

Innovative Approaches Help Solve N.O.'s Housing Woes



**Courting the
Creative Class:
New Strategies
for Urban Revival**

**GO Zone Tax
Credits and
Incentives**

**The Subprime
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Market**

**Case Making:
Building a
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Implementation**

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A New Orleans partnership has embraced modular construction in addressing the acute need for affordable housing destroyed by Hurricanes Katrina and Rita. Advances in modular quality and design have increased its acceptance and made it a viable option in many communities.

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Achieving the American Dream— Are We There Yet?



For as long as I can remember, purchasing a home has been celebrated as a pivotal point in one's life, as a sign of prosperity and personal success. One of our goals as a society has been to make it possible for more people to achieve the American dream of homeownership. And while we've been successful in bringing the percentage of homeowners to new heights, the causes for this shift are difficult to pinpoint.

According to the U.S. Census, the national homeownership rate was approximately 63 percent in 1965 and remained fairly stable for the next thirty years. However, in the mid-90s a housing boom raised the percentage of those owning homes higher each year until it topped out at close to 70 percent in 2005. More than 12 million joined the roster of new homeowners in just over a decade.

Exactly what has caused this rapid increase? The answer varies, depending upon whom you ask. Some studies indicate that lower interest rates allowed more people to enter the housing market. From the late 1980s through the early 1990s, interest for fixed-rate mortgages hovered around 10 percent. By the mid-1990s, rates began dropping rapidly, bottoming out at just over 5 percent for a fixed 30-year mortgage in 2002.

Other studies indicate that the aging of the population has been a strong factor in higher levels of homeownership. According to a study from the San Francisco Fed, a greater percentage of Baby Boomers compared to past generations have entered the housing market. The study additionally shows a direct correlation between longer lifespans and higher homeownership rates.

We have also seen a dramatic shift in the types of mortgage products on the market. In a testimony before the

Senate Banking Committee in February 2007, the Government Accountability

Office estimated that the proportion of nontraditional mortgages rose from 10 to 30 percent of the mortgage market between 2003 and 2005.

Federal agencies have expressed concern about risks inherent in several nontraditional mortgage products. A recent statement proposed on subprime mortgage lending practices highlights potential risks associated with particular adjustable rate mortgage products including interest-only loans and option ARMs; simultaneous first and second mortgages called "piggy back" loans; and products that do not require verification of income or assets, known by the industry as "low doc" or "no doc" loans.

Whether the higher homeownership rate is primarily due to an environment of lower interest rates, to people getting older and living longer, or to the creation of new mortgage products is unclear to me. One thing that's certain is that the mortgage industry has changed dramatically and will probably continue to evolve. While a larger percentage of families in the U.S. enjoy the American Dream today than ever before, risks are also greater as marketplace complexities increase. One of the biggest challenges ahead is to manage risk in a way that promotes and preserves housing opportunities.

A handwritten signature in black ink, appearing to read "Juan". The signature is stylized with a large, looping initial 'J' and a cursive 'uan'.

Juan C. Sanchez
Community Affairs Officer



Innovative Approaches Help Solve N.O.'s Housing Woes

THE LOW INCOME HOUSING TAX CREDIT (LIHTC) PROGRAM, CREATED BY CONGRESS TO GENERATE EQUITY CAPITAL FOR AFFORDABLE RENTAL HOUSING, HAS BEEN AROUND FOR A GENERATION NOW. MODULAR CONSTRUCTION METHODS HAVE BEEN IN USE FAR LONGER.

But the concept of using tax credits to finance modular multifamily housing development is novel. A New Orleans partnership faced with critical housing needs has made the leap.

What did it take? Their goal was clear: to produce high quality affordable housing in a short period of time. Ultimately, the partnership launched what's become New Orleans' first modular multifamily development using federal housing tax credits.

The new development, Louisiana Freedmen Homes, consists of 29 three-bedroom, two-bath apartments situated on three acres in the Uptown neighborhood between Audubon and Broadway Streets just south of Earhart Boulevard. All of the units are reserved for low- and moderate-income families.

New Orleans' slow recovery

New Orleans continues to struggle with replacing affordable housing destroyed by Hurricanes Katrina and Rita. Acute housing needs motivated the partners to consider nontraditional construction methods that involved lower costs for both labor and materials. Modular construction costs less per square foot because mass production results in economies of scale.

Modular construction is also a practical solution for some of the particular problems slowing construction in New Orleans, including labor shortages and theft of scarce building materials. It requires far fewer on-site

labor hours compared with traditional site-built construction. A shorter construction period also reduces the risk of site theft, and modular units can be locked and secured as soon as they're put into place.

Although some local examples of single-family modular infill housing exist to demonstrate the feasibility of this approach, the partners nevertheless took a risk since many people remain skeptical about modular construction.

The evolution of modular construction

Thanks to advances in quality and design, modular construction has been gaining acceptance as a viable option for affordable housing in many communities. In fact, improvements in the past decade have been so great that many modular homes may be considered better quality housing than some traditional, site-built construction.

Confusion still exists regarding modular housing in comparison with "HUD Code" manufactured housing. While it may appear to be the same, HUD Code homes are built according to federal HUD codes applicable in all 50 states; modular homes, on the other hand, are built using the same codes as any other local construction. HUD Code homes can only be single-family residences, but modular structures can house single families or multiple families.

Modular homes must comply with the same state or local codes used by builders of traditional structures.



The photo shows the different phases of the Louisiana Freedmen Homes and how the development comes together quickly – from building the foundations to placing the modules and constructing the front porches after the units are in place.

For instance, the same windspeed standards apply to modular construction. The manufacturer of the units being developed in New Orleans, like builders of traditional, site-built homes, must build to withstand a maximum windspeed of 130 mph.

