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FAX Transmittal Cover Sheet

Date: 3-27-98

Number of Pages: 21
(Including Cover Page)

From: **STEVEN J. TUMINARO**
Policy Analysis Director / Assistant Treasurer

To: Jon ORSZAG

Company: NATIONAL Economic Council

FAX Number: (202) 456-2223

Message: Jon: I WANT YOU TO KNOW THAT JOE VENTONE (DEPUTY STAFF DIRECTOR, HOUSE SUBCOMMITTEE ON HOUSING) ASKED GEORGE KNIGHT FOR SOME IDEAS FOR A "HOMEOWNERSHIP BILL". THE FOLLOWING TWO LETTERS (ONE FROM GEORGE; ONE FROM ME) REPRESENT OUR RESPONSE. MY LETTER WAS IN RESPONSE TO JOE'S REQUEST FOR MORE INFO. SEE YOU AT THIS AFTERNOON'S MEETING OF THE

FAX Number: (202) 376-2160

HOMEOWNERSHIP
WORK GROUP.

EXECUTIVE SERVICES DIVISION

Steve

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March 25, 1998

Mr. Joe Ventrone
Staff Director
Subcommittee on Housing and Community Opportunity
B-303 Rayburn House Office Building
Washington, DC 20515

VIA FAX

Dear Joe :

Homeownership ideas: [These are the result of our experience working in neighborhoods that are characterized by a median income of \$22,000, median home price of \$57,000 and new homeowner purchases by families who are 61 percent minority. Of these families, 70 percent earn less than 80 percent of the median income and 65 percent are single heads of households (women = 42 percent, men=23 percent).] These are practitioner drawn, thus not the result of deep statistical analysis.

1. Section 8 certificates to expand homeownership. If a family could use the 3-year value of a Section 8 certificate, in many places they could be permanently in homeownership without any continuing subsidy. See attached analysis based on actual sales in NeighborWorks® organizations' neighborhoods in the cities cited. Could fund a cost-capped demo without increasing the Department's budget.
2. Use power of Section 42 (Low Income Tax Credits) to move families from rental to Mutual Housing Association ownership. Working with Senator D'Amato's office, the attached language has been developed. This could be done without any increased costs.
3. Enable an aggressive FHA disposition program that favored homeownership occupancy. Perhaps similar to the RTC, designate up to 10 percent (pick a number) of FHA foreclosures in impacted neighborhoods for quick negotiated sale at a price that takes into account sound rehabilitation and existing market sales prices to pre-qualified organizations (profit, public, nonprofit). Require minimum blocks of 10 houses and a maximum of 30 to any one organization at a time.

Board of Directors

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Director, Office of
Thrift Supervision

Mr. Joe Ventrone
March 25, 1998
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4. Allow easy use of HOME funds for mixed-income loan pools provided that 5 times as many low-income families would be served as could be by direct use of the HOME funds. See attached write-up. Joe, this was prepared several years ago, some minor changes made, HOME funds still not very usable for these purposes. We could update if you want.
5. Always recognize that the largest block of central city potential new homeowners are those earning between \$15,000 and \$25,000. There were 5,177 families (21% of all families) as of 1995 with only 40% as homeowners. For families earning over \$50,000; 81% are owners. See attached chart.

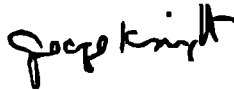
Joe, this may be less focused than perhaps either of us would like. Let me stress a few positives:

1. conventional capital is plentiful
2. local creativity abounds if a source of flexible capital funds are available
3. conservative underwriting has enabled NeighborWorks® clients to be good risks

Finally, I've enclosed a few key charts from the recently completed NeighborWorks® Campaign for HomeOwnership. The original goal of 10,000 new owners was overshoot by 50% with the last 6 months of data still being compiled. I would not be surprised if the final number of families exceeded 15,000 using about \$1.2B in lending – overwhelmingly from the conventional sector. By the way, during those five years Neighborhood Reinvestment's total appropriations were \$188M – of which only a small percentage was focused on the homeownership campaign.

Let me know if you have questions or need further information.

Sincerely,



George Knight
Executive Director

Attachments

cc: Ali Solis

USE OF SECTION 8 FOR HOME OWNERSHIP

The attached charts demonstrate that, in most of the jurisdictions studied, it would require less than 18 months of Section 8 subsidy at the 3 BR FMR level to provide enough down payment assistance to help a family purchase a home with an initial 20 percent equity position. Chart #1 shows that using a limited period of Section 8 payments to create equity for the purchase of a home – at the average purchase price experienced in the NeighborWorks® Campaign for Home Ownership – usually results in a 30-year mortgage that would be affordable for families below 50 percent of the area median income. Chart #2 shows that 15-year mortgages would also be affordable to the target population, although not in as many markets. For the purpose of this analysis, affordability is defined as limiting mortgage principal and interest payments to no more than 25 percent of income, which allows an additional 5 to 8 percent of income for taxes and insurance. Chart #3 shows that, even in the worst-case scenario of an ongoing need for subsidy, the level of subsidy required to support such new mortgages would be well below the 3BR FMR level in most markets. The analysis can be repeated for 2BR and 4BR FMR levels with similar results, as the slight reductions or increases in FMR would probably correlate with slight reductions or increases in the average home price associated with changes in family size.

Based on the actual experience of NeighborWorks® organizations, this program structure works in many local housing markets. There may be a large number of families currently receiving Section 8 assistance that could be converted to home ownership using this approach. The approach is a means of using a short-term subsidy to provide lifetime benefits for the families assisted, while generating significant short- and long-term budgetary savings in the process.

March 25, 1998

CHART #1: Comparison of 3BR FMR to Average Home Cost In NeighborWorks Campaign
(30-Year Mortgage)

Neighborhood Organization	City	State	County	FY97 3BR FMR	Average Home Cost	Ratio of Avg Home Cost to FMR	Ratio of Avg Home Cost to FMR	Ratio of Avg Home Cost to FMR	Ratio of Avg Home Cost to FMR	Ratio of Avg Home Cost to FMR	Ratio of Avg Home Cost to FMR	Ratio of Avg Home Cost to FMR
NHS of Phoenix	Phoenix	AZ	Maricopa	798	54,778	10,956	14	43,822	338	16,128	22,250	35,600
Los Angeles NHS	Los Angeles	CA	Los Angeles	1,153	107,999	21,600	19	88,389	884	31,872	25,300	40,480
San Bernardino NHS	San Bernardino	CA	San Bernardino	809	126,044	25,209	31	100,835	775	37,216	25,300	40,480
NHS of New Haven	New Haven	CT	New Haven	891	58,219	11,644	13	48,575	358	17,184	30,400	48,640
Miami-Dade NHS	Miami	FL	Dade	1,013	62,218	12,444	12	49,774	382	18,336	20,850	33,360
NHS of Chicago	Chicago	IL	Cook	916	64,867	12,973	14	51,894	389	19,152	26,550	42,480
Kankakee NHS	Kankakee	IL	Kankakee	647	41,838	8,367	13	33,469	257	12,336	18,800	30,080
NHS of Lake County	Waukegan	IL	Lake	916	75,100	15,020	16	60,080	482	22,176	28,550	42,480
Project Renew	Fort Wayne	IN	Allen	619	49,007	9,801	16	39,208	301	14,448	22,950	36,720
NHS of New Orleans	New Orleans	LA	Orleans	656	49,051	9,810	15	39,241	301	14,448	18,450	29,520
NHS of Shreveport	Shreveport	LA	Caddo	623	43,815	8,763	14	35,052	270	12,960	18,450	29,520
NHS of Baltimore	Baltimore	MD	Balt. City	799	55,852	11,170	14	44,682	343	16,484	29,400	47,040
Dayton's Bluff NHS	St. Paul	MN	Ramsey	841	79,817	15,963	19	63,854	491	23,568	27,350	43,760
Kensington-Bailey NHS	Buffalo	NY	Erie	638	33,864	6,773	11	27,091	208	9,984	25,000	40,000
NHS of Hamilton	Hamilton	OH	Butler	685	47,661	9,532	14	38,129	283	14,084	19,400	31,040
NHS of Tulsa	Tulsa	OK	Tulsa	694	44,004	8,801	13	35,203	271	13,008	20,100	32,160

CHART #2: Comparison of 3BR FMR to Average Home Cost In NeighborWorks Campaign
(15-Year Mortgage)

Neighborhood Organization	City	State	County	FY97 3BR FMR	Average Home Cost	Ratio of Avg Home Cost to FMR	Ratio of Avg Home Cost to FMR	Ratio of Avg Home Cost to FMR	Ratio of Avg Home Cost to FMR	Ratio of Avg Home Cost to FMR	Ratio of Avg Home Cost to FMR	Ratio of Avg Home Cost to FMR
NHS of Phoenix	Phoenix	AZ	Maricopa	798	54,778	10,956	14	43,822	431	20,888	22,250	35,600
Los Angeles NHS	Los Angeles	CA	Los Angeles	1,153	107,999	21,600	19	88,389	850	40,800	25,300	40,480
San Bernardino NHS	San Bernardino	CA	San Bernardino	809	126,044	25,209	31	100,835	893	47,662	25,300	40,480
NHS of New Haven	New Haven	CT	New Haven	891	58,219	11,644	13	48,575	458	21,984	30,400	48,640
Miami-Dade NHS	Miami	FL	Dade	1,013	62,218	12,444	12	49,774	490	23,520	20,850	33,360
NHS of Chicago	Chicago	IL	Cook	916	64,867	12,973	14	51,894	511	24,528	26,550	42,480
Kankakee NHS	Kankakee	IL	Kankakee	647	41,838	8,367	13	33,469	330	15,840	18,800	30,080
NHS of Lake County	Waukegan	IL	Lake	916	75,100	15,020	16	60,080	582	28,416	28,550	42,480
Project Renew	Fort Wayne	IN	Allen	619	49,007	9,801	16	39,208	389	18,528	22,950	36,720
NHS of New Orleans	New Orleans	LA	Orleans	656	49,051	9,810	15	39,241	386	18,528	18,450	29,520
NHS of Shreveport	Shreveport	LA	Caddo	623	43,815	8,763	14	35,052	345	16,560	18,450	29,520
NHS of Baltimore	Baltimore	MD	Balt. City	799	55,852	11,170	14	44,682	440	21,120	29,400	47,040
Dayton's Bluff NHS	St. Paul	MN	Ramsey	841	79,817	15,963	19	63,854	629	30,192	27,350	43,760
Kensington-Bailey NHS	Buffalo	NY	Erie	638	33,864	6,773	11	27,091	267	12,816	25,000	40,000
NHS of Hamilton	Hamilton	OH	Butler	685	47,661	9,532	14	38,129	375	18,000	19,400	31,040
NHS of Tulsa	Tulsa	OK	Tulsa	694	44,004	8,801	13	35,203	347	16,656	20,100	32,160

**CHART #3: Monthly Mortgage Payment as Percent of FMR
(30-Year and 15-Year Mortgages)**

City	State	County	FY97 30-YR FMR	FY97 15-YR FMR	Ratio	FY97 30-YR FMR	FY97 15-YR FMR	Ratio
Phoenix	AZ	Maricopa	796	336	42%	431	54%	
Los Angeles	CA	Los Angeles	1,153	684	58%	850	74%	
San Bernardino	CA	San Bernardino	809	775	96%	993	123%	
New Haven	CT	New Haven	891	358	40%	458	51%	
Miami	FL	Dade	1,013	382	38%	490	48%	
Chicago	IL	Cook	916	399	44%	511	56%	
Kankakee	IL	Kankakee	647	257	40%	330	51%	
Waukegan	IL	Lake	916	462	50%	592	65%	
Fort Wayne	IN	Allen	819	301	49%	386	62%	
New Orleans	LA	Orleans	656	301	46%	386	59%	
Shreveport	LA	Caddo	823	270	43%	345	55%	
Baltimore	MD	Balt. City	799	343	43%	440	55%	
St. Paul	MN	Ramsey	841	491	58%	629	75%	
Buffalo	NY	Erie	638	208	33%	267	42%	
Hamilton	OH	Butler	685	293	43%	375	55%	
Tulsa	OK	Tulsa	694	271	39%	347	50%	

**Suggested Changes to
Legislative Proposal to Extend Section 42 Credits to Housing Cooperatives:**

Although Neighborhood Reinvestment is supportive of the current legislative proposal to extend Section 42 credits to housing cooperatives, we are concerned that Mutual Housing Associations may "fall through the cracks" of the current proposal as written. However, the following changes to the proposed legislative language would fully address our concerns regarding Mutual Housing Associations.

MHA(?)

1. We recommend that the currently proposed Section 216A(b)(1)(A) be modified by the addition of a new subchapter (iii), to include language along the lines of the following:

"(iii) Provided however, that membership certificates may be accepted in lieu of shares in the case of resident-controlled, state-chartered Mutual Housing Associations which are tax-exempt under the provisions of Section 501(c)(3) of the Internal Revenue Code; and for such Mutual Housing Associations, membership certificates may substitute for shares, and membership certificate-holders may substitute for shareholders in all references within this section to non-patron shares, patron shares, non-patron shareholders, and patron-shareholders."

2. We would further recommend the following rewrite of proposed Section 216(e)(i):

"(i) the consideration paid for such shares by the first shareholder, as adjusted by a cost-of-living adjustment and any other acceptable adjustments determined by the Secretary, and ..."

D'Amato →
LISC → not approved.
Rangel →

March 25, 1998

HOME Changes

A. Loan Guarantees. § 92.205(b)(2)

Neighborhood Reinvestment strongly supports the inclusion of loan guarantees as an eligible use of HOME funds.

We also support the provision that the amount of HOME funds in the loan guarantee account may not exceed 20 percent of the total outstanding principal amount guaranteed.

However, the explanation of how such a loan guarantee could be structured (as contained in the Background section - page 36020-1) presents a cumbersome process that will not function well for HOME subrecipients. Among our concerns are the following:

- The use of the phrase: "*... it is the participating jurisdiction's choice and responsibility to properly underwrite and manage loans made under the guarantee,*" puts the participating jurisdiction in a position of not only approving a subrecipient's plan to establish a loan guarantee (ie. structure, size, percent of HOME funds in the account, type of loans, borrowers to be served, etc.) but would also require the participating jurisdiction to directly underwrite and manage the loans.

We urge that participating jurisdictions be given the authority to approve a loan guarantee structure/mechanism established by a subrecipient -- as well as to allow their subrecipient to underwrite and manage the loans made pursuant to the approved loan guarantee, subject to agreed upon criteria and reporting requirements.

- The language in the Background section also says: "*A PJ or its subrecipient would estimate the number of loans it potentially wants to guarantee . . .*," when in reality most loan pools are set by dollar amount. It is true that one could estimate the number of loans which might be made from a given size loan pool, but there are so many variables involved, that such an estimate may be meaningless. Why shouldn't a PJ and its subrecipient be able to establish a loan pool based on the dollar amount of the guarantee?

We recommend that participating jurisdictions be given the authority to approve loan guarantees based on either: the dollar amount of the loan pool, or an estimate of the number of loans it potentially wants to guarantee.

- We don't understand the reason for the statement: "*The number of loans initially planned for a loan guarantee project may not be increased.*" Why not? An increase in the number of loans made pursuant to the guarantee should not only be permitted, it should be encouraged, because it thins out the guarantee. We can understand not allowing the guarantee amount to increase, but if you can talk private lenders into making more loans with the existing guarantee amount, why wouldn't you want to do that?
- As the loan guarantee is now structured, one could have a pool of X loans contemplated. "*The PJ would draw down funds into its loan guarantee account at the time the loan is guaranteed equal to the amount of each guaranteed loan until the minimum balance amount is deposited in the account.*" (page 36021). At this point, each loan would in effect have a 100 percent guarantee. If these loans default, the loan guarantee would pay off the loans, and no other loans would be made.

While this scenario may not be likely, it demonstrates that in an apparent effort to safeguard HOME funds, an unwieldy process has been created — while still not assuring the safety of the HOME funds.

We recommend that a PJ or its subrecipient be permitted to draw down funds when there are clear, binding commitments in place by lenders and/or other non-HOME funding sources to fund a loan pool to be guaranteed by the drawn down HOME funds. To prevent HOME funds from sitting idly in a loan guarantee account, there should be restrictions regarding future draw downs of HOME funds by that entity, unless the loan pool is performing as projected or at a level acceptable to the PJ.

- The Background section (page 36021) includes the statement: "*Housing projects financed with HOME guaranteed loans must meet HOME requirements.*" -- and the interim rule in § 92.205(b)(2) states: "*While loan funds guaranteed with HOME funds are subject to all HOME requirements, funds which are used to repay the guaranteed loans are not.*"

Why not have the loan pool guarantee on loans that meet HOME eligibility standards, thus allowing other non-HOME eligible loans to also be made from the pool. This would likely result in more loans being made with the same amount of HOME-funded guarantee — bringing about increased benefit to the community, borrowers and lenders, with no additional cost or risk to the HOME account.

- The construct of the loan guarantee as described, doesn't seem to address the use of HOME funds as a possible interest subsidizer on a loan pool, in addition to being a guarantee source.

Given that HOME funds can be used to reduce interest rates for individual loans, PJs and their subrecipients should also be permitted to use HOME funds to subsidize the interest rate on a loan pool.

- The language in the last sentence of § 92.205(b)(2) is confusing, and should clearly state that: Repayments of non-HOME funds are not subject to HOME eligibility restrictions in their subsequent use.
- To assure that creative approaches to loan guarantees are not precluded, the final rule should contain a provision providing that other loan guarantee structures could be submitted to the Secretary, and the Secretary may approve such loan guarantee structures, provided they meet the principle of less than a 20 percent guarantee.

Recapture Provisions for Homeownership. § 92.254

Neighborhood Reinvestment is supportive of the rule change at § 92.254. However, recognizing that the interim rule provides three examples of recapture guidelines, and to assure that other reasonable approaches to recapture are not precluded, the final rule should include a provision whereby PJs could submit other recapture approaches to HUD for possible approval.

Definitions. § 92.2**Homeownership:**

Neighborhood Reinvestment enthusiastically supports *"allowing participating jurisdictions to classify limited equity cooperatives and/or mutual housing either as homeownership or rental housing based on State law."*

To avoid any future confusion, we suggest the final rule also include definitions for limited equity cooperative, and for mutual housing. We recommend that the final rule use the same language used in the definition section of the HOPE 2 regulations. To wit:

"The term 'Mutual Housing Association' means a private entity organized under State law that has been determined to be a tax-exempt entity under section 501(c) of the Internal Revenue Code of 1986 and that owns, manages and continuously develops affordable housing by providing long-term housing for low- and moderate income families. The residents of mutual housing participate in the ongoing management of the housing, and through the purchase of membership interests in the associations, have the right to continue residing in the housing as long as they own memberships in the associations."

Home Ownership in the United States

The Potential for Home Ownership in Central Cities 1995

(Units in Thousands)

INCOME OF FAMILIES AND PRIMARY INDIVIDUALS	NUMBER OF OWNER OCCUPIED UNITS	NUMBER OF RENTER OCCUPIED UNITS	TOTAL OF OWNER & RENTER OCCUPIED UNITS	PERCENTAGE OF OWNERS WITHIN INCOME GROUPS
less than \$5,000	738	1,467	2,205	28%
\$5,000 - \$9,999	798	2,689	3,485	23%
\$10,000 - \$14,999	957	1,955	2,912	33%
\$15,000 - \$19,999	976	1,555	2,531	39%
\$20,000 - \$24,999	1,088	1,555	2,643	41%
\$25,000 - \$29,999	1,419	1,572	2,991	47%
\$30,000 - \$34,999	862	1,048	1,910	48%
\$35,000 - \$39,999	845	640	1,485	57%
\$40,000 - \$49,999	1,668	1,108	2,772	60%
\$50,000 - \$59,999	1,363	533	1,896	72%
\$60,000 - \$79,999	1,763	920	2,683	77%
\$80,000 - \$99,999	929	159	1,088	85%
\$100,000 - \$119,999	497	114	611	81%
\$120,000 or more	912	113	1,025	89%
TOTAL	14,808	15,436	30,243	
MEDIAN	36,026	17,152	25,073	

In America's central cities, the home-ownership rate of 49% is considerably lower than the national rate of 64%. A substantial market exists for home ownership, especially for families with annual incomes of \$35,000 or less (which now have only a 36% home ownership rate). NeighborWorks® organizations provide technical assistance and financing mechanisms to make home ownership a reality for more residents of urban areas.

Source: American Housing Survey, Table 8-12; 1995.

NeighborWorks® Campaign for Home Ownership

Comparative Cost and Output

(PRELIMINARY 54-Month Data Ending June 30, 1997)

NEIGHBORWORKS® CAMPAIGN: JANUARY 1993 - JUNE 1997

Campaign Output

• Total Number of New Homeowners	12,466
• Total Number of Housing Units	14,221
• Total Amount of Investment	\$858,344,825*
• Total Number of Pre-Purchase Counseling	88,402

Characteristics of Homebuyers

- Home ownership is less costly than renting or only marginally more costly for 37 percent of the new homeowners.
- Forty-two percent of new homeowners are females.
- Ninety-five percent are first-time homebuyers.

* Out of 14,221 total units, investment information for 104 units were not available and therefore, not reflected in total investment figure.

Comparative Cost of Single-Family Purchased Homes: U.S. Market and NeighborWorks® Campaign

Cost and Affordability	U.S. Data 1995 ⁽¹⁾	NeighborWorks® Data 1993/97 ⁽²⁾
Home Purchase Cost		
<i>Average</i>	\$139,000	\$65,635 *
<i>Median</i>	\$112,900	\$58,500 *
Median Family Income	\$39,558	\$24,972
Monthly P&I Payment (Median)	\$653	\$377 *
Monthly Payments as % of Income (Median)		
<i>(Excluding taxes and insurance)</i>	20%	19% *
<i>(Including taxes and insurance)</i>	n/a	25% *

⁽¹⁾ Source: National Association of Realtors, 1996, "Real Estate Outlook," v.3, no.8.

⁽²⁾ Neighborhood Reinvestment, Campaign Data, Jan. 1, 1993 - June 30, 1997.

* Homes with more than one unit structure were excluded in calculation.

