



Testimony of

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Development**

Local Initiatives Support Corporation

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Good morning, Mr. Chairman and members of the Subcommittee. My name is Benson Roberts. I am Senior Vice President for Policy and Program Development at Local Initiatives Support Corporation.

About LISC

LISC is a national, nonprofit organization that raises capital and provides investments, loans, grants, and organizational support to local nonprofit community development corporations. CDCs are rebuilding many of America's most distressed and isolated urban neighborhoods and rural areas.

Since 1980, LISC has raised and invested \$7.1 billion, including \$938 million in 2005, predominately from the private sector. LISC has financed a wide range of activities, including the production of almost 200,000 homes, as well as charter schools, economic development, childcare, football fields, recycling vacant properties, supermarkets and public safety. Our Housing Authority Resource Center helps public housing authorities access private capital to rehabilitate and build affordable housing.

LISC operates through 33 local offices serving a city, region or state, as well a nationwide rural program. LISC combines this on-the-ground presence with national expertise in various issues and an ability to tap financial markets. Our work with Living Cities – a consortium of national financial services companies, foundations, and HUD – is an excellent example of this multi-sector, national/local partnership. LISC has had extensive experience in working with government at all levels to make public policies work in a wide range of local settings.

The Community Development Finance System and Federal Policies

Federal policies contribute in important ways to virtually all affordable housing and community development projects. Over the past 20 years, a cluster of federal policies has supported a flexible, decentralized, and well integrated production system. This system is distinctively market-driven, locally controlled, and performance-based. It builds sustainable partnerships among nonprofit and for-profit developers, private lenders and investors, and government at all levels. These institutional partnerships, locally and nationally, may be the most important legacy of these federal policies.

Attracting private capital is the key to the system. One reason is that public government grants are scarce and must be stretched as far as possible. Equally important, though, private financing provides market discipline, ensuring that projects are properly planned, underwritten and operated. Successful projects breed further private investment for subsequent activities, replacing the vicious cycle of disinvestment with a virtuous cycle of reinvestment.

The economics of affordable housing and community development determine what private sources can finance. Most affordable housing and community development requires three basic financing elements: equity investment, a private mortgage loan, and public funds. The role of federal policies is to maximize private financing and fill the financing gap.

Equity investments offer an ownership stake in projects. Traditional equity investors seek cash flow and capital appreciation. However, affordable rental housing and community development deals cannot produce much of either. Fortunately, equity investors also respond to well-structured tax incentives. *Low Income Housing Tax Credits*, *New Markets Tax Credits* for economic development, and *historic rehabilitation tax credits* have proven to be highly effective. The *Community Reinvestment Act* plays a crucial role in attracting equity investments from banks, and Fannie Mae and Freddie Mac are also important Housing Credit investors. Equity investments are usually structured to allow local sponsors to control day-to-day operations.

Private mortgage loans have two general constraints. (1) The loan amount cannot exceed about 80% of a property's appraised value for rental housing or economic development, since a lien on the property serves as collateral for the mortgage.¹ Market values are limited in low-income communities and for housing reserved for low-income residents. (2) Project cash flows (rents minus maintenance, taxes, and other operating expenses) must exceed mortgage payments by about 15%, to cushion against shortfalls. Low-income rental housing and most community economic development projects generate limited rents, so private mortgage amounts are limited too. The *Community Reinvestment Act* has provided crucial encouragement for banks to make mortgage loans consistent with safety and soundness. *Affordable housing goals* encourage Fannie Mae and Freddie Mac to purchase the private mortgages. In addition, *tax-exempt revenue bonds* can reduce the interest rate on a loan, so that a given level of cash flow can carry a larger loan.

Gap financing, as the term suggests, makes up the difference between a project's total development cost and the amount that private lenders and investors can reasonably finance. Gap financing is usually structured as a second mortgage with little or no current interest payments required, so it is not

¹ Mortgage loans to home buyers can approach the home's full market value.

available in the private market. Federal subsidies like *Community Development Block Grants, HOME, and HOPE VI*, or state and local subsidies where available, are essential to most development projects.

The following table shows how these three kinds of funds and various federal policies come together in a typical rental housing development costing \$150,000 to build. Costs can vary widely among local markets and specific projects.