The homes

Louisiana Freedmen Homes consists of 15 buildings—14 two-story duplexes and a single-family residence. Each unit contains approximately 1,250 square feet. Duplex units have four modules stacked two by two, with one unit on each floor. Site-built front porches in a New Orleans style and high-pitched rooflines that reflect the dominant architecture in the area create an authentic, local look.

Quality options chosen by the developer and builder, such as 9-foot ceilings, ceiling fans, venetian blinds, wood crown molding and window sills, parquet flooring, ceramic tile and high-grade carpeting, add to the appeal of the units. Other features include central heat and air, a washer and dryer, and high-quality kitchen appliances, cabinetry, countertops and sinks.

Structural upgrades have also been added: 220v electrical wiring is specified as opposed to the standard 110v permitted under local codes, as well as thermal windows and doors. These and other energy-saving design elements will provide excellent payback to residents over time.

Based in Eatonton, Ga., Horton Industries manufactures about 100 modular units per week through its

subsidiaries, Horton Homes Inc. and Dynasty Homes Inc. The company makes most of its sales in the Southeast. Horton employees do the actual lifting and placement of its units, and they guarantee to repair or replace any damage resulting from transportation or to fix any problems that stem from factory errors.

The partners at work

As with most affordable housing developments, the modular project began with a 501(c)(3) nonprofit organization, Louisiana Freedmen Homes LLC. Represented by dozens of local churches, the nonprofit owned the raw land and will have ongoing ownership and management of the property.

A developer and general contractor who have had experience with modular development are important to the success of a modular project. The developer is key in establishing the building plans, and the general contractor must have specialty skills to construct the infrastructure before the modular units can be placed. Developer James E. “Jamie” Neville, president of Neville Development LLC, works with general contractor Keith LeDuff of Keith LeDuff General Contractor.

The bank representative is Yvette Cola, vice president and commercial real estate relationship manager at Regions Bank, which is doing the construction and permanent financing for the project. As part of the financing package, Louisiana Freedmen Homes sold low-income housing tax credits to Regions Bank and obtained layered

financing that included Louisiana Housing Finance Agency's HOME funds, Gulf Opportunity Zone (GO Zone) credits, energy credits, leveraged private investment and funding from other sources.

Bringing it all together

This dynamic partnership brought together an innovative product and a new financing approach to meet New Orleans' pressing need for affordable housing. The city and Orleans Parish understood the project and were willing to grant permits. Jamie Neville noted that the greatest challenge was convincing all the participants to move at a pace that seemed very rapid compared with traditional site-building.

While there is much to applaud about the successful construction and financing of the modular multifamily development, the real celebration is about the 29 families who now have safe, decent, affordable housing. Louisiana Freedmen Homes stands as a model for future development in the Gulf Coast region and elsewhere. In fact, Jamie Neville and Keith LeDuff already anticipate developing additional modular subdivisions. ♦

This article was written by Wayne Smith, community affairs director at the Atlanta Fed.

For more information about Horton's modular division, refer to www.hortonhomes.com/hortonmodulmain.htm. To see floor plans and renderings, refer to New Orleans Modular Homes' website at www.nolamod.com. Specific duplex plans used in Louisiana Freedmen Homes are "The Orleans" and "The Victoria."

More on Modular Housing

The Internet provides innumerable resources for those seeking more information about factory construction. Such information covers the entire spectrum of consumer interests, from lower income single family and multifamily homes to multimillion-dollar modular mansions. Some luxury homes have over 8,000 square feet, totally dispelling old notions about the product. But large or small, the thought process is basically the same when undertaking modular construction.

Determine the home site and dwelling plans.

The land and its zoning will initially dictate what can and can't be done when exploring options regarding the type of home that can be built.

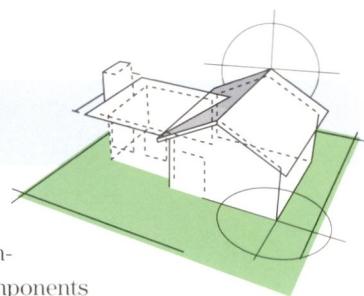
Find the best builder for the job.

Consumers cannot generally buy modular units factory direct, which helps ensure proper placement of modules on site. But modular factories can often assist in finding local developers and builders with experience in these products. Be sure to check references and inspect past projects. Seek competitive bids to ensure getting the best deal, which is not always the least expensive proposal.

Work out the budget.

The budget will help determine the size of the home, its features and whether an architect is needed. The developer or builder generally manages the total project

cost estimate, which will include on-site construction components such as the foundation, sewer/septic infrastructure, other utility connections, driveway and walkways, and porch or deck additions. Consider various financing options in advance. Don't forget the cost of homeowner's insurance.



Decide on a manufacturer.

While a manufacturer can assist in finding a builder, an experienced local builder can also assist in finding the most appropriate manufacturer to meet the buyer's needs. For example, request for special accommodations could narrow the options to those companies able to make certain customizations. Another consideration is the extent to which customizations might contribute to delays.

Follow the process.

As with building a traditional house, staying on top of the process every step of the way will help ensure that things go smoothly.

And the catch-all rule of thumb? As with entering any form of homeownership, the more the consumer knows the better!

Courting the Creative Class: New Strategies for Urban Revival

INSPIRED BY RECENT RESEARCH, CITY PLANNERS HAVE BEGUN TO THINK STRATEGICALLY ABOUT ATTRACTING A DEMOGRAPHIC THAT BY ITS VERY NATURE PROMISES TO REVITALIZE URBAN LIFE—THE CREATIVE CLASS.

