Comptroller of the Currency
Administrator of National Banks

Executive Summary

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Low-Income Housing Tax Credit Funds: Investment Opportunities for Banks

Speakers:

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Speakers: **John C. Dugan**, Comptroller of the Currency
Dana Boole, President and CEO, *Community Affordable Housing Equity Corporation*
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Barry Wides, Deputy Comptroller, Community Affairs

Overview

Housing tax credit funds provide banks with attractive investment options and opportunities to receive positive CRA consideration.

Due to market conditions, yields for tax credits are up, but the risks associated with these low-risk investments are unchanged. Before undertaking such an investment, it is important to thoroughly understand how these investments work, and to carefully evaluate the fund and fund manager. The OCC has a wealth of resources to assist banks in learning more about low-income housing tax credit funds.

Context

This teleseminar discussed investment opportunities available to banks through low-income housing tax credit funds. Mr. Dugan summarized the history and role of low-income housing tax credit funds. Mr. Boole provided an overview of investing in these funds. Mr. Floreani documented how these investments have performed, described current market conditions and yields, and commented on the effect of legislative changes. Mr. Wides summarized regulatory considerations, focusing on CRA and Part 24.

Key Points (Dugan)

- **The LIHTC program allows banks to earn favorable returns while benefiting low-income areas.**

  For more than 20 years, the low-income housing tax credit program has provided a market incentive to acquire, develop, and/or rehabilitate affordable rental housing. Each year this program channels billions of dollars of private financing to produce affordable rental units for low-income families, the elderly, and other special needs populations.

  While contributing to the revitalization of low-income areas, the LIHTC program also allows banks to earn attractive investment returns and offers an opportunity to diversify into other credit products and services. Such investments are also eligible for positive consideration under CRA (Community Reinvestment Act).

> *"This program [LIHTC] allows banks to earn attractive economic rates of return, contribute to revitalization in low-income areas, and gain opportunities to diversify into other credit products and services."*
> —John C. Dugan

Opportunities exist for banks of all sizes, geographies, and levels of experience to invest in low-income housing tax credit funds. Whether a bank is a veteran investor, has taken small steps, or has never invested in low-income housing tax credits or funds, there is much to be learned and many benefits to be earned.

Key Points (Boole)

Mr. Boole provided a thorough overview of low-income housing tax credit funds. He explained how tax credits compare to tax deductions, described who invests in them and why, and summarized the methods for investing in funds and the benefits of doing so. He shared criteria on how a bank evaluates a fund manager and a fund, provided underwriting and pricing considerations, explained how tax credits are calculated, and provided examples.

Tax Credits Versus Tax Deductions

A $1 *tax credit* reduces the amount of taxes owed by $1. A $1 *tax deduction* reduces the income on which taxes are paid by $1; at a 35% tax rate, it reduces taxes by $0.35.

Take an organization with $1 million in gross income, which is taxed at a 35% tax rate. This organization would owe taxes of $350,000. A tax credit of $100,000 would reduce the amount of taxes owed on a dollar-for-dollar basis, meaning that taxes of $250,000 are owed.

For a tax deduction of $100,000, the deduction is subtracted from the gross income resulting in adjusted income of $900,000. When taxed at 35%, taxes owed would be $315,000.

Why Invest in Housing Tax Credits?

The reasons to invest in housing tax credits:

- Increase after-tax earnings and provide a financial return through both credits and passive losses.
- Provide financial performance similar to bond instruments.
- Receive consideration under the investment test of the CRA.
- Provide safe and affordable housing, and provide community banks with an additional vehicle for their investment strategy.

> *"Everyone invests in tax credits for the credit, but banks have the added benefit of investing for the CRA."*
> —Dana Boole

Who Invests in Housing Tax Credits?

The largest investors in housing tax credits have been banks, GSEs (Government Sponsored Entities—Fannie Mae and Freddie Mac), and insurance companies. In 2007, the market for housing credits was about $9 billion. Banks made about 40% of investments, GSEs made another 40%, insurance companies represented 10%, and the remainder made by other investors.

The projected market for 2008 is $5 billion. Of this, banks are projected to make about 60% of the investments, insurance companies 30%, and other investors are expected to make 10% of the investments. GSEs are not expected to be major investors in 2008.

