Stimulating Investment in Central Appalachia: Tools and Partnerships

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Session Objectives

- Describe the basic operation of four important development incentives:
  - New Market Tax Credits
  - USDA Business Loan Guarantee
  - Historic Tax Credits
  - Low Income Housing Tax Credits
- Encourage community bank partnerships in the use of development incentives

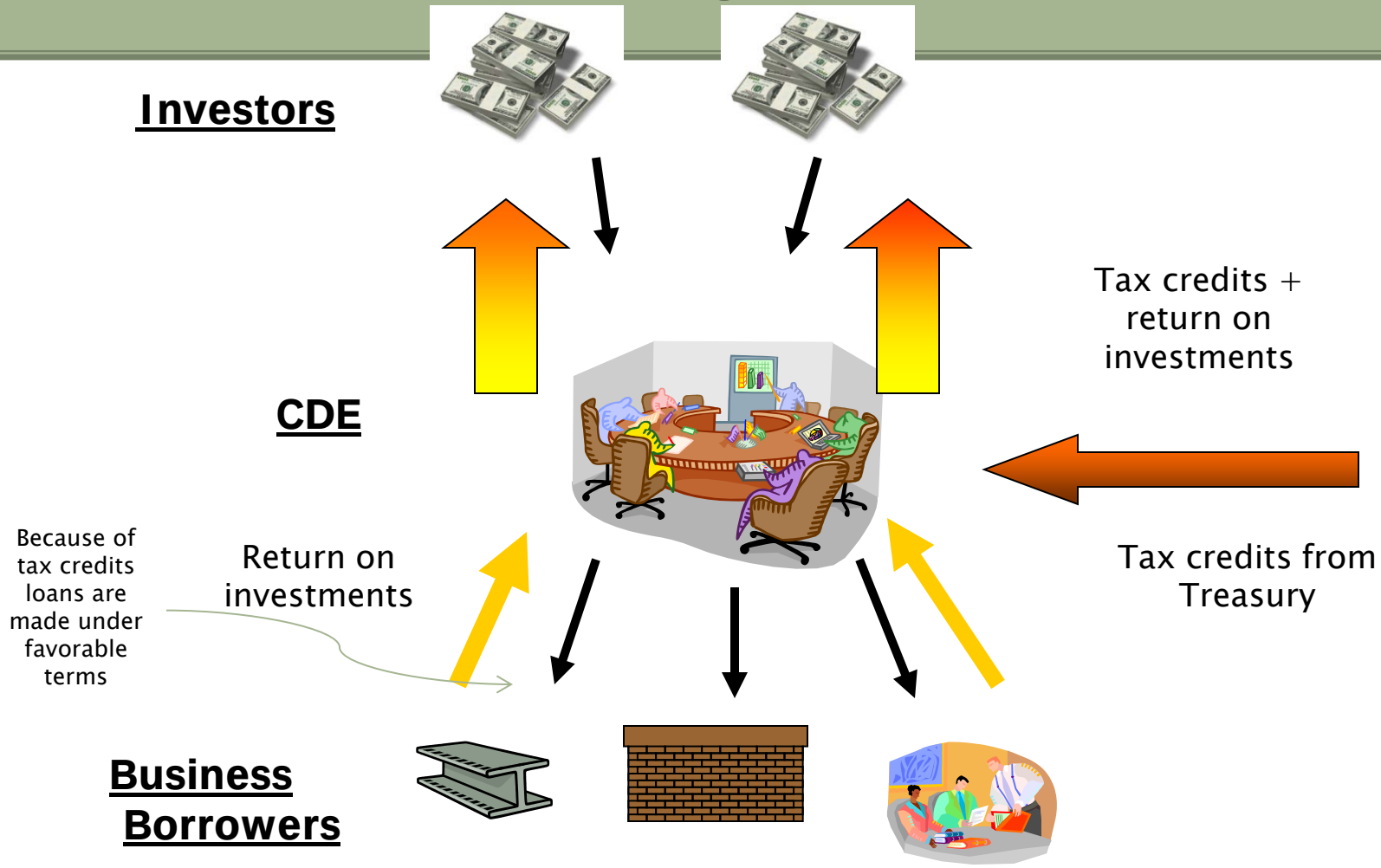
The New Market Tax Credit Program

