CRF USA

Capital for Communities –
Opportunities for People℠

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Matthew Josephs
NMTC Program Manager
Community Development Financial Institutions Fund
US Department of the Treasury
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ATTN: Comments/RIN 2590-AA18

Dear Mr. Josephs:

On behalf of Community Reinvestment Fund, USA ("CRF"), I appreciate this opportunity to share our views on the New Markets Tax Credit Program Allocation Application as outlined in the Notice and request for comments published in the *Federal Register* on August 3, 2009.

BACKGROUND

Community Reinvestment Fund, USA (CRF) is the nation's leader in accessing the capital markets to support community development financing activities. As a national CDFI, we provide new loan capital for community-based development lenders by operating a secondary market for their loans. CRF purchases performing economic development, small business, affordable housing and community facility loans from private nonprofits (such as CDFIs), governmental and quasi-public lending agencies. Since its inception, CRF and its affiliates have delivered more than $1.1 billion in capital to 767 communities across the country, which in turn leveraged an additional $1.1 billion in other resources. In partnership with 156 local lending partners, we have funded a total of 2,274 loans located in 46 states and the District of Columbia. CRF, working through its local lending partners, has directly assisted more than 210,000 families, including financing 16,500 affordable homes supporting small businesses creating or retaining almost 42,000 jobs and funding community facilities that serve 152,000 families.

We also played a pivotal role in developing the New Market Tax Credit ("NMTC") program and developed our own NMTC program focused solely on delivering the benefits of the tax credit to business borrowers. To date, we have funded more than 344 NMTC loans totaling $456.1 million in 182 cities in 34 states. CRF has a strong and successful track record of originating and managing NMTC investments as evidenced by the number of NMTC investments in our portfolio. Data provided by the CDFI Fund in their report entitled, "NMTC Program: Activities Financed Through 2007" reveals that our portfolio of 186 QALICBs was more than 15 times larger than the average

CDE portfolio of 12 QALICBs. The CDE with the second largest portfolio included 71 QALICBs or only 38% the size of our portfolio. As of December 31, 2008, CRF's portfolio had grown nearly 63% to 303 QALICBs.

CRF and our affiliate, National New Markets Tax Credit Fund (NNMTCF), one of the country's largest Allocatees, have been awarded NMTC allocations in Rounds 1, 2, 3 and 6, totaling $522.5 million as well as raised funds through loans to CDE structures provided by other Allocatees in the amount of $73.2 million. CRF has used these allocations to deliver hundreds of NMTC loans with flexible terms to support business lending and community facilities. The businesses financed through CRF's NMTC business lending activities are highly diverse and are distributed across more than 120 Standard Industry Classification Codes. Many are owned by minority or women entrepreneurs who have built personal wealth and security for their families because they had access to favorable NMTC loan terms. Others are nonprofit businesses operating charter schools, child care centers and health care facilities serving the needs of low-income people and residents of low-income communities. CRF's NMTC business strategy is distinctive because we identify financing gaps and tailor our tax credit resources as well as those of other Allocatees to meet the financing needs of business borrowers. As the economic crisis has unfolded, we continue to focus our efforts on delivering NMTC financing that directly supports small and medium sized businesses, including nonprofits, rather than lending to real estate development companies.

GENERAL COMMENTS ON NMTC PROGRAM AND SMALL BUSINESS FINANCING

The CDFI Fund's Request for Comment raises important questions regarding the NMTC Application process and the use of the tax credit more broadly. CRF's comment letter focuses primarily on the challenges we face when preparing the NMTC Allocation Application and carrying out our NMTC lending activities with operating businesses. In particular, we discuss the difficulties we face when trying to qualify loans to special purpose entities controlled by or under common control with an operating companies as either non-real estate or real estate Qualified Active Low Income Community Businesses (QALICBs). We provide detailed comments below in response to Question #9 and outline several changes to the Application, the Allocation Agreement and compliance documents associated with this program. However, we would first like to offer some general observations about the use of NMTCs for business financing.