Benefits of Fund Investing
The primary benefits of fund investing are:

- *Risk sharing and diversification.* In a fund, investments extend over multiple properties and states, which is a lower risk than if an investor invested directly in a single project.
- *CRA consideration.* Investments can provide banks with CRA consideration when the investments benefit the bank's assessment area or provide benefits to a broader statewide or regional area that includes the bank's assessment area(s), provided the bank has otherwise adequately addressed the community development needs of its assessment area(s), even if these activities will not directly benefit the institution's assessment area(s).
- *Underwriting expertise.* Fund managers select projects for inclusion in funds only after these projects meet very specific criteria necessary for the investors.
- *Asset and compliance management expertise.* With fund investing come fund managers who are well versed in Section 42 and applicable housing law.
- *Flexible investment amounts.* Banks can sometimes invest as little as $500,000, which is especially relevant to first-time investors like midsize and community banks.

Fund Structure
A sample fund structure was shared, which is similar to many of the funds that are available in the marketplace. In this structure there are two tiers. The first is the "upper tier," which includes the fund's general partner and its limited partners who are the investors. The upper tier shows what portion of each fund is represented by each investor. The "lower tier" includes the specific properties included in the fund's portfolio.

How to Evaluate a Fund Manager
A critical factor in considering an investment in a low-income housing tax credit fund is the fund manager. Some characteristics to look for in a fund manager:

- *Financial condition.* It is important to understand the financial strength of a fund manager's balance sheet.
- *Business strategy.* Understand a fund manager's strategy, along with their competencies and business direction, which leads to a sustainable competitive advantage.
- *Employees.* Understand their employee base. Do they have seasoned staff? Low attrition? Sound leadership?
- *Acquisitions and underwriting.* Are the guidelines consistent with current industry standards?
- *Asset management.* This is the ability to monitor ongoing compliance and provide investment data using industry-accepted performance criteria.
- *Risk management.* Historically the low-income housing tax credit program has had strong performance. However, no fund manager is perfect; everyone has a difficult deal here and there. What is important is to understand why a fund manager had a tough deal and what they did to manage and mitigate the risk and turn it around.
- *Investor reporting.* Investors want to understand what the fund manager's financial deadlines are in reporting to investors and their consistency in meeting financial deadlines.
- *Geographic knowledge.* Understand the geographic breadth and depth of the fund manager's portfolio.
- *Portfolio performance*. Understand the fund manager's ability to meet investors' target yields and benefits.

> *"Every fund manager out there has target yields. . . . It is important to understand how successful they are year in and year out in meeting their targets with regard to yield, credit projections, and loss projections."*
>
> —Dana Boole

- *Investor base.* Has the fund manager shown an ability to grow and diversify sources of capital?

How to Evaluate a Fund
Along with evaluating a fund manager, prior to making an investment in a low-income housing tax credit fund, it is also prudent to evaluate the fund. Suggested areas to evaluate:

- *CRA.* Affirm that the fund's target investments will satisfy the bank's CRA needs. This requires communi-cating with your regulator.
- *Properties.* Undertake due diligence of the fund, the syndicator, and the properties being acquired. This can be done through a simple face-to-face meeting with the fund manager or by enlisting a third party to do a rigorous analysis.
- *Accounting.* Secure approval from both internal and external auditors as to the non-CRA impact of an investment on the bank's financials.
- *Tax impact.* Ensure that your expected tax liability is sufficient to make use of the tax benefits. Investors can make use of the tax benefits against the Alternative Minimum Tax. Carry backs are allowed for one year and carry forwards are allowed for up to 20 years.
- *Investor profile.* Determine the fund manager's track record in working with investors whose size and needs align with yours.
- *References.* Learn about the experiences of institutions that have worked with the fund manager.

Calculating Housing Tax Credits
An example was shared of a project with a total cost of $4 million. From the total cost, it is necessary to determine the depreciable basis. This requires subtracting land cost and non-depreciable expenses (which in the example totaled $.5 million), resulting in a depreciable basis of $3.5 million. This amount is multiplied by the tax credit rate (in the example this was 9%), to arrive at an annual tax credit allocation of $315,000. This was multiplied by 10 years to get to a total amount of available credits for this project of $3,150,000.

The total equity investment in the project of $3.15 million is calculated by multiplying the available credits (in this example) by an estimated credit price of $0.83, which resulted in available equity of $2,614,500.

Underwriting Considerations
In evaluating a project, important underwriting considerations to be evaluated include: the past performance of the development team; the financial projections and their impact on both the fund and the project; real estate and tax due diligence; site and operational considerations; and project comparables.

Pricing Considerations
When evaluating pricing, important considerations include the timing of the equity investments compared to the delivery of the benefits (both the tax credits and the tax savings); the desirability of a property for CRA purposes; the strength of the development team and the guarantors; the strength of the market (including demand from qualified households and likely achievable rents); and the alignment of a project yield versus the expected fund target.