Financing Type	Federal Policy	Decision-maker	Amount/unit
Equity investment	Low Income Housing Tax Credits CRA	State agencies allocate credits Banks make investments	\$90,000
First mortgage	CRA Fannie Mae/Freddie Mac (GSE) affordable housing goals	Bank originates loan Fannie Mae/Freddie Mac purchase the mortgage	35,000
Gap financing:	HOME, CDBG Alternate: HOPE VI	States and localities HUD and local PHAs	<u>25,000</u>
Total cost of development			\$150,000

In addition to helping to finance the actual development of projects, public policies play two other important roles in the process.

Rental/operating subsidies. For rental housing it is important to recognize that extremely low-income households generally cannot afford rents sufficient to cover even the basic costs of maintaining a property in good condition. Reaching these households requires some kind of ongoing rental subsidy or a project operating subsidy, such as those provided through *Section 8 Housing Choice Vouchers, public housing operating subsidies, Section 202 (elderly), Section 811 (disabled), or McKinney-Vento (homeless) programs.*

Building nonprofit capacity. According to an Urban Institute evaluation, nonprofit community development corporations (CDCs) “in many cities are now the most productive developers of affordable housing, outstripping private developers and public housing agencies,”² and they play leading roles in a wide range of other revitalization activities as well. These nonprofits are mission-driven to address public priorities, often taking on the toughest projects, serving a diverse population that includes the poor, and leading the recovery of urban neighborhoods and rural areas that others avoid. Moreover, CDCs are vehicles through which residents become more self-sufficient and take responsibility for

² Christopher Walker and Mark Weinheimer, *Community Development in the 1990s*, Washington, DC: The Urban Institute, September 1998, page 1.

their communities' futures. But nonprofits need seed capital to pursue new projects and activities and to grow strong organizationally. *The Section 4 community capacity building program, Community Development Financial Institutions Fund, and the CHDO³ technical assistance element of HOME* provide important resources. LISC and Enterprise administer most of the Section 4 funds, in partnership with HUD.

The Role of Community Reinvestment Policies

Federal community reinvestment policies play a fundamental role in housing and economic development. The *Community Reinvestment Act* is the linchpin, but the *Home Mortgage Disclosure Act, Government Sponsored Enterprises (GSE) affordable housing goals, public welfare investment authority* for banks, and even the *Basel II international bank capital accord* all make important contributions.

Community Reinvestment Act (CRA). CRA requires all federally insured banks and thrift institutions (savings and loans) to help meet the credit needs of their entire communities, including low-income areas. CRA was enacted in 1977 to combat “redlining”, or the refusal to lend in low-income or minority neighborhoods. CRA became especially effective in the early and mid-1990s.

CRA has been remarkably successful. Banks are more willing to operate in low-income communities if they know other banks will operate there as well. CRA has helped to expand access to credit substantially in most low-income communities, helping banks to discover new markets where they are providing loans, investments and services consistent with safety and soundness. For example, the foreclosure rate on *Low Income Housing Tax Credit* properties is only 0.02% annually, far lower than on other real estate investments. Community reinvestment is also profitable for banks, though not quite as profitable as other activities. One reason is that low-income housing and community development financings tend to be relatively small, while also requiring more time and expertise to structure properly and coordinate with other private and public partners.

CRA also encourages banks to undertake innovative activities, as well as to enter into public-private partnerships. *Low Income Housing Tax Credits* were a breakthrough, starting in the late 1980s; *New Markets Tax Credits* are a more recent example. In such cases, CRA encourages banks to pioneer and then refine implementation of market-driven federal policies.

Four federal regulators are responsible for monitoring the CRA performance of federally insured financial institutions: the Office of the Comptroller of the Currency for national banks; the Federal Reserve Board for state chartered

³ Community Housing Development Organizations

banks that are members of the Federal Reserve system, as well as bank holding companies; the Federal Deposit Insurance Corporation for other state chartered banks; and the Office of Thrift Supervision for thrift institutions. An institution with poor CRA record may be denied approval for merging with another institution, and can suffer reputational damage.

Until 2004, the four regulators collaborated on writing uniform CRA regulations. This has ensured consistency, a level playing field for all institutions of similar size, clarity, and transparency. In 2004, the OTS unilaterally announced a policy that effectively eliminated investment and financial service⁴ requirements for all thrifts, leaving only lending obligations in place. Remarkably, OTS finalized this policy even though it had never formally proposed such a fundamental change, and ignored 4,000 comments opposing even the general concept with only 200 supportive comments. We urge the OTS to reverse this policy and rejoin its fellow regulators with a uniform and responsible policy.