First, the NMTC program has *not* been widely used by operating companies for either real estate or general financing purposes. CRF strongly believes the NMTC *should be* a flexible tool for attracting capital and credit to low income communities and that the credit is *an essential* financing tool for business borrowers. In practice, the NMTC program has demonstrated a "real estate tilt" as "…66 percent of all NMTC dollars invested through 2006 were made to real estate developers to finance the acquisition or rehabilitation of commercial, residential, and mixed-use real

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estate property."[1] A far smaller number of Qualified Low Income Community Investments (QLICIs) have been used for the acquisition or rehabilitation (including expansion) of operating company facilities (such as retail, industrial, manufacturing, warehouse, storage or community facilities) or for equity investments, working capital and equipment loans. CDFI Fund data shows that as of 2006, while nearly 66% of QLICI dollars has been used to fund investments to real estate development companies, only about 20% had been used to finance non-real estate activities of operating companies and only 11% had been used by operating companies to finance to purchase or rehabilitate their own facilties.[2]

Second, many of the challenges of funneling NMTC investment dollars to operating businesses are related to the nature of business lending, the lack of investor appetite for these transactions and compliance issues rather than aspects of the Application process. Challenges include, but are not limitied to:

- *Risk* (economic and compliance): Loans to large real estate development firms are considered to be significantly more secure than loans to operating businesses or nonprofits. Investor risk aversion has drastically increased in light of the economic crisis. Additionally, a large single real estate development transaction is easier to qualify and manage for compliance purposes providing greater comfort for investors.
- *Deal size and transaction costs*: Loans to operating businesses tend to be smaller transactions that don't provide enough revenue or margin to cover legal and transaction costs.
- *Ratio of Return on Investment (ROI) as compared with the level of due diligence required and risk profile*: Reviewing and executing twenty $1-$3 million loans in twenty different types of operating businesses requires significantly more effort and has a different risk profile than reviewing and executing one $20 million investment in a real estate development project being carried out by a well capitalized firm.
- *Collateral*: Loans to operating businesses to purchase equipment or for working capital purposes lack the collateral needed to meet investor requirements.
- *Shorter Term*: Equipment and working capital loans tend to be shorter term investments which pose many problems to structure appropriately within the 7 year compliance period (i.e. reinvestment risk to be substantially all invested).

The working paper entitled "*Addressing the Prevalence of Real Estate Investments in the New Market Tax Credit Program*" published by the Federal Reserve Bank of San Francisco discusses several reasons for the "NMTC real estate tilt" (referenced above) as well as offering several policy recommendations as to how to address the "tilt" and increase the flow of NMTC invesment dollars into operating businesses. CRF believes addressing these challenges is critical to improving the volume of NMTC investments in operating businesses. However, it should be noted that

[1] "Addressing the Prevalence of Real Estate Investments in the New Market Tax Credit Program," by Lauren Lambie-Hanson, Fall 2008, Working Paper 2008-04, Community Development Investment Center, Federal Reserve Bank of San Francisco, page 6.
[2] Ibid, see Figure 7: QLICI Dollars by Project Type, page 21.

many of these challenges and recommendations relate to NMTC program structure and potential policy changes, rather than the Application Process.

Third, it is important to understand how the credit falls short in supporting both real estate and non-real estate QLICIs made through operating businesses. These types of QLICIs directly fuel the growth of businesses in low income communities by financing critical aspects of their business activities. One key challenge we experience when using our NMTC allocation for business lending is that the credit is a *place-based subsidy that does not take into consideration how businesses operate and how to attract private capital and credit to underserved areas*. For example, we have received NMTC loan requests from a borrower that is not located in a qualifying census tract but would like to relocate in a low income (qualifying) community. These borrowers are not able to secure financing to acquire or rehabilitate a new facility in an eligible census tract because the NMTC program does not provide a means of qualifying a borrower on a *pro forma* or projected basis. If the tax credit program contained such a provision we believe substantial private capital would be invested by firms seeking to relocate or expand in qualifying areas – as is the stated intent of this program.

If the CDFI Fund seeks to better balance the use of NMTC financing by encouraging more tax credit resources be directed to operating companies for both real estate and non-real estate activities, we respectfully recommend that the Application and the review process stipulate that special consideration be given to Applicants that intend to make QLICIs for these purposes.

<u>SPECIFIC COMMENTS ON QUESTION #9</u>

In Question #9 of the request for comments, the CDFI Fund asks ***"Are there changes that can be made to the application process or elsewhere, that will increase the amount of Qualified Low-Income Community Investments (QLICIs) that support activities that have not traditionally received large scale financing from NMTC investment proceeds (e.g., loans and investments for small business operations; loans to and investments in other CDEs, including CDFIs; purchase of loans from other CDEs; etc.)?"***

In our experience, there is a significant inconsistency in the current Application that makes it difficult for Allocatees to utilize the NMTC to finance operating companies seeking to acquire or rehabilitate their own facilities. This inconsistency is arises from guidance provided in a TIP[3] (in the Business Strategy Section) and the way question 14

