economic Development 1989, p. 3). By 1997, an estimated 3,600 CDCs had completed affordable housing projects (National Congress for Community Economic Development 1999, p. 3).

Economic development policies for poor communities had been tried before, and only achieved mixed results. But several specific policy precedents seemed to make the case that a New Markets initiative would have more success.

First, there was the long-standing success of the Overseas Private Investment Corporation (OPIC), a federal agency that “helps U.S. businesses invest overseas, fosters economic development in new and emerging markets, complements the private sector in managing the risks associated with foreign direct investment, and supports U.S. foreign policy.” OPIC facilitated \$164 billion worth of investments through its insurance and loan programs and created more than 732,000 host-country jobs (OPIC Website). Gene Sperling, an economic advisor to Clinton and architect of New Markets said, “Our thought was, ‘why not do an economic mission to the United States?’” The idea behind New Markets was “to challenge corporate business America [and] community leaders to look in these places for new potential, for new profits, for new opportunity” (Babington 1999a, p. A2).

Second, the same basic tax credit approach that New Markets would use had worked stunningly well over the previous decade for producing low-income rental housing – another ambitious objective where federal policies generally had a bad reputation. When this Low Income Housing Tax Credit was enacted as a little publicized section of the Tax Reform Act of 1986, it seemed strangely out of sync with the broader tax reform trend to cut targeted incentives out of the tax code. It also defied conventional housing policy. Many in the industry scoffed at the idea that a tax credit could attract corporate investors on a large scale, especially since they could only claim and keep the tax credits if the housing were built on time, on budget, and successfully operated without traditional federal rent or mortgage guarantees. Yet the Housing Credit outperformed the hopes of even its most optimistic boosters,

virtually without failure, and the investment market responded by accepting lower and lower rates of return, year after unprecedented year. New Markets would later adopt many of the Housing Credit's signature features – limited bureaucratic interference, decentralized decision-making, private investment, market discipline, a competitive selection process to address clear public policy priorities, and pay for performance.

Third, the Housing Credit showed that it could create new opportunities in some of America's most isolated and persistently poor communities. These tangible and sustained improvements built the confidence of and attracted other businesses to areas that had only known disinvestment for years. An important legacy from this work was more than just the buildings it built; it was the highly sophisticated system of private investors, nonprofit and profit-motivated developers, and state and local governments, who had the experience and relationships that would be essential to a successful economic development effort. In other words, a new network of community developers, those who built housing in this case, demonstrated that they could rebuild some of the nation's most derelict areas, such as the Bronx in New York, or the South of Market district in San Francisco.

Finally, the Community Development Corporation (CDC) Tax Credit, a pilot demonstration enacted in 1993, also set an important precedent for using tax credits for economic development. The CDC Tax Credit showed real promise, generating nearly \$20 million in private financing for 20 nonprofit CDCs selected by HUD through a competitive process. The CDCs used the funds for financing small businesses and commercial real estate, in addition to working capital. Most of the investment induced by the tax credits came from banks, which were motivated in part by receiving Community Reinvestment Act credit (Steinbach 1998, p. 3). Local Initiatives Support Corporation, a national nonprofit community development leader that had helped to create the Low Income Housing Tax Credit and mobilize corporate investors, helped guide the CDC Tax Credit, too. Steinbach's Brookings Institution report drew many comparisons between the demonstration CDC Tax Credit and the well established Housing Credit, which "spawned the development of a healthy professional infrastructure of private and nonprofit developers, attorney[s], accountants, appraisers and marketers." The CDC Tax Credit did not have the chance to develop a similar network because it was "small and a pilot," but "it presumably could do so if expanded. It might even capitalize on the infrastructure already created to support the housing tax credit," according to Steinbach (Steinbach 1998, p. 19).

The Idea Becomes Law

The Washington policy machine generates literally hundreds of proposals for new federal programs annually, but Congress enacts only a small fraction of them. A major reason New Markets defied the odds was that low-income community economic development had caught the attention of the two most influential political leaders of the time: President Clinton and the Republican Speaker of the House, Dennis Hastert (R-IL).

Clinton used his 1999 State of the Union speech to elevate the issue to national stature. "I ask Congress to give businesses the same incentives to invest in America's new markets

that they now have to invest in foreign markets,” Clinton said, referring to OPIC. “This is not a Democratic or a Republican issue. It is an American issue.” The Speaker was sitting directly behind the President, and Clinton turned to shake Hastert’s hand, in recognition of Republican efforts and a tacit offer to work together.

The President further promoted the issue on a high-profile series of visits to poor urban and rural communities across the country, revisiting some of the same places Robert Kennedy had gone to promote the War on Poverty more than three decades before. Clinton’s last trip ended in Chicago, where Speaker Hastert joined him and both men pledged to enact economic development legislation within a year.

There may have been a lot of good will, but there were still many compromises in Congress before legislation could be passed. The initial Clinton package proposed three components: New Markets Tax Credits to generate equity investments; a Small Business Administration guarantee and grant program to foster venture capital investments in very small firms; and a long-term debt financing mechanism for the American Private Investment Companies (or APIC, an echo of OPIC). House Republicans initially proposed tax incentives for private investment in designated Renewal Communities, a version of enterprise zones, as well as faith-based drug and alcohol rehabilitation programs. The final legislative package included some elements from each side, and added other popular provisions too, such as the expansion of Low Income Housing Tax Credits and private activity bonds for housing and other purposes.

In the ensuing Congressional debates, what became apparent was that this formula did more than unite a Democratic President with a Republican House Speaker; it synthesized various schools of thought within the two parties. While Congress is often seen as hopelessly divided on partisan and ideological grounds, it is remarkable that Republicans and Democrats struck so many of the same chords on New Markets and Community Renewal.

Jim Talent (R-MO), then a leading House Republican sponsor and now a Senator, explained that “this bill is designed to increase the tools, the prestige, the visibility of redevelopment groups, of neighborhood intermediaries who are rebuilding the infrastructure of life in poor urban and rural communities around America. We know the Federal Government cannot get people out of poverty by itself,” Talent said. “We also know that individuals cannot just pull themselves up by the bootstraps.” Talent was explicit that this approach “set aside ideological baggage” (*Congressional Record*, pp. H6821-H6822).

Clinton had been stressing similar themes on his poverty tour. Clinton explained the idea behind this so-called “Third Way” strategy: “What we’re doing basically is using the government to facilitate a public-private partnership at the grass-roots level. It’s not government alone, it’s not private sector alone, but it’s a partnership, and I think it will genuinely change the landscape” (Seib 1999, p. A24).

Another leading sponsor was J.C. Watts (R-OK), chairman of the House Republican Conference. Watts said ignoring “struggling neighborhoods where vacant properties become home to crack users who destroy the sense of safety and security” was a “great moral peril.” Congress needed to act because “there are the neighborhoods where venture capital does not venture.” Watts also believed that the overall legislation represented creative problem

solving, the best ideas to confront the real and continuing problems of poverty. “This legislation establishes a model that merges new ideas about venture capital, regulatory reform, drug and alcohol rehabilitation, housing and home ownership, environmental clean-up, commercial revitalization and tax incentives” (*Congressional Record*, p. H6824).

Many struggling rural areas also stood to benefit. Representative Robin Hayes (R-NC) from rural North Carolina made this clear when he said, “Washington is finally waking up to the fact that success on Wall Street does not automatically translate into success on Main Street” (*Congressional Record*, p. H6828).

Other Republicans cited additional attributes. Representative Joe Pitts (R-PA), for example, praised local control. “The genius of this legislation is that it replaces faceless bureaucracies with the power of neighborly compassion,” he said. “This bill says to leaders in distressed communities, ‘You go on and do what you do best. We know you’ll do a better job than we can’” (*Congressional Record*, p. H6826).

A senior Republican on the tax-writing Ways and Means Committee, Phil Crane (R-IL) asserted: “This bill applies Republican principles of economic growth and opportunity to those communities that have not fully participated in the strong economic growth experienced by much of our nation in the last several years” (*Congressional Record*, p. H6839).

Democrats were also supportive for diverse reasons. Charles Rangel (D-NY), the senior Democrat on the Ways and Means Committee, made the bedrock case for adding jobs and income. With this approach, “people that now have such limited incomes will have more income to buy the things so America can continue manufacturing,” he said (*Congressional Record*, p. H6822). Rangel compared this program to the recent efforts to boost demand for American goods through expanded trade. “We hear a lot of talk when trade bills come to the House floor about how important it is going to be for us to expand our markets, how important exports are going to be, how important it is to get people to increase demand,” he said. But why not do this at home? “So if we are concerned about creating markets, why can we not go to the poor communities that we have to start talking about the same full employment that we have on the national average to make certain that every block, every road, every village, every community knows what the concept of full employment can be” (*Congressional Record*, p. H6822).