What is the “creative class” and how important is this sector of society in fostering urban vitality? In his book *The Rise of the Creative Class*, George Mason University Professor Richard Florida describes a group of young, educated, highly mobile workers who are employed in information technology, health care, finance, science, the arts and other knowledge-based fields. According to Florida, they represent the future of the U.S. economy.

City planners have typically focused on investment in physical infrastructure, commercial real estate and new housing construction to revitalize communities. But now they are considering new approaches.

Redevelopment initiatives have thus far tended to target traditional families as cities contended with the suburbs for growth in this demographic group. Urban economic development programs usually emphasize job recruitment, workforce development and tax incentives to large corporations.

In the past five years, however, some cities have started to evaluate their unique appeal to nontraditional demographic groups. Creative class workers are likely to choose a location before they choose a job, and they seek out certain cities because of the cultural and other lifestyle amenities offered. The creative class also values inclusion of gays, immigrants and other nontraditional groups.

Creative class values diversity

Florida argues that workers in the creative class want diversity in their communities and value acceptance of



alternative lifestyles. His research has shown that many cities attractive to creative workers also have a high concentration of gays. Florida’s explanation for this finding is that a concentration of gays is a proxy for tolerance—one of the factors important in the location choice of the creative class.

Because gay- and lesbian-friendly communities appear to be a harbinger of urban vitality, some cities are considering strategies to attract gays and lesbians to communities in need of new investment. The city of Baltimore, where city officials have actively developed marketing strategies to attract gays and lesbians to neighborhoods ripe for revitalization, is the example most often cited.

This strategy has raised significant questions about why cities would want to focus on attracting gays as well as why gays might have a preference for living in certain urban communities. It also raises a larger question about the connection between gays and demographic diversity in cities that appeal to creative class workers. New studies suggest that this diversity provides not only social benefits, but brings economic benefits as well.

Bringing back distressed neighborhoods

The size of the gay population in a community is not typically measured, so it is difficult to quantify their economic impact on urban revitalization efforts. However, Gary Gates, a research fellow at the UCLA School of Law, has attempted to analyze the role of gays and lesbians in neighborhood development. His research shows that neighborhoods with a high number of gay households have higher housing values than comparable neighborhoods composed primarily of traditional couples. The study indicates that the revitalization efforts of gay and lesbian homeowners have over time made neighborhoods more attractive to all types of households, including those with traditional family structures.

While there is a lack of quantitative data, extensive anecdotal evidence exists to show that investment by the gay population has led to the rehabilitation of housing stock and new business opportunities in many communities across the country. Gays and lesbians have a long-standing reputation for moving into distressed neighborhoods and revitalizing homes and businesses.

Some of the most well-known examples include San Francisco's Castro District, Dupont Circle in Washington, D.C., South Beach in Miami and Florida's Key West. Lesser-known examples include the East Nashville neighborhood in Tennessee, Midtown Atlanta and the Historic Kenwood area in St. Petersburg, Fla. All

of these neighborhoods are recognized for their cultural amenities, diverse housing stock and vibrant commercial centers. These areas pride themselves on being tolerant and open to diversity, and as a result have become centers not only for gay and lesbian populations, but also for the creative class generally.

Why gays, lesbians and the creative class revive neighborhoods

Nationwide, the gay population has been more willing than traditional households to move into run-down, racially and ethnically diverse neighborhoods that may have higher crime rates than more stable neighborhoods. This observation might extend to include members of the creative class who are young, adventurous and in need of affordable housing. The neighborhoods they select often have more affordable but architecturally unique homes ripe for renovation and investment. Investment by gays and lesbians has helped transform neighborhoods, and realtors tout the presence of gays as a sign of an up-and-coming neighborhood.

Gates has done extensive research to determine why gays and lesbians are more likely to locate in distressed communities. One of the key factors he cites is that gay households are not as likely to have children as traditional households. As a result, gays may be less concerned with school quality and less worried about higher crime rates. In addition, gay and lesbian households may have more disposable income available to put towards renovation of their homes because they do not have the expenses that come with children. This same reasoning could be applied to members of the creative class as a whole, who may also be single or childless and more tolerant of diversity.

Real estate agents and word-of-mouth referrals have been the primary tools used for attracting gays to certain neighborhoods. However, some cities have started to recognize that the gay population is a significant resource for urban revitalization. Encouraging gays to lead revitalization efforts can be a cost effective strategy for cities. The city will not only receive higher tax revenues from the improved properties, but, because gay households are less likely to have kids, they will not place an additional burden on schools.

Pros and cons of wooing the creative class

While clear evidence exists about the impact of gays and lesbians and the creative classes generally on the revitalization of distressed neighborhoods, there is a broader argument about the significance of this group for the economic competitiveness of cities and regions.

According to Florida, a large gay population is an indicator of how open the community is to new and nontraditional ideas, and it is this type of creativity that is needed to generate economic growth. However, a strategy focused entirely on recruiting gays and creative workers to live in a city will not necessarily improve the economic vitality in a community, nor will it lead to revitalization of all inner city neighborhoods. Planners must seek a broader strategy that looks at all of the attributes that make a community desirable.

While the creative class may bring needed capital into depressed communities, it is important to recognize several potential downsides of this investment. First, some existing residents may not be willing to embrace new demographic groups moving into their neighborhoods, especially if the result is a significant change in the socioeconomic composition of the neighborhood. Secondly, as neighborhoods improve and become more attractive to a wider population, housing prices will increase, making it more difficult for existing residents, even the first "urban pioneers" who moved into the community, to maintain their homes. This can lead to a shift in the character of the community, as over time it becomes less of an alternative enclave and more of a neighborhood for wealthy households.