Investor Benefits Projection
Everything that was discussed above comes together in the simplified investor benefits projection example illustrated below. This hypothetical example shows how a $1 million investment, where money is contributed over three years, earns $1.45 million in total benefits (the sum of columns 2 and 3), yielding a projected 7% IRR.

Year	(1) Capital Contributed	(2) Tax Credits Earned	(3) Tax Deductions Earned (at 35% tax rate)
2008	$200K	$0	$12K
2009	$300K	$0	$18K
2010	$500K	$110K	$33K
2011-2019	$0	$110K (annually)	$27K (annually, on average)
2020-2024	$0	$0	$22K (annually, on average)
Total	**$1M**	**$1.1M**	**$350K**

Key Points (Floreani)

Mr. Floreani discussed yields and market conditions based on his findings from the report, *Understanding the Dynamics*, an annual industry survey of housing tax credit investment and property performance.

- **Most LIHTC investments provide returns equal to or slightly better than what is expected. But yield isn't the whole story.**

  Analyzing the yield (IRR) of LIHTC investments since 1991, the actual yield turns out to be equal to or slightly higher than what was originally projected.

  So, on average, history would show that an investor expecting a 7% yield will most likely receive a yield of 7.1% or 7.2%. This trend holds true over time, whether looking at older or newer investments. But favorable performance isn't the whole story. It is important to look at the components of yield. They include:

  — *Tax credits.* The overall credits realized over the life of an investment are usually very close to what was originally projected. Although tax credits are frequently delayed during the initial investment period, yield is preserved by delays in capital calls and higher tax deductions.

  — *Tax deductions*. The amount of tax deductions often turns out to be higher than was originally projected. So, investors are receiving more in the amount of tax deductions earlier in the investment.

  — *Capital calls*. Capital calls are often delayed relative to initial projections.

  Other factors beyond yield making low-income housing tax credits attractive include:

  — *Community development benefits*. To earn tax credits, low-income housing tax credit developments have to be rented to low-income households and have to be rented at affordable rates. These criteria (which are precisely defined in Section 42) provide an important benefit to communities.

  — *Carry back/carry forward*. Housing tax credits can be carried back one year or carried forward up to 20 years.

  — *Low foreclosure rates*. Analysis of foreclosure rates across a wide variety of real estate asset classes from 1993 to 2006 shows that tax credit investments had the lowest rate of foreclosure.

  — *Economic performance*. In terms of occupancy rates, debt coverage ratios, and cash flow, these investments are usually on target or exceed their targets.

  It is important to keep in mind that the economic benefit to investors is through the tax credits and deductions; not through operating performance and cash flow. Because of this, it is not uncommon for properties to operate with deficits, but these deficits are usually short term and small in amount. For properties that incur deficits, risk is offset in a variety of ways. This includes requiring operating reserves, developer guarantees, management fee deferral provisions, and other structures to help insulate investors from risk.

- **Tax credit yields are increasing for a variety of reasons.**

  Since 1991 there have been four eras in yields for tax credit investments:

  — *Era 1: 1991-2000*. During this era, after-tax yields declined dramatically from around 18% in 1991 to roughly 8% in 2000. In the early part of this era, tax credits were an unknown, unproven class of investment with low demand. These factors combined to result in high yields. But during the period, comfort level with tax credit investments continued to rise, demand grew, and as a result, yields declined.

  — *Era 2: 2000-2004*. During this time, yields were fairly stable at around 8%.

  — *Era 3: 2004-2006*. This was another period of declining yields—from 8% down to about 5%—as demand for this asset class took off. Because supply was fixed and demand was increasing, yields fell.

  — *Era 4: 2007-2008*. The trend of declining yields from the previous three eras has reversed, as yields have climbed back up to the 7% range. This occurred as investors started to pull back from the market and reduce their investments. This was not due to concerns with the investment class; it was based on investors' own financial conditions. They either lacked tax liabilities, faced other capital constraints such as a lack of liquidity, or had financial issues unrelated to housing tax credit investments.

For more information visit:
www.occ.treas.gov/up_event.htm

Because of rising yields and more negotiating opportunities, new and sidelined investors are entering (or reentering) the market. At the same time, some syndicators are downsizing, while others are seeing growth opportunities. Syndicators are also showing greater flexibility and a willingness to work with small investors.

- **Recent legislative changes have a positive effect on the LIHTC program.**

  The Housing and Economic Recovery Act of 2008 contains many provisions to improve the housing tax credit program. The Act allows housing tax credits to be used against the Alternative Minimum Tax. It also eliminates investors' recapture bond requirements, thereby increasing the liquidity of investments by reducing resale costs and administrative burdens. The Act gives state allocators more flexibility, increases temporarily the amount of tax credits available by about 10%, provides technical fixes to streamline transactions, and clarifies many longstanding industry questions.