The direct effects of this OTS policy are bad, but the indirect effects are potentially more far reaching. For the first time, different rules apply to different kinds of federally insured financial institutions. This creates an un-level playing field, and sows uncertainty and instability in the system. Some institutions may be tempted to favor a thrift charter to get more lenient CRA treatment. Pressure could build to allow commercial banks the same chance to avoid responsibility for investments and services. This unraveling would weaken the investment market for community development activities. If, for example, there were less interest among investors in Low Income Housing Tax Credits, rates of return would rise and each dollar of tax credit would generate less money for housing. The federal government would be hard pressed to increase funding for *HOME* or *CDBG* to make up the difference. The bottom line would be less housing and community revitalization.

Home Mortgage Disclosure Act (HMDA). Enacted in 1975, HMDA now requires the public disclosure of where each lender makes home mortgages, the racial, income and gender characteristics of borrowers, and most recently, whether loans carry especially high interest rates. HMDA has consistently injected hard data into the sometimes heated debate about fair access to credit. New data on the cost of borrowing is now informing an important examination of whether minority, low-income, and inner-city or rural borrowers are paying substantially higher interest rates than others.

GSE Affordable Housing Goals. In 1992 Congress enacted legislation requiring Fannie Mae and Freddie Mac to purchase more loans made for low- and moderate-income people and communities. These goals have challenged Fannie and Freddie to focus on these markets. However, their targets are broader than

⁴ Access to convenient branches and no-frills checking accounts are examples of such services.

those for banks under CRA. As a result, the banks and thrifts that originate loans and the GSEs that purchase loans in the secondary market are not always well aligned. The GSE reform bill approved by the House would correct this problem by targeting the *affordable housing goals* to virtually the same people and places that CRA targets. LISC supports this provision of the House bill.

Public welfare investment authority. Since 1995, CRA regulations have required banks to make investments, but it is broader banking laws that govern exactly what activities banks can undertake. In 1992, Congress codified the authority of banks (and by extension, certain affiliates of thrifts) to make investments primarily designed to promote the public welfare, such as those benefiting low-income people and communities.⁵ The 1992 law has permitted bank investments in aggregate amounts up to 10% of their capital. In the last 14 years, public welfare investments have increased dramatically, principally based on *Low Income Housing Tax Credits*, which as noted above have an exceptionally low failure rate, and now *New Markets Tax Credits*. Together, these tax credits are generating about \$10 billion in investments each year, with typical holding periods of 15 years for housing and at least seven years for New Markets. Some banks are already reaching the 10% ceiling, and more are likely to do so in the next few years. Even approaching the 10% ceiling could cause banks to ration their investment activity. Here again, a reduction in the supply of investment capital would reduce the amount of funds for housing and economic development, widening financing gaps that the federal government would be hard pressed to close by expanding spending programs like *HOME* and *CDBG*.

The banking deregulation bill approved by the House would raise the ceiling on *public welfare investment authority* for national banks to 15%. However, the Senate bill does not include a similar provision. LISC urges the House-Senate conferees to accept the House provision and extend it to all federally insured depository institutions, including state chartered banks as well as thrifts.

Basel II international banking capital accord. In an example of how the global financial system affects the revitalization of low-income communities, the Basel II accord will determine how much capital banks must hold against the different kinds of loans and investments they make. Requiring banks to hold more or less capital affects their willingness to provide different kinds of financing. In general, U.S. banking regulators would require a bank with total equity investments exceeding 10% of its capital to retain a very high level of reserves. We urge that regulators disregard public welfare investments – primarily low-risk investments based on *Low Income Housing Tax Credits* and *New Markets Tax Credits* – when calculating whether a bank triggers this 10% “materiality” threshold. Failure

⁵ Before 1992, banks were permitted to make small public welfare investments under administrative authority.

to grant this exception would undermine related policies under *CRA* and *public welfare investment authority*.

Conclusion

Rebuilding low-income urban and rural communities is hard work under the best of circumstances. The good news is that a sophisticated network of local and national partners has become highly effective over the last 20 years. Practitioners must be able to trust the federal government as a reliable partner. Indeed, numerous federal policies are integral to fostering these partnerships. LISC is grateful to the Subcommittee for reviewing how these policies interact. Because various committees – Financial Services, Ways and Means, Appropriations – have responsibility for specific policies, it is sometimes difficult for Congress to appreciate how they intertwine. Although there have been several policy crises over the last several years, the basic system has survived mostly intact, and in some ways has become stronger.

This concludes my testimony. I would be happy to address any questions you may have.