Danny Davis (D-IL), former chair of the Black Caucus, drew connections among faith, hope, and economic development: “I remember the passage of scripture in the Bible that says, ‘And they rebuilt the walls because the people had a mind to work.’ This legislation would not only work for renewal communities, but it would work for all of America; and I urge that we vote its passage.” Not only because it would renew communities, Davis stressed, but because it would renew “people’s minds” (*Congressional Record*, p. H6826).

Outside groups also put their weight behind the bill. Articulate community development advocates such as the Community Development Tax Credit Coalition (now the New Markets Tax Credit Coalition), a group that represented more than 4,000 CDCs and Community Development Financial Institutions, lobbied in favor of New Markets. Ronald Phillips, President of Coastal Enterprises, Inc. of Maine, spoke for this coalition: “The New Markets Tax

Credit will build off of the proven success of the Low Income Housing Tax Credit and the CDC Tax Credit to leverage private investment funds for underserved communities. The network of community development entities already exists. This new tool would enable [them] to expand significantly their ability to attract private capital for economic development activities in these communities” (U.S. House Ways and Means Committee 2000).

Adding more Housing Credits and tax-exempt bonds to the bill helped attract state and local government support, through the U.S. Conference of Mayors and the National Council of State Housing Agencies. And the private sector weighed in too, with the National Association of Home Builders and National Association of Affordable Housing Lenders voicing support.

As popular as this bill was, some aspects raised important doubts. Representative Maxine Waters (D-CA) was among those who objected to the inclusion of faith-based groups as eligible to receive government grants for drug and alcohol rehabilitation. “I have serious concerns regarding the use of Federal dollars for the funding of religious-based institutions which may use the funds in a discriminatory manner.” She added, “this is discrimination creep” (*Congressional Record*, p. H6827). And the late Senator Paul Wellstone (D-MN) criticized the bill as insufficient to fight poverty: “We have to be careful that we’re not doing symbolic politics, or photo-op politics” (Babington 1999a, p. A2).

With apparently overwhelming momentum, the New Markets legislation sailed through the House with broad bipartisan support, 394 to 27, and a comfortable majority in the Senate. But then, as the 2000 elections approached, New Markets was caught up in the larger, more partisan battle over the federal budget, and progress ground to a halt. When George W. Bush defeated Clinton’s Vice President Al Gore for President and Republicans seized firm control of the Senate, many observers expected the Republicans to push pending budget decisions into the new administration and Congress in 2001. But Congress reconvened after the election for an unusual lame-duck session and hammered out a budget deal with the outgoing Clinton administration. The Community Renewal/New Markets package that established the New Markets Tax Credit was one of the last pieces of the last bill to fall into place, just in time for Christmas.

Implementing The Law: The Bush Administration Takes Charge

Of course, enacting legislation is just the first step in establishing any new policy. Implementing New Markets would be the responsibility not of the Clinton administration that had championed it, but of an incoming Bush administration with no affiliation with it. Moreover, three separate agencies within the Treasury Department would have to coordinate to launch New Markets – no small challenge even for an enthusiastic Department. The CDFI Fund would be the direct program administrator, but both the Office of Tax Policy and the IRS Chief Counsel’s office would have to write and administer the tax rules. Would the Bush administration extend itself to make this all happen?

One early factor was Congressional support. At his 2001 confirmation hearing in the Senate Finance Committee, Treasury Secretary-nominee Paul O’Neill faced an inquiry from

Senator Jay Rockefeller (D-WV), New Markets' leading Senate supporter: "I want to know that you will make this program, already law, Mr. O'Neill, a priority during your administration." O'Neill responded that he would implement New Markets "without fail" (Senate Finance Committee Hearing 2001).

Some New Markets advocates worried when President Bush proposed cutting the funding for other programs that the CDFI Fund administered. But the administration seemed to regard New Markets more positively. The first CDFI Fund director to oversee New Markets, Tony Brown, often framed the program as an extension of the Bush administration's goals. In a 2002 report to Congress, Brown touted the work of the CDFI Fund for launching the NMTC program within one year of the original legislation passing (Brown March 14, 2002).

In those first critical years, it was still unclear how the program would fare. After all, there could be no guarantee that New Markets would work. And the economic boom of the 1990s, which had spawned such urgent optimism for spreading the wealth to low-income communities, had given way to a recession by 2001. If investment was slowing in middle-class areas, could New Markets attract capital to historically disinvested areas? Brown, in a 2002 address to the Community Development Venture Capital Alliance, was understandably cautious: "If the program is embraced by investors, it will be a significant source of new, patient capital that will help to stimulate new industries and entrepreneurs, to diversify the local economy, and to generate new jobs in low-income communities." He went on to say that "President Bush has made the nation's economic recovery a top priority." And "while the stimulus package is debated in Congress, we have a head-start and a new tool in the community development finance field" (Brown March 5, 2002).

The administration delivered on its New Markets promise. All three Treasury offices worked diligently so that both tax rules and administrative procedures meshed, while balancing sometimes awkward statutory wording with the practical needs of investors and communities. Treasury made a serious effort to learn how community development actually worked on the ground, what assurances nervous pioneer investors would need to move forward, and how to fulfill its stewardship responsibilities to Congress without stifling creativity. The process was not without glitches, and sometimes proposed regulations needed to be revised. But the consultative process was mutually respectful and essential issues were resolved reasonably. The Treasury Department does not run many programs – indeed, it lacked many program administration systems when the CDFI Fund was established in 1994 – but it implemented New Markets effectively.

Brown continued to promote the program on behalf of the Bush administration. "Why does this administration continue to focus on community development issues?" he asked early in the 2004 election year. "The answer is easy. The President and members of Congress are serious about promoting economic prosperity and stability for all Americans and in all communities, and they understand that gaps in financial service and credit availability must be addressed. The Treasury Department recognizes the unique role of community development finance and we support it" (Brown February 5, 2004).

More skeptical observers might have noted that New Markets was politically convenient during a so-called jobless recovery and amid widespread concern about the "outsourcing of

jobs” in the evolving global economy. Bush’s support demonstrated that his administration was doing something about employment. It was common to hear representatives of the Bush administration praise New Markets as a job creation program.

But if this was political rhetoric, it continued well after the President’s re-election last year. “One of the president’s top priorities is to have a growing economy that creates lots of good jobs,” said Treasury Secretary John Snow in March 2005. “The desire to encourage business investment and job creation in areas of need is the idea behind the NMTC program” (Snow 2005). And the President himself praised New Markets in a speech to a group of African-American entrepreneurs in July 2005: “I believe the federal government can play a positive role in helping African Americans achieve the goal of owning their own business.” To that end, Bush said the federal government “provided \$8 billion in new markets tax credits to boost investment and community development in low-income areas” (Bush 2005).

Will Congress Renew New Markets?

Although Congress authorized New Markets through 2007, the deadline for proposals for that final year’s credits is expected in September 2006. That means Congress would probably have to extend authority for New Markets by the end of 2006 or early 2007 in order to continue the pattern of annual competitions without interruption.

New Markets would appear to be well positioned for reauthorization. It appeals to a broad ideological range. The Bush administration has implemented New Markets responsibly and effectively. Most important, the program is successfully drawing private capital into low-income communities, although some practitioners would like to see it attract a wider range of business financing to a wider range of communities. In practical political terms, as more communities benefit, more members of Congress are likely to take notice. Consider the following press releases from members of Congress after the CDFI Fund announced a round of New Markets allocations in May 2004:

- Senator Talent [R-MO] Announces \$52 Million Tax Credit Authority for Urban Renewal in St. Louis;
- Representative John Conyers [D-MO] Announces \$27 Million for Wayne County In New Market Tax Credit Funds;
- Senator Norm Coleman [R-MN] Announces \$185 million for Minnesota in New Markets Tax Credit Allocation;
- Representative Elijah Cummings [D-MD], a strong supporter of economic growth in Maryland, announced that four Maryland businesses will receive a total of \$345 million in federal tax credit allocations through the New Markets Tax Credit Program.¹

¹ <http://www.talent.senate.gov/News/singleNews.cfm?NewsID=713> (last visited September 16, 2005); http://www.house.gov/apps/list/press/mi14_conyers/108_5_05_04_TC.html (last visited September 16, 2005); [coleman.senate.gov/index.cfm?FuseAction=PressReleases.Detail&PressRelease_id=383&Month=5&Year=2004](http://www.senate.gov/index.cfm?FuseAction=PressReleases.Detail&PressRelease_id=383&Month=5&Year=2004) (last visited September 16, 2005).; <http://www.house.gov/cummings/press/04may05a.htm> (last visited September 16, 2005).