Some also question whether cities are becoming too concerned with marketing themselves to nontraditional demographics. Critics of the creative class argument claim that cities are starting to compete with each other to draw the creative class and are being distracted from fulfilling their core functions. Instead of focusing on affordable housing, recruiting new businesses and investing in schools, cities are emphasizing cultural amenities, the arts and coffee shops. Opponents argue that this strategy really only benefits the wealthy and increases the disparity between the haves and the have-nots. From this perspective, cities might risk becoming havens for wealthy, young, alternative populations

while ignoring adequate opportunities and services for traditional middle-class families.

Conclusion

Cities are always looking for new strategies to revitalize communities, attract businesses and encourage economic growth. Traditional programs that increase affordable housing, encourage economic development, promote education and improve public safety will always be needed. However, cities that are able to leverage the strength and creativity of all of their residents and that are inclusive and tolerant of different populations will have a stronger foundation for accomplishing these goals. ♦

This article was written by Jessica LeVeen Farr, regional community development manager in the Atlanta Fed's Nashville Branch.

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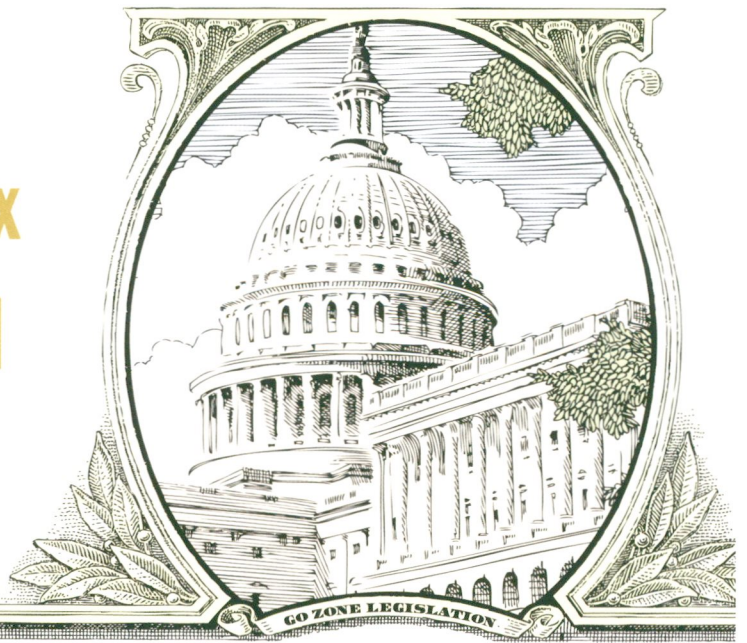
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GO Zone Tax Credits and Incentives



HURRICANE KATRINA, WHICH WREAKED AN ESTIMATED \$86 BILLION IN DAMAGES ACROSS 90,000 SQUARE MILES, RANKS AS THE MOST EXPENSIVE NATURAL DISASTER IN THE HISTORY OF THE UNITED STATES.

On the heels of Katrina came two more hurricanes—Rita, which affected the southwestern portion of Louisiana and Texas, and Wilma, which swiped southern Florida. In response to these devastating hurricanes, Congress passed a package of tax relief and incentives designed to jumpstart economic recovery by providing much-needed businesses and services in hard-hit areas.

The Gulf Opportunity Zone (GO Zone) Tax Incentives and Relief Act makes available almost \$14 billion in federal tax incentives to encourage businesses to invest in the region. An additional award of \$400 million in tax credits from the U.S. Department of the Treasury is expected in fall 2007. The GO Zone stretches as far north as Jackson and Columbus, Miss., and as far east as Tuscaloosa, Ala. In Louisiana, it includes not only New Orleans, but also Baton Rouge. The program extends to 31 parishes in Louisiana, 49 counties in Mississippi and 11 in Alabama.

Incentives aim to attract new investment

A recent series of information sessions about GO Zone incentives hosted by the New Orleans branch of the Federal Reserve Bank of Atlanta in January 2007 drew

over 200 bankers, investors and other financial professionals from as far away as Canada. The IRS, the U.S. Department of Housing and Urban Development and the U.S. Department of the Treasury explained how financial institutions and their customers could benefit from the new legislation.

Because the tax credits are implemented by the IRS, it is difficult to quantify how many projects have been prompted by the program. However, Alabama's Governor Bob Riley has reserved up to \$900 million in tax incentives and provisions under the GO Zone Act that will likely be used to attract a steel plant to Mobile. Louisiana is also contending for the plant. Other projects approved through bond allocations for Alabama include \$2.6 million for the Demopolis Hotel and \$35.9 million for Alabama Power.

Louisiana has won preliminary approval for a \$150 million film and digital studio in one of the areas of New Orleans seriously affected by flooding. This is the first Louisiana project that will be eligible for GO Zone tax-free bond financing. The studio would generate an estimated 2,000 temporary construction jobs and about 2,000 new permanent jobs with a payroll of

\$125.3 million. Other Louisiana projects that could benefit from the legislation are in the pipeline:

- a \$9 million new components factory for 84 Lumber Company in Hammond;
- a \$3.5 million new plant construction for Baumer Foods in La Place;
- a \$6 million new building systems factory for ABSI/Emmedue in Jefferson Parish;
- a \$65 million plant expansion for Dow Chemical in St. John the Baptist Parish;
- a \$715 million Hyatt Regency downtown revitalization project including a 20-acre multi-use center and park redevelopment in Orleans Parish;
- a \$200 million luxury residential, hotel and retail complex, Trump Tower, in Orleans Parish.