Key Points (Wides)

Mr. Wides discussed CRA and Part 24.

- **Investing in low-income housing tax credits can help a national bank on its CRA investment test.**

  The Community Reinvestment Act is a provision of law which encourages insured depository institution banks and thrifts to provide financial services in the communities from which they take deposits. CRA ratings are determined by how well a bank meets its obligations to reinvest in the community, based on three tests—investment, lending, and service.

  A bank's LIHTC fund investment will be considered under the CRA Investment or Community Development Test, provided that the fund benefits the bank's assessment area. (A bank may also be able to receive positive CRA consideration for making an investment in a low-income housing tax credit fund that has a purpose mandate or function across a broader geography that includes the assessment area).

  > *"It's important for a bank to obtain documentation from the fund manager as to how that investment will benefit the bank's assessment area."*
  > —Barry Wides

- **The legal authority under which banks may make low-income housing tax credit investments is "Part 24."**

  Part 24 of the Community Reinvestment Authority [12 USC 24 (Eleventh) and regulation 12 CFR 24 Part 24] provides the legal authority under which national banks may make low-income housing tax credit investments. These investments must be designed primarily to promote the public welfare and affordable housing promotes the public welfare. National banks can typically make these investments in amounts up to 5% of their capital and surplus; however, with the OCC's approval, these investments can now be up to 15% of a bank's capital and surplus.

  A national bank seeking to invest in a low-income housing tax credit fund would make a filing with the OCC using a CD-1 form. Some banks can also provide documentation "after the fact" within ten days of having made an investment. More information is available on a fact sheet provided by the OCC.

Additional Resources

- **OCC District Community Affairs Officers.** The OCC has ten Community Affairs officers around the country that can be a valuable resource. Information about these offices can be found at: http://www.occ.treas.gov/cdd/commfoc.htm
- **Community Developments Insights**. For the *Community Developments Insights Report* on low-income housing tax credits issued by the OCC in February 2008 go to: http://www.occ.treas.gov/ftp/release/2008-10a.pdf.
- **More OCC information.** For more on LIHTC investing, see the OCC's Fact Sheet and e-zine articles at http://www.occ.treas.gov/cdd/ca_info.htm. Also on the OCC's website is a fact sheet on Part 24, http://www.occ.treas.gov/cdd/Fact%20Sheet%20Part%2024.pdf
- **Understanding the Dynamics**. This is an annual survey by Ernst & Young on tax credit performance. This survey includes 15,000 properties, 1.2 million apartment units, and almost $44 billion in equity investment. It is available for free at http://www.ey.com/us/taxcreditadvisory
- **Other industry sites.** Other organizations with tools and resources include the National Association of State and Local Equity Funds (http://www.naslef.org), the National Council of State Housing Agencies (http://www.ncsha.org), and the Affordable Housing Investors Council (http://www.ahic.org). Also, local bankers associations can be a source of valuable information.

Speaker Biographies

John C. Dugan

Comptroller of the Currency

John C. Dugan was sworn in as the 29th Comptroller of the Currency on August 4, 2005.

The Comptroller of the Currency is the administrator of national banks and chief officer of the Office of the Comptroller of the Currency (OCC). The OCC supervises 1,900 federally chartered commercial banks and about 50 federal branches and agencies of foreign banks in the United States, comprising more than half the assets of the commercial banking system. The Comptroller also serves as a director of the Federal Deposit Insurance Corporation, the Federal Financial Institutions Examination Council, and the Neighborhood Reinvestment Corporation.

Prior to his appointment as Comptroller, Mr. Dugan was a partner at the law firm of Covington & Burling, where he chaired the firm's Financial Institutions Group. He specialized in banking and financial institution regulation. He also served as outside counsel to the ABA Securities Association.

He served at the Department of Treasury from 1989 to 1993 and was appointed assistant secretary for domestic finance in 1992. While at Treasury, Mr. Dugan had extensive responsibility for policy initiatives involving banks and financial institutions, including the savings and loan cleanup, Glass-Steagall and banking reform, and regulation of government-sponsored enterprises. In 1991, he oversaw a comprehensive study of the banking industry that formed the basis for the financial modernization legislation proposed by the administration of the first President Bush.