But Congressional renewal of New Markets in 2006 is by no means assured. First, a five-year extension at its current \$3.5 billion annual volume of investment authority, with inflation adjustments, would cost the Treasury a projected \$5.4 billion over ten years, the normal time frame in which tax proposals are analyzed (Joint Committee on Taxation 2005). Unlike spending programs, which for budget purposes are assumed to continue indefinitely, tax incentives are assumed to expire as scheduled. Under this zero-based budget rule, extending a tax incentive like New Markets requires additional “tax expenditures.” In the five years since New Markets was enacted in 2000, the federal budget outlook has deteriorated from substantial surplus to substantial deficit. Five billion dollars may not be huge in the context of other tax proposals, but it is not insignificant either. Moreover, the queue for tax incentives is already long. Numerous industries are pushing for targeted tax incentives, making tax policy one of the most competitive arenas in Congress.

Second, New Markets has not been before the Congress since it was enacted in 2000. Some members paid it scant attention then. Other members had not yet been elected at that time. And New Markets itself is still relatively new. Bringing Congress up to date will take considerable time and effort.

Finally, the President’s advisory panel on tax reform recently recommended major changes to the tax code that assume the repeal of most tax preferences. New Markets would presumably be among those discontinued. The panel proposed simplifying the tax code, repealing the alternative minimum tax (AMT), and cutting taxes on savings and investments. To offset the tax cuts, the panel recommended killing or scaling back highly popular deductions for home mortgage interest, state and local taxes, employer health care expenses, and charitable donations. While the panel did leave open the slight possibility of retaining a few preferences, it would set a very high standard for them. At this point the President himself has not endorsed any proposal, but if Congress does tackle tax reform in 2006, New Markets and many other tax incentives will face an uphill climb.

That said, the effort to renew New Markets is off to an early bipartisan start. In the House, Reps. Ron Lewis (R-KY) and Charles Rangel (D-NY) have introduced a bill to extend New Markets for five years. In the Senate, Olympia Snowe (R-ME) and Jay Rockefeller (D-WV) have done likewise. All four are members of the tax writing committees, House Ways and Means and Senate Finance, respectively.

From here, the next step will be to build the list of Congressional sponsors to demonstrate broad support. The New Markets Tax Credit Coalition is already working towards this goal. The great demand for allocation of New Markets investment authority – annual proposals to the CDFI Fund typically are eight to ten times the available volume – should bolster the case in several respects. First, the market response has been very favorable. Second, the applicant pool is a potentially energetic and broad constituency. And third, the CDFI Fund has used the competitive process to move applicants to deliver more public benefits than the statute requires.

In addition to the simple bills to extend New Markets, practitioners and policy makers are beginning to discuss possible substantive changes to the underlying statute. These discussions and legislative efforts are likely to proceed on a separate but parallel track to the extension effort. The two tracks would presumably merge at some point in the process.

As a practical matter, any extension of New Markets is likely to be part of broader tax legislation in 2006, but it is too early to anticipate whether such legislation is likely or what its other components might be. An important aspect of the successful effort to enact New Markets in 2000 was its place at the center of a broader, high profile legislative package. Though not necessary to extending New Markets in 2006, a similar, broader effort could improve the chances for success.

To keep abreast of the upcoming political developments in the NMTC renewal fight, be sure to check the websites for the NMTC Coalition (www.newmarketstaxcreditcoalition.org) and the Local Initiatives Support Corporation (www.lisc.org).

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Investor Perspective: How to Invest in NMTCs

Bob Taylor

President, Wells Fargo Community Development Corporation

The New Markets Tax Credit (NMTC) program can serve as an effective tool for community and neighborhood revitalization, job creation, and redevelopment. It can help bring much needed capital to distressed communities, areas with high levels of poverty or unemployment, and neighborhoods in need of repair. The program also can help capitalize and grow small business concerns that support these neighborhoods with jobs and services, as well as employ entry-level workers. Used effectively, NMTCs can provide banks and other investing institutions with good returns on invested capital as well as credit under the Investment Test of the Community Reinvestment Act.

As is the case with other banks and financial institutions, Wells Fargo is regularly presented with a number of different types of investing opportunities. The different types of investments and asset classes have distinct performance criteria, risks, returns, and community impact. A long-term, below market rate loan to a non-profit organization is quite different from an investment into a syndicated Low Income Housing Tax Credit fund, yet each plays a vital role in filling unmet needs for affordable housing. Similarly, the purchase of a participation in an asset-backed security that holds small business loans is quite different than limited partnership interests in a venture capital fund targeting emerging market growth companies. All these investments are included in our portfolio and undergo similar due diligence and underwriting, and in many respects NMTC investments are no different. But this new tax credit program does have a few unique characteristics that require extra analysis and new investment strategies.

As a leading investor in the NMTC program, Wells Fargo had to be a quick study to make this new program work in a way that furthered our “double bottom line” objectives—returns both to our shareholders and to the community. Most of our NMTC investments, for example, have been in real estate projects. Aspects of the program, especially the recapture provisions, make real estate a more attractive investment, although we look forward to reviewing more NMTC investment opportunities in companies and small businesses that generate permanent employment for distressed communities.

We have structured the investments around the seven-year compliance period, which has forced us to be creative in various ways. And because this program is new, all parties involved (investors, intermediaries, and project developers) have had to feel their way through aspects of the deals, including legal documentation, appropriate fees, and risk/reward assumptions. That said, at root this program requires basic underwriting processes. The following is an investor’s perspective on how to evaluate the purpose, people, and projects for NMTC investments.

The Underwriting Process

Purpose. For any investment made at Wells Fargo, we start our underwriting analysis with two fundamental questions: does the request meet both the letter and the spirit of the Community Reinvestment Act; and do we feel comfortable in dealing with the people who present it? While these questions may seem obvious, they nonetheless form the foundation of our review. Wells Fargo is interested in funding investments or projects that deliver not only economic returns to our shareholders, but also help revitalize neighborhoods, eliminate blight, and create employment opportunities. We seek opportunities for investments in projects where capital may not be readily available in the marketplace, and where, without our involvement, they may not get done. The Wells Fargo Community Development Corporation also uses our local community development representatives to ascertain the community impact of a project in their markets, and makes sure that the local Wells Fargo Bank management is supportive of the project.

People. The “people” aspect of our review cannot be understated. It may seem old fashioned to base our underwriting on the people involved, but even NMTC investing is all about relationships. Since many of our investments require creative thinking, alternative forms of capital, and often involve local or government agencies, we strive to make sure the investment sponsor has a track record of similar experience and activities. Also, we want to feel comfortable with all of our partners since the investments often require long-term partnerships that span good times and bad. In addition, many of our investments present opportunities for positive public relations for all parties, so we want to make sure we are comfortable with any potential press opportunities.

Our due diligence starts with obtaining information about the investment sponsors and their firms. Does Wells Fargo have a depository, lending, or prior investing relationship with the company? Do any of the principals or governing officers have a personal banking relationship with Wells Fargo? If so, how long has it been in place, and how has it been managed?

If the firm and/or the principals do not have a relationship with or are not known by the Bank, we check banking references. We also require other references from banks and investing entities that can vouch for the integrity and track record of the principals for similar activities. Our due diligence also includes background investigation that involves a look at business credit reports and public records (e.g., Office of Foreign Asset Control, Bank Secrecy Act, and Patriot Act).

Wells Fargo also reviews audited financial statements, portfolio and project metrics from existing investments (losses, returns against plan, etc.), as well as staffing and personnel. These factors are very important as they help the Bank understand the organizational support for the ongoing asset management once an investment is made.

We also look at the sponsor’s management information and reporting systems, as well as data and information security. Face-to-face meetings, office visits, and multiple telephone conversations are used to help verify and confirm the data. Taken together, Wells Fargo will assess the organizational capacity and track record as well as financial strength of the investment sponsor: track record, capacity, and integrity are the cornerstones of our due diligence.

Project. After the organizational sponsor passes the “purpose” and “people” tests, we then review the specific investment proposal. Our review generally focuses on two aspects: (1) the underlying or first level asset; and (2) the upper-tier fund. In reviewing the financial terms of a proposed investment, any investor needs to determine the minimum return hurdles it may have, as well as any preferences for leverage, interest payments, and tax credits. For example, we will consider the amount of equity or down payment the borrower has agreed to fund into the project, and the loan-to-value ratio this equity yields. There are many different ways to structure investments, and there may be different investors in a single project. An NMTC investment generally needs to produce cash flow to cover interest payments, and be structured to allow investors to capture the allocated tax credits. Since the structure of the credit itself only provides a return of 39 percent of invested capital to investors over a seven-year period, understanding the underlying economics of the project is vital. Both the credits and the cash flow need to produce a return of capital and a return on capital.

For example, most of Wells Fargo’s NMTC projects involve some form of commercial real estate. Many have also involved ground-up construction or major rehabilitation. These types of projects have their own set of special risks, and prior underwriting experience is vital to understanding project viability. This is true not only to ensure the project is economically viable and will stay in compliance with the tax credit program, but also because the project must throw off enough cash to pay back the investor. In this regard, the NMTC program is quite different from the deeper subsidy of the Low Income Housing Tax Credit.