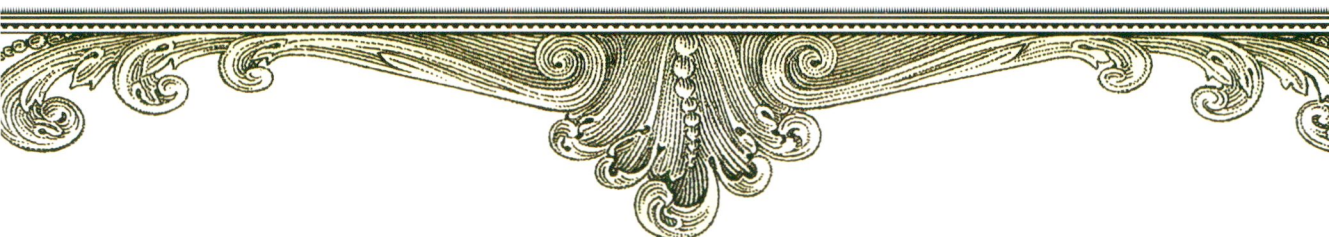
Challenges persist

Although much optimism surrounds the potential for new investment, two significant challenges could thwart businesses' ability to take advantage of the incentives. First, the credits and incentives are slated to expire in

2008. Because materials and skilled labor are scarce for construction projects as far away as Florida (which is still recovering two years later from Hurricane Ivan), New Orleans' prospects for rebuilding remain unclear and the "place in service" date of 2008 seems unrealistic if not impossible to achieve.

Secondly, insurance costs for commercial businesses have increased as much as 268 percent, severely cramping cash flow and profitability. Projects eligible for low-income housing tax credits typically maintain small operating margins and thus are not able to absorb the additional costs or volatility. Estimates indicate that as many as half of the allocated GO Zone credits are in jeopardy due to skyrocketing insurance costs. Recently delegations from the affected areas have been petitioning Congress to extend the credits through 2010, and the outlook is favorable. ♦

This article was written by Nancy Montoya, regional community development manager in the Atlanta Fed's New Orleans branch.



What Does GO Zone Legislation Provide?

THE GO ZONE ACT PACKAGES A BASKET OF TAX INCENTIVES AND CREDITS THAT HAVE THE POTENTIAL TO SPUR ECONOMIC DEVELOPMENT AND INCREASE THE PRODUCTION OF AFFORDABLE HOUSING. SOME OF THE SIGNIFICANT MEASURES ARE:

- **Expansion of low-income housing tax credits within the Zone.** Allocation of low-income housing tax credits rose dramatically for 2006, 2007 and 2008. In Louisiana, for example, housing tax credits jumped to 10 times the annual amount per capita prior to the storms. In Mississippi they increased 6 times the annual amount per capita. The legisla-

tion further rules that in difficult-to-develop areas in the GO Zone, the credit can be calculated at 130 percent of the basis of the property rather than 100 percent.

- **Increase in the rehabilitation tax credit to help restore commercial buildings.** GO Zone

legislation raises the existing tax credit for rehabilitated buildings constructed prior to 1936 from 10 percent of qualified expenditures to 13 percent. The credit for certified historic structures increased from 20 percent to 26 percent. To qualify, rehabilitation expenses must be incurred between August 28, 2005 and December 31, 2008 and must meet guidelines related to structure, facades, brickwork and other requirements.

- **Additional bonding authority.** To assist in the rebuilding effort, the bond authority granted to the GO Zone states has been raised by approximately \$7.9 billion for Louisiana, \$4.8 billion for Mississippi and \$2.1 billion for Alabama. This special class of tax-exempt, private activity bonds called GO Zone Bonds may be used to finance acquisition, construction and renovation of commercial real property or residential rental property at an interest rate savings of up to 2 percent. The additional bonding authority expires after 2010.
- **A 50 percent bonus depreciation within the Zone.** Through this incentive businesses can claim an additional first-year depreciation deduction equal to 50 percent of the cost of new property investments made in the Zone. The increased depreciation allowance applies to software, leasehold improvements, and certain equipment and real estate expenditures used in the active conduct of a trade or business. All depreciation deductions would be exempt from Alternative Minimum Taxes. This provision applies to property placed in service through 2007 or, in the case of real property, through 2008. (It should be noted that a business may choose tax-exempt financing or bonus depreciation, but not both.)
- **Enhanced expensing for small businesses.** Under section 179, eligible small businesses may expense up to \$200,000 of investment made in the Zone—up from \$100,000—on investments between August 28, 2005 and December 31, 2007. Legislation lifted the phase-out floor for investment from \$400,000 to \$1 million through 2007.

- **Extension of net operating loss carryback.**

The net operating loss (NOL) carryback period is extended from two to five years for losses attributable to repair of existing investment damaged by Hurricane Katrina; business casualty losses due to Hurricane Katrina; moving expenses and temporary housing expense for employees working in areas damaged by Hurricane Katrina; losses created due to claiming the 50 percent bonus depreciation on assets placed in service within the GO Zone.

- **Demolition costs.** Fifty percent of demolition costs paid or incurred before January 1, 2008 can be expensed.

- **Remediation expensing.** Costs incurred prior to January 1, 2008 through qualified environmental remediation inside the GO Zone, including clean up of petroleum products, may be expensed. (Typically these costs must be capitalized.)

- **Expanded Work Opportunity Tax Credits (WOTC).** The Katrina Emergency Tax Relief Act of 2005 (KETRA) allows employers to claim WOTC credits for hiring any employee in the GO Zone area who lived in the core disaster area between August 28, 2005 and August 28, 2007. Credit extends to 40 percent of the first \$6,000 of qualified first-year wages paid to eligible employees.

- **Increased New Markets Tax Credits.** \$1 billion in New Markets Tax Credit authority for 2006 and 2007 is available for community development entities that serve disadvantaged communities in the GO Zone.

- **Increased Hope Scholarship and Lifetime Learning Credits.** This provision doubles the Hope Credit dollar amount to a maximum of \$3,000 and doubles the Lifetime Learning Credit to 40 percent, allowing a maximum of \$4,000.

