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November 3, 2003

Mr. John D. Hawke, Jr.
Office of the Comptroller of the Currency
250 E Street, SW, Washington, DC 20219
Fax: (202) 874-4448 regs.comments@occ.treas.gov.
Attention: Docket No. 03-14

Ms. Jennifer J. Johnson, Secretary,
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, NW, Washington, DC 20551
Fax: (202) 452-3819 regs.comments@federalreserve.gov
Attention: Docket No. R-1154

Mr. Robert E. Feldman, Executive Secretary
Federal Deposit Insurance Corporation
550 17th Street, NW, Washington, DC 20429
Fax: (202) 898-3838 comments@FDIC.gov.
Attention: Comments, FDIC

Regulation Comments, Chief Counsel's Office,
Office of Thrift Supervision
1700 G Street, NW, Washington, DC 20552
Fax: (202) 906-6518 regs.comments@ots.treas.gov
Attention: No. 2003-27

Dear Sir or Madam:

Local Initiatives Support Corporation (LISC), National Equity Fund, and Community Development Trust appreciate the opportunity to comment on the proposed Basel II Capital Accords.

In summary, we support the exclusion of all investments in community and economic development entities (CEDEs) and community development corporations (CDCs), as well as most legislated program equity exposures, from the A-IRB capital charge on equity investments. However, it is imperative that

such investments must also be excluded in calculating the 10% materiality test for equity exposures. Otherwise, we believe that some banks will have a strong incentive to minimize such publicly beneficial investments in favor of other, higher-return/higher-risk investments.

LISC is a national nonprofit organization that provides financing and technical assistance to nonprofit low-income community development corporations through 38 offices nationwide and a national rural program. Our comments also reflect the views of the National Equity Fund, an affiliate that raises equity capital for low-income rental housing, and The Community Development Trust, which LISC formed as the nation's first real estate investment trust dedicated exclusively to benefit low-income families and communities. Taken together, we have raised approximately $4 billion in equity investments for urban and rural community development, including a large portion from banks to which the Basel II Accords are likely to apply, though in some cases voluntarily.

The equity investments we have received all meet the requirements of CEDEs as defined in the public welfare investment regulations and would also meet the definition of legislated program equity exposures. Among the specific legislated programs are the Community Reinvestment Act (CRA), whose implementing regulations provide for equity and other investments; Low Income Housing Tax Credits; New Markets Tax Credits; and Historic Rehabilitation Tax Credits.

- National Equity Fund alone has raised $3.8 billion based on Low Income Housing Credits and invested in the development of 1,100 properties serving 59,000 families, as part of a broader industry that raises $6 billion annually from banks and other corporations.

- The Community Development Trust has raised $60 million in equity capitalization, which has already enabled it to provide $150 million in financing. The Trust itself meets the requirements of a CEDE, all of the properties it finances meet the requirements of CRA, and some of them also involve other legislated programs, such as Section 8 and other federal housing and community development programs. Through September 30, 2003, the Trust has never experienced even a single 30-day delinquency within its mortgage portfolio.

- LISC is now raising equity investments based on New Markets Tax Credits, which Congress enacted in 2000 to attract $15 billion in equity investments for the economic development of distressed low-income communities. LISC plans to use most of the proceeds of these equity investments to make or purchase mortgage loans. LISC has previously raised equity capital from banks for economic development based on the CDC Tax Credit, enacted as a demonstration in 1993, and without benefit of direct incentives through The Retail Initiative, an affiliate created to invest in inner-city supermarkets and related retail centers.

These investments have been enormously valuable to communities, both in directly meeting such critical needs as housing, shopping, employment and entrepreneurial opportunities, and more broadly by rebuilding communities and repairing damaged local real estate markets.