Wells Fargo starts with a standard “sources and uses” spreadsheet for the project. We focus on understanding construction costs, financing costs, as well as other project soft costs that go into a real estate project. Construction costs and contingencies are reviewed by our in-house costing and engineering experts, as are sample leases and letters of interest. We also commission a standard appraisal of the subject property to have validation of comparable properties, costs, lease terms, and neighborhood demographics. This is all done so that we will have a good understanding of the costs associated with the construction of the building, and to determine whether the sources of funds will be sufficient to complete it. Additionally, understanding lease terms and any competing projects in the market service area are needed in order to ascertain the projected cash flow as a source of repayment. We also conduct a site visit to get a feel for the development, the surroundings, and the neighborhood.

Financial Structure. Since NMTC investments need to be substantially deployed for the seven-year term, most loans amortize little if any. This can become a problem in the seventh year when the compliance period is up and the property needs to be refinanced in order to pay off the investors. This is especially true if the project starts out with a higher than market loan-to-value ratio. Additionally, one needs to be aware of any tax liabilities that may be due in the seventh year, and to make sure the property can support a refinance loan large enough to pay off the existing debt as well as provide funds for any taxes due. When reviewing the financial structure of transactions, we examine financial models that outline our capital account through the term of our investment so that we can determine if we will incur a tax liability as we exit the investment.

It is at this point that the NMTC equity is reviewed. The equity funded by the NMTC will generally constitute 20-35 percent of the capitalization and as such plays a vital role in determining the viability of a project. Many community-driven projects include support from local, state or federal programs. We will often consider this additional support as equity in the projects when underwriting our investments.

At the next level up, Wells Fargo wants to understand the structure of the Community Development Entity, or CDE. It may be a single investor or multi-investor structure, and may contain single or multiple Qualified Equity Investments, or QEIs. If the CDE has multiple investors, we also reach out to the other investors in the structure to make sure we are all obtaining the same information and feel the same way about the proposal. We then turn to the legal and accounting professionals to help navigate us through accounting and tax complexities. This process has been laborious, costly, and time-consuming, yet we feel we have learned quite a bit about how to structure a good deal. We believe a good deal includes the collaboration of multiple sources of capital all working together to support the underlying project or business.

During the underwriting process, we have also had very frank discussions about costs, fees and structure with project sponsors. Because we feel strongly about limiting up-front fees to a reasonable level and require cost justification for ongoing asset management, many sponsors have chosen not to deal with us. We believe that this is part of the maturation process of the program, and that in the future the industry will begin to establish standard transaction fees.

Once a deal has been approved by all the necessary parties, we develop a checklist of performance criteria. This list includes construction completion milestones, occupancy milestones, financial statements, tax credit information, and completion certification. We also require quarterly progress reports as well as financial statements from the sponsoring entity to evaluate its viability as a going concern. It is important to remember that the funding of the investment is not the end of the work!

Successful investing requires a tremendous amount of up-front work. Various data are obtained, compiled, reviewed, and analyzed. Extended negotiations are often needed, as is the ability to compromise. Legal documentation, title reports, cash flow statements, and leases are all integrated into a decision about an investment, as is a certain amount of trust. It has been interesting to watch the NMTC program evolve and work out the operational kinks, just as the Low Income Housing Tax Credit program did years ago. And while we all strive for more efficiency in the industry, we must never lose sight of the purpose of the credit, which is helping distressed communities.

Bob Taylor is the President of the Wells Fargo Community Development Corporation, a wholly-owned subsidiary of Wells Fargo & Company. In this role, he works with team members across Wells Fargo's 23-state service area to help meet the requirements of the Investment Test of the Community Reinvestment Act. Taylor, who has been with Wells Fargo for 18 years, manages a portfolio that includes Low Income Housing Tax Credits, New Market Tax Credits, private equity, as well as equity-equivalent loans.

Case Study from Application to Construction: Clearinghouse CDFI Puts New Markets Tax Credits to Work

Doug Bystry

President & CEO Clearinghouse CDFI

The New Markets Tax Credit (NMTC) program, managed by the U.S. Department of Treasury's Community Development Financial Institutions (CDFI) Fund, has a reputation as a difficult program to use. The laborious application, fierce competition, and expensive legal costs have scared off all but the most dedicated community development practitioners. It has been equally challenging for some to find equity investors for qualifying projects, known as Qualified Low Income Community Investments (QLICIs). But for all of its real and exaggerated challenges and obstacles, the program has enabled groups like ours, the Clearinghouse CDFI, to make community-enhancing loans in low-income areas that otherwise would not have been considered.

The concept behind the program is simple: attract new and increased investment capital to projects in low-income neighborhoods by giving investors a federal tax credit in return for their equity investment in a community lender. For the sake of the program, the community lender is required to be a Community Development Entity, or CDE.

The Application Process

The Clearinghouse CDFI, which is a certified CDE, has been successful in obtaining allocations in two of the first three rounds of NMTC competition for a total of \$131 million. Of the total of 824 applicants in all three rounds, only 170 (20 percent) have been successful. This ratio of winners to losers has fostered the impression that successful applicants have accomplished something really special.

While many applicants have used outside consultants to assist in writing the NMTC application, the Clearinghouse CDFI did not. We concluded that no one could tell our story, and make our case for NMTCs, as well as we could. We were also not excited about paying tens of thousands of dollars for assistance that would not necessarily result in a winning application. There are many horror stories of expensive consultants that provided minimal assistance in the NMTC application process.

In essence, an application to the CDFI Fund is like a proposal to an investor. You must demonstrate that you have good management and a viable business strategy. You also must show how your projects will further the goals of the Fund. While there are many aspects to the application, we think there are three areas that clearly distinguish the successful applicant from the also-rans: (1) track record of lending; (2) ability to raise equity investments; and (3) level of impact in low- and moderate-income communities.

Community Lending Track Record

As a community lender since 1990, we viewed the New Markets Tax Credit program as an extension of our existing lending effort. In the years prior to the first NMTC round, 74 percent of all of our loans were made in communities that qualified as eligible under the NMTC program criteria. In other words, we already had an established track record of serving the low-income communities that the New Markets Tax Credit program is designed to assist.

The sections of the application stressing track record and previous experience clearly benefit certified CDFIs over many other types of applicants for NMTCs. Conventional lenders, particularly those with community development banks, that can demonstrate previous commitments and experience in making commercial and economic development loans in low-income communities should also score well in this area. It is surprising how many NMTC applicants apply for credits, yet have never made a community development loan prior to submitting their application. Mortgage bankers, developers and real estate speculators are prime examples in this category.

Ability to Raise Equity

The applicant's ability to raise equity is also scrutinized in the application. An applicant must show past experience in raising both equity and debt, as well as provide letters of interest and intent for the amount of tax credits requested. The CDFI Fund wants to make sure the CDE can raise the funds from investors that it claims it can in its application. Some successful awardees have struggled in raising equity after receiving an allocation under the program. Of the 52 first round NMTC winners, several have not raised the equity authorized to them through their award under the program.

Applicants with little or no background in raising equity will have trouble with this part of the application. Several applicants with experience in raising equity for low-income housing or historic tax credit programs have been able to parlay their experience into successful NMTC applications.

The success of the Clearinghouse CDFI in the first round in both raising equity and funding worthwhile projects has greatly helped us attract investors in our subsequent award. All of the \$56 million in our first round award has been raised and 70 percent has been deployed into projects. Over half (\$40 million) of the \$75 million from our second award has also already been raised.

Community Impact

The application awards more points for positive economic and community development impact. Applicants are asked to specify what percentage of their award will be directed to communities with higher levels of distress than the minimum poverty/income criteria required by the program guidelines. The higher the percentage indicated, the better off the applicant will score. Of course, if granted an award, the applicant is held to this requirement under a binding agreement, known as the allocation agreement.

In addition to identifying what specific types of impacts will be obtained through the program, the Fund also requires the applicant to explain the extent to which the impacts would not be obtained without the incentives of the New Markets Tax Credit program. In this way, the Fund is striving to ensure that deals done through the program are a good use of the allocation and not just providing duplicative loan dollars that could be obtained through conventional means.

Once again, a track record of providing loans with strong community impact is asked for and viewed as favorable under this section of the application. Every applicant CDE is required to have a governing or advisory board of low-income community representatives that provide a direct tie to the low-income community.

The applicant's business model or structure is another key component required to be addressed in the NMTC application. We attribute much of our New Markets success to the structure we created and a straightforward business plan for implementing the program. This is unique in the complex world of New Markets, particularly as more complicated "leveraged" transactions often have dual sources of investment, bringing with it more attorneys, accountants, consultants, and fees. We are aware of at least three NMTC transactions in which legal fees alone exceeded \$100,000. We decided early on that our typical transaction would have one investor in one fund with one or more qualifying projects (QLICIs). This decision has served us well.