- **Additional provisions include** relief for small timber owners, restructuring of outstanding debt to reduce cost to municipalities, and authorization of Gulf Tax Credit Debt Service Bonds.

The Subprime Mortgage Market



Remarks by Chairman Ben S. Bernanke

Excerpts from the Federal Reserve Bank of
Chicago's 43rd Annual Conference on Bank
Structure and Competition,
Chicago, Illinois
May 17, 2007

The recent sharp increases in subprime mortgage loan delinquencies and in the number of homes entering foreclosure raise important economic, social, and regulatory issues. Today I will address a series of questions related to these developments. Why have delinquencies and initiations of foreclosure proceedings risen so sharply? How have subprime mortgage markets adjusted? How have Federal Reserve and other policymakers responded, and what additional actions might be considered? How might the problems in the market for subprime mortgages affect housing markets and the economy more broadly?

The development of the subprime mortgage market

Let me begin with some background. Subprime mortgages are loans made to borrowers who are perceived to have high credit risk, often because they lack a strong credit history or have other characteristics that are associated with high probabilities of default. Having emerged more than two decades ago, subprime mortgage lending began to expand in earnest in the mid-1990s, the expansion spurred in large part by innovations that reduced the costs for lenders of assessing and pricing risks. In particular, technological advances facilitated credit scoring by making it easier for lenders to collect and disseminate information on the creditworthiness of prospective borrowers. In addition, lenders developed new techniques for using this information to determine underwriting standards, set interest rates, and manage their risks.

The ongoing growth and development of the secondary mortgage market has reinforced the effect of these innovations. Whereas once most lenders held mortgages on their books until the loans were repaid, regulatory changes and other developments have permitted lenders to more easily sell mortgages to financial intermediaries, who in turn pool mortgages and sell the cash flows as structured securities. These securities typically offer various risk profiles and durations to meet the investment strategies of a wide range of investors. The growth of the secondary market has thus given mortgage lenders greater access to the capital markets, lowered transaction costs, and spread risk more broadly, thereby increasing the supply of mortgage credit to all types of households.

These factors laid the groundwork for an expansion of higher-risk mortgage lending over the past 15 years or so. Growth in the market has not proceeded at a uniform pace, but on net it has been dramatic. About 7-1/2 million first-lien subprime mortgages are now outstanding, accounting for about 14 percent of all first-lien mortgages.¹ So-called near-prime loans—loans to borrowers who typically have higher credit scores than

subprime borrowers but whose applications may have other higher-risk aspects—account for an additional 8 to 10 percent of mortgages.²

The expansion of subprime mortgage lending has made homeownership possible for households that in the past might not have qualified for a mortgage and has thereby contributed to the rise in the homeownership rate since the mid-1990s. In 2006, 69 percent of households owned their homes; in 1995, 65 percent did. The increase in homeownership has been broadly based, but minority households and households in lower-income census tracts have recorded some of the largest gains in percentage terms. Not only the new homeowners but also their communities have benefited from these trends. Studies point to various ways in which homeownership helps strengthen neighborhoods. For example, homeowners are more likely than renters to maintain their properties and to participate in civic organizations. Homeownership has also helped many families build wealth, and accumulated home equity may serve as a financial reserve that can be tapped as needed at a lower cost than most other forms of credit.

Broader access to mortgage credit is not without its downside, however. Not surprisingly, in light of their weaker credit histories and financial conditions, subprime borrowers face higher costs of borrowing than prime borrowers do and are more likely to default than prime borrowers are. For borrowers, the consequences of defaulting can be severe—possibly including foreclosure, the loss of accumulated home equity, and reduced access to credit. Their neighbors may suffer as well, as geographically concentrated foreclosures tend to reduce property values in the surrounding area.

The recent problems in the subprime mortgage sector

With this background in mind, I turn now to the recent problems in the subprime mortgage sector. In general, mortgage credit quality has been very solid in recent years. However, that statement is no longer true of subprime mortgages with adjustable interest rates, which currently account for about two-thirds of subprime first-lien mortgages or about 9 percent of all first-lien mortgages outstanding. For these mortgages, the rate of serious delinquencies—corresponding to mortgages in

foreclosure or with payments ninety days or more overdue—rose sharply during 2006 and recently stood at about 11 percent, about double the recent low seen in mid-2005.³ The rate of serious delinquencies has also risen somewhat among some types of near-prime mortgages, although the rate in that category remains much lower than the rate in the subprime market. The rise in delinquencies has begun to show through to foreclosures. In the fourth quarter of 2006, about 310,000 foreclosure proceedings were initiated, whereas for the preceding two years the quarterly average was roughly 230,000.⁴ Subprime mortgages accounted for more than half of the foreclosures started in the fourth quarter.

The sharp rise in serious delinquencies among subprime adjustable-rate mortgages (ARMs) has multiple causes. "Seasoned" mortgages—mortgages that borrowers have paid on for several years—tend to have higher delinquency rates. That fact, together with the moderation in economic growth, would have been expected to produce some deterioration in credit quality from the exceptionally strong levels seen a few years ago. But other factors, too, have been at work. After rising at an annual rate of nearly 9 percent from 2000 through 2005, house prices have decelerated, even falling in some markets. At the same time, interest rates on both fixed- and adjustable-rate mortgage loans moved upward, reaching multi-year highs in mid-2006. Some subprime borrowers with ARMs, who may have counted on refinancing before their payments rose, may not have had enough home equity to qualify for a new loan given the sluggishness in house prices. In addition, some owners with little equity may have walked away from their properties, especially owner-investors who do not occupy the home and thus have little attachment to it beyond purely financial considerations. Regional economic problems have played a role as well; for example, some of the states with the highest delinquency and foreclosure rates are among those most hard-hit by job cuts in the auto industry.