6/97 - Semi-Annual

NeighborWorks® Campaign for Home Ownership
Comparative Data
(PRELIMINARY 54-Month Data Ending June 30, 1997)

Characteristics of Homebuyers	HMDA DATA 1995 ⁽¹⁾		NeighborWorks® Loans 1993/97 ⁽²⁾	U.S. Population 1993 ⁽³⁾
	Conventional Loans	Government Backed Loans		
Race/Ethnicity				
White	84%	70%	39%	83%
African-American	5%	15%	38%	12%
Hispanic	6%	12%	20%	(10)% ⁽⁴⁾
Other	5%	3%	3%	4%
Household Income (% of MSA Median)				
Less than 80%	24%	38%	70%	40%
80 - 120%	26%	38%	22%	16%
More than 120%	50%	24%	8%	44%
Gender				
Male	20%	25%	23%	49%
Female	17%	18%	42%	51%
Joint (Male/Female)	63%	57%	35%	—

⁽¹⁾ Source: Home Mortgage Disclosure Act (HMDA), 1995 aggregate tables;
government-backed loans include FHA, VA and Farmers Home Administration (FMHA)
mortgages.

⁽²⁾ Neighborhood Reinvestment, Campaign Data, Jan. 1, 1993 - June 30, 1997.

⁽³⁾ U.S. Census Bureau.

⁽⁴⁾ The U.S. Census counts Hispanic origin as an ethnic category included in racial groups.

NeighborWorks® Campaign for Home Ownership**Affordability****(PRELIMINARY 54-Month Data Ending June 30, 1997)****AFFORDABILITY MEASURES**

Household Income and Monthly Payments (PITI)

- Seventy-six percent of new homeowners pay less than 30% of their annual household income for their housing costs.
- Fifty percent of new homeowners pay less than 25% of their annual household income for their housing costs.
- Twenty-five percent of new homeowners pay less than 20% of their annual household income for their housing costs.

Monthly Payments (PITI) and Prior Rent

- Home ownership is less costly than renting for 26% of the new homeowners.
 - Home ownership is either less costly than renting or only marginally more costly for 37% of the new homeowners (marginally more costly = 1-10% above their previous rent).
-

Neighborhood Reinvestment Corporation

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March 27, 1998

Mr. Joe Ventrone
Deputy Staff Director
Subcommittee on Housing and Community Opportunity
B-303 Rayburn House Office Building
Washington, DC 20515

Via Fax to: (202) 225-6635

Dear Joe:

George Knight has asked me to provide further information and rationale regarding the recommendation (in his March 25, 1998 letter) to: *"Allow easy use of HOME funds for mixed-income loan pools."*

We thank you for your interest in the suggestion that the HOME program be modified to permit use of HOME funds for loan guarantees and loan-pool reserves by subrecipients -- and for the copy of HUD's HOME program loan guarantee proposal.

The recommendation to *allow easy use of HOME funds for mixed-income loan pools* really involves two distinct issues related to the use of HOME funds by subrecipients.

- The use of loan pools by HOME subrecipients, funded in part with HOME funds which leverage private, conventional capital; and
- Using HOME funds to serve a range of incomes.

This letter attempts to further address each of these points, and offers possible legislative revisions to the HOME program.

I. The use of Loan Pools, funded in part with HOME funds.

From the inception of the HOME program, Neighborhood Reinvestment (based on our experience) has urged HUD and various congressional members and staff to permit HOME subrecipients to use HOME funds for loan guarantees and loan-pool reserves. HUD *has* moved on this issue, but not yet in a way that allows community-based nonprofit organizations to maximize their leverage of HOME funds.

Board of Directors

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Federal Reserve System

Andrew C. Hove Jr.
Acting Chairman, Federal Deposit
Insurance Corporation

Andrew Cuomo
Secretary of Housing
and Urban Development

Norman E. D'Amours
Chairman, National Credit
Union Administration

Ellen Seidman
Director, Office of
Thrift Supervision

Nicolas P. Reusinas
Assistant Secretary for Housing/
Federal Housing Commissioner,
Department of Housing and
Urban Development

Joe Ventrone
March 27, 1998

Page 2.

Specifically:

HUD published an interim rule for the HOME program on July 12, 1995, which included provision for the use of HOME funds for loan guarantees. However, this was specifically designed for loan guarantee funds established directly by participating jurisdictions, and it does not function well (if at all) for HOME subrecipients. (Note: The attachment to my March 25, 1998 letter, excerpts relevant portions of our comments to HUD).

HUD's current HOME program loan guarantee proposal is similarly structured to address only:
"... the notes or other obligations issued by eligible participating jurisdictions or by public agencies designated by and acting on behalf of eligible participating jurisdictions ..."

While this latest HUD proposal undoubtedly has merit, it does nothing to address the current obstacles faced by subrecipients in establishing HOME-funded loan-pool reserves.

Neither the HOME statute nor regulations preclude the use of HOME funds for loan guarantees or loan-pools established by community-based nonprofit subrecipients of HOME funds. However, there is continued confusion as to whether (or how) such a loan guarantee or loan pool reserve fund can be established and operated, and the resulting complexity has effectively blocked any such efforts. As a result, HOME funds are not being leveraged anywhere near as effectively as they could be.

The most significant technical issue is the requirement (in statute and regulation) that HOME funds must be "expended" or "invested" within 15 days.

HUD regulations require that funds must be "expended for eligible costs within 15 days of the disbursement" [24 CFR Part 92.502(c)(2)].

The statute states: "The participating jurisdiction shall, not later than 15 days after the funds are drawn from the participating jurisdiction's HOME Investment Trust Fund, invest such funds, together with any interest earned thereon, in the affordable housing for which the funds were drawn" [Title 42, Section 12748(e)].

The obvious intent of these provisions is to assure that HOME funds not sit idle for any significant period of time simply earning interest. It is unreasonable however, to allow (for example) \$100,000 of HOME funds to be used to directly fund eligible activities but not allow that same \$100,000 to leverage \$1,000,000 or more in other funds that can then be used to support HOME-eligible activities.

For example, if the average second mortgage funded with HOME funds is \$20,000, you can serve 5 families with the \$100,000 in HOME funds ($5 \times \$20,000 = \$100,000$). If you use the \$100,000 in HOME funds in a combination of second mortgages and top loan-loss guarantees in a \$1.1 million pool (\$1 million in conventional funds, leveraged by \$100,000 in HOME funds) you could serve many more families. Of these families, more than 5 (most likely 25 or more) would be HOME-eligible — and some might not be. The point is, for \$100,000 do you want to serve 5 HOME-eligible families, or many, many more?

Joe Ventrone
March 27, 1998

Page 3.

All of this assumes local creativity, measuring for results, and the ability to tap local sources of conventional capital -- with the specific details of each loan-pool worked out locally, and subject to the approval of the participating jurisdiction.

In order to permit community-based subrecipients to use HOME funds for loan guarantees or loan-pool reserves (with the approval of their participating jurisdiction), legislative revision may be needed. Joe, we do not claim to be the experts in drafting legislation, so we offer the following "Possible Legislative Revisions" as *one way* to implement our recommendations. It may alternatively make sense to weave similar language into HUD's current "HOME Program Loan Guarantees" proposal -- specifically adding HOME subrecipients. However, I think significant changes would need to be made to (to among other things) place the authority for approval of subrecipient loan-pool reserve details with the participating jurisdiction.

POSSIBLE LEGISLATIVE REVISIONS TO THE HOME PROGRAM -

1. Revision to Title 42, Section 12748(e) -- (Investment within 15 days)

This suggested revision attempts to 'eliminate' the current problem associated with "investment within 15 days" by in effect redefining what constitutes "investment" in the case of leveraged loan-pool reserves or loan guarantees.

Add to the existing Section 12748(e), the following:

In instances where HOME funds are leveraging other funds at a minimum ratio of \$10 for every \$1 of HOME funds, the participating jurisdiction may authorize a subrecipient to utilize HOME funds for loan-pool reserves or partial loan guarantees, provided that a written agreement clearly defining the terms and conditions of the loan-pool reserve or partial loan guarantee shall be executed by the parties not later than 15 days after funds are drawn from the participating jurisdiction's HOME Investment Trust Fund.

2. Revision to Title 42, Section 12748(g) -- (Expiration of right to draw funds)

This suggested revision similarly attempts to 'eliminate' the current problem associated with the requirement that HOME funds be "placed under binding commitment to affordable housing within 24 months" by in effect redefining what constitutes being "placed under binding agreement" in the case of leveraged loan-pool reserves or loan guarantees.

Add to the existing Section 12748(g), the following:

For the purpose of this section, HOME funds used or approved for use by the participating jurisdiction for loan-pool reserves or partial loan guarantees, shall be considered as being placed under binding agreement if the funds are obligated subject to a written agreement clearly defining the terms and conditions of the loan-pool reserve or partial loan guarantee.

Joe Ventrone
March 27, 1998

Page 4.

3. Section 12745 would require some change to permit the use of mixed-income loan-pool reserves.

One possible approach would be to add a new Section after the existing Section 12748(e) and the language recommended in point 1 above (or in some other appropriate section of the statute), wording similar to the following:

Notwithstanding other provisions of this statute, in instances where HOME funds are leveraging other funds at a minimum ratio of \$10 for every \$1 of HOME funds, the participating jurisdiction may authorize a subrecipient to utilize HOME funds to serve a range of incomes, as part of a comprehensive strategy to support neighborhood stability.

In such instances, a participating jurisdiction may permit a subrecipient to use up to 25 percent of its leveraged loan pool to serve households earning up to the area median income, with the remaining 75 percent of the loan pool serving households at or below 80 percent of the area median household income, with a minimum requirement that 5 times more families will be served through this approach than were historically served through local use of HOME funds for direct grants or loans.

Because I understand that this change (i.e. the use of HOME funds to serve a range of incomes) could be viewed as a significant change in the HOME program, please permit me to provide some further explanation on this point.

II. Using HOME funds to serve a range of incomes.

While Neighborhood Reinvestment fully supports the policy of using federal funds to serve very-low and low-income households, we find that the current requirements regarding who may or may not be served with HOME funds makes it extremely difficult to expand affordable housing opportunities within the context of a comprehensive strategy to support neighborhood revitalization.

We are not advocating the elimination, or even a significant relaxing of the income targeting provisions of HOME, but rather, the expansion of eligible impact. We believe there are ways to accomplish the intent of income targeting without excluding everyone whose income is even just slightly above 80 percent of median, by utilizing the synergy of HOME to leverage conventional capital.

In order to revitalize already distressed neighborhoods and promote economic integration, it is frequently necessary to address some of the most distressed properties in the neighborhood; since those properties (frequently fire damaged, boarded-up, and/or vacant) have a blighting influence on the entire neighborhood. It is often impossible to assemble subsidies large enough to make such properties affordable to families below 80 percent of median -- and private lenders frequently shy away from the perceived added risk associated with such properties -- unless there is a vehicle like a loan-loss reserve available to mitigate their risk. And yet, by utilizing a modest amount of HOME funds to leverage conventional capital in loan-pool reserves, and by allowing participating jurisdictions to devise and/or approve locally appropriate strategies, financing could be arranged that would enable many more families to support a mortgage covering acquisition and rehabilitation.

Joe Ventrone
March 27, 1998

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The main point is that the HOME statute envisioned mixed-income projects, but in reality severely limits the use HOME funds for mixed-income homeownership strategies.

For example, Section 12745(a) allows mixed-income projects if the housing meets all the criteria specifically set forth in that section -- but, the use of HOME funds is restricted to households at or below 80 percent of median.

A proposed remedy would be to consider the type of leverage mentioned above.

In that example, \$100,000 in HOME funds would leverage \$1 million or more in affordable housing activity. It appears reasonable to allow a portion of that \$1 million to be used to serve a broader range of incomes, as long as a significant portion of the amount leveraged is used to serve households below 80 percent of median. In our example, 5 times as many low-income families are served through a HOME-leveraged loan-pool than would otherwise be served by direct HOME loans or grants.

Carrying the example further, if 75 percent of the \$1.1 million leveraged loan pool were used to serve households below 80 percent of median, the \$100,000 of actual HOME funds would result in:

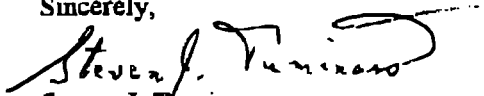
- \$825,000 or more being used to serve households below 80 percent of median, with
- Up to \$275,000 being available to serve households above 80 percent of median (up to median).

This 75 percent low-income / 25 percent moderate-income mix would mirror the "safe harbor guidelines" for nonprofit organizations that provide low-income housing, issued by the Internal Revenue Service [Revenue Procedure 96-32, issued May, 1, 1996].

Joe, I again thank you for your interest in our homeownership ideas, and for your support. I trust this letter helps clarify our recommendation. I have also enclosed a couple of graphics which include data on a series of actual (fairly typical) loans made by NeighborWorks® organizations, which I think reinforce the examples used in this letter. I know we have offered a lot to think about. In some ways, all of this could be boiled down to one simple question. Are you trying to get results, or dictate/prescribe exactly how HOME funds could be used?

Please let me know if you need any further information related to these ideas.

Sincerely,



Steven J. Tuminaro
Policy Analysis Director / Assistant Treasurer

Att.

cc: George Knight
Ali Solis

READING (PA) NHS: COMMUNITY DEVELOPMENT LENDING

Reading (MSA) Median Family Income is \$38,500

**1136 Church St.
3BR/1BA**

single female with no
children
annual income
\$17,160



National Penn Bank
\$29,700, 9.25%, 30 years

2nd mortgage: NHS
\$3,300, 5%, 60 months
monthly payment: \$385

*for \$11,000 in
with soft money like Home,
you have in \$98,000.
\$11,000 soft money not enough to
do single deal.
page 327*

**1019 Windsor St.
3BR/1BA**

couple with 3 children
annual income
\$30,888

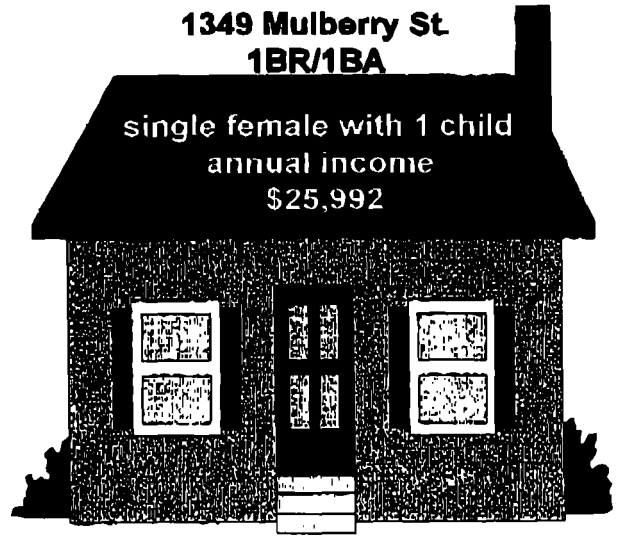


National Penn Bank
\$32,210, 8.9%, 30 years

2nd mortgage: NHS
\$3,690, 5.5%, 60 months
monthly payment: \$367

**1349 Mulberry St.
1BR/1BA**

single female with 1 child
annual income
\$25,992



Meridian Bank
\$36,000, 8.4%, 30 years

2nd mortgage: NHS
\$4,000, 5.5%, 60 months
monthly payment: \$386

NeighborWorks® Organizations Community-Development Lending

Housing becomes affordable, even for families earning well below the median income, when financial institutions join with NeighborWorks® organizations. Often the financing package includes a low-interest second mortgage. Pre- and postpurchase counseling also ensures successful ownership.

Toledo, Ohio -- Median Income: \$30,980. This family's income: \$22,800

A married couple with no children and an annual income of \$22,800 purchases a 3BR/1BA home on Hurd Street. The purchase is financed using the following loan package:



1st Mortgage: Key Corporation, \$24,000, 7.25%, 30 years
2nd Mortgage: NeighborWorks® Organization, \$9,360, 6%, 20 years

Total Cost: \$33,360
Monthly Payment: \$286

*Joe -
even with
a high cost area
you can get a better
than normal return
4:1*

Gainesville, Fla. -- Median Income: \$31,321. This family's income: \$21,900

A married couple with one child and an annual income of \$21,900 purchases and rehabilitates a 3BR/2BA home on 7th Avenue. The purchase and rehabilitation are financed using the following loan package:



1st Mortgage: M & S Bank, \$20,000, 8.25%, 30 years
2nd Mortgage: NeighborWorks® Organization, \$3,300, 3%, 20 years

Total Cost: \$23,300
Monthly Payment: \$237

Inglewood, Cal. -- Median Income: \$42,300. This family's income: \$35,568

A single woman with one child and an annual income of \$35,568 purchases a 2BR/1BA home on 78th Street. The purchase is financed using the following loan package:



1st Mortgage: Hawthorne Savings Bank, \$91,350, 7.5%, 30 years
2nd Mortgage: Family Fund Lenders' Pool, \$40,000, 6.5%, 30 years

Total Cost: \$132,072
Monthly Payment: \$984

H&R Block, Inc.
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Suite 700
Washington, D.C. 20005-5922
Tel (202) 508-6363
Fax (202) 508-6330
RWeinberger@compuserv.com

Robert A. Weinberger
Vice President, Government Relations

February 9, 1998

Mr. Gene Sperling
Assistant to the President
National Economic Council
Old Executive Office Building
Washington, DC 20502

Dear Mr. Sperling:

Enclosed are ten suggestions developed by H&R Block's Training and Research Department for tax code simplification. They are not meant to be comprehensive but are modest steps that can be taken now even as Congress debates larger questions of tax policy. We hope you'll consider them favorably.

The proposals affect taxpayers who receive interest and dividends, families that qualify for a child tax credit, refinancing home owners, small business owners, workers with retirement savings accounts, students deducting interest on education loans, and taxpayers subject to the alternative minimum tax.

With 8,500 offices in the U.S., H&R Block prepared one out of seven returns filed with the IRS in 1997 and over half of the electronically filed returns. Our suggestions are based on feedback from average taxpayers relayed to us by our over 80,000 tax preparers.

Please let me know if we can respond to any questions. We look forward to working with you to improve our tax system.

Sincerely,



Robert Weinberger

Panetta

Tyson

Spaulding

THE WHITE HOUSE

WASHINGTON

May 15, 1996

THE PRESIDENT HAS SEEN

5.15.96

MEMORANDUM FOR THE PRESIDENT

FROM: TODD STERN

SUBJECT: Sec. 127 -- Employer-paid education benefits

The attached Tyson memo concerns extension of Sec. 127 and a possible related tax credit for small business. Sec. 127, which expired December 31, 1994, allowed workers to exclude employer-paid education expenses from taxable income -- up to \$5,250 per year -- even if these expenses were not directly related to a worker's current job. Our FY 97 budget proposal endorses a revenue-neutral extension of a number of "tax extenders", including Sec. 127, the R&E tax credit and others. House Ways and Means is now marking up a retroactive extension of Sec. 127 (Jan. 1 1995 to end of 1996). Two issues are presented: (i) whether to support extension of Sec. 127 (alone or with other extenders); (ii) whether to support a new education and training tax credit for small business.

Extension of Sec. 127 -- Your economic team agrees on extension of Sec. 127 -- which fits your core education message -- separately or with other tax extenders including the R&E tax credit. Extension is also strongly supported by business and education groups -- though doing it alone could signal a lack of support for the R&E credit -- which high-tech community might resent. Cost of extension effective January 1, 1996 (which has to be offset): \$1.2 billion through 1997; \$4.7 billion through 2002.

Small business credit -- Employers with average receipts of \$10 million or less would get a 10% non-refundable credit for amounts paid to third parties for employee education and training under a Sec. 127 plan. *NEC, DOL and SBA support the credit; Treasury and CEA oppose.* Treasury says such a credit wouldn't be cost-effective in stimulating education expenses, would be highly uneven in its effects on firms and individuals, would be administratively burdensome, and would have to be offset (\$0.2 billion through 2002 assuming permanent extension of Sec. 127). DOL and SBA favor the credit as a means of both addressing the underinvestment by small business in education and training and boosting productivity and wages. NEC believes the credit underscores your commitment to education.

Announcement. The final issue -- if you decide to support separate extension of Sec. 127, with or without the small business credit -- is whether to announce it at the Corporate Citizenship Conference Thursday. Con: distracts from private sector challenge and might be seen as too small for a major announcement. Pro: provides news for the Conference and allows you to make education the main message of the conference.

Approve extension of Sec. 127 ☒

Disapprove ☐

Discuss ☐

Approve small business credit ☒

Disapprove ☐

Discuss ☐

Announce position at Conference ☒

Don't announce ☐

Discuss ☐

— THE WHITE HOUSE
WASHINGTON

May 14, 1996

MEMORANDUM TO THE PRESIDENT

FROM: LAURA TYSON

SUBJECT: Options on Section 127

You inquired about what our policy should be on Section 127, which permitted an employee to exclude employer-paid education benefits from income for both payroll and income tax purposes. This memo provides you with options on Section 127.

Background:

As you know, under current law employees can only exclude from their income employer-provided education expenses that maintain or improve skills required for their current job. These expenses generally include the costs of tuition, books, laboratory fees, and similar items. Section 127 offered a broader tax incentive: it allowed workers to exclude from taxable income employer-paid education expenses -- up to \$5,250 per year -- even if it were not directly related to a worker's current job.

Your FY1994 budget proposed making Section 127 permanent, but OBRA 1993 only extended it through December 31, 1994. Section 127 has now expired, and has not yet been extended.

Rather than including an explicit extension of Section 127 in our FY1997 budget proposal, we proposed that we work together with the Republicans to extend and find offsets for the following "tax extenders" (provisions that routinely expire): Section 127, the R&E tax credit, targeted jobs tax credit, orphan drugs tax credit, and deductions for appreciated stock contributed to private foundations. Thus, the budget endorses revenue-neutral extension of all the tax extenders.

You should know that the House Ways and Means Committee marked up a tax bill today (Tuesday) that includes an extension of Section 127 retroactively from January 1, 1995 through the end of 1996. This provision, however, does not allow employees to exclude the costs of employer-paid graduate education. We opposed the limitation to undergraduate education because we ought to be encouraging both undergraduate and graduate education. During the mark-up, Democrats offered an amendment to allow both graduate and undergraduate education expenses to be excluded from income, but it was defeated. Democrats also offered an amendment to extend the R&E tax credit, but it too was defeated. A version of your tuition tax deduction was also offered and defeated. The Ways and Means bill does, however, extend a modified version of the targeted jobs tax credit.

Decisions:

The basic threshold question you face is whether to support continuing with our current budget approach -- which calls for us to work with the Republicans on all the extenders -- or whether we make a specific proposal to extend Section 127 separately along with appropriate offsets. On this, there is some division on your economic team.