Creating Equity

New Market Tax Credit

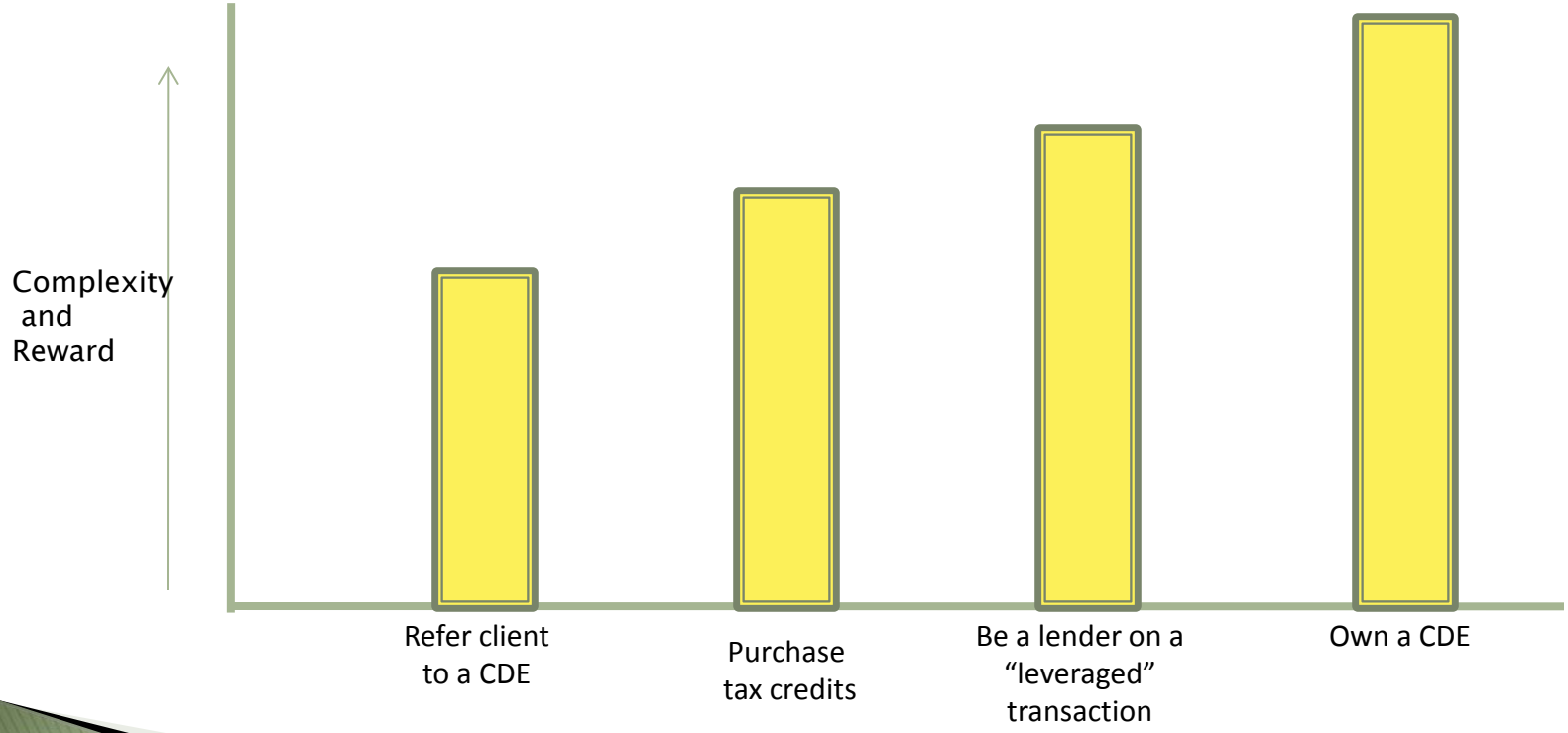
- NMTC program created by the Community Renewal and Tax Relief Act of 2000
  - Title I, subtitle C, section 121
- Create a nationwide network of specialized, privately owned financial corporations.
  - Approx. 2,200 CDEs
  - Approx. 200 organizations have received direct NMTC allocations
- Channel $20 billion of private investment capital to economically distressed areas.