In general, our investor's return is derived from three sources: (1) the tax credits; (2) a portion of the cash flow as paid by the borrower; and (3) a residual split of the remaining income from the project after all expenses have been paid. The result has been after-tax internal rates of return (IRRs) ranging from 5.1 to 6.75 percent.

Financing Projects

With the New Markets Tax Credit program rapidly approaching legislative phase-out in 2007, and the move for re-authorization getting underway, the ability to show impact is critical for the continuation of the program. All twenty projects we have funded under the NMTC program have some strong social or economic benefit that fit the program's goals. But finding QLICIs that make a difference in communities is an ongoing challenge for mission-driven CDEs.

The job of the CDE is to balance the community benefits of the projects with the economic and risk tolerance requirements of the NMTC investor. The ability to satisfy both parties is not always easy.

The ideal New Markets Tax Credit loan for the Clearinghouse CDFI is one that we identify and underwrite. Then, with a fully-formed deal, we look for an investor. This approach ensures that our mission of impact and community benefit is well served. We also seek to find projects sponsored by nonprofit organizations whenever possible.

Another part of our strategy is to fund loans in areas the U.S. Department of Treasury has designated as having "greater economic distress." This means projects that are located in a census tract with one or more of the following characteristics: poverty rates greater than 30

percent; unemployment rates at least 1.5 times the national average; or a median income of less than 60 percent of the area median income. To date, 18 of our 20 NMTC projects are in areas that have one or more of these “greater economic distress” characteristics.

Our loans typically have a balloon payment at the end of seven years because that is the term of the NMTC program and most investors require a return of their equity at that point. All projects must demonstrate the ability to be refinanced at the end of seven years. The inability to refinance an NMTC loan or the inability to sell the loan at that time could seriously jeopardize the return of an investor’s equity investment.

Who finds the deal? Sometimes the investor brings the loan request to the CDE for consideration. As long as the project is providing clear benefit to the community and the CDE supports the project, there is no problem. Alternatively, we have had to tell investors we would not do a proposed project even though the loan technically met the requirements of the NMTC program because those projects did not meet our standards for community impact. The best projects we have funded under the program have been Clearinghouse CDFI projects where we handpicked investors. One project that fit this profile was Market Creek Plaza, a high-impact project that could not have been done without the New Markets Tax Credit program.

Case Study: Market Creek Plaza

In 1998, a non-profit organization, Jacobs Center for Neighborhood Innovation (JCNI), purchased a former aerospace factory, which for many years was abandoned and overgrown with weeds. Numerous investors lacked any interest in transforming the location into a shopping mall, calling it high risk and “unbankable.” JCNI is the development arm of the Jacobs Foundation, which was started by the late Joe Jacobs, founder of Jacobs Engineering in Pasadena. A project like Market Creek fit the philosophy of Mr. Jacobs who believed in creating sustainable community projects instead of simply writing checks through his foundation. He challenged the foundation staff to make a lasting economic difference in low-income communities.

Thousands of residents from many backgrounds and cultures joined teams to work on community outreach, design, construction, business development and the leasing and marketing of Market Creek Plaza. Even the neighborhood’s children were involved – over 1,300 kids helped decorate a 150-foot retaining wall along the bordering Chollas Creek.

At the early stages of construction, JCNI began working with California Southern Small Business Development Corporation (SBDC) to assist them by helping tenants secure the financing needed to open businesses in the plaza. JCNI wanted local entrepreneurs from the community to become tenants in the plaza so every effort was made to assist them. California Southern made working capital and equipment loans to several of the start-up businesses.

One of the things JCNI did to assist the community tenants was to provide leases that allow payments based on residual income or monthly profit as opposed to a fixed amount each month. This flexibility was wonderful for the start-up businesses, but hard for us because it was extremely difficult to underwrite future income for the overall project.

JCNI created Market Creek Partners LLC to own and operate the development, and began seeking permanent financing for the project under construction. JCNI applied for and received a total of \$1.5 million in program-related investments from the Rockefeller Foundation, and the F.B. Heron Foundation provided low interest subordinate debt on the project.

The project required more financing, however, and Mike McCraw, president of California Southern SBDC, contacted the Clearinghouse CDFI seeking a \$15 million permanent loan with a below market interest rate. Mr. McCraw was aware of the Clearinghouse CDFI's first round \$56 million NMTC award as he had previously worked with our staff on other projects and has since been named to our NMTC Advisory Board.

We worked for months with JCNI staff to analyze the project and submitted it to the Clearinghouse CDFI loan committee for approval. The committee approved the project with the below market interest rate, and we then went searching for an NMTC investor.

We solicited several financial institutions to be investors, but the first four lenders turned down the project. Finally, Wells Fargo Bank agreed to pursue the deal and began their due diligence. Bob Taylor, who heads Wells Fargo's tax credit investment department, was already somewhat familiar with JCNI as they had a depository relationship with the bank. Mr. Taylor also had been approached about opening a bank branch at the Market Plaza. Alva Diaz, who works with Mr. Taylor in the Wells Fargo Tax Credit Investment Department, crunched the numbers for them and worked through the difficult issues regarding the residual leases.

Within three months the project was fully approved by Wells and the borrowers received a three percent fixed rate loan for seven years. The three percent rate loan was at an even



lower interest rate than what was approved by the Clearinghouse CDFI Loan Committee. Wells Fargo agreed to help the Market Creek project because they recognized the tremendous benefit the project would have on the low-income community. The project would not have been feasible at that rate without the New Markets Tax Credit program.

Today Market Creek Plaza is fully leased and open for business. Among the tenants are Starbucks, Wells Fargo Bank, Cold Stone Creamery, and a 57,000 square-foot Food 4 Less supermarket as the anchor. Ninety-one percent of the employees hired for the supermarket were local residents trained through a local workforce agency. Local entrepreneurs with restaurants and small businesses are also among the plaza's tenants. Market Creek's focal point is a 500-seat outdoor amphitheater available for cultural performances and special events.

To date, Market Street Plaza has created nearly 200 jobs. That number is expected to increase to 300 when a planned three-story, 75,000 square-foot office building is completed

on the site. Furthermore, the discounted loan ensured the center's success, allowing JCNI to free up capital for the future development of a mixed-use center adjacent to Market Creek Plaza. This future project will include 400 residential units and an additional 100,000 square feet of commercial space.

In addition to Market Creek, Clearinghouse CDFI has financed many other worthwhile projects through the New Markets Tax Credit program. We recently funded a \$7.5 million NMTC loan for an acute health care facility for infants and small children needing specialized intensive care hospitalization. This project provides invaluable health care services to low-income residents in Los Angeles, while also creating relatively high-paying medical jobs.

In spite of its challenges, expenses, and competitiveness, the New Markets Tax Credit program is a great investment for community development practitioners and investors alike. It is vital that both NMTC awardees and investors continue to direct the resources and benefits of the program to those in this country that need them the most.

Doug Bystry is president and CEO of Clearinghouse CDFI, a community development financial institution based in Orange County, California. More information on Clearinghouse CDFI and its programs can be found at www.clearinghousecdfi.com or by contacting Doug Bystry at dbystry@clearinghousecdfi.com.

Case Study from Application to Construction: Lenders for Community Development Puts New Markets Tax Credits to Work

Jeff Wells

Manager, LCD New Markets Fund

Introduction

To the outside world, the San Francisco Bay Area is known as a center of the high-tech economy and a place where millionaires are made every day. But skyrocketing prices and a growing disparity between the haves and have-nots make the Bay Area one of the hardest places in the nation to be poor.

Lenders for Community Development (LCD) is a nonprofit community development financial institution (CDFI) that provides financial tools and training to benefit low-income individuals, families, and communities, helping them to move beyond poverty and toward self-sufficiency. Founded in 1993, LCD channels resources into San Francisco Bay Area communities that have been underserved by conventional financial institutions. Our programs include: small business, affordable housing, and community facilities loan programs; one of the nation's largest Individual Development Account programs; and the New Markets Tax Credit program.

Through these programs, LCD has directed over \$73 million in community investment into economically challenged neighborhoods and has improved the lives of more than 5,000 households. The core of LCD's support comes from its 24 member banks, with additional support coming from foundations and government.

In 2003, LCD joined 65 other NMTC allocatees (out of a pool of 345 applicants) in receiving a tax credit allocation in the first round of this new program. Utilizing part of its first \$25 million NMTC allocation, to date LCD has financed two innovative, high community-impact projects in the San Francisco Bay Area:

- a \$9.7 million new campus facility at The National Hispanic University in East San Jose; and
- the \$8.3 million tenant purchase of Preservation Park, a nonprofit and small business office complex located in Oakland.