If you think we should extend Section 127 independently of the other extenders, the next issue is whether there is a means to strengthen or expand Section 127. This memo provides two options beyond our current approach:

Option 1: Separately extend Section 127.

Option 2: Extend Section 127 and provide a new education and training credit for small businesses.

We considered other options as well, such as increasing and/or indexing the dollar limit of excludable expenses under Section 127 and allowing educational expenses as an employee benefit in cafeteria plans, but there was not sufficient support to warrant further consideration.

If you choose to endorse the separate extension and/or expansion of Section 127, the final issue to decide is whether to announce your position at Thursday's corporate citizenship conference. On this issue there is also some division on your economic team.

Option 1: Separate Extension of Section 127.

Pros:

- Education is so central to your core economic message and your corporate citizenship message that there is a strong reason to give Section 127 special treatment by calling for its separate extension.
- Extension of Section 127 would complement the Administration's proposals for deducting tuition payments and allowing penalty-free IRA withdrawals for tuition, without allowing taxpayers to double-dip.
- Extension of Section 127 would help simplify the tax code because excluding employer-paid assistance for education -- unrelated to the employee's current job -- eliminates the problem of precisely defining "job-related" education expenses.
- Under the expired Section 127 law, it is our understanding that Section 127 benefits were available for education provided as part of a package of severance benefits to displaced workers. If we were to extend Section 127, we could highlight this feature either by explicitly mentioning severance benefits in the legislation or by issuing an administrative clarification. In the current debate about downsizing, this new twist could be an important way to highlight the fact that we are lowering the costs of education and training to displaced workers (when they may be especially concerned about income loss, but still need to invest in new skills).

- Extending Section 127 has widespread support from the business community and education groups. As the *Wall Street Journal* reported last week, the American Payroll Association -- a trade group representing 13,000 businesses and individuals -- was urging people to flood Congress with phone calls in favor of extending the provision.

Cons:

- Extending Section 127 would require a revenue-raising offset. Extending Section 127 permanently (effective January 1, 1996) would cost \$4.7 billion between 1996-2002. A temporary extension through 1997 (effective January 1, 1996) would cost \$1.2 billion between 1996-2002. It should be noted that a temporary extension would discourage some employers from adopting educational assistance programs. Democrats did not offer an amendment to extend Section 127 permanently at today's Ways and Means Committee markup.

If your tuition tax deduction were enacted, the revenue estimates of extending Section 127 would be affected. Along with your tuition tax deduction, extending Section 127 permanently (effective January 1, 1996) would cost \$3.5 billion between 1996-2002. A temporary extension through 1997 (effective January 1, 1996) would cost \$1.0 billion from 1996-2002.

- A proposal to extend Section 127 separately risks being interpreted by many in the business community as a sign that the Administration is backing away from its announced support for extending the R&E credit and could be greatly resented. The business community, particularly high-tech firms in California and elsewhere, strongly supports extension of the R&E credit. While Republicans explicitly endorsed extending Section 127 without extending the R&E tax credit at today's Ways and Means markup, continued emphasis on Section 127 alone could still incur resentment by many in the business community.
- Based on survey data for years during which Section 127 was in effect, only 1 to 1.5 million employees are likely to benefit from the provision. Managerial, technical and professional employees of medium and large firms in goods-producing industries would be disproportionately represented among beneficiaries.

Note: One other possible modification of Section 127 would be to retroactively extend it to include 1995, as done in the Ways and Means Committee bill. Some workers participated in these programs in 1995 expecting amounts to be excluded and employers did not withhold taxes on amounts but did render W-2s that include the amounts. Since the 1995 filing season is over, it would be complicated to permit workers to file amended returns. Alternatively, employees could receive a special, above-the-line deduction in 1996 for 1995 educational expenses paid by employers, but this would require special reporting by employers.

Option 2: Extend Section 127 and Provide a Credit for Small Businesses.

Under this option, in addition to the availability of Section 127, employers with average receipts over the prior three years of \$10 million or less would be allowed a 10 percent non-refundable income tax credit with respect to amounts paid to third parties for employee education and training under a Section 127 plan. The employer's deduction for education expenses would be reduced by the amount of the credit.

Pros:

● Gives a "small business angle" that makes Section 127 better fit the overall small business package. House Republicans have put Section 127 in a small business tax relief Section which is described as moderating the negative impact of the President's small business Section. Yet, there is no specific small business angle in the Republican package. Our proposal would trump theirs by targeting Section 127 to small business.

- The delegates to the White House Conference on Small Business strongly recommended legislation to provide tax incentives to small businesses to fund workforce training programs; the training recommendation was one of the Conference's top priorities.
- Small employers under-invest in employee training that has the spillover effect of benefiting employees in subsequent jobs. A credit would provide added encouragement for small employers to offer generalized education and training.
- The credit would further encourage smaller firms to turn to community colleges and other outside training suppliers, which may be more efficient suppliers of training. To the extent small firms stepped up their training efforts, it would tend to reach more low-wage and low-skill workers who are more likely to work for smaller companies.
- The additional cost of the small business training credit would be \$0.2 billion between 1996–2002 (assuming Section 127 was extended permanently).

● Linking the credit to Section 127 limits potential abuse, such as payments for hobby- and sports-related courses. Section 127's nondiscrimination requirements help to ensure that the credit is not taken primarily in connection with education for owners, their relatives, or other highly compensated employees.

Cons:

- The credit may be too small to overcome the low (or negative) returns to worker training perceived by most small employers, but will cut taxes for those small firms that already provide educational assistance, including training mandated by governmental regulations and professional society rules.
- Employers will be encouraged to convert in-house training to a format eligible for the credit, for example, replacing instruction by their own employees with contracted services. SBA notes that small businesses do not conduct much formal training, so this effect is likely to be small.
- Linking the credit to Section 127 creates some administrative burdens for small businesses by mandating a formal educational assistance plan. However, absent the tie to Section 127, the credit could be abused and would be difficult to administer. For example, without nondiscrimination rules employers could hire their children and claim the credit for their educational expenses. In addition, employers would have an incentive to unbundle employee training from the package of services provided by equipment vendors and to characterize a wide variety of payments to third parties, e.g., to lawyers and accountants, as payments for training.

- Credits will not benefit employers who are tax-exempt institutions or have no tax liability, such as many start-up companies. But, over 60 percent of small businesses do have a tax liability in any given year.
- A credit would treat employer-provided education more favorably than other fringe benefits such as health insurance.
- A credit varies the real cost of training based upon arbitrary firm size cut-offs.
- For some employers credits will be discouragingly complex because of interactions with other credits, the alternative minimum tax, carryover rules and overall limitations on business credits. SBA argues that the credit is unlikely to be very complex for the size of businesses we would target.

Recommendations:

1. **Extend Section 127 Separately (Or With The Other Tax Extenders Including The R&E Tax Credit), But Not With New Small Business Tax Credit:** Treasury and CEA support the extension of Section 127 on a revenue-neutral basis either alone or together with the other expiring tax provisions. However, Treasury and CEA oppose creation of a small business credit.

According to Treasury, proposals for expansion -- beyond simple extension of Section 127 -- would not be cost-effective in stimulating educational expenses, would be highly uneven and arbitrary in their effects among firms and individuals, would be administratively burdensome, and would have to be offset either by savings in our balanced budget or additional savings. CEA opposes a small business training credit because CEA believes the social benefits are likely to be smaller than the revenue loss. CEA notes that any market failure in the provision of training would be addressed by the extension of Section 127, making a small business tax credit superfluous.

2. **Extend Section 127, Either Separately Or With The Other Tax Extenders, And Provide a Small Business Training Credit:** Labor, SBA and the NEC recommend this option. The rationale is two-fold: (1) there is a market failure in the provision of training -- especially for small businesses, and (2) education and training improves productivity and increases wages.

Labor and SBA note that firms underinvest in education and training because of the difficulty in claiming the benefits of increased skills. Small businesses -- facing the additional barrier of scale economies -- are especially unlikely to devote the efficient amount of resources to their employees' skill development. Moreover, Labor and SBA point to the academic evidence that suggests that education and training improves productivity and raises wages. Labor and SBA believe that expanding Section 127 and creating a new small business training credit are important policies to address these problems. And they think that these policies will complement your overall economic agenda by increasing educational opportunity and providing direct economic incentives for companies to invest in their workers. We, at the NEC, support this mostly because together with the education tax deduction and your overall education agenda, it further stresses your commitment to education as a key to investing in the future.

Announcement Issues and the Corporate Citizenship Conference:

If you decide to propose a separate extension or expansion of section 127, a major question is whether you would announce it at the Corporate Citizenship Conference.

CONS: The arguments against a Conference announcement are as follows:

- 1) Distracts from Private Sector Challenge:** The focus on the conference is supposed to be challenging companies to be citizens and to highlight best practices in the private sector. This would alter the focus, and could make tax incentives more of the focus.
- 2) Trivialization:** Others feel that it would be seen as small and therefore not worthy of a major announcement because we are already on record in support of extending Section 127. In this view, the only real news would be an expansion proposal, but the small business tax credit would be small -- it would only cost \$200 million over 7 years. However, this might not be the case if we were to announce also a permanent extension of Section 127, which would have a \$3.5 billion cost over 7 years (assuming enactment of your tuition tax deduction).

PROS: The arguments for it are as follows:

- 1) Need News for the Day of Conference:** While we are doing well on set-up pieces for the economic conferences, we may be short on "news" for the day of the conference -- though the award may generate some news. This would play into the "tax incentives" issue and the action on the House floor and could help generate some news -- other than AT&T being at the breakfast.
- 2) Part of an Education Tax Incentive First Message:** You could make the message at the economic conference that tax incentives for education should come first -- and use the extension section 127 and the special small business tax credit to drive this home -- along with the \$10,000 education deduction and the IRA expansion for education.



WASHINGTON COUNSEL, P.C.

ATTORNEYS AT LAW

ROBERT M. ROZEN

January 6, 1997

Mr. Gene Sperling
Assistant to the President for
Economic Policy
National Economic Council
The White House
Washington, D.C. 20500

Dear Gene:

I want to thank you again for meeting with Paul, Stephanie and me in December to discuss the work of the Local Initiatives Support Corporation (LISC) in the context of the Fiscal Year 1999 budget. We are very appreciative of the support the Clinton Administration has shown over the years for the community economic development agenda.

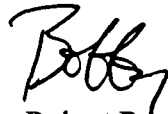
As you may recall, at the conclusion of the meeting we brought to your attention our current effort to establish a program for training and placing in productive employment former welfare recipients. This is a project now in the planning stages that envisions the syndication of the Work Opportunity Tax Credit and the Welfare to Work Tax Credit to raise job training operational funds from corporate investors. LISC is quite excited about this concept and we are very hopeful that it will eventually be a very successful, nationwide program that makes a major contribution to the President's efforts to move individuals from welfare to work. However, we first must obtain clearance on some technical issues before the IRS.

The attached memorandum from Jeff Armistead, Senior Vice President at LISC, explains this proposal in greater detail. We will soon be meeting with the IRS to review the proposal to ensure that it passes muster. Since neither the WOTC nor the WTWC was designed to be syndicated and utilized by nonprofit organizations, a number of unique tax issues have arisen. While we believe we have properly addressed all of these potential tax issues, we are nevertheless concerned that the IRS will raise problems because this is a novel approach.

We are bringing this to your attention because we believe this proposal helps carryout a major initiative of the Clinton Administration – moving individuals from welfare to work – and, therefore, you may be interested in assisting our efforts with the IRS and Treasury.

Thank you for taking a look at the attached memorandum. We are, of course, available to discuss this in greater detail with your office.

Sincerely,

A handwritten signature in black ink, appearing to read "Bobby" or "Robert", with a stylized flourish at the end.

Robert Rozen

Enclosure

cc: John Orszag



Local Initiatives Support Corporation

To: **Gene Sperling**
 Assistant to the President
 Director, National Economic Council

Jonathan Orszag
 Economic Policy Advisor

From: **P. Jefferson Armistead, Senior Vice President, LISC**

Date: **January 5, 1998**

Re: ***A Strategy to Implement the Clinton Administration's Program to***
 Move Individuals from Welfare to Work
 Syndicating the Work Opportunity Tax Credit (WOTC) and the
 Welfare to Work Tax Credit (WTWC)

I. Overview

For the past few months the Local Initiatives Support Corporation (LISC) and its affiliate the National Equity Fund (NEF) have been exploring possible approaches to creating an infrastructure that uses nonprofit organizations to train and employ former welfare recipients and other hard-to-employ individuals. This would be accomplished by taking the syndication model used with the Low Income Housing Tax Credit and applying it to the Work Opportunity Tax Credit (WOTC) and the Welfare to Work Tax Credit (WTWC). Our intent is to make the benefits of these wage-based tax credits, which are already available to for-profit employers, available as a new resource for public and private nonprofit efforts to assist welfare recipients and other disadvantaged people to succeed in the transition to work. Syndication of the credits (i.e. selling them to for-profit companies that would supply capital for training in return for a rate-of-return based on the tax benefits) was not a use originally envisioned by the authors of the legislation. However, based on our analysis, with clarification of certain tax issues (discussed below) it appears that a syndication approach is not only possible, but would make the legislation more effective in achieving its goals of moving welfare recipients into full-time permanent employment.

Nonprofit organizations already play a critical role in assisting hard-to-employ people to move into the workforce, but that role must grow to help make welfare reform work. In addition to training, work readiness, placement and other supportive services, nonprofits are increasingly hiring disadvantaged people to provide the work experience necessary for them to obtain and hold private sector jobs. However, the activities of successful nonprofit organizations in employment training and welfare to work are often under-funded -- the organizations experience difficulty in raising sufficient funds from both public and private sources to sustain their activities. Because they are exempt from taxation, nonprofits have been unable to use the WOTC and WTWC to expand their activities. By pursuing the syndication of wage credits in concert with public agencies and successful nonprofit employment services providers, LISC and NEF hope to:

- Generate new resources for successful nonprofit employment services organizations to strengthen and expand their efforts to hire and train former welfare recipients.
- Foster stronger linkages and explore new alliances between successful employment organizations and nonprofit community development corporations to increase workforce participation and incomes in CDC neighborhoods.

The syndication approach can accommodate a variety of program structures. In this memo we focus on two structures: (1) "Earnfair", an effort to work with state and local government to create an employment experience program which represents a significant advance over "workfare" programs; and, (2) an employee leasing model, designed to help successful not-for-profit employment training and welfare-to-work providers increase their training and placement capacity.

II. What role can the WOTC and WTWC play in moving individuals from welfare to work?

While the WTWC is new and the WOTC has been recently revised, many tax and labor policy experts have questioned the efficacy of wage tax credit programs in the past. Either because the tax benefits are limited, or because employers are simply hiring individuals they would have hired without the tax credits, recent studies have questioned whether the federal government is getting a good value for its revenue cost. In addition, with the increased targeting of the program, the absence of training benefits has made the economics of employing the targeted population even more difficult, raising further questions about the ability of these wage credits programs to serve a useful function. At the same time, welfare reform has created a new environment which makes it even more important for these wage tax credit programs to operate successfully.

We believe the proposed syndication program we are working on can be an answer to the critics concerns. This syndication program can be a very important part of an overall welfare-to-work strategy, by using it to assist state and local governments and not-for-profits to increase their capacity and run excellent welfare-to-work programs that provide a needed training component.

III. What kinds of programs can syndication support?

Through our discussions with public and private nonprofit organizations engaged in this work we have found that wage credits can be syndicated to support a variety of program structures. One is a program we call "Earnfair" which represents an alternative to the "workfare" or work experience programs which many municipalities are now implementing. A second is an Employee Leasing approach which is designed to enable successful not-for-profit employment training and welfare-to-work organizations to expand their activities. Both models are described below.

(1) Earnfair

In most workfare models, during a defined program period, welfare recipients are required to "work off" their welfare benefits at minimum wage by providing services primarily to government agencies and nonprofit organizations. They also participate in skill and job readiness training. Under the alternative "Earnfair" scenario:

- participants would be **employees** instead of welfare cases;
- they would receive a **paycheck and fringe benefits** instead of welfare benefits;
- they would be assigned to government, nonprofit, and/or for-profit organizations which would provide them work experience;
- this **employee status** enhances participants' work history, helping them to secure a full-time permanent job after the defined program period is over;
- the proceeds of the tax credit, in part, can be used to pay for **additional skill and job readiness training, supported work, placement, follow-up or other services** to improve their chances of getting and keeping a full-time permanent job at the conclusion of the program.

In comparison to the alternative model, workfare, we believe, these components, have the potential to produce a significantly higher rate of permanent full-time jobs after the defined program period is over. The function of the tax credit is to raise funds to cover some of the additional costs of implementing the program and to fund a higher level of services, producing better results.

(2) Employee leasing

This model is designed to enable successful not-for-profit employment training/placement and welfare-to-work organizations to expand their activities and increase the number of welfare recipients they are able to place in permanent employment.

Numerous experienced not-for-profit organizations now play important roles in welfare-to-work. These roles include not only the provisions of classroom training, job readiness training, and supportive services of various kinds; they also sometimes include the provision of temporary jobs on the not-for-profit company's payroll, which is an integral part of the training process. The employee leasing approach is designed to allow the not-for-profit to generate funds based on its playing the role of employer, and then using the funds to provide more intensive training and support services.

IV. What are the structural elements of the program?

To take advantage of wage credits, an employer must be a for-profit entity with sufficient tax liability to realize the benefits. To accomplish this, a for-profit limited liability company (LLC) will be formed, which will be the employer of the eligible workers. The company will have as a **managing member** a nonprofit corporation which will play a variety of key roles in providing training and placement services, and an **investor member** which will be able to use the tax benefits generated by the LLC.

V. What are the roles of the participants?

The function of the LLC is to provide employment training, placement and welfare to work services. The LLC would be the employer of record and would assume responsibility for wages, benefits, and compliance with federal, state and local laws applicable to employers. The LLC will hire former welfare recipients, place them in temporary work assignments or lease them to affiliated organizations, and provide training and supportive services. These services will be paid for in part by the proceeds of the tax credit.

The nonprofit managing member will have two roles. It will serve as the managing member of the LLC and oversee its training, education, and placement operations as well as its core administrative functions. In addition, on a contract basis, the nonprofit managing member may directly provide training, education, supportive services and placements in temporary positions similar to internships in preparation for full-time permanent jobs. It may also be the lessee of LLC employees.

In the Earnfair model, state or local government will refer former welfare recipients to the LLC for work assignments. Under a contract with the LLC, the

government agency will provide funds to cover LLC expenses such as wages, overhead and other costs associated with employing the workers.

LISC will work with nonprofit employment organizations, public agency partners and select CDCs to design a syndication program that is appropriate to the local environment and local goals.

The National Equity Fund (NEF), LISC's affiliate, will price the investment opportunity commensurate with its risk, market it to corporate investors and secure their participation. Corporate investors will become limited partners in an "upper tier" partnership which will invest in the LLC as its investor member.

VI. What are the key issues to be resolved before moving forward?

There are a small number of issues with respect to tax law which must be resolved before we can proceed. We are submitting a request for a Private Letter Ruling to the Internal Revenue Service which, if favorable, will make it possible for us to sell the tax credits to investors.

We are scheduled to meet with the IRS on January 14, 1998 for a pre-submission conference, and we plan to submit our request for a Private Letter Ruling within 10 days following the meeting. Proceeding further with the project would then depend upon receiving a favorable ruling.