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[3]These definitions may be found in the TIP located in the Business Strategy Section of the NMTC Application under the Products, Services and Investment Criteria, (Page 7).*"TIP: For the purposes of completing the Business Strategy section and all relevant exhibits, real estate refers to the development or leasing of a specific real estate project or projects, usually through special purpose entities established for that purpose. Investments in real estate businesses (development, management or other) in support of general business operations (as opposed to a specified project or projects) are considered non-real estate business transactions.*

Transactions with businesses that are involved in all other types of business activities should be classified as non-real estate business transactions regardless of: 1) how the business intends to use the proceeds of the transaction; or 2) whether the business intends to use any real estate owned as (out of that same section) is structured. The language of the TIP defines real estate and non-real estate transactions for the purposes of classifying borrowers as QALICBs (Qualified Active Low Income Community Businesses). The TIP provides further guidance and flexibility to CDEs when seeking to lend or invest in special purpose entities that are controlled by or under common control with a non-real estate QALICB and were set up to lease back property to the QALICB.[4] These borrowers may be classified as either real estate or non-real estate QALICBs at the discretion of the CDE. This language clearly leaves it up to the CDE to determine or qualify an SPE borrower affiliated with a non-real estate QALICB as either a real estate or non-real estate QALICB. This flexibility has been the hallmark of the NMTC program.

Unfortunately, the structure of Question #14 is not consistent with the discretion provided in the TIP. This question is critical to establishing the types of Qualified Low-Income Community Investments (QLICIs) an Applicant intends to make and directly influences the CDE's Allocation Agreement, Schedule I. As currently construed, Question 14 (a) allows an Applicant to indicate its intent to make investments in, or loans to, non-real estate QALICBs either for (1) business operations or (2) to develop or acquire property to be used in operating the business. The second part of the question - 14(b) allows an Applicant to indicate its intent to make investments in, or loans to, real estate QALICBs but does not make the distinction included in the TIP (for this section) between those real estate QALICBs that are developing, acquiring or rehabilitating real estate (i.e. real estate development) vs. developing, acquiring or rehabilitating real estate to support activities carried out by operating companies.

While this may seem an insignificant oversight, in practice, the absence of this distinction has truly constrained CRF in using its NMTC resources to support business borrowers. To date, CRF has made 343 QLICIs, of which 65% represent business borrowers that chose to form Special Purpose Entitites (SPEs) specifically for the purpose of owning property, and then leasing it back to the operating company. Because it is not part of CRF's current NMTC business strategy to finance real estate development companies, or QALICBs whose principal activities involve the development or rehabilitation of real estate that will be sold or used by third parties, we are not able to check the box

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collateral for a loan. For example, if an Applicant provided a loan to a childcare provider for the purpose of purchasing the property where the childcare center would be housed, the Applicant would categorize this loan as a non-real estate business transaction. However, if the Applicant provided a loan to a development company for the purpose of building a childcare center, and the organization's primary business is the development of community facilities, this loan would be considered a real estate business transaction.

*Notwithstanding the above, **loans or investments made to special purpose entities that are principally owned by a non-real estate QALICB, and that were set up specifically to lease property back to the QALICB such that the QALICB is the principal user of the property, may be classified as either a "real estate QALICB" or a "non-real estate QALICB", at the discretion of the CDE." (emphasis added)***

[4] While the actual language of the TIP refers to special purpose entities (SPEs) *principally owned by non-real estate QALICBs*, CRF recommends modifying the language by replacing the phrase ***"non-real estate QALICB "*** with the phrase "***operating company***" so as to allow SPEs that are owned or controlled by an operating company that *is not* or *cannot* be qualified as non-real estate QALICB to access NMTC financing. Challenges often arise when trying to qualify an operating company that is not located in or doing business in an eligible census tract but which would like to relocate or expand its operations to a low income community.

for Question 14 (b). Thus, we lack the flexibility under our Allocation Agreement to qualify an SPE controlled by or under common control with an operating company as a real estate QALICB. The final result is that without this flexibility there are borrowers we must simply turn away despite the fact that the project or loan they are seeking is in keeping with both the regulations and the spirit of the NMTC program. We have provided an example below to illustrate the kind of loans we often deny due to the current challenges posed by Question #14.

Example: Assume a privately held toy manufacturer wishes to purchase a builidng and expand its activities at this new location. Based on advice from its legal and tax advisors, the toy manufacturer forms a special purpose entity (SPE) to buy and lease back the new facility to the operating company. The toy manufacturer would like to finance the purchase of the building with a NMTC loan, however; the operating company cannot be qualified as a non-real estate QALICB since its assets, employees and are revenues are not located in or derived from activities in a qualifying area. If the operating company cannot be qualified as a non-real estate QALICB, a second option is to qualify its SPE as a real estate QALICB only, since the new facility *will* be located in a qualifying tract.