LCD worked with 13 different lenders and equity investors for these two deals.

This year, LCD was again honored to join 40 other Community Development Entities (CDEs) in receiving allocations and was awarded an additional \$25 million in credits.

Application Process and Allocation Phases

Anyone who has submitted an application to the Fund can attest that the process of preparing and submitting an application can be time consuming and expensive. Our effort to earn an NMTC allocation was no exception, as we estimate that we spent some 160 hours and nearly \$100,000 in staff, consulting, and legal fees preparing the application and securing the award. (Fortunately for LCD, most of these fees were donated by the City of San Jose or provided by our pro bono attorneys.) Some of the challenges in preparing the application included gathering and reconstituting data, obtaining letters of interest from potential investors, and identifying potential NMTC deals. The strengths of our application included a significant track record of community development finance as a CDFI, a healthy pipeline of deals, and excellent backing from potential investors.

In March 2003, the first round NMTC allocatees were announced by the Secretary of the Treasury. In November 2003, along with many other NMTC first round allocatees, we executed our NMTC allocation agreement. While many of the potential investors we approached had a lengthy record of investing in our loan pools, the NMTC program represented a much larger and more complicated capital commitment to LCD than in the past.

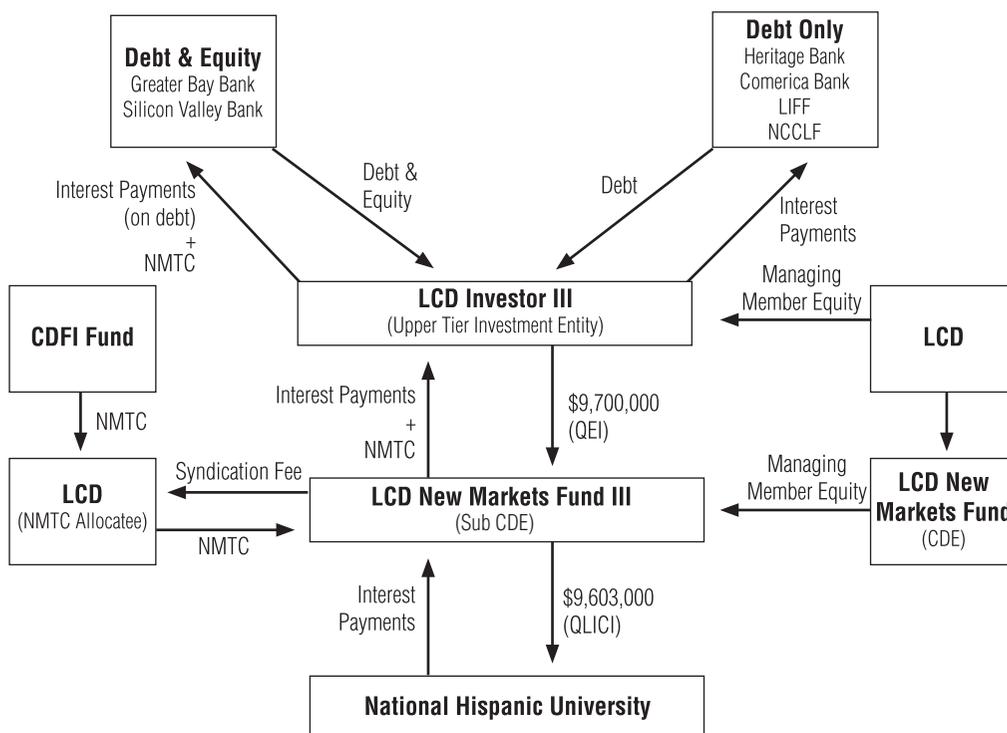
While still a considerable time commitment, the preparation of our second NMTC application in 2004 took less time and money than the first one for a number of reasons. We saved time and money on legal documents and financial models because we had developed these for our first round application. We had a better understanding of which deals would work with the NMTC guidelines and a number of potential projects that we could discuss in our application. Finally, we had existing relationships with NMTC investors, which was important because they understood the program and we had already negotiated key business points.

Program Development Phase

Developing the program and bringing our first deals to fruition took us longer than we expected, mostly due to the complexity of government guidelines and the relative inexperience of all parties involved.

We engaged in extensive negotiations with 29 potential investment entities. We had expected that the investors, many of whom were investors in LCD's existing loan pools, would consent to invest capital into a "blind pool" for New Markets Tax Credit projects. Over months of negotiations, however, we realized that investors would require a review of each deal. We also had to overcome a fair amount of initial investor uncertainty, which was exacerbated by the delay of the release of final IRS NMTC regulations in December 2004.

Our discussions with potential investors and other allocatees convinced us that the "leveraged" investment model was the most attractive and profitable way to utilize the NMTC program (see chart on next page). In this model, investors make equity and debt investments into an upper-tier entity, which in turn makes a qualified equity investment (QEI) into a sub CDE. The introduction of debt into this model effectively supercharges the NMTC, providing a greater return to the equity investor. One drawback to the leveraged model, however, is its complexity, which added significantly higher fees for consultants.



During this period, we worked very closely with our pro bono attorneys, Wilson, Sonsini, Goodrich & Rosati, whose extensive experience representing venture capitalists was instrumental in the program development phase. They assisted us with the allocation agreement, including the provision of an extensive legal opinion. To create the infrastructure necessary to receive leveraged investments, we formed and provided the initial capitalization for nine distinct upper-tier investment entities. In addition to this legal preparation, we also worked with Novogradac & Company to develop an accounting template for investments.

The combination of the multi-investment tiered structure, the New Markets Tax Credits themselves, the specific tax consequences, and the distribution of excess cash flow, produces a staggeringly complex financial model (the models for our leveraged transactions each contained 38 inter-related spreadsheets). However, these financial models were a critical tool for educating and negotiating with investors.

Finding the Right Project

With the legal and accounting framework formed and a number of potential investors lined up, we commenced the search to find a qualifying project that would also meet LCD's high standards for community impact. With our finite allocation of NMTC, we did not want to make loans to "bankable" projects. At the same time, due to the newness of the program and some uncertainty with the interim IRS regulations, we learned that investors were not

interested in investing in really tough deals. This narrowed our window of opportunity to “near-bankable” deals and reduced the size of our pipeline dramatically.

According to the New Markets guidelines, each potential NMTC deal must be reviewed to determine if the project meets a number of key qualifying criteria including geographic location of: sources of revenues, employee services, tangible assets, and future plans. While all of these tests seemed reasonable, some of them resulted in unexpected consequences. For instance, NMTC tests require that at least 40 percent of employee services and 50 percent of revenues be generated in qualified NMTC census tracts. We had hoped to finance a new homeless services center for a prominent local nonprofit. This nonprofit has 17 sites where it provides transitional housing services to more than 15,000 very low-income men, women, and mentally ill adults annually. Nearly all of their sites are in NMTC-qualified census tracts, including the proposed NMTC project. Their administrative office, however, is located in a non-NMTC-qualified census tract, disqualifying the organization from receiving an investment using NMTC-eligible funds.

We also learned that mixed-use projects, especially those involving Low Income Housing Tax Credits, are difficult to finance through NMTC unless the commercial portion of the project represents at least 80 percent of the revenues. Additionally, because a business must remain within an NMTC qualifying census tract for the duration of the investment, the tax credit recapture provisions bias investors toward real estate-secured deals, reducing the potential of investing in small businesses.

Putting the Credits to Work

After over a year of developing the program, we were finally ready to convert the NMTC into investments into the community we serve.

Located in an urban, low-income census tract, The National Hispanic University (NHU) is a private university with an affiliated charter school and a bilingual childcare center. NHU is one of only three accredited universities in the U.S. specializing in Latino education. NHU offers credentials ranging from business administration to computer information systems, bilingual teacher education, and math and science. NHU’s tuition is less than the local public state university thanks to the support from foundations, government, and corporate sponsors. More than 90 percent of the university’s students work full or part time, 85 percent are Hispanic, and 81 percent are low- or moderate-income.

When NHU approached LCD for financing, the university was located in a former elementary school built in 1958. With the promise of an NMTC loan, LCD and one of LCD’s member banks, Comerica Bank, provided interim financing for the construction of a new 66,000 square foot state-of-the-art facility. The project was completed in August 2004, with “take-out” financing provided by LCD’s NMTC program in November 2004. The terms of the NHU NMTC financing included unconventional features such as a below-market interest rate, interest-only payments and an agreement to provide a substantial grant (estimated to be \$800,000) to NHU at the conclusion of the tax credit period. Herb Stevens, an attorney with Nixon, Peabody, referred to this last feature as the “Mother Teresa CDE” model. In this deal, the QEI was capitalized by the following: two upper-tier equity investors

(Greater Bay Bank and Silicon Valley Bank); four bank debt investors (Greater Bay Bank, Silicon Valley Bank, Heritage Bank of Commerce, and Comerica Bank); and two CDFI debt investors (Low Income Investment Fund and Northern California Community Loan Fund).