However, we are structuring a number of pilot projects which would go forward if we receive a favorable ruling. We are currently in discussion with the following parties with respect to developing pilot projects, among others

(1) Earnfair model:

- New York City
- City and County of San Francisco
- Alameda County

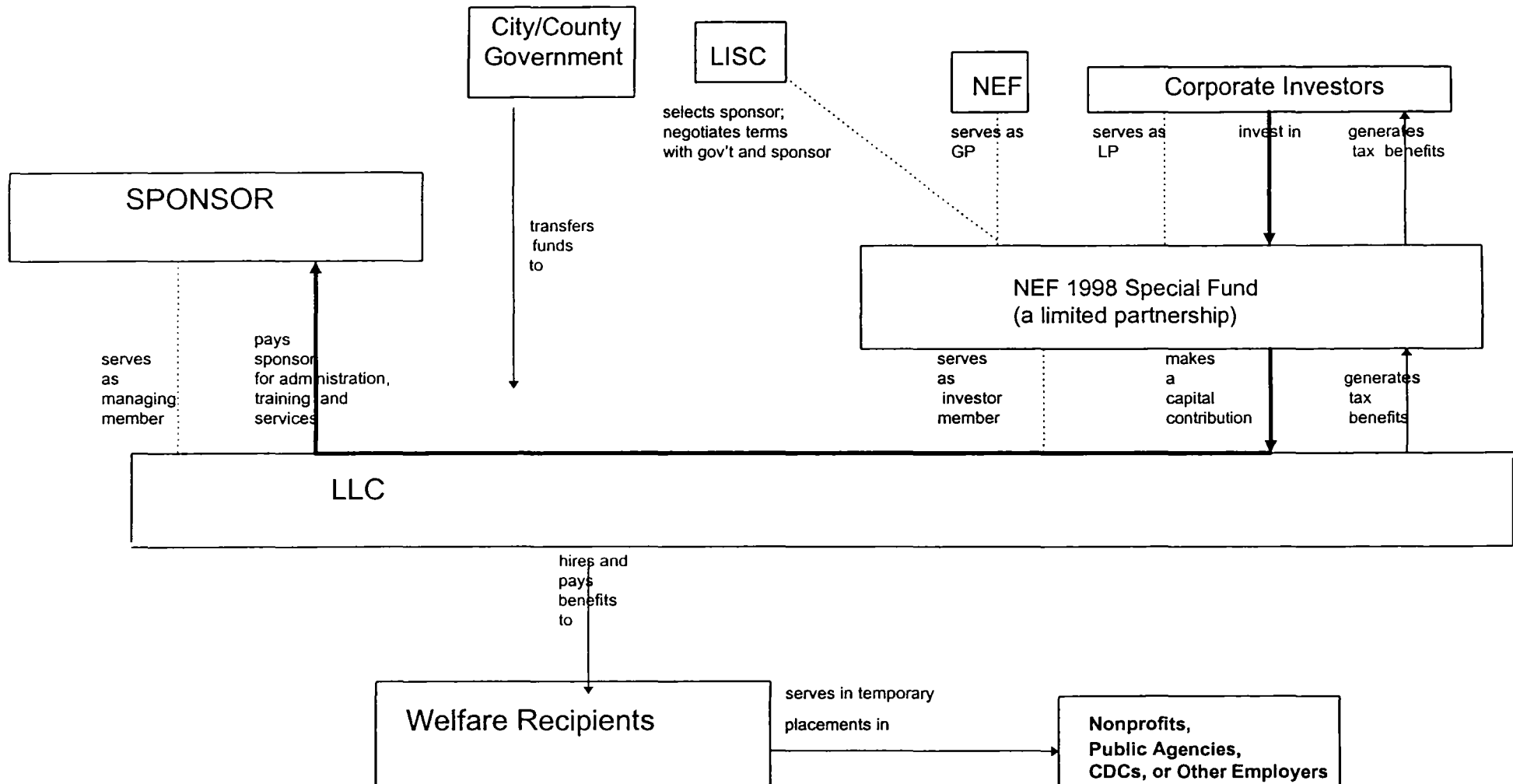
(2) Employee leasing model:

- Goodwill Industries of Southeastern Wisconsin
- Corporation for Supportive Housing
- Federation of Employment Guidance Services

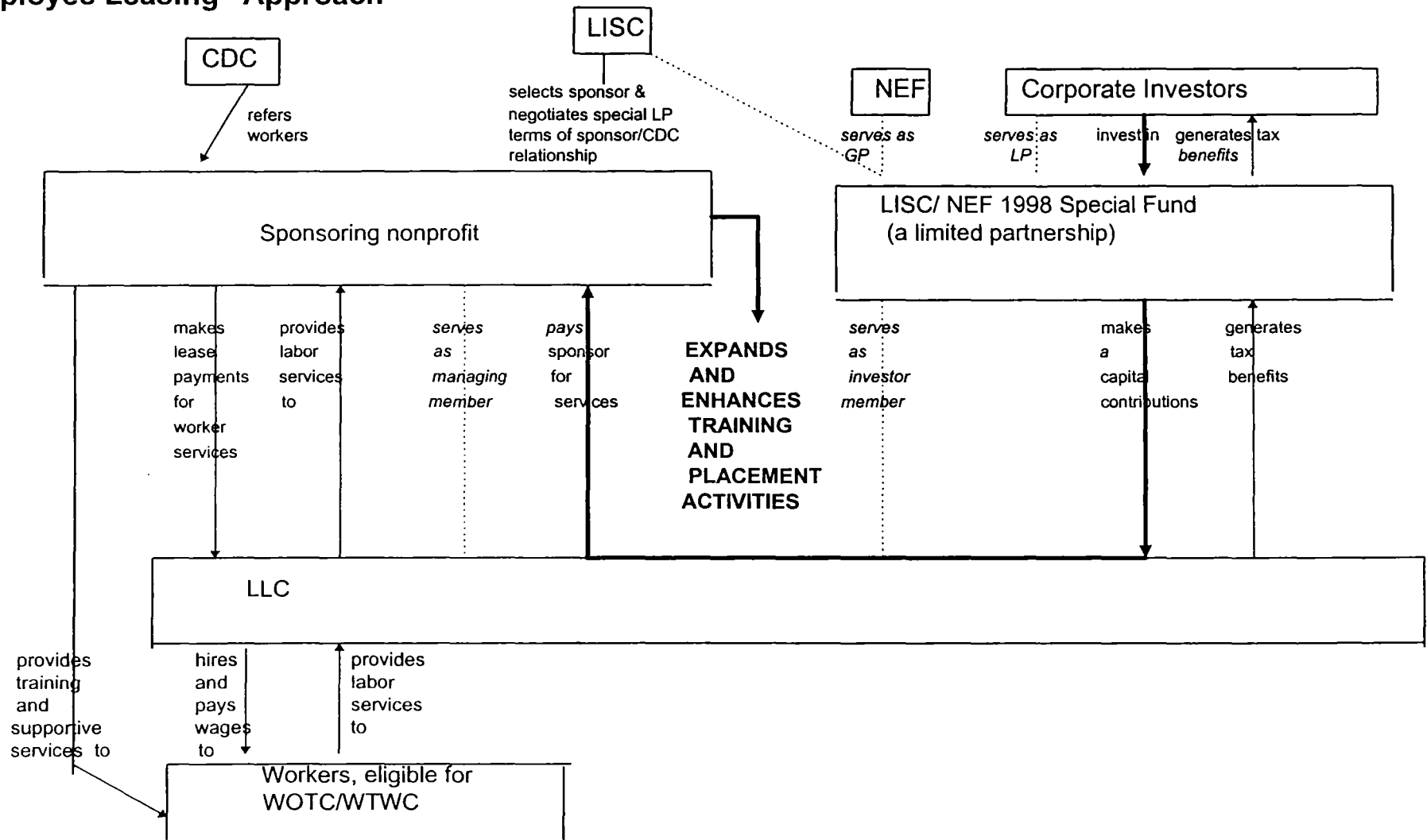
We would be pleased to meet with you at your convenience to discuss this project in greater detail.

Earnfair

Syndication Flow Chart



"Employee Leasing" Approach



Community Reemployment Zones Significant Issues and Concerns

Political Issues:

The Department is extremely concerned about several potentially serious political ramifications of expanding the current trade adjustment programs to all displaced workers in an entire community. Those concerns include:

- ◆ Given the significance of a community designation under this initiative, the political pressures related to the design and implementation of the trigger mechanism could be immense. The current TAA and NAFTA-TAA determination process results from a comprehensive but, nonetheless, specifically-focused analysis of the data and information gathered during the course of the investigation. How could the existing TAA and NAFTA-TAA programs avoid being politicized as a result of the importance of the trigger mechanism?
- ◆ Any program which depends, to some degree, on response to proposals submitted on a first come/first served basis and is influenced by the extent to which funds remain available at a particular point in the budget year risks huge political and public perception difficulties. The political implications of creating a program wherein individuals are entitled to a package of benefits based upon where they live or work are overwhelming to consider.

Other Concerns

- ◆ Under TAA and NAFTA-TAA, workers must be eligible to receive UI in order to receive TRA. This requirement disqualifies the self-employed and those with short employment histories. Should these workers be included in this initiative?
- ◆ What would be the duration of the eligibility period and how would funds needed for each year be appropriated?
- ◆ Performance measures for the TAA and NAFTA-TAA programs are only now being implemented. Why would Congress want to expand the program to an entire community when many are not certain TAA and NAFTA-TAA work?
- ◆ How would jurisdictional issues be resolved. What would be the definition of Community?

- ◆ How could it be ensured that companies do not move into these areas (now populated with desperate but fully trained people) from other parts of the country?
- ◆ Would this create incentives for workers to remain unemployed in order to qualify for the program?
- ◆ Where does the funding for capacity building come from? Would capacity creation be a prerequisite for designation under this initiative?
- ◆ Would there be issues related to the "freeing up" of funds from other programs for use elsewhere? Would there be any implications regarding the fact that other, non-trade affected cities could benefit from the designation of a city under this initiative?
- ◆ Although the existing TAA and NAFTA-TAA programs are effective and successful tools for the adjustment of workers directly affected by trade, wouldn't the broader needs of displaced workers in an entire community be addressed more appropriately by a discretionary program rather than by an expansion of an entitlement program such as TAA? Wouldn't use of discretionary funds provide greater flexibility to impacted communities in addressing their own unique and specific worker readjustment needs?

COMMUNITY REEMPLOYMENT ZONES

I. Overall Concepts

Although the benefits to the nation of a more global trading system are widely recognized, particularly in the areas of economic growth and the creation of high paying jobs, certain worker groups may suffer job dislocation due to changes in trade patterns which may result from reductions in trade barriers. Certain communities, particularly smaller communities whose livelihood is dependent upon a small number of trade-sensitive manufacturing enterprises, may experience undue hardship as a result of trade.

The existing programs which are targeted toward workers directly affected by trade - TAA and NAFTA-TAA - offer an extensive Federally-funded retraining and income support system to assist those dislocated workers in developing the skills to become successfully reemployed. The Administration's proposals for enhancement of these programs, including the targeting of workers secondarily affected by trade for enhanced benefits under Title III of JTPA, would significantly widen the safety net to include a greater number of workers. These programs do not, however, address the overall needs of those communities which have borne the brunt of worker dislocations resulting from changing trade patterns - including not only workers employed in service industries which may have experienced the ripple effects of plant closures but even the overall adverse effects of a potentially eroding tax base.

The principal of the Community Reemployment Zone Initiative is to identify and provide adjustment assistance to workers in those communities in which the adverse effects of increased imports or shifts of production to other countries are concentrated to the extent that the economic vitality of large segments of the workforce and of the community itself are compromised. It proposes to expand eligibility from not only those covered by trade certifications to all displaced workers in the community. Assistance would be provided in the form of an expansion of the current adjustment assistance opportunities which are currently only available to manufacturing workers who are directly or secondarily affected by trade to all workers in that community who become totally or partially separated from employment during periods of trade impact.

II. Assumptions

- ◆ The Initiative would be an expansion of the existing TAA/NAFTA-TAA entitlement program. As such, benefits such as funding of training and income support would necessarily remain identifiable to the recipients of the benefits (e.g., trainees). Further, funds would not take the form of grants to the community, nor could they be used to develop infrastructure.
- ◆ Funds for the Initiative would remain in an appropriation separate from the appropriations for TAA and NAFTA-TAA, so as not to adversely impact services to workers in non-designated communities.

- ◆ Program services available to non-trade impacted workers as a result of their community's designation would be identical to those currently available to trade-impacted workers.
- ◆ Funding of benefits and services for eligible workers who are already receiving benefits under another Federal program at the time of designation would continue until there is a break in the funding cycle. Thus, there would be no deobligation/reobligation.
- ◆ This proposal also assumes enactment of the Administration's current proposals for expansion and enhancement of the existing programs for trade-impacted workers, including
 - 1) adding shifts of production to any country as a basis for certification under TAA,
 - 2) reduced investigation times and 3) increased funding of benefits under Title III of JTPA for secondarily affected workers.

III. Establishment of a "Trigger" Mechanism

As discussed below, designation of a community to receive funds appropriated for this Initiative would be based upon the Department's acceptance of that community's proposal for use of the funds. In order for a community to be eligible to submit a proposal, it would first have to be identified as trade-impacted by some type of "trigger".

Among the factors which could be included in a "trigger" formula would be: 1) the number of workers certified under the TAA and NAFTA-TAA programs during an established period of time - in either absolute terms or relative to the size of the workforce in the community; 2) the number of unemployment insurance claims in relative to the size of the workforce; 3) proportion of claimants who exhaust their UI (long-term unemployment); 4) dependence of the community economy on specific trade-impacted industries; and 5) median income in the community, etc.

Although TAA and NAFTA-TAA certification activity in a community would be an important factor in the trigger formula, certification numbers as a basis for qualification should not be "overweighted". TAA and NAFTA-TAA caseload figures are based upon estimates of actual and possible future worker separations and are not always indicative of actual displacements. Further and most importantly, undue emphasis on TAA and NAFTA-TAA caseload could risk "politicizing" the certification and caseload development process. It is suggested the trigger which is applied should take into account several variables, none of which would be depend upon in a narrow range to trigger qualification.

IV. Designation Proposals

In order to be considered for assistance under this initiative, a "triggered" community would be required to submit a proposal. Proposals would include information regarding 1) estimates of the number of participants (beyond those certified under TAA and NAFTA-TAA), 2) existing capacity to service the estimated participant population or sources for funding of capacity building from other sources (such as the Economic Development Administration), 3) the types of training to be offered, with an emphasis of variety (OJT, classroom, vocational), 4) estimated costs including consideration of the average cost and duration of training and income support, and 5) actual or anticipated reemployment prospects for those who complete training, etc.

Designations by the Secretary of Labor would be based upon the relative efficacy of the proposals, with an eye toward costs. In that the relative sizes of those communities submitting proposals would vary widely, it would be inevitable that some determinations of the costs of different proposals vis a vis their timing relative to annual appropriations would have to be considered. The plan is to limit the number of designations to 5-10 per year by use of the trigger mechanism and the designation process.

V. Program Implementation

Implementation of the initiative would be identical to that of the existing TAA and NAFTA-TAA programs. It would be expected that each applicant would be individually screened and training would be designed which link local employer needs to training provided.

Cornerstones of this process would be individual choice and quality labor market information. To the extent possible, participants should be directed through the State's One-Stop Centers which provide workers with access to a full range of information about jobs, skill requirements, success rates for service providers, etc. A "voucher" system, whereby each participant would "shop" for the best, most suitable training possible could also be considered.

Coordination with other Federal programs: It is recognized that many non-trade impacted workers who would be eligible for training and benefits under this initiative would already be in Federally funded programs - particularly Title III - at the time of the community's designation. In that this initiative would be an entitlement and offers a more generous package, it is expected that such workers would be converted into this initiative at the earliest point possible. Although it would be expected that all workers would benefit from the best features of each program, other Federal funds, such as Title III Governor's formula funds, would be freed up as a result of this initiative. This could, in turn, result in those funds being made available to other parts of the State, or revert to USDOL.

VI. Costs

Costs associated with this initiative would range widely depending upon which communities were triggered as eligible to submit proposals. Further, the balancing off of the proposals of smaller communities with lower estimated costs vs. larger communities with higher costs would be highly problematic. And, depending upon the duration of a period within which worker separations would qualify, cost estimates for future years would be extremely difficult to derive.

Appropriations in support of this initiative are estimated to range from \$100 million to \$300 per year. It is proposed that funding for this initiative be coordinated with the establishment of the contingency fund for the existing TAA and NAFTA-TAA programs which is currently being proposed. It is also proposed that the training portion of this initiative be capped as under the current programs.

Attached are estimates of the costs of providing community-wide adjustment assistance to certain CAIP areas. The estimates assume a 30 percent participation (take-up) rate for all workers who received first UI payments in those communities in 1996. The estimates have been factored down by 25 percent to account for workers who would have received TAA or NAFTA-TAA program benefits under the existing programs.

VII. Evaluations

It is proposed that, not less than one year following the completion of the first worker training contracts, an evaluation of the initiative be conducted. Post-program follow-up information would include at a minimum: 1) completion rates, 2) post-completion reemployment rates and 3) wage replacement rates.

December 18, 1997

Reemployment Zone Cost Estimate

City	1996 Avg. Total Unempl.	1996 State Avg. Tot Unempl.	City Share of Unempl.	City Share of First Payments	1996 State UI First Payments	City First Payments	TAA Benefit Recipients	Total Benefits (\$M)	TAA Trainees	Training Cost (\$M)
Brownsville, TX	15615	548620	2.8%	2.8%	350443	9974	2200	14.4	2200	8.5
El Paso, TX	28985	548620	5.3%	5.3%	350443	18515	4200	27.5	4200	16.2
Erie, PA	4021	312987	1.3%	1.3%	467434	6005	1400	9.2	1400	5.4
St. Joseph, MO	3251	132356	2.5%	2.5%	147109	3613	800	5.2	800	3.1
Racine, WI	2523	102975	2.5%	2.5%	234291	5740	1300	8.5	1300	5.0
Watsonville, CA	2932	1126215	0.3%	0.3%	1178279	3068	700	4.6	700	2.7
Richland, WA	1503	187675	0.8%	0.8%	223630	1791	400	2.6	400	1.5
Elizabeth, NJ	5668	255445	2.2%	2.2%	312370	6931	1600	10.5	1600	6.2
Syracuse, NY	4852	539516	0.9%	0.9%	541784	4872	1100	7.2	1100	4.3
Lumberton, NC	5133	164937	3.1%	3.1%	235074	7316	1600	10.5	1600	6.2
TOTAL							15300	100.0	15300	59.2
									Total Cost	159.2

- Cities used for the estimate are a cross-section of the August CAIP list.
- City share of statewide UI first payments assumed to be equal to the share of statewide unemployed.
- Assumes 30% of UI first payments receive TRA benefits and 30% receive training.
- Assumes 25% of eligibles are also eligible under the current TAA or NAFTA-TAA program.
- Average benefit duration = 28.8 weeks; average weekly benefit amount = \$227
- Average training cost = \$3222 (plus 20% for administration)
- Metropolitan area data used for Brownsville and St. Joseph; county data used for Lumberton.

MEMORANDUM

TO: EMPLOYMENT AND TRAINING WORKING GROUP

FROM: ANNE LEWIS, JON ORSZAG, AND CECILIA ROUSE

RE: BRAIN-STORMING ABOUT RE-EMPLOYMENT ZONES

DATE: March 9, 1998

At tomorrow's (3/10) meeting (at 2pm in OEOB 239) we plan to discuss Re-employment Zones. Re-employment Zones would provide an area that had a "sudden and severe economic dislocation" benefits to *any worker* who lost their job due to no fault of their own. This would complement our new Office of Community and Economic Adjustment at the Commerce Department which will help coordinate the Federal government's response to major economic dislocations.

At this stage, no one has committed to a particular way in which the zones should be structured; rather, we would like to continue brain-storming about them. There are many ways in which Re-employment Zones could be structured. One possibility would be to use these zones to experiment with different re-employment strategies. For example, an area in which the last plant has closed (and there is little other employment) might provide grants to help workers re-locate to another area or they might use the funds to encourage new businesses to locate in the area. In contrast, an area which has experienced a sudden downturn employment, but where there continues to be an industrial base, might experiment with wage subsidies and/or training programs. During the meeting we plan to consider the following questions:

- **What are the goals of Re-employment Zones?**
 - What are the goals of these particular zones?
 - How does this fit-in with Empowerment Zones (and Enterprise Communities) and with the Out-of-School Youth Opportunity Areas initiative? (Both of which target areas)
- **What is a Re-employment Zone?**
 - What services would be provided? (Should they be the same in each area? Or tailored to each site?)
 - Which areas would be eligible? What is the definition of a "zone" or "area"? (Candidates include, but are not limited to: areas with "sudden and severe" dislocation (such as areas with major plant closings and/or areas with large changes in the unemployment rate (note: this is the change, not the level of unemployment))) Should we try to distinguish between areas which have chronic problems (e.g., Detroit) and those which experience a shock (e.g., El Paso)?
 - Which individuals would be eligible? (Should we include all workers who have lost a job or only those workers displaced because of our trade policies?)

- To what extent might the base-closings model hold?

- **Conceptual issues to be resolved**
 - How long would an area be classified as a Re-employment Zone? Is this a short-term or long-term program?
 - What might be the role of the Employment Development Administration?
 - How many zones would be included?
 - How should communities be chosen? (First-come-first-served?)
 - How large might the disincentive effect be? (i.e., that workers might become or remain unemployed in order to qualify for the services)
 - Others?

- **How might these be funded?**
 - Can we use the Secretary of Labor's discretionary fund or should this be a part of the next budget?)
 - Might we "free-up" funds from other programs?
 - Are these discretionary funds or an entitlement program?

- **Evaluation**
(For example, any potential for random assignment?)

105TH CONGRESS
1ST SESSION

S. 411

To amend the Internal Revenue Code of 1986 to provide a tax credit for investment necessary to revitalize communities within the United States, and for other purposes.

IN THE SENATE OF THE UNITED STATES

MARCH 6, 1997

Mrs. HUTCHISON (for herself, Mr. ABRAHAM, Mr. CAMPBELL, Mr. D'AMATO, Ms. MOSELEY-BRAUN, and Mr. SPECTER) introduced the following bill; which was read twice and referred to the Committee on Finance

A BILL

To amend the Internal Revenue Code of 1986 to provide a tax credit for investment necessary to revitalize communities within the United States, and for other purposes.

1 *Be it enacted by the Senate and House of Representa-*
2 *tives of the United States of America in Congress assembled,*

3 **SECTION 1. SHORT TITLE.**

4 This Act may be cited as the “Commercial Revitaliza-
5 tion Tax Act of 1997”.

1 **SEC. 2. COMMERCIAL REVITALIZATION TAX CREDIT.**

2 (a) ALLOWANCE OF CREDIT.—Section 46 of the In-
3 ternal Revenue Code of 1986 (relating to investment cred-
4 it) is amended by striking “and” at the end of paragraph
5 (2), by striking the period at the end of paragraph (3)
6 and inserting “, and”, and by adding at the end the follow-
7 ing new paragraph:

8 “(4) the commercial revitalization credit.”

9 (b) COMMERCIAL REVITALIZATION CREDIT.—Sub-
10 part E of part IV of subchapter A of chapter 1 of the
11 Internal Revenue Code of 1986 (relating to rules for com-
12 puting investment credit) is amended by inserting after
13 section 48 the following new section:

14 **“SEC. 48A. COMMERCIAL REVITALIZATION CREDIT.**

15 “(a) GENERAL RULE.—For purposes of section 46,
16 except as provided in subsection (e), the commercial revi-
17 talization credit for any taxable year is an amount equal
18 to the applicable percentage of the qualified revitalization
19 expenditures with respect to any qualified revitalization
20 building.

21 “(b) APPLICABLE PERCENTAGE.—For purposes of
22 this section—

23 “(1) IN GENERAL.—The term ‘applicable per-
24 centage’ means—

25 “(A) 20 percent, or

1 “(B) at the election of the taxpayer, 5 per-
2 cent for each taxable year in the credit period.

3 The election under subparagraph (B), once made,
4 shall be irrevocable.

5 “(2) CREDIT PERIOD.—

6 “(A) IN GENERAL.—The term ‘credit pe-
7 riod’ means, with respect to any building, the
8 period of 10 taxable years beginning with the
9 taxable year in which the building is placed in
10 service.

11 “(B) APPLICABLE RULES.—Rules similar
12 to the rules under paragraphs (2) and (4) of
13 section 42(f) shall apply.

14 “(c) QUALIFIED REVITALIZATION BUILDINGS AND
15 EXPENDITURES.—For purposes of this section—

16 “(1) QUALIFIED REVITALIZATION BUILDING.—
17 The term ‘qualified revitalization building’ means
18 any building (and its structural components) if—

19 “(A) such building is located in an eligible
20 commercial revitalization area,

21 “(B) a commercial revitalization credit
22 amount is allocated to the building under sub-
23 section (e), and

1 “(C) depreciation (or amortization in lieu
2 of depreciation) is allowable with respect to the
3 building.

4 “(2) QUALIFIED REHABILITATION EXPENDI-
5 TURE.—

6 “(A) IN GENERAL.—The term ‘qualified
7 rehabilitation expenditure’ means any amount
8 properly chargeable to capital account—

9 “(i) for property for which deprecia-
10 tion is allowable under section 168 and
11 which is—

12 “(I) nonresidential real property,
13 or

14 “(II) an addition or improvement
15 to property described in subclause (I),

16 “(ii) in connection with the construc-
17 tion or substantial rehabilitation or recon-
18 struction of a qualified revitalization build-
19 ing, and

20 “(iii) for the acquisition of land in
21 connection with the qualified revitalization
22 building.