The practices of some mortgage originators have also contributed to the problems in the subprime sector. As the underlying pace of mortgage originations began to slow, but with investor demand for securities with high yields still strong, some lenders evidently

loosened underwriting standards. So-called risk-layering—combining weak borrower credit histories with other risk factors, such as incomplete income documentation or very high cumulative loan-to-value ratios—became more common. These looser standards were likely an important source of the pronounced rise in "early payment defaults"—defaults occurring within a few months of origination—among subprime ARMs, especially those originated in 2006.

Although the development of the secondary market has had great benefits for mortgage-market participants, as I noted earlier, in this episode the practice of selling mortgages to investors may have contributed to the weakening of underwriting standards. Depending on the terms of the sale, when an originator sells a loan and its servicing rights, the risks (including, of course, any risks associated with poor underwriting) are largely passed on to the investors rather than being borne primarily by the company that originated the loan. In addition, incentive structures that tied originator revenue to the number of loans closed made increasing loan volume, rather than ensuring quality, the objective of some lenders. Investors normally have the right to put early-payment-default loans back to the originator, and one might expect such provisions to exert some discipline on the underwriting process. However, in the most recent episode, some originators had little capital at stake and did not meet their buy-back obligations after the sharp rise in delinquencies.⁵ Intense competition for subprime mortgage business—in part the result of the excess capacity in the lending industry left over from the refinancing boom earlier in the decade—may also have led to a weakening of standards. In sum, some misalignment of incentives, together with a highly competitive lending environment and, perhaps, the fact that industry experience with subprime mortgage lending is relatively short, likely compromised the quality of underwriting.

The accuracy of much of the information on which the underwriting was based is also open to question. Mortgage applications with little documentation were vulnerable to misrepresentation or overestimation of repayment capacity by both lenders and borrowers, perhaps with the expectation that rising house prices would come to the rescue of otherwise unsound loans.

Some borrowers may have been misled about the feasibility of paying back their mortgages, and others may simply have not understood the sometimes complex terms of the contracts they signed.

As the problems in the subprime mortgage market have become manifest, we have seen some signs of self-correction in the market. Investors are scrutinizing subprime loans more carefully and, in turn, lenders have tightened underwriting standards. Credit spreads on new subprime securitizations have risen, and the volume of mortgage-backed securities issued indicates that subprime originations have slowed. But although the supply of credit to this market has been reduced—and probably appropriately so—credit has by no means

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evaporated. For example, even as purchases of securitized subprime mortgages for collateralized debt obligations—an important source of demand—have declined, increased purchases by investment banks, hedge funds, and other private pools of capital are beginning to fill the void. Some subprime originators have gone out of business as their lenders have cancelled credit lines, but others have been purchased by large financial institutions and remain in operation. Importantly, we see no serious broader spillover to banks or thrift institutions from the problems in the subprime market; the troubled lenders, for the most part, have not been institutions with federally insured deposits.

What about borrowers already in distress? The Board and other federal supervisory agencies have taken actions

to encourage the banks and thrift institutions we supervise to work with borrowers who may be having trouble meeting their mortgage obligations. Often, loan workouts are in the interest of both parties. With effective loan restructuring, borrowers facing temporary economic setbacks may be able to work through their problems while staying in their homes, and lenders may be able to avoid the costs of foreclosure and the losses usually associated with selling a repossessed home.

Servicers of loans aim to minimize losses, and they appear to be actively working with thousands of individual borrowers to modify their mortgages. To some extent, the dispersed ownership of mortgages may combine with legal and accounting rules to make successful workouts more difficult to achieve. For example, the "pooling and servicing agreement" associated with a given securitized mortgage pool may restrict the share of accounts that can be modified. Accounting rules that, in some cases, require substantially modified pools to be brought back on the originator's balance sheet may dissuade lenders from undertaking workouts. And extensive modifications that reallocate expected cash flows across different securities associated with the pool could trigger a review of those securities by the ratings agencies. At the same time, if workouts are economically viable, then an incentive exists for third parties to purchase distressed pools at a discount and to undertake the workout process. We see these purchases taking place in the marketplace, a development that should help to increase the number of successful workouts.

Also, local community organizations that work to promote homeownership and prevent foreclosures have stepped up their efforts. For example, NeighborWorks America advises borrowers about restructuring their mortgages. A survey conducted by this group found that many homeowners do not understand that lenders also want to avoid foreclosure. Thus, the simple step of encouraging borrowers in trouble to contact their lenders can be very productive. The Federal Reserve and the other supervisory agencies have encouraged financial institutions to identify and contact borrowers who, with counseling and financial assistance, may be able to avoid entering delinquency or foreclosure. Indeed, some lenders are being proactive in this regard—for

example, by contacting borrowers to discuss possible options well before a scheduled interest-rate reset.

Possible regulatory responses

Looking forward, the Federal Reserve, other regulators, and the Congress must evaluate what we have learned from the recent episode and decide what additional regulation or oversight may be needed to prevent a recurrence. In deciding what actions to take, regulators must walk a fine line; we must do what we can to prevent abuses or bad practices, but at the same time we do not want to curtail responsible subprime lending or close off refinancing options that would be beneficial to borrowers. ♦

Footnotes

1. This estimate is based on data from the Mortgage Bankers Association, adjusted to reflect the limited coverage of the association's sample.
2. Near-prime loans include those securitized in "alt-A" pools and similar loans that are held on lenders' books.
3. Estimates of delinquencies are based on data from First American LoanPerformance. The rate of serious delinquencies for variable-rate subprime mortgages also reached about 11 percent in late 2001 and early 2002.
4. Foreclosure starts are based on data from the Mortgage Bankers Association, adjusted to reflect the limited coverage of their sample.
5. Many mortgage brokers are subject to minimum licensing standards and bonding or net worth criteria, but these standards and criteria vary across states.