Basic NMTC Concept



Four possible roles

Four possible roles for a community bank in a NMTC transaction



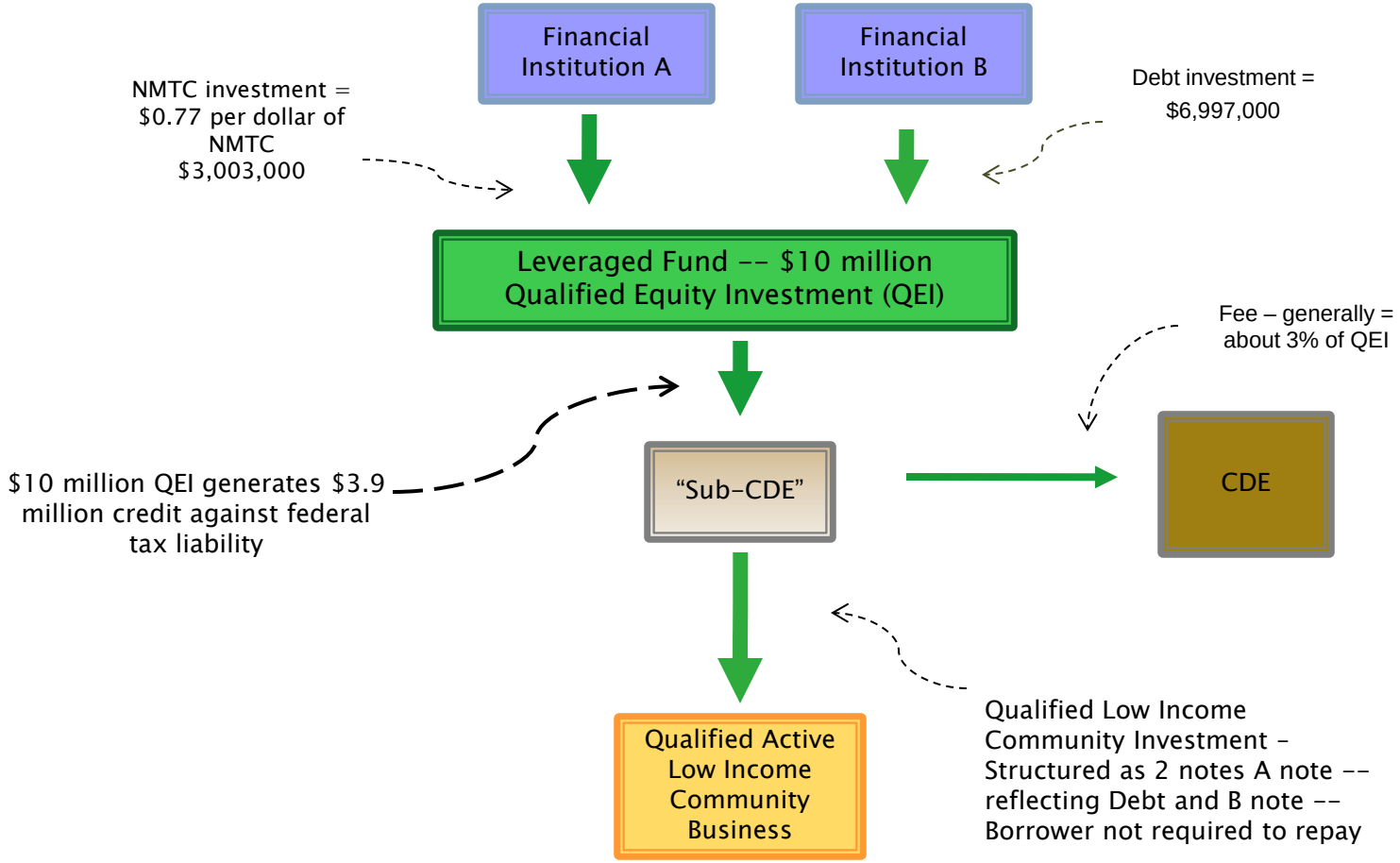
Refer a client to a CDE

- A CDE lends to an eligible borrower for an eligible project on favorable terms
- Generally for loans in the $1 million to $ 5 million range
  - 7 year interest only, balloon at end of 7 years
  - Low interest rate
  - Flexible underwriting terms
    - Lower than normal LTV
    - Lower equity requirements

Purchase NMTCs

- NMTCs currently selling in range of $0.65 to $0.70 per $1 tax credit
- Tax credit claimed over a seven year period – 5% in each of first three years; 6% in each of remaining four years
- There is no credit risk associated with NMTCs
- There is a regulatory risk

Community Bank as a lender in a "leveraged" transaction



Transaction Summary

- Business borrows $10,000,000
- Business receives loan proceeds of $9,700,000
- Business makes interest only payments for seven years on $6,997,000 at market rate of interest
- Business makes interest only payments on $3,003,000 for seven years at very low rate of interest – ¼ to ½ of one percent
- At end of seven years business repays $ 6,997,000 -- business does not repay $3,003,000.