23 “(B) DOLLAR LIMITATION.—The aggre-
24 gate amount which may be treated as qualified
25 revitalization expenditures with respect to any

1 qualified revitalization building for any taxable
2 year shall not exceed \$10,000,000, reduced by
3 any such expenditures with respect to the build-
4 ing taken into account by the taxpayer or any
5 predecessor in determining the amount of the
6 credit under this section for all preceding tax-
7 able years.

8 “(C) CERTAIN EXPENDITURES NOT IN-
9 CLUDED.—The term ‘qualified revitalization ex-
10 penditure’ does not include—

11 “(i) STRAIGHT LINE DEPRECIATION
12 MUST BE USED.—Any expenditure (other
13 than with respect to land acquisitions) with
14 respect to which the taxpayer does not use
15 the straight line method over a recovery
16 period determined under subsection (c) or
17 (g) of section 168. The preceding sentence
18 shall not apply to any expenditure to the
19 extent the alternative depreciation system
20 of section 168(g) applies to such expendi-
21 ture by reason of subparagraph (B) or (C)
22 of section 168(g)(1).

23 “(ii) ACQUISITION COSTS.—The costs
24 of acquiring any building or interest there-
25 in and any land in connection with such

1 building to the extent that such costs ex-
 2 ceed 30 percent of the qualified revitaliza-
 3 tion expenditures determined without re-
 4 gard to this clause.

5 “(iii) OTHER CREDITS.—Any expendi-
 6 ture which the taxpayer may take into ac-
 7 count in computing any other credit allow-
 8 able under this part unless the taxpayer
 9 elects to take the expenditure into account
 10 only for purposes of this section.

11 “(3) ELIGIBLE COMMERCIAL REVITALIZATION
 12 AREA.—The term ‘eligible commercial revitalization
 13 area’ means—

14 “(A) an empowerment zone or enterprise
 15 community designated under subchapter U,

16 “(B) any area established pursuant to any
 17 consolidated planning process for the use of
 18 Federal housing and community development
 19 funds, and

20 “(C) any other specially designated com-
 21 mercial revitalization district established by any
 22 State or local government, which is a low-in-
 23 come census tract or low-income nonmetropoli-
 24 tan area (as defined in subsection (e)(2)(C))

1 and is not primarily a nonresidential central
2 business district.

3 “(4) SUBSTANTIAL REHABILITATION OR RE-
4 CONSTRUCTION.—For purposes of this subsection, a
5 rehabilitation or reconstruction shall be treated as a
6 substantial rehabilitation or reconstruction only if
7 the qualified revitalization expenditures in connec-
8 tion with the rehabilitation or reconstruction exceed
9 25 percent of the fair market value of the building
10 (and its structural components) immediately before
11 the rehabilitation or reconstruction.

12 “(d) WHEN EXPENDITURES TAKEN INTO AC-
13 COUNT.—

14 “(1) IN GENERAL.—Qualified revitalization ex-
15 penditures with respect to any qualified revitaliza-
16 tion building shall be taken into account for the tax-
17 able year in which the qualified rehabilitated build-
18 ing is placed in service. For purposes of the preced-
19 ing sentence, a substantial rehabilitation or recon-
20 struction of a building shall be treated as a separate
21 building.

22 “(2) PROGRESS EXPENDITURE PAYMENTS.—
23 Rules similar to the rules of subsections (b)(2) and
24 (d) of section 47 shall apply for purposes of this
25 section.

1 “(e) LIMITATION ON AGGREGATE CREDITS ALLOW-
2 ABLE WITH RESPECT TO BUILDINGS LOCATED IN A
3 STATE.—

4 “(1) IN GENERAL.—The amount of the credit
5 determined under this section for any taxable year
6 with respect to any building shall not exceed the
7 commercial revitalization credit amount (in the case
8 of an amount determined under subsection
9 (b)(1)(B), the present value of such amount as de-
10 termined under the rules of section 42(b)(2)(C)) al-
11 located to such building under this subsection by the
12 commercial revitalization credit agency. Such alloca-
13 tion shall be made at the same time and in the same
14 manner as under paragraphs (1) and (7) of section
15 42(h).

16 “(2) COMMERCIAL REVITALIZATION CREDIT
17 AMOUNT FOR AGENCIES.—

18 “(A) IN GENERAL.—The aggregate com-
19 mercial revitalization credit amount which a
20 commercial revitalization credit agency may al-
21 locate for any calendar year is the portion of
22 the State commercial revitalization credit ceil-
23 ing allocated under this paragraph for such cal-
24 endar year for such agency.

1 “(B) STATE COMMERCIAL REVITALIZATION
2 CREDIT CEILING.—

3 “(i) IN GENERAL.—The State com-
4 mercial revitalization credit ceiling applica-
5 ble to any State for any calendar year is
6 an amount which bears the same ratio to
7 the national ceiling for the calendar year
8 as the population of low-income census
9 tracts and low-income nonmetropolitan
10 areas within the State bears to the popu-
11 lation of such tracts and areas within all
12 States.

13 “(ii) NATIONAL CEILING.—For pur-
14 poses of clause (i), the national ceiling is
15 \$100,000,000 for 1998, \$200,000,000 for
16 1999, and \$400,000,000 for each calendar
17 years after 1999.

18 “(iii) OTHER SPECIAL RULES.—Rules
19 similar to the rules of subparagraphs (D),
20 (E), (F), and (G) of section 42(h)(3) shall
21 apply for purposes of this subsection.

22 “(C) LOW-INCOME AREAS.—For purposes
23 of subparagraph (B), the terms ‘low-income
24 census tract’ and ‘low-income nonmetropolitan
25 area’ mean a tract or area in which, according

1 to the most recent census data available, at
2 least 50 percent of residents earned no more
3 than 60 percent of the median household in-
4 come for the applicable Metropolitan Standard
5 Area, Consolidated Metropolitan Standard
6 Area, or all nonmetropolitan areas in the State.

7 “(D) COMMERCIAL REVITALIZATION CRED-
8 IT AGENCY.—For purposes of this section, the
9 term ‘commercial revitalization credit agency’
10 means any agency authorized by a State to
11 carry out this section.

12 “(E) STATE.—For purposes of this sec-
13 tion, the term ‘State’ includes a possession of
14 the United States.

15 “(f) RESPONSIBILITIES OF COMMERCIAL REVITAL-
16 IZATION CREDIT AGENCIES.—

17 “(1) PLANS FOR ALLOCATION.—Notwithstand-
18 ing any other provision of this section, the commer-
19 cial revitalization credit dollar amount with respect
20 to any building shall be zero unless—

21 “(A) such amount was allocated pursuant
22 to a qualified allocation plan of the commercial
23 revitalization credit agency which is approved
24 by the governmental unit (in accordance with
25 rules similar to the rules of section 147(f)(2)

1 (other than subparagraph (B)(ii) thereof) of
2 which such agency is a part, and

3 “(B) such agency notifies the chief execu-
4 tive officer (or its equivalent) of the local juris-
5 diction within which the building is located of
6 such project and provides such individual a rea-
7 sonable opportunity to comment on the project.

8 “(2) QUALIFIED ALLOCATION PLAN.—For pur-
9 poses of this subsection, the term ‘qualified alloca-
10 tion plan’ means any plan—

11 “(A) which sets forth selection criteria to
12 be used to determine priorities of the commer-
13 cial revitalization credit agency which are ap-
14 propriate to local conditions,

15 “(B) which considers—

16 “(i) the degree to which a project con-
17 tributes to the implementation of a strate-
18 gic plan that is devised for an eligible com-
19 mercial revitalization area through a citi-
20 zen participation process,

21 “(ii) the amount of any increase in
22 permanent, full-time employment by reason
23 of any project, and

1 “(iii) the active involvement of resi-
2 dents and nonprofit groups within the eli-
3 gible commercial revitalization area, and

4 “(C) which provides a procedure that the
5 agency (or its agent) will follow in monitoring
6 for compliance with this section.

7 “(g) TERMINATION.—This section shall not apply to
8 any building placed in service after December 31, 2000.”

9 (b) CONFORMING AMENDMENTS.—

10 (1) Section 39(d) of the Internal Revenue Code
11 of 1986 is amended by adding at the end the follow-
12 ing new paragraph:

13 “(8) NO CARRYBACK OF SECTION 48A CREDIT
14 BEFORE ENACTMENT.—No portion of the unused
15 business credit for any taxable year which is attrib-
16 utable to any commercial revitalization credit deter-
17 mined under section 48A may be carried back to a
18 taxable year ending before the date of the enactment
19 of section 48A.”

20 (2) Subparagraph (B) of section 48(a)(2) of
21 such Code is amended by inserting “or commercial
22 revitalization” after “rehabilitation” each place it
23 appears in the text and heading thereof.

24 (3) Subparagraph (C) of section 49(a)(1) of
25 such Code is amended by striking “and” at the end

1 of clause (ii), by striking the period at the end of
2 clause (iii) and inserting “, and”, and by adding at
3 the end the following new clause:

4 “(iv) the basis of any qualified revital-
5 ization building attributable to qualified re-
6 vitalization expenditures.”

7 (4) Paragraph (2) of section 50(a) of such Code
8 is amended by inserting “or 48A(d)(2)” after “sec-
9 tion 47(d)” each place it appears.

10 (5) Subparagraph (B) of section 50(a)(2) of
11 such Code is amended by adding at the end the fol-
12 lowing new sentence: “A similar rule shall apply for
13 purposes of section 48A.”

14 (6) Paragraph (2) of section 50(b) of such Code
15 is amended by striking “and” at the end of subpara-
16 graph (C), by striking the period at the end of sub-
17 paragraph (D) and inserting “, and”, and by adding
18 at the end the following new subparagraph:

19 “(E) a qualified revitalization building to
20 the extent of the portion of the basis which is
21 attributable to qualified revitalization expendi-
22 tures.”

23 (7) Subparagraph (C) of section 50(b)(4) of
24 such Code is amended by inserting “or commercial

1 revitalization” after “rehabilitated” each place it ap-
2 pears in the text and heading thereof.

3 (8) Subparagraph (C) of section 469(i)(3) is
4 amended—

5 (A) by inserting “or section 48A” after
6 “section 42”, and

7 (B) by striking “CREDIT” in the heading
8 and inserting “AND COMMERCIAL REVITALIZA-
9 TION CREDITS”.

10 (c) EFFECTIVE DATE.—The amendments made by
11 this section shall apply to property placed in service after
12 December 31, 1997.

○

**Tax Treatment of Major Educational Assistance
Current Law and Administration Proposal**

Type of Assistance

Student qualifications	Type of			Nondiscrimination plan required	Tax treatment	
	Institution	Education	Expenses		General rule	Special limitations

Current Law

Qualified scholarship (section 117)	degree candidates	any	any	tuition, fees; related expenses	N.A.	excluded from gross income	not excludable if teaching, research or other services required
Qualified tuition reductions (section 117)	employee (spouse or dependent children) of educational institution	any	no graduate education (except for grad students who teach or do research)	tuition	yes	excluded from gross income*	none
Forgiveness of student loan indebtedness (section 108(f))	must be working in certain professions	any	any	covered by loan	N.A.	excluded from gross income*	none
Employer paid (section 132)	employee	any	must be related to current job	any	no	excluded from gross income*	none
Fringe benefit - no additional cost to employer (section 132)	employee (spouse or dependent children) of educational institution	any	Any	similar to expenses charged to customers	yes	excluded from gross income*	none
Employee paid (section 162)	taxpayer	any	must be related to current job	tuition, fees, books, supplies and equipment	N.A.	deductible as itemized deduction	subject to 2% of AGI limitation
Savings Bond proceeds (section 135)	taxpayer, spouse and dependent children	public and private non-profit post-secondary	any, except hobby, etc.	tuition & required fees;	N.A.	interest excluded from gross income	income phase-out married: \$76,250 - 106,250; single: \$50,850 - 65,850; ranges indexed
Employer paid (section 127) (expires 5/31/00)	employee	any	any, except hobby, etc; no graduate after 6/30/96	tuition, fees, books, supplies and equipment	yes	excluded from gross income*	\$5,250 per year
State pre-paid tuition plans	named beneficiary	colleges, etc eligible to participate in GSL program (depending on state plan)	any	tuition, fees, books, supplies and equipment; room and board	N.A.	earnings taxable to beneficiary upon disbursement	amounts reasonably required to pay qualified educational costs

*Net assets - savings adjust
with -> don't provide info.*

Type of Assistance

Type of Assistance	Type of				Nondiscrimination plan required	Tax treatment	
	Student qualifications	Institution	Education	Expenses		General rule	Special limitations
Tuition credit (HOPE Scholarship)	taxpayer, spouse and dependents; drug felons ineligible	colleges, etc eligible to participate in GSL program	degree or certificate program; at least 1/2 time; 13th & 14th year	tuition & required fees	N.A.	lesser of first \$1000 +50% of next \$1000 of tuition & fees; reduced by grants, etc; per student basis	income phase-out, married: \$80,000 - 100,000 single: \$50,000 - 70,000 indexed beginning in 2002;
Tuition credit (Lifetime Learning)	taxpayer, spouse and dependents	colleges, etc eligible to participate in GSL program	any except hobby, etc.	tuition & required fees	N.A.	20% of up to \$10,000 (\$5000 before 2002); per taxpayer basis	income phase-out, married: \$80,000 - 100,000 single: \$50,000 - 70,000; indexed beginning in 2002
Student loan interest	taxpayer, spouse and dependents	colleges, etc eligible to participate in GSL program; health institutions	at least 1/2 time	tuition, fees, books, supplies and equipment; room and board	N.A.	deduction of up to \$2500 (\$1000 in 1998, \$1500 in 1999, \$2000 in 2000) of interest on qualified loan	income phase-out, married: \$60,000 - 75,000 single: \$40,000 - 55,000; indexed beginning after 2002
IRA withdrawals	taxpayer, spouse, dependents, children, and grandchildren	colleges, etc eligible to participate in GSL program	any; at least 1/2 time for room and board to qualify	tuition, fees, books, supplies and equipment; room and board	N.A.	no early withdrawal penalty	income phase-out for \$2,000 contribution deduction - married: \$50,000 - 60,000 in 1998; increasing to \$80,000 - 100,000 after 1998; single: \$30,000 - 40,000 in 1998; increasing to \$50,000 - 60,000 after 1998
Education IRAs	named beneficiary	colleges, etc eligible to participate in GSL program	any; at least 1/2 time for room and board to qualify	tuition, fees, books, supplies and equipment; room and board	N.A.	\$500 annual contribution limit; distributions excludable from gross income	income phase-out, married: \$150,000 - 160,000 single: \$95,000 - 110,000

Administration Proposal

Employer paid (section 127 expires 5/31/00)	employee	any	any, except hobby, etc; graduate after 6/30/98	tuition, fees, books, supplies and equipment	yes	up to \$5,250 excluded from annual gross income*	limited to courses beginning before June 1, 2001
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*Also reduces the Social Security and Medicare tax bases.

subsidy → tax cut

SELF HELP

HOME LOAN SECONDARY MARKET PROGRAM

Expanding home ownership for low-wealth families.

Through its Secondary Market Program, Self-Help is dramatically increasing access of low-wealth people to mortgage loans. To date, Self-Help has purchased mortgages for more than \$100 million from North Carolina banks. As a result, an additional 1,800 families will be able to buy their own homes. New investments in Self-Help are continually needed to provide capital for this program, which has national ramifications (see right).

Home ownership is a big part of the American dream, but many lower-income families cannot qualify for conventional mortgages. The federal Community Reinvestment Act (CRA) encourages banks to make this kind of "nonconforming" loan.

But when they do, banks often find themselves in a bind. The agencies that purchase mortgages from banks (freeing the bank's capital to make

additional loans) are reluctant to buy CRA loans, seeing them as risky. Thus, if banks are to fulfill their commitment to make loans to lower-income home buyers, they must tie up their money for 15 years or more. When a bank has too many of these loans in its portfolio (and thus too much money tied up in them), it must scale back or cut off lending to low- and moderate-income borrowers.

Self-Help's Secondary Market Program offers an alternative for banks and borrowers. Self-Help buys a package of nonconforming loans, and in return the bank makes a commitment to re-lend the money to an equivalent number of lower-income home buyers in the future. By 1999, Self-Help projects that some 4,000 North Carolina families will own homes with the help of this program.



National Home Ownership Program Uses Self-Help Model

Federal legislation to generate up to \$100 million in new home mortgages for low-wealth families across the U.S. was approved in October 1997. This demonstration project builds on the successful Self-Help model described on this page.

The national home ownership demonstration program will provide \$10 million in capital to selected nonprofits with home ownership expertise, which the nonprofits will use to purchase mortgages from banks.

The effect of the program will be much greater than the \$10 million grant. "Based on our experience," said Martin Eakes, Self-Help's Executive Director, "nonprofits participating in the demonstration can leverage the \$10 million *tenfold*, which means \$100 million in additional affordable housing loans. That's 2,000 more deserving families who will be able to buy homes."

Over \$100 Million in Loan Purchases

Families served - 1,809

Minority - 30%

Typical income - 59% of
area median income

Female - 44%

Rural - 56%



CREATING OWNERSHIP AND ECONOMIC OPPORTUNITY

Secondary Market Purchases: Growing Reach and Impact

Wachovia Bank, 1994

Self-Help's first purchase, this \$20 million portfolio includes 461 loans. Borrowers had a median income of 54% of their county average. More than 30% of these home owners were minorities; 50% were women; and 60% were rural.

First Union National Bank, 1996

Self-Help purchased a \$9.75 portfolio of 182 loans made to families earning 80% or less of the area median income. Of these mortgages, 16% were made to minorities, 38% to women, and 61% to rural residents.

Centura Bank, 1997

Four purchases, totaling \$62.4 million, added 933 loans to Self-Help's holdings. Of these, 32% went to minorities, 50% to women, and 55% to rural residents.

BB&T, 1997

This \$10 million purchase included 206 loans, 13% to minorities, 43% to women, and 57% to rural residents. Borrowers had household income below 80% of the area median income.

Secondary Market Program Short- and Long-term Goals

By supporting more "nonconforming" home lending, the secondary market program enables Self-Help to further its mission of creating wealth and economic opportunity for people throughout North Carolina – particularly minorities, women, rural residents, and low-wealth families. For example, there is a wide disparity in home ownership rates for white and black home owners in North Carolina and in the country as a whole, which reflects broader economic disparities. Only 49.6 percent of the nation's African-American families own homes, compared to 72.9 percent of white families. While less than 5 percent of conventional secondary market pools comprise loans made to black families, minorities (mostly African-Americans) represent some 30 percent of the borrowers in Self-Help's purchased portfolios.

The program's long-term goal is to open up the conventional secondary market for these nonconforming loans by overcoming the market's perception that these bear unacceptably high risks of delinquency and default. Self-Help has already had success in originating over \$45 million to more than 900 supposedly "high risk" North Carolina home buyers - with losses on only two loans. And Self-Help's experience with the portfolios it has purchased from banks shows that their performance is well within acceptable limits, with loan losses of less than one percent. If this and other initiatives can demonstrate persuasively to mainstream capital markets and the key secondary market players that these loans represent acceptable risks, the central obstacle to home loan financing for families of modest means will be removed.

Since its start in 1980, Self-Help has lent over \$110 million to help minorities, women, rural residents, and low-wealth families buy homes, build businesses, and strengthen community resources. Self-Help is a nonprofit consisting of the Center for Community Self-Help and two financing affiliates, Self-Help Credit Union and Self-Help Ventures Fund. We serve all of North Carolina through our regional offices in Asheville, Charlotte, Durham, Greensboro, and Greenville.

**Self-Help Ventures Fund
Secondary Market Loans
Initial Purchase and Current Status Data**

updated on: 5/1/98

Portfolio Purchased	Initial Purchase									Current Status	
	Date Purchased	Dollar Volume (at Purchase)	Gross Interest Rate	Number of Loans	African American	Total Minority	Female-Headed Households	Rural	Median Income	Mar 1998 Outstanding Balance	Mar 1998 60+ Day Delinquency Rate
Wachovia	Mar-94	\$ 19,976,390	8.313%	461	29%	32%	48%	60%	54%	\$ 12,995,761	1.52%
First Union	Dec-96	\$ 9,745,025	8.735%	182	16%	21%	38%	61%	58%	\$ 7,923,702	0.00%
Centura I	Feb-97	\$ 11,778,385	8.892%	218	32%	36%	50%	55%	55%	\$ 9,607,003	0.96%
Self-Help 97	through 12/31/97	\$ 630,022	8.852%	11	44%	44%	11%	56%			
UCB/BB&T	May-97	\$ 10,040,595	8.596%	206	13%	14%	43%	57%	55%	\$ 8,494,804	0.00%
Centura II	Jun-97	\$ 6,496,325	8.804%	112	31%	40%	46%	62%	60%	\$ 6,227,328	0.00%
Centura III	Aug-97	\$ 28,297,268	8.498%	407	37%	41%	41%	48%	68%	\$ 27,690,642	2.17%
Centura IV	Dec-97	\$ 15,799,027	8.215%	223	40%	41%	46%	52%	66%	\$ 15,644,130	0.00%
Totals:		\$ 102,763,036	8.517%	1,820	30%	33%	44%	55%	60%	\$ 88,583,370	1.22%



CREATING OWNERSHIP AND ECONOMIC OPPORTUNITY

**Self-Help's Home Loan Secondary Market Program
May 5, 1998**

Self-Help is a community development financial institution (CDFI) with a mission to create ownership opportunities for minority, women-headed, rural, and low-wealth families in North Carolina. Self-Help began making home loans to low-wealth families after realizing that home equity is the primary way families accumulate wealth and stabilize their finances. Equity in a home can help a family send children to college, start a new business, or absorb a personal crisis, such as a job loss. Self-Help recognizes that, with only five branches in North Carolina, we can never meet the need for home loans to our core constituencies solely through making home loans ourselves. Self-Help began its Home Loan Secondary Market Program to partner with large North Carolina banks and national secondary market groups to increase availability of home loan credit to low-wealth families beyond what we could accomplish alone.

The secondary market is a critical component of home financing. This market purchases conventional mortgage loans, freeing funds for banks to make additional loans. Historically, there has not been a secondary market for low-wealth mortgage loans spurred by the Community Reinvestment Act (CRA) due to their lack of private mortgage insurance and non-conformance with secondary market purchase guidelines. Self-Help's program addresses this problem by purchasing the loans from the banks, in exchange for the banks' commitment to lend an equal amount of additional loans to low-wealth families.