From 1985 to 1989, Mr. Dugan was minority counsel and minority general counsel for the U.S. Senate Committee on Banking, Housing, and Urban Affairs. There he advised the committee as it debated the Competitive Equality Banking Act of 1987, the Proxmire Financial Modernization Act of 1988, and the Financial Institutions Reform, Recovery, and Enforcement Act of 1989.

Among his professional and volunteer activities before becoming Comptroller, he served as a director of Minbanc, a charitable organization whose mission is to enhance professional and educational opportunities for minorities in the banking industry. He was also a member of the American Bar Association's committee on banking law, the Federal Bar Association's section of financial institutions and the economy, and the District of Columbia Bar Association's section of corporations, finance, and securities laws.

A graduate of the University of Michigan in 1977 with an AB in English literature, Mr. Dugan also earned his JD from Harvard Law School in 1981. Born in Washington, DC in 1955, Mr. Dugan lives in Chevy Chase, Maryland, with his wife, Beth, and his two children, Claire and Jack.

Dana Boole

President and CEO, Community Affordable Housing Equity Corporation (CAHEC)

Dana Boole is the President and CEO of Community Affordable Housing Equity Corporation (CAHEC). He has been with CAHEC since 2001. His duties include the management of CAHEC's operations and oversight of its fund raising efforts throughout the United States with primary focus in the mid-Atlantic and southeastern states. His management responsibilities include (1) guiding CAHEC's overall strategy and operations; (2) accountability for CAHEC's growth, furtherance of its mission, and oversight of its financial condition; and (3) provision of the leadership, vision, and resources necessary to maintain the company's strategic competitive advantage. Fund-raising responsibilities include (1) managing the company's activities for federal, state, and historic tax credit funds; (2) diversifying efforts to include multi-investor, private label, and historic-only funds; and (3) sourcing investors through a combination of direct originations and broker relationships.

Mr. Boole came to CAHEC from Edison Capital Housing Investments in Boston. As Acquisitions Director at Edison, he focused primarily on equity syndication in the eastern United States. Before joining Edison, he held positions as Vice President of Acquisitions for National Partnership Investments Corp. and as a commercial real estate consultant for the Leggat Company.

Mr. Boole received his bachelor of arts in economics from the University of Vermont and his MBA in finance and strategy from the F.W. Olin School of Business at Babson College. Mr. Boole currently serves as a Class B Director for the Federal Reserve Bank of Richmond and is a standing member of its Planning and Operations Committee and Audit Committee.

Richard A. Floreani

Senior Manager, Tax Credit Investment Advisory Services, Ernst & Young

Richard A. Floreani is Senior Manager for the Tax Credit Investment Advisory Services group at the accounting firm of Ernst & Young. In that position, he advises institutional clients on risk analysis and investment evaluation in a majority of housing credit investment funds syndicated.

He has 17 years of experience counseling clients on tax credit transactions. Since joining Ernst & Young in 1996, he has focused on representing institutional investors in transactions that earn them tax credits for investing in low-income housing, historic rehabilitation, community development ("new markets"), and renewable energy.

Mr. Floreani also advises banking and insurance clients on regulatory matters relating to tax credit investments and tax policy evaluation. He also helps investors and tax credit syndicators benchmark performance and improve operational efficiency. In addition, he produces Understanding the Dynamics, the industry's annual survey of housing tax credit investment and property performance.

Prior to joining Ernst & Young, Mr. Floreani was employed at Affirmative Investments, Inc., a development and financial consulting firm specializing in housing tax credit transactions. During his tenure, he prepared financial projections, conducted real estate due diligence, structured legal and tax issues, and negotiated financing terms on behalf of affordable housing developers.

Mr. Floreani graduated with a BA degree (cum laude) from Boston University and currently serves on the board of directors of AIDS Housing Corporation.

Barry Wides

Deputy Comptroller for Community Affairs, Office of the Comptroller of the Currency

Barry Wides is the OCC's Deputy Comptroller for Community Affairs, in which capacity he leads a department of community development professionals located in Washington, D.C., and the four OCC districts. The Community Affairs staff is responsible for outreach to banks and their community partners, the administration of the "Part 24" public welfare investment authority, the development of policy, and the creation and distribution of educational materials on community development issues.

Prior to joining the OCC in 1999, Mr. Wides was Director of Affordable Housing Sales at Freddie Mac. He led a nationwide sales team responsible for developing products and strategies to achieve the company's congressionally mandated affordable housing goals. He previously served as Deputy Director of the Resolution Trust Corporation's Affordable Housing Program. Mr. Wides began his career in Washington as a presidential management intern and budget examiner at the Office of Management and Budget.

Barry is a Certified Public Accountant and holds a BS in accounting and an MBA from Indiana.