Three financial institutions in a "leveraged" transaction

- **New Market Investor** – purchases tax credit from the CDE
- **CDE** – arranges transaction, assures compliance with NMTC regulations
- **"Leveraged" lender --** Loans approximately 70% of total capital

Possible role of community bank

Characteristics of "leveraged" lender

- Lends approximately 70% of total capital needed
- Lends into "upper tier leveraged fund"
- Loan for 7 years, interest only, balloon at end of 7 years
- Market rate of interest
- Loan must stay in place for 7 years; in case of default loan is reinvested in another NMTC eligible project for balance of 7 years
- Has first position on all collateral

Community Bank as CDE

- CDEs are for-profit financial institutions, most CDEs are affiliated with commercial banks
- Banks form CDEs for two reasons
  - Serve clients they could otherwise not serve
  - Earn fees
- A CDE does not have a credit risk in a “leveraged” transaction

A two step process

- Incorporate the CDE
  - 20% of the governing body or an advisory committee must be representative of low and moderate income population served
  - CDE can be formed at any time

- Incorporated CDE applies for an allocation of tax credits
  - Application can be submitted only once a year
  - Application process is very competitive

USDA Loan Guarantee Program

encouraging community bank loans

Guarantee depends upon loan

- USDA will guarantee a percentage of qualifying loans originated by a community bank
  - 80% of loan up to $5 million
  - 70% of loans between $5 million and $10 million
  - 60% of loans between $10 million and $25 million
- Interest rate and loan terms are established by the lender – not regulated by USDA

Eligibility

- Eligibility
  - Construction
  - Business acquisition
  - Working capital
  - Equipment
  - Must be in a rural area – jurisdiction other than a city of 50,000 or more and immediately adjacent urbanized areas.