Some of the eligibility tests associated with the NMTC program resulted in unintended consequences. The university had plans to increase its scholarship endowment fund for low-income students, but these plans potentially would run afoul of the IRS NMTC requirements limiting non-working capital assets, including this scholarship endowment, to less than five percent of total assets. After months of delay, we were able to develop a legitimate strategy to address this issue.

With its loan closure in November 2004, the NHU deal became the first NMTC loan in the San Francisco Bay Area. We would not have been able to close this deal as quickly without the tremendous help of our investors, our attorney, Scott Lindquist of Sonnenschein, Nath & Rosenthal, and our accountants, Novogradac and Company. Equally important, we found the CDFI Fund to be very accessible and professional, with staff providing ready responses for the many questions arising from the program.

Clearly, the most important part of this project is the thousands of low-income students who will receive a first-class education in this wonderful facility, but the physical juxtaposition of the “before” (shabby elementary school) and “after” (modern, state-of-the-art facility) is truly stunning as well. This facility instills a tremendous sense of pride for the current NHU students, their families and the thousands that will follow them, and signifies the importance and value of higher education for the working poor families of San Jose.

In the short time since its new facility was built, NHU’s freshman student enrollment has grown by 300 percent. The number of first-time undergraduate students has grown from 57 last year to 250 for the semester starting August 2005. The new library is ten times the size of the old library and new labs have permitted the science and math programs to expand dramatically. In addition, the school’s new athletic field and community spaces have been widely utilized by the surrounding community.



Lessons Learned

The first few years of the NMTC program have taught much to practitioners, investors, and borrowers alike. With the right type of project, the NMTC program can truly be a tremendous catalyst for community change in our nation's low-income communities. The challenges we faced included what one would expect with the implementation of a new federal initiative: considerable ramp up time, lack of clarity regarding the IRS code, substantial professional fees, and investor reticence requiring extensive education.

We learned that willing and NMTC-savvy investors are a critical component of success. It also appears that the most viable NMTC projects need to be near-bankable, single real estate asset entities. And we found that when new IRS regulations bump up against real project conditions, potential program difficulties are revealed. Modifying the regulations based upon these experiences will be critical to the program's success.

We believe that Congress intended the New Markets Tax Credit program as a vehicle to encourage new private and public capital investment in low-income communities. As long as the NMTC industry stays true to the mission focus of the original NMTC legislation, the future looks bright for this program.

Jeff Wells has worked in the community development finance field for more than thirty years at a community development credit union, as a banker, and as a consultant for CDFIs and regulators. Currently, he is the Manager of the LCD New Market Fund and serves as Chair of the Capitalization Committee for the National Federation of Community Development Credit Unions. More information on Lenders for Community Development and its programs can be found at www.L4CD.com or by contacting Jeff Wells at jeffwells@L4CD.com.

Trends and Observations from the CDFI Fund Director

Arthur A. Garcia

CDFI Fund Director

As Director of the Community Development Financial Institutions (CDFI) Fund, and as a former banker, I am all too familiar with the challenges of making investments in underserved markets.¹ There are risks in these markets, both real and perceived, that are not often overcome through traditional banking and underwriting criteria. I believe that the New Markets Tax Credit (NMTC) program is a valuable tool for mitigating the risks of these transactions and stimulating economic development activities in underserved markets. To date, the Fund has made 170 awards totaling \$8 billion in allocation authority. Though the NMTC program is still young, I have seen several trends that I find particularly encouraging.

1. Interest in the NMTC program is extraordinary. In less than four years, the CDFI Fund has certified over 1,950 entities as Community Development Entities (CDEs). Through three allocation rounds, the CDFI Fund has received allocation applications from 824 CDEs collectively requesting over \$79 billion in total allocation authority. In any given allocation round, the CDFI Fund receives total requests for allocations that are approximately ten times greater than the total amount of allocation authority available.
2. A wide variety of CDEs have applied for and received allocations of tax credits. NMTC allocatees include CDEs created by state and local governmental entities; local non-profit organizations; CDFIs; national, regional and local banks; investment banking and securities firms; real estate development companies; and venture capital companies. Approximately 50 percent of the NMTC allocation awards made to date have been provided to entities sponsored by governmental or mission-driven organizations (e.g., non-profits, CDFIs). NMTC allocatees are headquartered in 38 different states and the District of Columbia, and their target markets encompass 48 different states, the District of Columbia and the U.S. Virgin Islands.
3. Allocatees have committed to achieving benchmarks well above what is minimally required by the NMTC program statute and regulations. In the Allocation Application, the Fund asks applicants to commit to achieving results that extend beyond the minimum requirements of the NMTC program. The allocatees from the 2005 allocation round were successful because they committed to achieving high benchmarks. For example:
 - Thirty-seven of the 41 allocatees indicated that at least 75 percent of their activities

¹ The CDFI Fund, established in 1994, is a wholly owned government corporation within the Department of the Treasury. Its mission is to expand the capacity of financial institutions to provide affordable credit, capital and financial services to underserved populations and communities in the United States.

would be undertaken in communities characterized by significantly higher indices of distress than those minimally required by program rules and/or in communities that have been designated for economic development through other governmental programs, such as Empowerment Zones, Renewal Communities, and Brownfields.

- All 41 of the allocatees indicated that at least 75 percent of their loans and investments will have flexible or non-traditional features (e.g., equity and equity-equivalent terms and conditions, subordinated debt, below market interest rates, or reduced origination fees), and 36 of the 41 allocatees indicated that 100 percent of their loans and investments would have flexible or non-traditional features.
- All 41 of the allocatees indicated that they would invest more than the minimally required 85 percent of Qualified Equity Investment (QEI) dollars into qualified low-income community investments, and 35 of the 41 allocatees indicated that at least 95 percent of their QEI dollars would be invested into qualified low-income community investments.

In all cases the CDFI Fund will require these allocatees, through their allocation agreements, to meet the specific benchmarks identified in their applications.

4. Investors have been quick to embrace the NMTC program. By statute, CDEs have five years from the date of allocation to receive QEIs from investors. However, due to strong investor interest and the capabilities of allocatees, QEIs are being issued at a much faster pace. In less than two years after receiving their allocation agreements, 50 of the 66 first round allocatees have received investments totaling \$1.28 billion. And in just over one year after receiving their allocation agreements, 39 of the 63 second round allocatees have received a total of \$1.19 billion of QEIs from investors. The cumulative amount of QEIs received to date is \$2.47 billion – or 41 percent of the \$6 billion allocated under the first two allocation rounds.
5. CDEs are financing an array of community and economic development projects. The NMTC program provides a very flexible financing tool. CDEs have used NMTC proceeds to finance a variety of activities in distressed urban and rural communities throughout the United States, including: a sustainable forestry project and paper mill in rural Maine; a technology business incubator in Detroit; a coal mining company in West Virginia; a charter school in Los Angeles; a large commercial mall in Everett, Washington; a cultural and community center in San Diego, California; and an airline parts manufacturing company in rural Oklahoma. In most if not all of these cases, the allocatees indicate that the projects would not have been undertaken without NMTC subsidy.

The CDFI Fund is pleased with the progress of the NMTC program to date. We recognize, however, that there is much analysis that needs to be done on this young program. To this end, we will soon be soliciting bids from independent contractors to perform a longitudinal evaluation of the NMTC program. It is our hope that over time it will be possible to more fully understand and measure the benefits of the tax credit and the impacts that NMTC investments are having on low-income communities. In the interim, I am excited by the program's early successes in stimulating private sector investment in low-income communities, and in making a real difference in the lives of the people in these communities.

How One CDC is Changing Neighborhoods with NMTC

Mary Nelson

Former President, Bethel New Life

New Markets Tax Credits have been a major boost to Bethel New Life's community development efforts. Bethel, a 26 year-old faith based community development corporation on the West Side of Chicago, was awarded \$4 million in tax credits in the first round of allocations. Bethel has used them to significantly expand our housing development program (utilizing a revolving construction loan pool) and to leverage investment in Bethel's commercial projects, thus expanding Bethel's development efforts and enhancing the financial sustainability of its real estate development activities.

Bethel's successful experience with the earlier CDC Jobs Tax Credits (\$2 million) helped in planning for the New Markets application, and Bethel's planned and existing development efforts set the stage for a successful application. Once the allocation agreement was finalized at last, Bethel was ready to firm up the preliminary commitments of five regional and local banks.

The challenge of a new investment vehicle with still emerging definitions and procedures slowed the initial start, but New Markets enabled Bethel to involve new financial partners in working together to bring new investment dollars into our low-income, primarily African American community. Three of the initial five banks ultimately invested in the program. It was remarkable that these banks were willing to accept the tax credits as the only return on their investment (making us unique among the allocatees). Two of the investor banks are new relationships for Bethel, and widen the scope and future development opportunities in the community.