Self-Help is able to purchase these loans through a unique partnership with banks and secondary market groups. Banks utilize their large branch networks to originate large volumes of low-wealth home loans. Self-Help, as a non-profit, has been successful in raising equity and low-cost funding to buy these loans from banks. Fannie Mae has joined in this partnership by agreeing to buy loans from Self-Help, as long as Self-Help retains the risk of default.

Self-Help hopes to purchase \$100 million of CRA loans each year for the next five years. In the past year, we have purchased \$80 million of home loans, bringing our total purchases to date to over \$100 million. Once purchased, Self-Help has two options for managing the newly acquired loans: 1) we can retain the loans in portfolio ("portfolio strategy"), or 2) we can immediately sell the loans to Fannie Mae ("conduit strategy"). To date, we have almost exclusively followed the portfolio strategy.

The portfolio strategy requires Self-Help to attract funding to purchase the home loans from banks. The key source of financing has come from the Federal Home Loan

Bank of Atlanta (FHLB). FHLB has provided 50% of the financing for the program, in exchange for first-lien position on the underlying mortgage loans. Another 40% of the financing has come from foundations and institutional investors. This financing is usually unsecured. The final 10% of the financing has come from equity grants, primarily from federal and state sources. This equity financing serves as a loan loss cushion to protect Self-Help from losses of these untested low-wealth home loans.

The conduit strategy enables Self-Help to purchase the loans from a bank and then immediately resell them to Fannie Mae. Self-Help thus sells off the interest rate risk involved in the portfolio strategy while retaining the credit risk of default. This strategy will become more important as the volume of loan purchases exceeds \$100 million of loans and outpaces our ability to attract low-cost financing. Self-Help will still need to retain at least a 5% loan loss cushion under the conduit strategy.

Self-Help is monitoring both the programmatic and financial aspects of these low-wealth home loans in order to promote the inclusion of these loans in the traditional secondary mortgage market. Programmatically, these loans are serving our core constituencies. For example, the percentage of African-American borrowers in our portfolio (30%) is ten times greater than the percentage in traditional mortgage pools (3%). Female-headed households have accounted for almost half (44%) of the loans. These loans have reached rural families (55% of the portfolio). Finally, these programs are reaching working-class families; the average income of the borrower is 60% of the county median income.

Financially, the loans have performed well to date. The 60-day delinquency rate has been approximately 1%, and Self-Help has suffered a loss on only one of the 1,800 loans purchased to date.



Office of Thrift Supervision
Department of the Treasury

1700 G Street, N.W., Washington, DC 20552

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April 24, 1998

Mr. Bill Himpler
Legislative Director
Congressman Jerry Weller
130 Cannon House Office Building
Washington, DC 20515-1311

Subject: Ideas Regarding Use of Low Income Housing Tax Credit
To Support Homeownership -- Through Use of Loan Pools

Dear Bill:

It was a pleasure meeting with you recently to discuss the work of Neighborhood Reinvestment. Your question regarding how the Low Income Housing Tax Credit (LIHTC) might be expanded to support homeownership is intriguing. I apologize for the delay in getting this to you, but in response to your request, I offer the following thoughts for your consideration. These ideas are presented within the constraint of being revenue-neutral, and operate within the basic parameters of the existing LIHTC.

Introduction:

As you know, the (LIHTC), established by the Tax Reform Act of 1986 and set forth in Section 42 of the Internal Revenue Service Code, is specifically aimed at encouraging the construction or rehabilitation of rental properties. These are typically large multifamily properties because of the complexity of the tax credit program. Tax credits have been applied to more than 90 percent of the low-income rental housing developed in recent years. And in the process, tax credits have also fostered an increased level of corporate funding for affordable housing and neighborhood revitalization efforts. As helpful as this has been (and it has been very helpful), in many neighborhoods and smaller towns, assisting families with home ownership would be equally or even more helpful.

I see no reason why the same rationale and logic which led to the public policy decision to create the LIHTC for rental properties, shouldn't be used to expand the program's applicability and create a mechanism to raise equity investments for acquisition, rehabilitation and new construction of single-family low-income housing (for homeownership by low-income households).

As a frame-of-reference, in the recently ended NeighborWorks® Campaign for Home Ownership, over 15,800 lower income families were assisted to become homeowners. Of this total 5% had incomes below \$10,000 and 11% had incomes below \$15,000. In many cases these families were assisted through use of a second mortgage that had the effect of leveraging a fully conventional first mortgage (usually at 80% LTV) with a lower monthly payment (and thus affordable to them).

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Mr. Bill Himpler
April 24, 1998

Page Two

The use of an expanded LIHTC for single-family properties, used in conjunction with loan pools, has the potential of significantly expanding efforts such as this by leveraging billions of dollars in additional mortgage money from the private sector -- creating new affordable housing and economic opportunities for families, and revitalizing neighborhoods in the process.

The following proposal builds on the recognition that our nation's system for financing home mortgages, primarily through the secondary mortgage markets' issuance of mortgage-backed securities, works wonderfully for most people in our country. But it doesn't work for those individuals, properties or neighborhoods that do not fully conform to the current underwriting standards of the secondary markets -- including many low-income families who could afford to live in a decent home for less money than they are currently paying to rent a substandard apartment.

For more than 20 years, Neighborhood Reinvestment and its affiliate, Neighborhood Housing Services of America (NHSA), have used a range of techniques, including the use of below-market loan pools and a secondary market to provide liquidity to those loan pools, to provide low cost second mortgages to existing and new homeowners who seek to improve their homes. The use of below-market loan pools works particularly well in lower income neighborhoods. Nationally, of families whose incomes are above \$40,000, 82 percent are homeowner, while among families whose incomes lie between \$15,000 and \$25,000, only 54 percent are homeowners. I believe there is a tremendous potential to expand homeownership for low-income families through the use and impact of below-market loan pools, but the limiting factor is reasonably priced investment capital.

This proposal aims to expand housing opportunities for tens of thousands of low-income families and others (including many young families and senior citizens) excluded by the current system, by using LIHTC to, in effect, enhance the yield on investments in below-market community development loan pools.

I am not attempting to present a full proposal or specific legislative revisions, but simply offer these thoughts for your consideration.

Proposal: Use of Low Income Housing Tax Credits (LIHTC) for Homeownership -- through Public-Benefit Investment in Loan Pools Operated by Community Development Lenders

In order to generate a large source of private capital for homeownership by low-income families, and minimize the complexity and burdensome transaction costs associated with the current LIHTC (which would be totally unworkable if applied in its current form to individual single family properties), I recommend an expansion of the LIHTC program, to allocate tax credits at the 'wholesale level' to investors in below-market second mortgage loan pools benefiting low- and very-low income homeowners.

Just as the LIHTC is currently allocated by a State agency to a sponsor of a multifamily rental development, the tax credit would continue to be allocated by the State agency -- but an additional eligible use would be to community development lender/sponsors of second mortgage loan pools for purchase of homes.

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Examples of community development lender/sponsors would include (but not be limited to): housing finance agencies, credit unions, community development banks, special purpose lenders such as NeighborWorks® organizations, NHSA, LISC, Habitat for Humanity, the Housing Assistance Council and the Enterprise Foundation.

Clearly the assumption is that the second mortgages issued through the loan pool would be used in conjunction with first mortgages, just as in the rental credit where first mortgages are often used in conjunction with tax credit "equity" and public subsidy funds. Therefore, investment in loan pools is likely to serve many times as many households, as the same amount of funds would serve through direct first mortgage lending — due to the ability to leverage the investment with large amounts of private, conventional first mortgages. I envision a system in which the tax credit received by the investor accomplishes three basic objectives along the lending chain:

- It provides a competitive yield to the investor, on a reasonably safe investment (at a rate somewhat more attractive than similar term Treasury Bills);
- It defrays a portion of the costs incurred by the community development lender in organizing/operating the loan pool (including aggregating investors and loans). Similar to asset management fees this ensures continuation of monitoring, maintenance and monthly payments to investors;
- It results in a below-market rate loan to lower income buyers.

The current LIHTC provides a 9 percent tax credit for new construction or substantial rehabilitation without federal subsidies; and a 4 percent tax credit for acquisition, or for projects with federal subsidies or tax exempt financing. (Note: The 9 percent and 4 percent levels are approximate percentages, with the actual percentages published monthly by the Department of Treasury.)

Applying the current LIHTC calculation would mean that a tax credit of 9 percent, taken over a ten year period, will have a present value of 70 percent of the qualified basis (for properties which are not federally subsidized). For properties with federal subsidies, the present value of the allowable credit is 30 percent of the allowable basis.

I would point out that in a current LIHTC rental project, in addition to the tax credit, the project would also provide a flow-through to the investor on depreciation and interest deductibility. These ancillary benefits would not be available to homeowner loan-pool investors.

Specific criteria should define the type of loan pools eligible for the tax credits. I would recommend that

- The loan pools be strictly limited to pools comprised of subordinate mortgages (i.e. second mortgages) issued for the purchase, rehabilitation or construction of single-family homes; and
- The current levels of tax credit and the same basic rules for the use of 9 percent and 4 percent tax credit rates should apply to a revised tax credit for single-family loan pools, so that the tax credit for single-family loan pools is fully consistent with the current eligibility requirements for LIHTC. Specifically:

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- ✓ No less than 20 percent of the amount of mortgages held in the loan pool should be to individuals at or below 50 percent of area median income; or no less than 40 percent of the amount of mortgages held in the loan pool should be to individuals at or below 60 percent of area median income;
- ✓ Direct housing costs for residents should be restricted to no more than 30 percent of income (for PITI);
- ✓ The tax credit "set-aside" total mortgage amount within the loan pool would be subject to the current low-income use restrictions for a period of 30 years (15 years, plus 15-year extension).

Aside from basic statutory requirements such as these, I don't believe it is necessary or prudent to legislatively prescribe the definition or operation of such loan pools. Rather, State allocating agencies should be given maximum flexibility to determine or negotiate the specific terms, including yield to the investor(s), the average rate of loans in the pool, and a series of other factors related to the operation and conditions of each specific loan pool.

There would be no additional cost or revenue give-up by the federal government if the expanded LIHTC program operated within the existing annual cap established for LIHTC. And, since the tax credits are allocated by State allocating agencies, this proposal would not impose any *requirement* that the State allocating agencies use the LIHTC to encourage private investment in loan pools. It would simply expand eligibility so that State allocating agencies *could* allocate LIHTC to loan pools, if they felt that was an appropriate strategy to meet the housing needs in their particular area.

In regard to monitoring low-income use restrictions and recapture of benefits if the loan pool does not maintain the required percentage of original mortgage amounts to low-income households, for a practical matter, it is unlikely that a loan pool would ever be faced with a recapture of tax credit benefits.

It should be recognized that most loan pools would be operating with a very healthy 'cushion' of income-eligible households, well beyond the required income-level percentages -- in an effort to serve as many low-income families as possible, and to allow for a reasonable degree of change among the mortgage holders (income increases and home sales) without triggering recapture provisions. Additionally, the organizer/operator of the loan fund has ample opportunity to manage the make-up of the loan pool in an ongoing manner. In any case, the community development loan pool organizer/operator should be responsible, during the entire period of long-term affordability, to maintain the required low-income use restrictions, or to repay an amount equal to the balance of the tax benefit received if the required low-income use restrictions are not maintained.

The ability of the community development loan pool organizer/operator to manage market changes and loan risks by managing the composition of the loan pool (in regard to both loans and investors) also decreases the investor's exposure and risk.

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Potential Impact of Proposed Tax Credit:

While the investor and the community development organizer/operator of the loan fund are critically important elements of this proposal, this section attempts to show that the real beneficiaries of the proposed expanded tax credit would be low-income families who currently fall through the cracks of America's housing finance system.

I have not used numeric calculations to demonstrate this impact, since there are an infinite number of permutations that could be run (including a range of property values; varying amounts, interest rates, and terms for the first and second mortgages; different percentages of the total amount funded by the first and second mortgage; etc). And I am confident that the enormous creativity of the housing finance players (including community development lenders, first mortgage lenders, State housing finance agencies, investors, and others) will bring the needed efficiency and structure to the basic approach laid out here.

Impact on Homeowner/Borrower:

The LIHTC (if revised as proposed) would result in a second mortgage with a below-market interest rate, combined with a conventional market-rate first mortgage. Among the advantages of this approach, are:

- The second mortgage could represent a significant portion of the upfront cash needed by a lower income family, for downpayment and closing-costs. Frequently, families are able to pay the monthly payments needed for homeownership (which are often less than they may currently be paying for rent), but are unable to come up with the cash needed for downpayment, closing costs, and necessary improvements.
- The family may not be able to qualify for a conventional first mortgage in the full amount needed (due to income level, credit blemishes or up-front debt ratios) or the property appraisal may not come in at a high enough level to support the first mortgage. However, the safety and soundness underwriting performed by the originator of the conventional first mortgage, would now be heavily based on the family's ability to carry the monthly payment on the first mortgage -- which, when combined with a below-market rate second mortgage, results in expanded affordability for low-income families.
- The second mortgage would typically be for a shorter term than the first mortgage, and would usually be fully paid off within 10 years. At that point, at about the point of heavy property maintenance needs, the family's monthly payment is reduced -- helping assure the family's long term ability to stay in and maintain their home for the long term; and
- Affordability can be further expanded to families with even lower incomes through use of various housing subsidy programs (including HOME or CDBG funds) in a third mortgage position, similar to many current multifamily layered-financing deals.

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Impact on Community Development Organizer/Operator of Loan Fund:

Under this proposal, the community development organizer/operator of the loan fund is essentially held harmless -- meaning they would not receive any appreciable economic benefit from the tax credit. They would need to receive a small allowance (probably best determined through negotiation with the investors) to off-set a portion of the costs incurred in aggregating and managing the mix of loans and investors for the loan fund.

Impact on Investors:

The investor would receive a lower than market-rate yield on their investment in the loan pool. Per the above assumptions, the return to the investor would be reduced below the normal market rate, to:

Reduce the interest rate to the homeowner/borrower during the term of the second mortgage, and

Offset a portion of the costs incurred by the organizer/operator of the loan fund.

The tax credit would essentially restore the yield on the loan-pool investment to a par with more typical, market-rate investments. For example, an allowable return might be tied to some factor above an investment such as Treasury Bills.

Bottom-line to the investor: It allows them to "do good" while receiving a reasonably competitive yield on a relatively safe, public-benefit investment.

Determining "Eligible Basis":

One issue not fully resolved in this proposal has to do with the determination of the "eligible basis" for the LIHTC.

Currently, the "eligible basis" for the LIHTC is: The cost of acquisition and rehab or construction (less the cost of land and non-allowable federal subsidies).

There would appear to be at least two alternative approaches that could be used to determine "eligible basis" for investment in loan-pools.

1. The first would be to apply the tax credit, similar to the current LIHTC, against the full value of the structures contained in the loan-pool (that is, the full cost of acquisition and rehab or construction, less the cost of land and non-allowable federal subsidies).

The advantage of this approach would be that it would provide for a more generous portion of the individual property transactions to be financed through a below-market second mortgage, with a smaller market-rate first mortgage. Clearly, this would have a much greater impact in terms of reduced monthly payments by the homeowner/borrower, and would therefore expand affordability to lower-income households.

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2. The second alternative would be to limit the "eligible-basis" to include only the amount of the second mortgages used for acquisition and rehab or construction (less cost of land and non-allowable federal subsidies).

This would translate to a smaller portion of each deal being financed through a below-market second mortgage, and more of the deal being financed through a market-rate first mortgage. This would result in a higher monthly payment for the homeowner/borrower than "Alternative 1" (but still less than a market-rate mortgage alone would be), but also results in a much thinner federal 'investment' in the deal. The advantage of this approach is that it spreads the federal 'investment' further, through a greater degree of leverage. The flip-side of this approach, is that it isn't able to expand affordability to as low an income household as "Alternative 1".

While "Alternative 1" would be the more attractive approach to me (and probably to most affordable housing players) I realize that budgetary, policy and political considerations may make "Alternative 2" more attractive to others. In any case, I will at this point simply leave this as an unresolved issue.

Closing Comments:

Through this proposal, a relatively small federal 'investment' (in the form of a tax credit) would generate a much larger total investment -- comprised largely of private capital (representing credit-enhanced investments and conventional market rate capital in the form of first mortgages).

I recognize that this type of credit-enhanced investment might not be competitive in an open market, but it could be an attractive inducement and investment for a significant number of social investors, and for others related to the home-building or home sale industry. And, this type of tax credit gives the State allocating agencies increased flexibility to use the credit to meet local housing needs.

I have enclosed several attachments that contain additional information related to this concept.

- Chart: Showing comparison of current Low Income Housing Tax Credit (LIHTC) with proposed revision to include investment in loan pools for single family properties (for homeownership by low-income households)"
- Graphic: Showing comparison of current multifamily Low-Income Housing Tax Credit (LIHTC) deal, to use of a tax credit to investors in homeownership loan pool.
- Chart: Showing Neighborhood Housing Services of America (NHSA) secondary market 90-day delinquency rate (from FY 1988 - FY 1997).
- Chart: Showing "The Potential for Home Ownership in Central Cities".
- Chart: Showing household/family income of NeighborWorks® Campaign for Homeownership clients -- and mortgage sources for homeowners with income below \$15,000
- Chart: Showing NeighborWorks® Campaign for Homeownership sources of first and second mortgages.

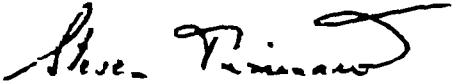
Mr. Bill Humpler
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Again, I am recommending that the requirements for use of this expanded Low-Income Housing Tax Credit for homeownership closely follow the current statutory requirements, and that State allocating agencies be given maximum flexibility to negotiate specific provisions which best serve the needs and realities of their markets.

Recognizing that Neighborhood Reinvestment does not have experience in drafting legislative proposals, I have not attempted to provide legislative language in support of this proposal. If this proposed concept makes sense to you, I can ask my staff to take a first-shot at drafting some proposed language. Should this idea assist you in your quest, I would be glad to meet with you and/or appropriate other parties to discuss it further.

Sincerely,



for George Knight
Executive Director

Attachments

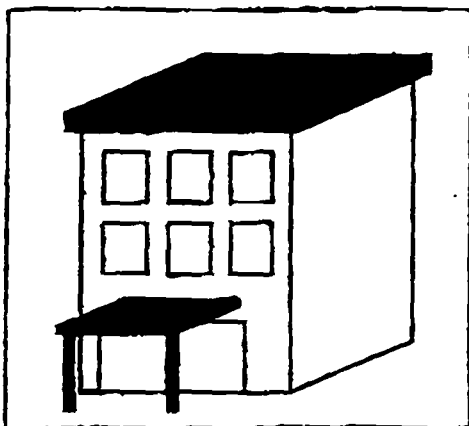
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Comparison of Current Low Income Housing Tax Credit (LIHTC) with Proposed Revision to Include Investment in Loan Pools for Single family Properties (for Homeownership by Low-Income Households)		
CHARACTERISTICS	CURRENT LIHTC (RENTAL)	PROPOSED (LOAN POOL)
Basic Purpose	To raise equity for acquisition, rehab, or construction of low-income rental housing.	To raise equity for acquisition, rehab, or construction of low-income homeownership housing.
Eligible Units	Rental housing for low-income households (tends to be multifamily because of program complexity and transaction costs).	Expand to include investment in loan pools providing second mortgages for low-income, single family, homeownership.
Income Eligibility Requirements	20% of units for residents at or < 50% of median, or 40% of units for residents at or < 60% of median.	20% of loan pool amount for residents at or < 50% of median, or 40% of loan pool amount for residents at or < 60% of median.
Use Restrictions	Income eligibility requirements must be maintained for 30 years (15 years plus 15 year extension.	Same
Maximum Housing Costs	Rents on set-aside units must be restricted to no more than 30% of income.	Housing costs (PITI) on set-aside units must be restricted to no more than 30% of income.
Recipient of Tax Credit	Property owner (who typically translates the credit into cash by selling the credits to investors through syndication).	Investors in loan pools, backed by second mortgages to low-income, single family, homeowners.
Recapture Provisions	Responsibility of property owner (typically, the general partner in syndications).	The community development organizer/operator of the loan pool is responsible to maintain required income mix, or repay tax credit benefits remaining.
Amount of Tax Credit	9% for construction or substantial rehab projects without federal subsidies. 4% for projects with federal subsidies or tax exempt financing, and for acquisition.	Same
Eligible Basis	Cost of acquisition and rehab or construction (less cost of land and non-allowable federal subsidies).	To be determined. Either the Same, or the amount of second mortgages used for acquisition and rehab or construction (less cost of land and non-allowable federal subsidies).
Agency Allocating Tax Credits	States designate agency (typically the State Housing Finance Agency).	Same
Annual Limit of Tax Credits that may be Allocated by Each State	\$1.25 per capita (although an increase has been proposed).	Same (Would operate within existing annual cap).

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**Proposal to Expand Use of Low Income Housing Tax Credits
To Investments In Loan Pools Operated by Community Development Lenders
(To Expand Homeownership Opportunities for Low-Income Households)**



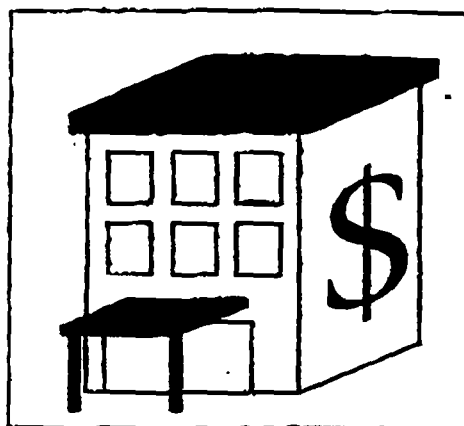
**Multifamily Tax Credit Deal
(Rental)**

Assume:

- 100 unit property
- 40% of units set-aside for low-income households
- 40 units directly assisted through Low Income Housing Tax Credit

On rental properties, pressure is toward 100% low-income.

Final, end-of-day investor access to units/building, which may or may not be salvageable behind first mortgage rights.



**Tax Credit to Investors
In Homeownership Loan Pools**

Assume:

- \$1 million loan pool
- 80% of loan pool amount serving tax-credit eligible families (below-market, second mortgages – serving families at 50-60% median income).
- Community Development leader, to maintain and manage LIHTC eligibility of loan pool.