Sell guaranteed portion of loan

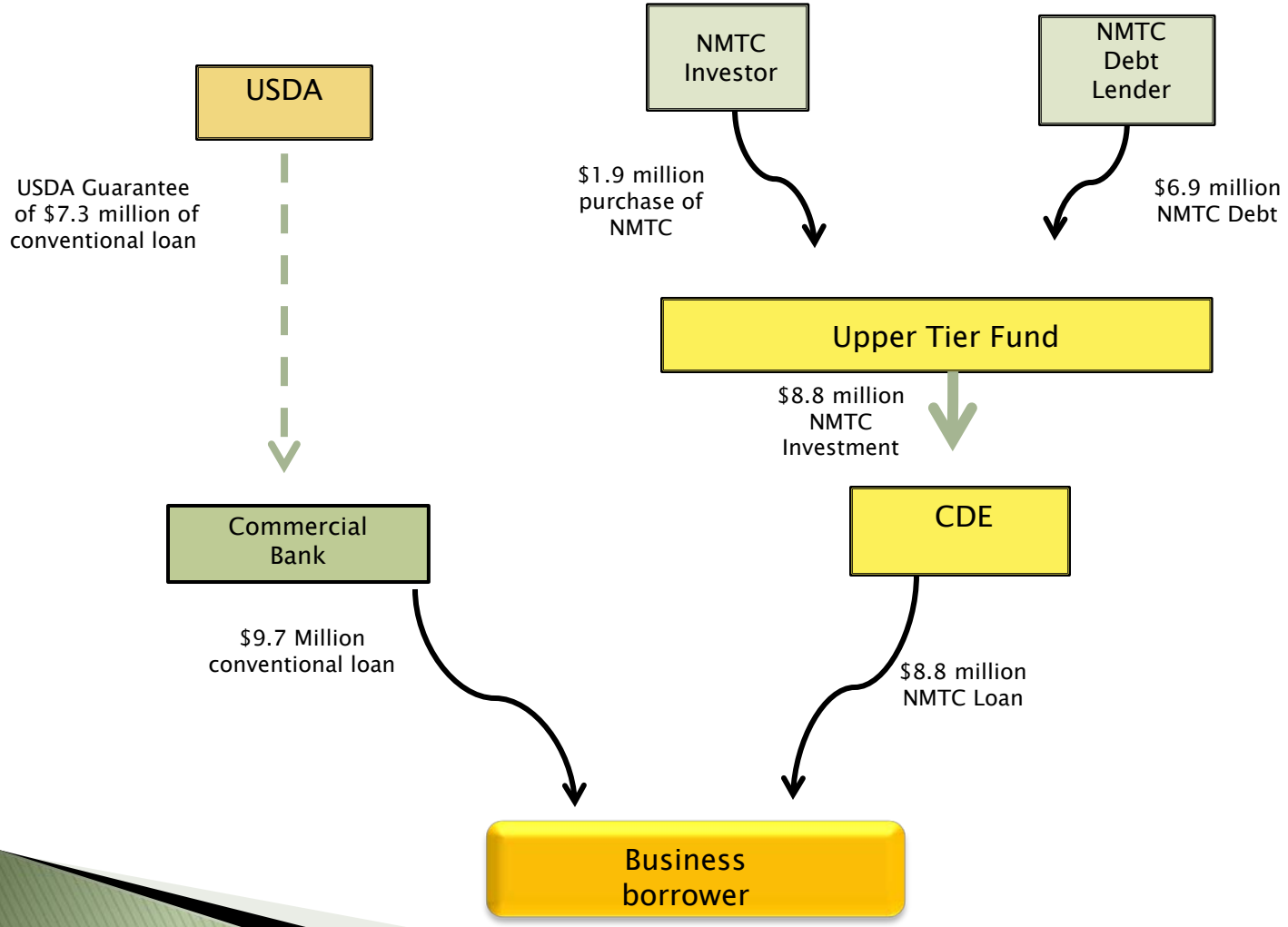
- Frequently the originating bank sells the USDA guaranteed portion of the loan.
  - In the current market the loan is sold at a premium to par – 105% to 107%.
  - Originating bank retains the non –guaranteed portion of the loan.
  - Originating bank typically retains the servicing and is paid a servicing fee.

B&I Guarantee *and* NMTC

- B & I loan guarantee and NMTC loan are combined by making two separate loans.

- B&I guarantee can not be applied directly to “debt lender” portion of NMTC structure.

B&I and NMTC structure



Historic Tax Credits

adds equity

A Little National Park Service Humor

- "The process is straight-forward"*

* **Introduction to Federal Tax Credits for Rehabilitating Historic Buildin**gs – National Park Service, Technical Preservation Services

Historic Tax Credit Basics

- Credit is equal to 20% of the qualifying costs of building rehabilitation
- Project must be “substantial” – rehab expenses must exceed $5,000 or adjusted basis of the building
- Building must be certified as historic by National Park Service

Selling HTCs

- Typically the developer will sell the HTCs to raise funding for the project and reduce financing costs.

- Current market for HTCs -- $0.95 to $0.97 per dollar

Reasons banks purchase HTCs*

- Earning attractive return
- Leveraging other tax credit programs and increasing the possibility of receiving favorable CRA consideration
- Contributing to the stabilization or revitalization of historic communities
- Gaining opportunities to diversify into other credit products and services

*"Community Developments" published by Comptroller of the Currency, November 2008

Low Income Housing Tax Credits

encouraging affordable housing

LIHTC Basics

- Tax payer – usually a corporate partner of a partnership that owns the housing development -- is allowed a credit against federal taxes equal to a significant percentage of cost of developing low-income units in a rental housing project.

- Tax Credits allocated over a 10 year period.

- Program administered by state housing agency with each state receiving a fixed allocation of tax credits based upon population

Why are LIHTCs of interest to banks*

- Earning attractive economic rates of return on investments.
- Contributing to revitalization in low-income areas
- Gaining opportunities to diversify into other credit products and services
- Receiving favorable CRA consideration

*"Community Developments" published by Comptroller of the Currency, February 2008

Amount of Credit

Value of tax credit based upon

- Amount of tax credit awarded to project (competitive process)
- Actual cost of project
- Tax credit rate announced by IRS
- Percentage of project units rented to low-income tenants

Thank You

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