Bethel used 57 percent of the allocation to establish a revolving construction loan fund for the development of for-sale affordable housing, thus enabling Bethel to expand from 14 to 50 single family homes annually. This provides greater community impact and allows more affordability with lower interest rates and flexible terms.

Bethel used 28 percent of the allocation as a construction take out, interest only loan on a recent commercial development. The 23,000 square-foot development incorporates green building designs. It is located next to a transit stop, replacing a rundown, neglected corner with a new commercial anchor that houses six commercial storefronts. The tenants include Bethel's employment center and a child day care center for over 100 children. Several financial institutions turned us down for financing because of the facility's location and the uncertainty of annual funding for day care and employment programs (activities which take up 65 percent of the building's space). The tax credits enabled Bethel to get construction financing and to structure a more flexible seven-year interest-only balloon loan at a lower interest rate, thus lowering the costs of operating day care and employment programs during critical start up years.

Bethel's small \$4 million New Markets Tax Credit allocation has had a major impact on both Bethel and the community. It enables Bethel to sustain a greater volume of real estate development on a continuing basis, and allows for more flexibility in structuring terms and conditions of the financing. It also has leveraged (on a 4:1 basis) significant new dollars into the west side Chicago community from financial institutions not formerly active in the area.

Bethel is actively working with the New Markets Tax Credit Coalition to seek the expansion and extension of the program, building on the success of these early efforts and the growing familiarity of the investment community with this vehicle. We also are working with others on the modification of the alternative minimum tax and seeking to extend the time when a project can be brought back into compliance (the "cure period"). In light of the ever-diminishing federal dollars and programs to stimulate development and improvements in our very low-income community, it is important to expand, enhance and sustain this important vehicle.

Mary Nelson is the former president of Bethel New Life, a west side Chicago faith-based CDC. She is also a former board chair of the National Congress for Community Economic Development.

Making Markets Work

Cliff Kellogg

As darkness settles on the Congress Heights neighborhood of southeast Washington, DC, we drive past renovated public housing and new for-sale town homes. Arriving at the cultural arts campus, through the dramatic and brightly-lit glass second floor studio, we see young girls stretching at the ballet bar. Once inside and down the hall, we hear a classical pianist rehearsing at the music school while local visual artists show off new studios. The Boys & Girls Club and the community health center had closed a few hours earlier. An actor recreates the stentorian Frederick Douglass on stage while an audience of hundreds applauds. Welcome to THE ARC, a new and vibrant cultural center for which New Markets Tax Credits (NMTC) controlled by City First Bank, filled a key financing gap.

At a time when most other federal economic development programs are being cut, the NMTC is attracting new investor capital and talent to poor neighborhoods. NMTC financing is supporting major community and arts facilities, urban retail projects, charter schools, medical clinics, manufacturing facilities, and sustainable forestry projects. In the two years since the very first NMTC awards were made, the early results surpass many of the original policy goals. Most importantly, the NMTC is enabling exciting projects such as THE ARC. As a side benefit, for the first time new partnerships are forming between major investors with billion-dollar balance sheets and long-time community leaders who see the needs and opportunities in their neighborhoods. NMTC projects are fostering significant community impact and new organizational capacity that we should all be proud to see.

However, compared to other community development incentives, the NMTC feels different. Why? First, the NMTC is truly market-based. The credit depends on private capital taking the time to understand these unusual investment opportunities, while earning sufficient risk-adjusted financial returns. In some cases, these players and motivations are new ingredients to the field of economic development.

Second, because the NMTC assists commercial enterprises, its financial value is modest. The NMTC was designed to slightly expand the frame of an “investable” deal. NMTC cannot turn an unprofitable enterprise into a profitable one. Nor should the value of NMTC be compared to the size of equity injection provided by the Low Income Housing Tax Credit. Subsidizing below-market rate rental housing will always require a deeper subsidy than the NMTC objectives: the NMTC was designed to provide just enough subsidy to overcome market inertia created by cost disadvantages such as high cost of land assembly, redeveloping obsolete infrastructure, and developing in an urban environment rather than a green-field. The NMTC was designed to overcome market failures resulting from investors’ lack of market information. And finally, the NMTC was designed to connect major pools of capital, channeled through local CDFI-type conduits, to neighborhood-based projects.

Many people in and outside government helped design and promote the potential of the NMTC. There is more potential to be tapped. NMTC capital is not yet flowing sufficiently to smaller projects and to non-real estate businesses, especially in the form of equity investments. NMTC investors still underwrite too many individual transactions, resulting in high transaction costs, rather than delegating that task to qualified community development entities. The CDFI Fund must continue to consider applicants' commitment to community impact and delivering subsidy to the ultimate project.

The goal of the NMTC is to make markets work more efficiently. The early results are promising. The NMTC cost to the federal government is quite small compared to the amount of unleashed private investment. However, here in 2005, the first projects are just coming on line while the NMTC expires in only two more years. We must rally to extend this successful tax credit program to ensure that this good work continues.

Cliff Kellogg is the President & CEO of City First Bank of DC, the first and only community development bank in Washington, DC. Mr. Kellogg previously worked at the U.S. Treasury and the National Economic Council as part of the team that designed the New Markets Tax Credit.

NMTC Program Overview and Glossary

The following is adapted from the CDFI Fund (the Fund) website (www.cdfifund.gov). The New Markets Tax Credit (NMTC) program permits taxpayers to receive a credit against Federal income taxes for making qualified equity investments in designated Community Development Entities (CDEs). Substantially all of the qualified equity investment must in turn be used by the CDE to provide investments in low-income communities. The credit provided to the investor totals 39 percent of the cost of the investment and is claimed over a seven-year credit allowance period. In each of the first three years, the investor receives a credit equal to five percent of the total amount paid for the stock or capital interest at the time of purchase. For the final four years, the value of the credit is six percent annually. Investors may not redeem their investments in CDEs prior to the conclusion of the seven-year period.

NMTCs are allocated annually by the Fund to CDEs under a competitive application process. These CDEs then offer the credits to taxable investors in exchange for stock or a capital interest in the CDEs. To qualify as a CDE, an entity must be a domestic corporation or partnership that: (1) has a mission of serving, or providing investment capital for, low-income communities or low-income persons; (2) maintains accountability to residents of low-income communities through their representation on a governing board of or advisory board to the entity; and (3) has been certified as a CDE by the CDFI Fund.

Based on its initial authorization in 2000, the Fund will allocate tax credits sufficient to attract \$15 billion in equity for New Markets projects over seven years. The Fund allocated \$2.5 billion in the first round in 2003, \$3.5 billion in the second round in 2004, and \$2 billion in the third round in 2005. The remaining two rounds of allocations, one in 2006 and the last in 2007, will be \$3.5 billion each.

Glossary of NMTC Terms

For the complete definitions of the following, and additional terms used in the NMTC program, consult the CDFI Fund website.¹

Allocatee

An Applicant that receives an NMTC Allocation.

Allocation Agreement

An agreement to be entered into by the Fund and a CDE that stipulates the use of the tax credit allocation.

Community Development Entity (CDE)

Any domestic corporation or partnership where:

¹ <http://www.cdfifund.gov/programs/programs.asp?programID=5>

- (1) The primary mission of the entity is serving, or providing investment capital for, low-income communities or low-income persons;
- (2) The entity maintains accountability to residents of low-income communities through their representation on any governing board of the entity or on any advisory board to the entity; and
- (3) The entity is certified by the Fund as a CDE.

Low-Income Community

Any population census tract where:

- (1) The poverty rate for such tract is at least 20 percent; or
- (2) (a) In the case of a tract not located within a metropolitan area, the median family income for such tract does not exceed 80 percent of statewide median family income; or (b) in the case of a tract located within a metropolitan area, the median family income for such tract does not exceed 80 percent of the greater of statewide median family income or the metropolitan area median family income.

Qualified Active Low-Income Community Business (QALICB)

Any corporation (including a nonprofit corporation) or partnership where:

- (1) At least 50 percent of the total gross income of such entity is derived from the active conduct of a qualified business within any low-income community;
- (2) A substantial portion of the use of the tangible property of such entity (whether owned or leased) is within any low-income community; and
- (3) A substantial portion of the services performed for such entity by its employees are performed in any low-income community.

Qualified Equity Investment (QEI)

Any equity investment into a CDE where substantially all of the investment is made into a Qualified Low-Income Community Investment.

Qualified Low-Income Community Investments (QLICI)

- (1) Any capital or equity investment in, or loan to, any QALICB;
- (2) The purchase from a CDE of any loan made by such entity that is a QLICI;
- (3) Financial counseling and other services to businesses located in, and residents of, low-income communities; or
- (4) Any equity investment in, or loan to, any CDE.