Moreover, such investments have proven safe and sound. In 2002, Ernst & Young published a report entitled, *Understanding the Dynamics: A Comprehensive Look at Affordable Housing Tax Credit Properties*. The report analyzed 7,824 properties with a cumulative investment of $13.67 billion. It found:

> "The impact of a foreclosure to an owner of a housing credit property includes the loss of its equity investment, partial recapture of credits previously claimed and the loss of any future housing credits. As a result, foreclosure represents the single largest risk for investors in housing credit properties. Based on the survey results, it is clear that foreclosures are exceedingly rare in housing credit properties:
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> - "Of the 7,824 properties surveyed, only 14 had either been foreclosed upon or tendered a deed in lieu of foreclosure to their lender. Thus, only 0.14% of these properties had been lost to foreclosure during the period surveyed (1987-2000), or 0.01% on an annualized basis.
> - "On this basis, the foreclosure rate in housing credit properties would be approximately 100 times lower than it is for commercial real estate." [page 2]

As a result of this remarkable track record, yields on Low Income Housing Tax Credits are currently under 8% and most other CEDE investments generate only modestly higher returns, substantially below the projected yields on other equity investments generally. Federal policies, including such banking policies as CRA and public welfare investments, have been critical to the success of these investments.

Most public welfare investments are fundamentally different from conventional equity investments such as stock, venture capital, or convertible debt. For example, the source of return on most tax credit investments is tax credit itself, and investors do not require substantial operating profits or capital appreciation to recover their capital or achieve projected returns. Since the tax credits are paid in predictable amounts over time, these investments perform more like fixed-income instruments than stock or venture capital, for which risks are greater and values and returns can fluctuate widely. In addition, as the proposal notes, most public welfare investments involve substantial government oversight and often participation.

Accordingly, we applaud the proposal to exclude all CEDE and CDC investments, as well as legislated program equity exposures and SBIC investments up to 10% of a bank's Tier 1 plus Tier 2 capital, from the A-IRB capital charge on equity exposures. Under this approach, such investments would be 100% risk-weighted, thus requiring banks to hold capital equal to 8% of such investments, instead of much higher levels for other equity investments. This policy will be critical in enabling banks to make such investments going forward.

We seek clarification on two aspects of this policy.

- First, the agencies should clarify that a bank that invests more than 10% of its capital in legislated program exposures or SBICs should apply the 100% risk weight to investment amounts up to the 10% level, and a higher risk weight above that level. Otherwise, the policy will create a so-called "cliff effect" such that the marginal investment breaching the 10% level actually imposes a massive marginal capital requirement.

- Second, the agencies should clarify that the exclusion for an investment that meets the definition both for a CEDE and for a legislated program equity exposure, such as an investment based on the Low Income Housing Tax Credit or the New Markets Tax Credit, would not be subject to the 10% limitation. We do recognize that some legislated program equity investments will not meet the CEDE definition, and a different standard for those is plausible, but an equity investment that meets both definitions should not face greater restrictions than those in other CEDEs.

Moreover, it appears that legislated program equity exposures and CDC, CEDE, and SBIC investments all would be included in calculating whether a bank would meet the materiality threshold for applying the A-IRB approach to a bank's other equity investments, including venture capital and convertible debt securities. Some banks, and especially large banks, may well choose to ration their equity investments to avoid breaching the 10% materiality threshold, in order to avoid setting aside capital equal to 16%, 24%, depending on the particular investment. In such a rationing process, we are deeply concerned that banks would forego relatively low-yield CEDE investments in favor of other, much higher-yield equity investments. Banks would still be able to meet CRA's investment test by purchasing mortgage backed securities, but these may not provide comparable benefits to low-income communities and families. This result would undermine support for CEDE and similar investments, and accordingly the Congressional intent in enacting public welfare investment legislation, CRA, and various tax credits and incentives. Therefore, we urge that these public benefits be excluded from calculations of the 10% materiality test.

While we understand only a small number of banks would be required to follow the risk-based capital rules, we also recognize that many other banks will do so voluntarily, and that some federal banking regulators have already suggested they do so. Thus, we believe that the Basel II Accords will effectively apply to many more banks.

Even if a given bank may not have investments approaching the 10% materiality threshold, the policy could still have an important market effect. Banks comprise an estimated 30-40% of the investment market for Low Income Housing Tax Credits. If even a small number of important market investors curtail their participation, the price effect could be substantial. The result would be to increase rates of return, and to reduce the amount invested per dollar of tax credit. The consequence would be to reduce the number of affordable homes produced, as well as the efficiency of the federal tax incentive.

This concludes our comments. Again, we appreciate the opportunity to comment, and would be pleased to provide additional information at your request.

Sincerely,

Benson F. Roberts
Vice President for Policy