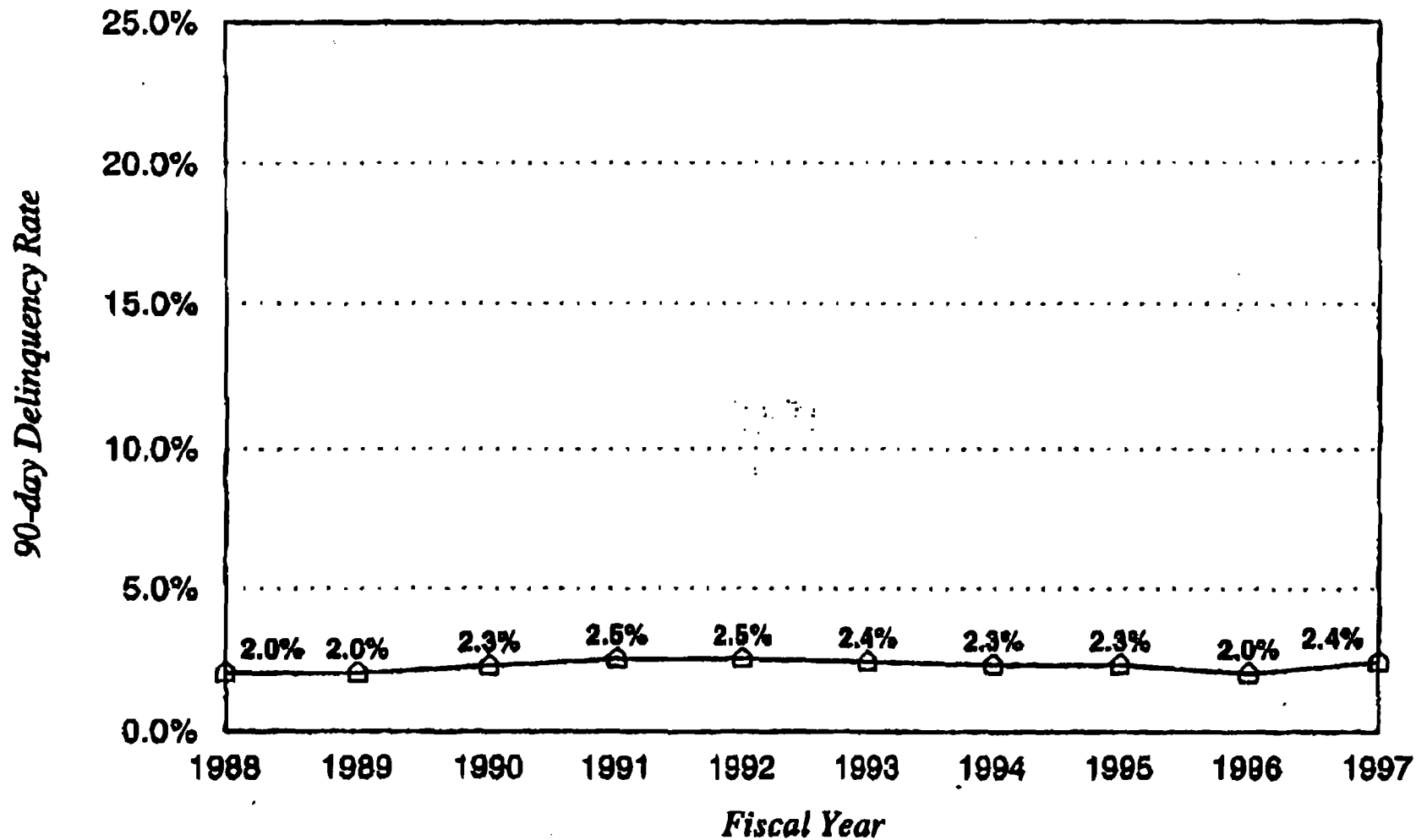
On loan pools, pressure is toward less than 100% low-income.

Final, end-of-day investor access to individual loans – recognizing they are highly illiquid second mortgages.

Neighborhood Housing Services of America

Secondary Market 90-day Delinquency Rate

FY 1988 - FY 1997



Neighborhood Reinvestment Corporation
Research Department
April 2, 1998

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Home Ownership in the United States

The Potential for Home Ownership in Central Cities 1995

(Units in Thousands)

INCOME OF FAMILIES AND PRIMARY INDIVIDUALS	NUMBER OF OWNER OCCUPIED UNITS	NUMBER OF RENTER OCCUPIED UNITS	TOTAL OF OWNER & RENTER OCCUPIED UNITS	PERCENTAGE OF OWNERS WITHIN INCOME GROUPS
less than \$5,000	735	1,881	2,616	28%
\$5,000 - \$9,999	796	2,639	3,435	23%
\$10,000 - \$14,999	957	1,959	2,916	33%
\$15,000 - \$19,999	976	1,556	2,531	38%
\$20,000 - \$24,999	1,088	1,508	2,596	41%
\$25,000 - \$29,999	1,419	1,572	2,991	47%
\$30,000 - \$34,999	862	1,046	1,908	48%
\$35,000 - \$39,999	845	840	1,685	57%
\$40,000 - \$49,999	1,686	1,108	2,772	60%
\$50,000 - \$59,999	1,363	533	1,896	72%
\$60,000 - \$79,999	1,763	529	2,293	77%
\$80,000 - \$99,999	829	169	1,008	86%
\$100,000 - \$119,999	457	114	571	81%
\$120,000 or more	912	113	1,025	89%
TOTAL	14,808	16,436	38,243	
MEDIAN	36,026	17,152	25,073	

In America's central cities, the home-ownership rate of 48% is considerably lower than the national rate of 64%. A substantial market exists for home ownership, especially for families with annual incomes of \$35,000 or less (which now have only a 38% home ownership rate). NeighborWorks® organizations provide technical assistance and financing mechanisms to make home ownership a reality for more residents of urban areas.

Source: American Housing Survey, Table 8-12; 1995.

NeighborWorks® Organizations**Campaign for Home Ownership: 60-Months Ending December 31, 1997****Campaign Clients**

Household/Family Income	# of Households	% of Total
Below \$15,000	1,590	10%
Between \$12,500 and \$15,000	851	5%
Between \$10,000 and \$12,500	467	3%
Less than \$10,000	272	2%

Mortgage Source	Homeowners with Income Below \$15,000			
	First Mortgage	%	Second Mortgage	%
Bank, standard product	\$9,689,151	18%	\$57,484	1%
Bank, special product	\$16,260,863	30%	\$412,585	7%
Bank, FHAVA	\$5,437,587	10%	\$109,337	2%
NeighborWorks® Organization	\$3,917,382	7%	\$2,443,409	39%
Public Funds	\$5,479,064	10%	\$1,828,854	29%
Bank and NWO Joint Product	\$3,253,922	6%	\$207,001	3%
Foundation	\$412,264	1%	\$83,304	1%
NHSA	\$4,333,677	8%	\$225,538	4%
Others	\$3,286,373	6%	\$653,005	10%
Not Available	\$1,611,973	3%	\$199,478	3%
Total	\$53,692,275	100%	\$6,220,005	100%

NeighborWorks® Organizations

Campaign for Home Ownership: 60 months ending December 31, 1997

First Mortgage Sources and Investment

Mortgage Source	First Mortgage			Second Mortgage		
	Total Investment	Percentage	# of Cases	Total Investment	Percentage	# of Cases
Bank, standard product	\$234,985,813	24.4%	3,808	\$853,607	1.1%	83
Bank, special product	\$385,230,076	38.0%	5,529	\$5,257,188	6.8%	641
Bank, FHA/VA	\$92,290,337	9.6%	1,562	\$888,721	1.1%	110
NeighborWorks® Organization	\$37,440,652	3.9%	800	\$27,987,888	36.7%	4,170
Public Funds	\$38,247,580	4.0%	689	\$21,225,022	27.8%	1,675
Bank and NWO Joint Product	\$55,840,176	5.8%	1,054	\$13,080,773	17.1%	645
Foundation	\$1,447,681	0.2%	31	\$488,380	0.6%	65
NHSA	\$62,412,452	6.5%	1,122	\$711,395	0.9%	48
Others	\$30,010,850	3.1%	573	\$3,355,427	4.4%	383
Not Available	\$44,371,114	4.6%	565	\$2,537,682	3.3%	278
Total	\$982,056,731	100.0%	15,713	\$76,344,741	100.0%	8,198

Source: Campaign for Home Ownership January 1993 - December, 1997.

Research Department - April 2, 1998

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OPTION 1 **EXAMPLE OF LOW INCOME HOUSING TAX CREDITS (LIHTC) FOR** **HOMEOWNERSHIP**

Here is one example of how the proposal might work. There are many options based on the qualified basis, terms, interest rates, etc. that could be determined at the state level.

QUALIFIED BASIS:

Determine the value of the structure, not including the value of the land

Value	\$ 75,000	
Less Land	<u>\$ 15,000</u>	
Qualified Basis:	\$ 60,000	\$60,000

TAX CREDIT:

For new construction or substantial rehabilitation without other federal subsidies LIHTC allocation - 9%

70% of present value of the home (qualified basis)

\$60,000 times 70% \$42,000

SALES PRICE (PRESENT DOLLAR VALUE OF THE TAX CREDIT):

The for-profit investor will buy the tax credit from the loan pool manager. The market will determine this price, but in this example, it is assumed to be 60

percent of the face value of the tax credit (60 cents on the dollar).

\$42,000 times 60% \$25,200

DISTRIBUTION OF PROCEEDS FROM SALE OF TAX CREDIT:

Homeowner:	Second Mortgage	\$12,600
Homeowner:	Third non-amortizing mortgage	\$12,600

NOTES:

1. **Second Mortgage Ten Year Term**
The shorter term allows for increased cash flow at the point homes most likely need heavy repair.
2. **Third Silent**
The third stays in place for 30 years, paid off if home is sold to non-LIHTC eligible buyer. After 30 years, loan is forgiven.

**Comparison Between Pooled Conventional and a 100% Conventional
OPTION 1**

	<u>CONVENTIONAL</u>	<u>LIHTC 2ND MTO.</u>	<u>LIHTC SILENT 3RD</u>	<u>TOTAL</u>	<u>100% CONVENTIONAL</u>
Loan Amount	\$ 49,800	\$ 12,600	\$ 12,600	\$ 75,000	\$ 75,000
Term (in years)	30	10	30*		30
Interest Rate	8.00%	3.00%	0.00%		8.00%
Monthly Payment - Principal and Interest	\$ 365.41	\$ 121.67	\$ -	\$ 487.08	\$ 550.32
Payment - Taxes and Insurance	\$ 150.00	\$ -		\$ 150.00	\$ 150.00
Payment - PMI	\$ -	\$ -		\$ -	\$ 124.67
Monthly Housing Payment	\$ 515.41	\$ 121.67		\$ 637.08	\$ 824.99
Annual Income Needed (assuming no more than 30% can go to housing)				\$ 22,935	\$ 29,700

* The third mortgage is a 30 year non- amortizing loan, repayable upon sale to a non-LIHTC eligible buyer. Loan forgiven if held to maturity.

OPTION 2
EXAMPLE OF LOW INCOME HOUSING TAX CREDITS (LIHTC) FOR
HOMEOWNERSHIP

Here is one example of how the proposal might work. There are many options based on the qualified basis, terms, interest rates, etc. that could be determined at the state level.

QUALIFIED BASIS:

Value of Second Mortgage \$10,000

TAX CREDIT:

For new construction or substantial rehabilitation without
other federal subsidies LIHTC allocation - 9%

70% of value of second mortgage (qualified basis)

\$10,000 times 70% \$ 7,000

**SALES PRICE (PRESENT DOLLAR VALUE OF
THE TAX CREDIT):**

The for-profit investor will buy the tax credit from the
loan pool manager. The market will determine this
price, but in this example, it is assumed to
be 60 percent of the face value of the tax credit
(60 cents on the dollar).

\$7,000 times 60% \$ 4,200

**DISTRIBUTION OF PROCEEDS FROM SALE OF
TAX CREDIT:**

Homeowner: Third non-amortizing mortgage * \$ 4,200

- * Third non-amortizing mortgage payable upon sale of property if sold to non-LIHTC eligible buyer. After 30 years loan is forgiven.

**Comparison Between Pooled Conventional and a 100% Conventional
OPTION 2**

	<u>CONVENTIONAL</u>	<u>2ND MTO.</u>	<u>LIMTC SILENT 3RD</u>	<u>TOTAL</u>	<u>100% CONVENTIONAL</u>
Loan Amount	\$ 60,800	\$ 10,000	\$ 4,200	\$ 75,000	\$ 75,000
Term (in years)	30	10	30*		30
Interest Rate	8.00%	3.00%	0.00%		8.00%
Monthly Payment - Principal and Interest	\$ 448.13	\$ 88.56	\$ -	\$ 542.69	\$ 550.32
Payment - Taxes and Insurance	\$ 150.00	\$ -		\$ 150.00	\$ 150.00
Payment - PMI	\$ -	\$ -		\$ -	\$ 124.67
Monthly Housing Payment	\$ 598.13	\$ 88.56		\$ 692.69	\$ 824.69
Annual Income Needed (assuming no more than 30% can go to housing)				\$ 24,937	\$ 29,700

* The third mortgage is a 30 year non-amortizing loan, repayable upon sale to a non-LIMTC eligible buyer. Loan forgiven if held to maturity.

Executive Summary of Testimony of Eric Stein
Vice President, Self-Help Credit Union
Presented to the Federal Housing Finance Board Monday, May 11, 1998

I. Introduction. My name is Eric Stein, Vice President at Self-Help. I'd like to thank the Finance Board for the opportunity to testify. Self-Help is a walking advertisement for the FHLBank System -- we use to great effect the Bank's advance and AHP products to serve our low-wealth customers in a variety of ways. The staff at the Atlanta Bank has been superb in helping us serve our mission time and time again.

II. Background on Self-Help. Self-Help Credit Union and its nonprofit affiliates together are considered one of the nation's strongest and most innovative community development financial institutions (CDFIs). Self-Help was one of the first CDFI FHLBank members and, we understand, the first one to take a Community Investment Program advance. Self-Help's mission is to increase the opportunities of North Carolina's disadvantaged groups by increasing the flow of home and small-business loans to people unable to obtain traditional financing. In significant part through Bank advances, Self-Help has purchased over \$100 million of CRA mortgages from banks in North Carolina in order to create a secondary market for these low-wealth home loans.

III. Self-Help's existing partnership with FHLBank of Atlanta. First, access to advances has allowed Self-Help Credit Union to expand its direct home loan products by offering, for the first time, a fixed-rate loan product. Second, low-cost advances have been essential to our secondary market program, both as a source of liquidity and as a tool to manage interest rate risk. Third, two AHP grants have also allowed us to develop 30 houses in a distressed Durham neighborhood.

IV. In support of a targeted investment authority. As a results-oriented practitioner, our focus is on the mission outputs that the FHLBank System provides: we'd like to see the maximum amount of FHLBank investments and advances at the lowest possible rates for targeted investments that benefit disadvantaged communities. As a System member, we care about these outputs because our ability to promote our mission of serving low-wealth families is increasingly contingent on obtaining funding from the Atlanta Bank at the most favorable rates possible. We are therefore in favor of whatever investment strategy leads to this result.

If the FHLBank's heavily mission-related activities -- CIP, AHP and targeted investments as discussed below -- can be increased and their pricing improved through mandating restrictions on FHLBank investments, then we'd be in favor of these restrictions. If, on the other hand, restrictions on investments, through reducing Bank profitability, would have the net effect of reducing the Banks' ability to serve CDFIs with such products at favorable prices, then we would oppose these restrictions. We'd want to know, then, if restricting Bank investment authority would require the Bank to make alternative, lower-yielding investment choices and have the result of restricting the Banks' ability to support CDFIs like Self-Help through favorably-priced products.

This results-oriented approach leads us to an affirmative response to Question (15). We believe it is appropriate and feasible for FHLBanks to make targeted investments in members and nonmembers that are highly mission-related -- particularly to provide long-term capital to CDFIs and their lending/investing programs. As one example of such an incentive, we support the

proposal of former Board member Nic Retsinas. As a GSE with access to funds on favorable terms, we think that the System does have a public-purpose mission underlying its existence. Given how much the Atlanta Bank has helped us already, if it had the investment authority to make such targeted investments in Self-Help, and could receive an effective incentive to use this authority, then we are confident that we would be able to advance our mission substantially.

While the financial returns of such investments may not be comparable to alternative investments currently being made by the Banks, these mission-related investments can be profitable. However, just as Fannie Mae and banks such as NationsBank make heavily mission-related investments that have a large impact in limited amounts at below-market rates, we see no reason why FHLBanks cannot also provide such investments in modest amounts (say, a total of 2% to 5% of Bank capital) at below-market rates of interest. Furthermore, these investment can be carried out such that they do not pose material risks to the Banks or the system.

V. Opportunities for extended partnerships using the Banks' investment authority.

There are myriad types of badly needed investments that should count as heavily mission-related investments. CDFIs such as Self-Help have a strong appetite for additional capital, particularly long-term capital, to meet the large and growing demand for their services. To the extent that such capital is available on favorable terms, it permits us to reach deeper, provide more technical assistance, and cover the higher transactions costs of our products and services.

There are two basic approaches that the Banks could take to CDFI investments, the first a "retail" strategy in which individual Banks would invest in individual CDFIs and their projects or activities, and the other a more "wholesale" strategy in which multiple Banks would invest in CDFI consortia, trade associations, or other mechanisms supporting the balance sheets and activities of more than one CDFI.

On the "retail" side, creative yet sound use of the Banks' investment authority would permit them to back the strongest CDFIs irrespective of their membership status. The investments could be based on the CDFI's balance sheet and overall creditworthiness rather than the amount and quality of specific collateral. Examples of safe, high-impact investments just in Self-Help include concessionary loans from NationsBank, the Fannie Mae Foundation, and Duke University. A more ambitious partnership with our secondary market program could be a similar investment to what Fannie Mae is currently considering in Self-Help where, with a structure like the Chicago or CICNC model, we could potentially buy and recycle a billion dollars of bank CRA home loans. The "wholesale" approach would engage FHLBanks, individually or in combination, in investments in multiple strong CDFIs. Examples include secondary capital for CDCUs, equity-like investments in non-depository CDFIs, sector-focused initiatives or the addition of CDFI loans into existing and new FHLBank pilots.

VI. Conclusion. First, the FHLBank System, through the Atlanta Bank, has been exceedingly helpful to date in helping us promote our mission. Second, through an enhanced incentive program to promote narrowly targeted investments in organizations like Self-Help, often at below-market rates, the System could be of even more use.

Testimony of
Eric Stein, Vice President
Self-Help Credit Union

Presented to the
Federal Housing Finance Board
Monday, May 11, 1998

I. Introduction

My name is Eric Stein. I am Vice President at Self-Help and the director of our secondary market program. On behalf of Self-Help, I'd like to thank the Finance Board for the opportunity to testify on the investment practices of the Federal Home Loan Bank System. Self-Help is a community development financial institution and one of its financing entities, the Self-Help Credit Union, is a member of the Atlanta FHLBank. We have a continuing interest in how FHLBank's can promote community development; indeed, we represented the Community Development Financial Institution (CDFI) Coalition in the CDFI Task Force of the Housing and Community Development Committee of the Federal Home Loan Bank Presidents' Conference.

I spoke a few months ago at the new FHLBank director orientation conference. At that time, I stated that Self-Help is a walking advertisement for the FHLBank System. We still are -- we use to great effect the Bank's advance and AHP products to serve our low-wealth customers in a variety of ways, as I'll describe later. In fact, given our small \$150 million asset size, we can even be considered a big user of the Atlanta Bank: our \$32 million of advances puts us at number two out of 900 Bank members in terms of advances as a percentage of total assets.

Before talking about FHLBank System policies, I'd like to mention that the staff at the Atlanta Bank -- from Paul Hill on down to the fifteen or twenty other staff we've had the pleasure of dealing with over the past 18 months -- have gone well beyond the call of duty to adjust their products and procedures to meet our needs. The Atlanta Bank has not only told us that it was committed to helping us serve our mission, it has demonstrated this fact time and time again with the hard work and good deeds of its extremely capable staff.

II. Background on Self-Help

Self-Help Credit Union and its nonprofit affiliates together are considered one of the nation's strongest and most innovative CDFIs. Self-Help was one of the first CDFI FHLBank members and, we understand, the first one to take a Community Investment Program advance. Self-Help has received honors from Presidents Reagan and Clinton for its work and was cited as one of the models that inspired the Treasury Department's CDFI Fund. Our loan loss rates are less than one percent, comparable to well-run

conventional lenders.

The Center for Community Self-Help was founded in 1980. Although it began as a technical assistance provider to minority-owned businesses in rural communities, the staff quickly realized that access to credit was a significant barrier to expanding ownership. In 1984, the Center therefore created two financing affiliates: the Self-Help Credit Union, a state-chartered, federally-insured credit union, and the Self-Help Ventures Fund, a nonprofit community development loan fund that is capitalized through capital grants, loans and program-related investments. The Center continues to serve as a "research and development" arm while home and business lending occurs through the Credit Union and Ventures Fund.

Self-Help's mission is to increase the opportunities of North Carolina's disadvantaged groups -- minorities, women, people who live in rural areas, and others with little wealth - to own homes and businesses and thus to begin to acquire the assets that can help to stabilize their families and communities. Self-Help does this primarily by increasing the flow of home and small-business loans to people unable to obtain traditional financing. Increasing the number of home loans to low-wealth families is central to Self-Help's mission, since it is largely by increasing equity in their homes that low- and moderate-income families can start to accumulate wealth. Borrowers can use this equity to obtain the financing they need to start a small business, obtain a college education, or ride out a medical crisis. Without increasing the number of minorities who own their homes, for example, we will never begin to address the large (10 to 1) disparity in wealth between African-Americans and whites.

Self-Help's experience shows that properly selected persons who fall outside of traditional underwriting criteria, those that it is Self-Help's mission to support, are good credit risks. Since 1984, we have made about \$50 million in home loans to 1,000 families unable to receive bank loans and have suffered a loss of principal in only four loans. However, Self-Help recognizes that, with only five branches in North Carolina, we can never meet the need for home loans to our core constituencies solely through making home loans ourselves. Self-Help therefore began its Home Loan Secondary Market Program to partner with large North Carolina banks to increase availability of home loan credit to low-wealth families beyond what we could accomplish alone.