In this case, CRF would not be able to make a NMTC loan to the toy manufacturer because the current wording of Question #14 (b) makes no reference to real estate QLICIs to support operating businesses activities. CRF only checked the loans or investments into non-real estate QALICBs in Question 14, and in this example we are not able to qualify the operating company because it is not located in an eligible census tract.

We do not check the loans to or investments in real estate QALICBs because our activities support operating businesses and do not create "real estate" impacts such as construction jobs. The types of QLICIs reflected in our Application are then incorporated into our Allocation Agreement and comprise the types of NMTC financing activites we are permitted to conduct with our allocation. The irony is that CRF has tremendous expertise in providing just this type of financing. Furthermore, encouraging private capital to be invested in LICs by firms outside of those communities will generate new jobs, bring additional resources and create demonstrated community impact in underserved areas.

RECOMMENDED CHANGES

We believe this inconsistency in the Application that limits the use of the NMTC for real estate financing for operating businesses can be remedied with changes to the Application, the Allocation Agreement and the Community Investment Impact System (CIIS) as we describe below.

We suggest that new language be added to Question 14 (b) as shown in bold:

"b. ________ % Investments in, or loans to, real estate QALICBs

> _______*% Investments in, or loans to QALICBs whose principal activities involve the development or rehabilitation of real estate.*
>
> _______***% Investments in, or loans made to special purpose entities that are controlled by or under common control with an operating company, and that were set up specifically to hold and lease property back to the operating company such that the operating company is the principal user of the property.*** *"*

We would also recommend broadening the TIP language (in the Business Strategy Section) in order to expand the use of NMTC resources by operating companies that are controlled by or under common control with an SPE and would like to purchase or rehabilitate property for their own use in an eligible census tract. Specifically, we propose replacing the phrase ***"non-real estate QALICB"*** with the words ***"operating company"***. This change is in keeping with the intent and flexibility of the tax credit, as it would allow more operating companies outside of eligible areas to deploy capital and credit in low income communities. We respectfully recommend the final paragraph of the TIP be modified to read as follows (changes are shown in bold):

"Notwithstanding the above, loans or investments made to special purpose entities that are ***controlled by or under common control with an operating company****, and that were set up specifically to lease property back to the* ***operating company*** *such that the* ***operating company*** *is the principal user of the property, may be classified as either a "real estate QALICB" or a "non-real estate QALICB", at the discretion of the CDE."*

In addition, there are conforming changes that should be made to Tables C1 and C2: Historic Community Impacts and Projected Economic Development Impacts. Currently, Tables C1 and C2 require Applicants to provide historic and projected impact data for real estate QALICBs, such as construction jobs and square footage developed, that are ill-suited to describing the impact generated by an operating company (as opposed to a real estate developer) using an SPE structure. These operating companies do not engage in traditional real estate activities and therefore do not create real estate related impacts. A new row labeled "***2c Special Purpose Entities owned by non-real estate QALICBs"*** should be added to each Table for Applicants indicating that a defined percentage of their real estate QALICBs are investments in, or loans made to special purpose entities that are controlled by or under common control with an operating company, and that were set up specifically to lease property back to the operating company such that the operating company is the principal user of the property. These QALICBs *should not* be required to enter impact data associated with traditional real estate activities, such as square footage developed or constructions jobs created, but rather should be asked to enter impact data for measures that are meaningful and appropriate to the nature of the activity.

Finally, we recommend several technical and conforming changes to Section 3.3 H and Schedule 1 the Allocation Agreement (see Appendix I) and to the Transaction Level Report of the Community Investment Impact System (CIIS)

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(see Appendix II) to ensure that all program documents and compliance systems are properly aligned and allow maximum flexibility to use the tax credit for real estate financing for operating businesses.

CONCLUSION

In closing, we appreciate this opportunity to share our views on the NMTC Allocation Application and ways to enhance this vital tax credit program so that more Qualified Low-Income Community Investments might support activities that have not traditionally received large scale financing from NMTC investment proceeds. In light of the current economic crisis, the NMTC program is critically important to the revitalization of our underserved and distressed communities. We at CRF are committed to working with the CDFI Fund to strengthen this program. We commend the dedication of the CDFI Fund staff for their efforts to review and administer this program. We would be pleased to answer any questions regarding the comments provided in this letter.

Sincerely,

Frank Altman
President and CEO

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