As you are well aware, the secondary market is a critical component of home financing. This market purchases conventional mortgage loans, freeing funds for banks to make additional loans. However, there will always be people who fall just outside of secondary market guidelines because of lack of wealth, which translates into low-downpayment capability (lack savings to put money down) and often blemished credit reports (lack savings to keep payments current during inevitable family crises). As a result, banks need the flexibility to customize underwriting criteria through portfolio-type products. Historically, there has not been a secondary market for low-wealth mortgage loans spurred by the Community Reinvestment Act (CRA) due to their lack of private mortgage insurance and non-conformance with secondary market purchase guidelines.

This lack of a market limits the amount of CRA lending that banks can do. Self-Help's program addresses this problem by purchasing the loans from the banks, in exchange for the banks' commitment to lend an equal amount of additional loans to low-wealth families.

Self-Help has purchased over \$100 million of CRA mortgages from banks in North Carolina to date. Self-Help is monitoring both the programmatic and financial aspects of these low-wealth home loans in order to promote the inclusion of these loans in the traditional secondary mortgage market. Programmatically, these loans are serving our core constituencies. For example, the percentage of African-American borrowers in our portfolio (30%) is ten times greater than the percentage in traditional mortgage pools (3%). Female-headed households have accounted for almost half (44%) of the loans. These loans have reached rural families (55% of the portfolio). Finally, these programs are reaching working-class families; the average income of the borrower is 60% of the county median income. Financially, the loans have performed well to date. The 60-day delinquency rate has averaged around 1%, and Self-Help has suffered a loss on only two of the 1,800 loans purchased to date.

III. Self-Help's existing partnership with FHLBank of Atlanta

Self-Help's existing partnership with the FHLBank of Atlanta is a very strong one. First, access to advances has allowed Self-Help Credit Union to expand its direct home loan products by offering, for the first time, a fixed-rate loan product. A fixed-rate home loan is particularly important to our customers, who often could not withstand unexpected interest rate increases. Membership in the Bank has allowed us to draw long-term, fixed-rate CIP advances to match-fund expected prepayments and thus manage our interest rate risk. We also appreciate the Bank for providing us flexibility in pledging our low-wealth home loan portfolio as collateral with a relaxed delinquency standard, which corresponds with our low loss experience and relatively high thirty-day delinquency experience.

Second, advances have been essential to our secondary market program, both as a source of liquidity and as a tool to manage interest rate risk. Roughly half of our recent purchase liquidity has come from advances. In addition to FHLBank funds, we use granted state and federal equity, plus retained earnings, as 10% to 20% of our purchases, with the final 30% to 40% coming from institutional investors in an unsecured or second position. Since our yield on CRA mortgages is capped at the market rate for mortgages, even though the loans are somewhat riskier than conventional mortgages and lack private mortgage insurance, we need the lowest possible cost of funds to buy the loans and operate our program. Through CIP and daily rate credit advances, we have found these funds from the Atlanta Bank, and nowhere else.

Here, too, the Atlanta Bank has been extremely flexible to accommodate our needs wherever possible. For the first time, the Bank allowed the affiliate of a member (the nonprofit Self-Help Ventures Fund) to pledge its assets (the purchased mortgages) as collateral for advances, and to act as a co-borrower in the transaction. Incidentally, we

understand that other members have subsequently been able to use this structure to good advantage too. Additionally, the Bank allowed us to use CIP funds for the purchase of loans since we require the originating lender to make an equivalent number of loans in the future. While establishing this structure and working through the analysis to take the advances has been challenging for all concerned given the non-conventional nature of the transactions, the Bank has been able to see the job through to completion, and we are most appreciative.

In addition to making home loans and buying them, we also develop low-income housing for homeownership. We are revitalizing a neighborhood off of Duke University's campus called Walltown where we have bought 30 dilapidated vacant and rental houses in two of the worst blocks of this distressed area. We are renovating the houses to model home standards and selling them to low-income families. This project won the NC Housing Finance Agency's award for a homeownership project in a metro area. The project would not have been possible without AHP grants we received for each of the two phases of the project to increase affordability, funds that we have been able to leverage 25 times with funding from other sources. We have also obtained AHP grants for partners -- the Durham Habitat and a rural CDC -- that have been very important in other projects.

IV. In support of a targeted investment authority

As a results-oriented practitioner, our focus is on the mission outputs that the FHLBank System provides: we'd like to see the maximum amount of FHLBank investments and advances at the lowest possible rates for targeted investments that benefit disadvantaged communities. As a System member, we care about these outputs because our ability to promote our mission of serving low-wealth families is, as discussed above, increasingly contingent on obtaining funding from the Atlanta Bank at the most favorable rates possible. We are therefore in favor of whatever investment strategy leads to this result.

If the FHLBank's heavily mission-related activities -- CIP, AHP and targeted investments as discussed below -- can be increased and their pricing improved through mandating restrictions on FHLBank investments, then we'd be in favor of these restrictions. If, on the other hand, restrictions on investments, through reducing Bank profitability, would have the net effect of reducing the Banks' ability to serve CDFIs with such products at favorable prices, then we would oppose these restrictions. We'd want to know, then, if restricting Bank investment authority would require the Bank to make alternative, lower-yielding investment choices and have the result of restricting the Banks' ability to support CDFIs like Self-Help through favorably-priced products.

This outcome-oriented approach leads us to strongly answer Question (15) in the affirmative: FHLBanks **should** be permitted to make a small amount of narrowly targeted investments in people and communities left behind, that would have credit quality significantly below the double-A level, and that might be more heavily weighted in evaluating the mission-related character of the overall portfolio.

We believe it is appropriate and feasible for FHLBanks to make targeted investments in members and nonmembers that are highly mission-related – particularly to provide long-term capital to CDFIs and their lending/investing programs. As a GSE with access to funds on favorable terms, we think that the System does have a public-purpose mission underlying its existence. We understand the challenge of balancing this mission with bottom-line considerations. Indeed, balancing programmatic and financial goals on a daily basis is a defining characteristic of Self-Help and other CDFIs.

This mission is recognized in the Financial Management Policy, which urges Banks to consider “the role of the investment portfolio in fulfilling the Bank’s public purpose, maintaining liquidity and generating earnings.” We applaud the 1996 changes in the FMP that enumerated permissible investments for the Banks, including non-AAA-rated instruments and “Other Investments” that support “housing and community development financing that is not generally available or that is available at lower levels or under less attractive terms.” This interpretation has stimulated important innovation throughout the system, as evidenced in the recent pilots, which have produced significant public benefit and have the potential to greatly expand FHLBank service to underserved geographies and populations.

We would urge adoption of incentives or goals to promote greater realization of the first of the FMP goals, i.e., meeting the credit needs of underserved people and communities. Given how much the Atlanta Bank has helped us already, if it had the investment authority to make such targeted investments in Self-Help, and could receive an effective incentive to use this authority, then we are confident that we would be able to advance our mission substantially.

As one example of such an incentive, we support the proposal of former Board member Nic Retsinas. In a February 26, 1998, memorandum, Retsinas proposed that Banks be permitted to invest a small percentage of their capital in highly-targeted investments. He further suggested that as an incentive, the Banks receive “extra credit” through the weighting system for these investments, thereby increasing their permissible level of non-mission-related investments. We would also be open to other incentive approaches that increased these types of investments.

While the financial returns of such investments may not be comparable to alternative investments currently being made by the Banks, these mission-related investments can be profitable. They need not be, however; just as Fannie Mae and banks such as NationsBank make heavily mission-related investments that have a large impact in limited amounts at below-market rates, we see no reason why FHLBanks cannot also provide such investments in modest amounts (say, a total of 2% to 5% of Bank capital) at below-market rates of interest. As Retsinas said, the overall impact on Bank profitability is likely to be no more than a rounding error.

Furthermore, these investment can be carried out such that they do not pose undue risks

to the Banks or the system. The impact on overall risk and returns is likely to be immaterial at the level proposed by Mr. Retsinas. Other bank regulatory agencies such as the OCC have used this “materiality” approach, permitting the financial institutions they regulate to make targeted community development investments at levels that do not jeopardize the institution’s financial stability or returns while delivering considerable public benefit. Indeed, the Finance Board recognized this “materiality” principle in reviewing the FHLBank-New York pilot. We understand that Fannie Mae does not have to set up reserves against their \$300 million or so of heavily mission-related investment funds because the amounts are so small given its size; the same might be true with FHLBanks too.

We believe the rationale for targeted investments is strong and that development of these investment partnerships would bring long-term benefits to the FHLBank system, as well as to CDFI, community-based development organizations, and the people and places they serve.

- First, such an initiative would be highly consistent with the public purpose of the FHLBank system.
- Second, by boosting the impact, scale, and financial capacity of the strongest CDFIs across the country, it could help build future FHLBank members and nonmember mortgagees, both depository and nondepository institutions.
- Third, it would provide a service to existing FHLBank members, by helping them develop new markets, joint ventures with CDFIs, and expanded CRA lending and investing opportunities.
- Fourth, it would offer an opportunity for the Banks to learn about and get comfortable with new markets for their advances and other products and services, such as small business and community development loans.
- Fifth, targeted investment in CDFIs would almost certainly permit the Banks to leverage other investors, with which they could share investment risks and costs, credit, and lessons (see below concerning potential investment partners and credit enhancement opportunities). We are confident that targeted investments at the 2% to 5% level could be made without compromising safety and soundness considerations or the fundamental “bottom line” of the system.
- Finally, CDFIs need the capital and can put it to good use in disinvested communities and enterprises.

V. Opportunities for extended partnerships using the Banks’ investment authority

There are myriad types of badly-needed investments that should count as heavily mission-related investments; ones involving CDFIs are described below. Self-Help has had a long-standing interest in exploring how CDFIs’ access to and use of the FHLBank system might be expanded, to the benefit of underserved communities, households, and enterprises. As a member of the Atlanta Bank and of the CDFI Coalition Steering Committee, Self-Help, through Kate McKee, was invited to serve on the CDFI Task

Force of the Housing and Community Development Committee of the Federal Home Loan Bank Presidents' Conference chaired by President Thiemann, which first met early last year. Throughout those deliberations, Self-Help consistently advocated attention to potential partnership between CDFIs, FHLBanks, and the System that would draw upon the Banks' investment powers, as elaborated upon in the 1996 FMP changes.

Earlier this afternoon, you heard from Christine Gaffney, Director of the CDFI Coalition, about CDFIs' need for capital of the type the Banks might provide through investments. CDFIs such as Self-Help have a strong appetite for additional capital, particularly long-term capital, to meet the large and growing demand for their services. We need equity and long-term subordinated debt, to complement the shorter-term debt and project financing that is more readily available from other public and private sources to support our community development lending and investing activities. To the extent that such capital is available on favorable terms, it permits us to reach deeper, provide more technical assistance, and cover the higher transactions costs of our products and services.

We would like to suggest that there are two basic approaches that the Banks could take to CDFI investments, the first a "retail" strategy in which individual Banks would invest in individual CDFIs and their projects or activities, and the other a more "wholesale" strategy in which multiple Banks would invest in CDFI consortia, trade associations, or other mechanisms supporting the balance sheets and activities of more than one CDFI. I will briefly describe illustrative partnership opportunities for each, drawing on Self-Help for the "retail" examples.

Retail

Creative yet sound use of the Banks' investment authority would permit them to back the strongest, highest-impact CDFIs irrespective of their membership status. The investments could be based on the CDFI's balance sheet and overall creditworthiness rather than the amount and quality of specific collateral available. It is noteworthy that many CDFIs have considerable net worth-to-asset ratios, even if they do not have high volumes of the types of collateral currently accepted for advances by members and nonmember mortgagees. Self-Help, for example, has approximately \$50 million of net worth out of its \$150 million in assets.

Investments have become increasingly important part of Self-Help's capital base. Self-Help has received investments, both market rate and below market rate, from many different institutions, including Met Life Insurance Company, Duke University, Fannie Mae, Board of Pensions of the United Methodist Church, NationsBank, First Union, and several foundations and religious institutions. Here are some examples:

Secondary capital for Self-Help Credit Union. Recently, the National Credit Union Administration defined "secondary capital" as a new category of Tier II capital; its equity-like characteristics help expand the lending capacity of community development credit unions, which can otherwise only grow their capital base through retained earnings. To count as "secondary capital," a deposit or investment in a CDCU must have a term of

at least 5 years, be unsecured, and be subordinated to the NCUA.

Investment in our small business lending and community facilities capacity. Self-Help received an investment of \$1 million from NationsBank in early 1997 that provided critical capital for commercial lending. The loan has a 10-year term and an interest rate of 2%. Self-Help used the funds within 9 months for loans to eight borrowers, including a retail ceramics business, a music school, and a radiology center. Nations is now considering a similarly concessionary \$2 million investment in Self-Help.

Program-related investment for assisted housing. The Fannie Mae Foundation invested \$250,000 for 5 years at 2% in Self-Help to support assisted housing efforts. This capital was used to provide a guarantee fund and has supported over \$4 million in loans made to 32 organizations that house over 500 individuals.

Specific development projects such as Walltown. Self-Help received a \$2 million investment from Duke University to support our homeownership programs. This loan has 10-year term and is at 4%. In part, the investment from Duke was used for seed capital to purchase the homes near Duke that we are renovating. It also provided loan capital for eight new homeowners, a line of credit with the local Habitat affiliate to support the construction of 50 new homes, and funds for our secondary market program.

Secondary market capital. As previously stated, we depend on investments from institutions to fill the gap between the FHLBank advances, which have a first-lien position on all the loans, our equity and the remaining value of the purchased loans. The Methodist Board of Pensions invested \$10 million in our program at a fixed rate for ten years at a favorable market rate by taking a second position; a number of other investors are unsecured, backed by Self-Help's full faith and credit and net worth.

A more ambitious partnership with our secondary market program could be a similar investment to what Fannie Mae is currently considering in Self-Help. A major foundation is considering granting us a large amount of equity, which Fannie Mae would match. We would purchase CRA loans from large national lenders. In turn, we would sell these loans to Fannie Mae, using the combined equity, in addition to a yield spread, to guarantee the loans. We can envision a scenario where we could replicate a similar structure with the FHLBank of Atlanta in a billion dollar purchase program, perhaps similar to the Chicago and CICNC programs.

Wholesale Examples

The "wholesale" approach would engage FHLBanks, individually or in combination, in investments in multiple strong CDFIs. An advantage of the types of "wholesale" vehicles described below is that a multi-Bank, multi-CDFI initiative would permit diversification of risk in terms of geography and products.

Secondary capital for CDCUs. The National Federation of Community Development

Credit Unions has been working to develop this instrument, and has raised funds to make and match investors' secondary capital investments in its members. While several FHLBanks have recently made insured deposits in community development banks and CDCUs, long-term deposits structured as "secondary capital" would have greater development impact and be more useful to credit unions serving low-income people and places. FHLBanks, individually or in combination, could make investments in the National Federation, which would in turn place them in qualified member CDCUs in the form of secondary capital.

Equity-like investments in non-depository CDFIs. The National Community Capital Association, for example, has created an "Equity Equivalent" or EQ2 product to attract investments from banks and other financial institutions. This long-term, deeply subordinated debt product is designed to have an equity-like impact on members' balance sheets. In 1997 Citibank made a \$1 million EQ2 investment in the Association, which is in turn reinvesting the funds in its membership, the great majority of which are nondepositories.

Sector-focused initiatives. FHLBanks could invest in CDFI financing pools targeted to specific sectors and types of loans with high social impact, such as a nationwide child care lending facility. This is a sector in which a growing number of CDFIs have expertise, a solid lending track record, and strong demand for long-term, fixed-rate debt.

The addition of CDFI loans into existing and new FHLBank pilots. This could provide a mechanism for FHLBanks to provide much-needed liquidity to CDFIs, when the geography and purposes are consistent (since the pilots do not appear to be necessarily restricted to members).

Both of these options (retail or wholesale) offers an advantage over advance-type mechanisms as there is considerable potential for credit enhancement of FHLBank investments. These credit enhancements could be structured in various ways, including but not limited to guarantees, loan loss reserves, linked deposits, and interest-rate buy-downs offered by the third-party credit enhancement source. Indeed, individual CDFIs and national trade associations have already raised tens of millions of dollars in risk capital for precisely this purpose of leveraging public and private financing.

The authorizing statute for the CDFI Fund, for example, permits the Fund considerable flexibility to undertake investments that enhance the liquidity of CDFIs (see Section 113 of the Community Development Banking and Financial Institutions Act of 1994, entitled "Capitalization Assistance to Enhance Liquidity"). The CDFI Fund could directly guarantee FHLBank investments in CDFIs, or provide capital to CDFI trade associations to guarantee investments in their members. Other potential sources of public-sector credit enhancement include HUD Section 108 guarantees, and local and state governments. For example, North Carolina, New York, New Jersey, California, and Pennsylvania have each passed authorizing legislation for state investment in CDFIs or provided significant risk capital to CDFIs.

In addition, private-sector institutions have shown a growing interest in CDFIs and would be likely sources of credit enhancements and companion investments. NationsBank, for example, has created its National Community Investment Fund to make investments in depository and nondepository CDFIs. Banks have a powerful incentive in the form of the CDFI Fund's Bank Enterprise Awards, which provide "rebates" of up to 15% for every dollar invested in or granted to CDFIs. This program has already generated tens of millions of dollars in CDFI investments by banks. Fannie Mae has also launched a specialized CDFI initiative, a Housing Impact Fund, and various partnership initiatives with CDFIs and community-based development organizations, as have other private funders such as foundations and insurance companies.

VI. Conclusion

In conclusion, I'd like to reiterate two points. First, the FHLBank System, through the Atlanta Bank, has been exceedingly helpful to date in helping us promote our mission. Second, through an enhanced incentive program to promote narrowly targeted investments in organizations like Self-Help, often at below-market rates, the System could be of even more use. Thank you for the opportunity to testify today.

SH/ L. M. 10/10/98
DOW W

Small Business Tax Credit for Employee Training and Education Expenses
March 17, 1998

Background

In May 1996 and again in its FY98 Budget, the Administration proposed a tax credit for small businesses equal to 10 percent of amounts paid to third parties for employee education and training under a section 127 employer-provided educational assistance program¹. Small business was defined as employers with average receipts over the prior three years of \$10 million or less. The credit would be treated as a general business credit so the employer's deduction for the education and training expenses would be reduced by the amount of the credit to prevent "double-dipping." At the time, the credit was estimated to lose about \$200 million in revenue over five years.

The small business tax credit was proposed in conjunction with an extension of Section 127, which had expired at the end of 1994, and an expansion to include graduate education. (The Small Business Job Protection Act, enacted in August of 1996, reinstated the exclusion retroactive to courses beginning on or after January 1, 1996.) The Taxpayer Relief Act of 1997 extended Section 127 until June, 2000, but did not cover assistance for graduate education and did not adopt the small business credit. The Administration's FY99 Budget proposed extending the Section 127 exclusion by one year to apply to undergraduate courses beginning before June 1, 2001, and to reinstate the exclusion for graduate education, effective for courses beginning between June 30, 1998 and June 1, 2001. The FY99 Budget did not propose the small business credit a second time.

Discussion

The Administration was interested in the credit mainly because small employers are thought most likely to under-invest in employee training. Small businesses have a higher proportion of entry-level and low-income workers for whom training can be crucial to their employment future.

Other reasons offered in support of the credit include the following:

- ◆ The 1995 White House Conference on Small Business identified funding of workforce training programs as a high priority.

¹ Section 127 provides that workers may exclude from their taxable income education expenses of up to \$5,250 per year paid for by their employer. The education need not be related to the employee's job, but cannot be for sports, games or hobbies, nor for graduate level courses beginning after June 30, 1996. The employer has to maintain a program of educational assistance for employees that does not discriminate in favor of highly compensated employees. The provision currently is set to expire for courses beginning after May 31, 2000. In the absence of the exclusion, educational assistance is excludable from income only if it is related to the employee's current job.

- ◆ Because the credit only applied to training provided by third parties, it could encourage small firms to turn to community colleges and other outside training supplies, which may be more efficient suppliers of training.
- ◆ Linking the credit to Section 127 limits potential abuse, such as payments for hobby- and sports-related courses. Section 127's nondiscrimination rules help ensure that the credit is not taken primarily in connection with education for owners, their relatives, or other highly compensated employees.
 - Moreover, without a tie to Section 127, employers would have an incentive to unbundle employee training from the package of services provided by equipment vendors and to characterize a wide variety of payments to third parties, e.g., to lawyers and accountants, as payments for training.

The following disadvantages of the credit were noted:

- ◆ The conceptual case for a credit is weak. For training that benefits the firm (firm-specific human capital), there is no general market barrier to prevent even small firms from providing such employee training, and therefore no need for a credit. For general human capital (education and training that benefit the worker but not necessarily the firm), businesses run the risk of not capturing the benefits and therefore will offer less than might be ideal from the employee's perspective. Because they may not benefit, firms are less likely to respond to a credit than would workers if the credit were offered directly to employees. Firms are not a good place to provide a credit for investment in general human capital. We already have credit for emp's.
- ◆ Much of the cost of the credit is likely to pay for education that was going to take place even without the credit. Small firms that already provide education assistance, including training mandated by governmental regulations and professional society rules, will use it to reduce their taxes. The little evidence that is available suggests that higher-income workers are more likely to receive employer-provided education assistance.²
- ◆ A credit would treat employer-provided education more favorably than other fringe benefits such as health insurance.
- ◆ It would encourage businesses to substitute the education credit for wages, at the margin providing an incentive to hire persons who value the payment of tuition rather than wages. The already-disadvantaged urban workers who have no intention and possibly no aptitude for college are disadvantaged relative to the college students who are willing to accept some of their compensation in tax-free tuition. The effect is likely to be small, but this could be an undesirable though unintended consequence of a small business credit. If labor not very fluid

² Joint Committee on Taxation, "Description of Revenue Provisions Contained in the President's Fiscal Year 1999 Budget Proposal," February 24, 1998 (JCS-4-98); section 226. More recent data from Current Population Survey suggest a similar conclusion.

- ◆ Subsidies delivered through the tax code have inherent limitations. For example, credits will not benefit the many employers who have no tax liability, such as many start-up companies and tax-exempt institutions. Eligibility for the credit would depend more on tax characteristics of the business than on size. Fewer than 150,000 firms would be excluded because they are too big, whereas 1.4 million corporations have no tax liability. In addition, credits will be discouragingly complex for some companies and their owners, because of interactions with other credits, carryover rules, and overall limitations on business credits.
- ◆ When the Administration proposed the credit in 1996 and again in the FY98 Budget, it did not receive much congressional support. No member came forward to endorse it, the Joint Tax Committee revenue estimators report no requests for estimates of alternatives, and Congress dropped it when it extended Section 127 in TRA97.