The full text of Chairman Bernanke's speech is available at <http://www.federalreserve.gov/boarddocs/speeches/2007/20070517/default.htm>.

Case Making: Building a Pathway to Implementation



In the following article, M. von Nkosi, former director of the Mixed Income Communities Initiative (MICI) at the Atlanta Neighborhood Development Partnership (ANDP), shares his recent experience as a case study of how to move an agenda forward—whether it involves housing, transportation or health issues—by leading from a place of shared vision.

How do you move an agenda? How do you get people to buy in and support your cause so you can have an impact on regional change?

Combining a dedicated staff, volunteers from grassroots to Fortune 500, topflight consultants and strong financial support from philanthropic organizations and corporations, MICI has worked tirelessly to provide solid facts and figures about the need for more affordable housing in the Atlanta region. Over the past 10 years the organization has presented its findings to the business community, policy makers and the public at large. The discussion that follows presents some of the tools we used to help persuade our audience that this issue needs their immediate attention.

Funding and synergistic circumstances

MICI grew out of a solid, nonprofit organization, ANDP. Led by charismatic founder, president and CEO Hattie B. Dorsey (recently retired), ANDP supports affordable housing through real estate development, lending and advocacy. ANDP provided long-term resources for MICI totaling about \$800,000. Additional funds, including an initial kick-off of \$150,000 from the Terwilliger Family foundation in 1998 along with planning and matching grants from the Ford Foundation, have helped sustain and advance the work over time.

Several additional circumstances contributed to the synergy: A post-Olympic “bounce” in 1996 gave momentum to our efforts. The region’s negative EPA

designation brought attention to the need for change. In addition, other housing advocates and nonprofits were working on the issue of affordable housing, such as community development corporations (CDCs) and the Atlanta Community Food Bank, which for more than 10 years has hosted a monthly forum on housing affordability. Strong, charismatic, visionary leadership inside and outside of ANDP, supported by internal and external funds, helped foster a collaborative process. These foundational underpinnings lent added credibility to the housing affordability movement and allowed for strong buy-in by partners, volunteers and consultants.

Recruiting and keeping stakeholders at the table: building an atmosphere of safe space

Recognizing that the uneven growth of Atlanta profoundly affects the quality of life for all of the region's residents, ANDP established MICI in 1998 to focus attention on and promote dialogue about the connections between affordable housing and quality-of-life issues. It was clear from the very beginning that to move the agenda forward, it would be necessary to convene key economic and political stakeholders, as well as other advocacy groups, around the table to make sure that mixed-income housing became a basic component of regional planning.

By February of 2007, the network of individuals who comprised the MICI Committee had grown from about 5 people in 1998 to about 70, representing nearly as many organizations. The goal of the MICI committee was not to get everyone to agree about every decision, but to encourage people with different points of view to discuss the issues and come up with solutions to be considered by a wider audience. It was tantamount to MICI's success to make sure that major employers, planners, developers, environmental groups and others understood how affordable housing affected their concerns so they could take the message to their constituencies and make their own arguments.

Throughout the process, MICI committee members became our ambassadors and spokespersons by presenting reliable data to support their positions on the need for mixed-income and affordable housing. They spoke

to people who trusted and liked them, and this created instant credibility. By 2005, the MICI committee had taken ownership of the work and ANDP became mainly a facilitator of the MICI process.

Making the case: securing the facts

In 2003 after several years of discussing, fact-finding, committee building and developing case studies, members of the MICI committee decided that it was essential to make a "business case" for affordable housing in metro Atlanta. Although advocates in the region had done a great job for over a decade raising awareness about the need for affordable housing in our region, a gap persisted between the advocate's message and the audience that could influence major change.

The MICI staff was directed to help close this gap. The first item on the agenda was to obtain solid empirical data to support the need for additional affordable housing in our region as well as analysis of the barriers that prevented the region from achieving its housing goals.

THE FIRST ITEM ON THE AGENDA WAS TO OBTAIN SOLID EMPIRICAL DATA TO SUPPORT THE NEED FOR ADDITIONAL AFFORDABLE HOUSING IN OUR REGION.

MICI engaged some of the best researchers in the country, including the Center for Neighborhood Technology (CNT) in Chicago; Georgia Institute of Technology's Planning and GIS Departments; PolicyLink in Oakland, Ca. and New York City; and the Center for Quality Growth and Regional Development (CQGRD). These organizations and others were instrumental in providing convincing data about the lack of affordable housing and its impact on other quality-of-life indicators.

In mid-2004, MICI released a landmark study, "Making the Case for Mixed Income and Mixed Use Communities,"

which not only described the problem but also offered workable solutions. The document became a focal point for affordable housing advocacy, not only for ANDP but for many other organizations as well. (Visit www.andpi.org/mici to read the study or download the executive summary.)

Meeting people where they are (instead of where we want them to be)

Figuring out how to move different audiences toward action means learning how to “meet people where they are versus where we think they should be.” For example, ANDP has been working with homebuilders for years to help foster an understanding of the critical need for more affordable housing in the region. In MICI’s public policy work, the committee recommended pushing for mandatory inclusionary zoning, which requires developers to include affordable housing in projects above a certain size, as a way to get more affordable housing built. Developers often object to this strategy. However, through conversations we found that their opposition was not really an opposition to providing affordable housing; in fact many builders wanted to be able to meet housing needs. What they really objected to was governmental regulations and unfunded mandates that seemed intrusive.

In an effort to “meet the homebuilders where they are,” MICI agreed to help the homebuilders reduce regulatory barriers that thwart building a diversity of housing types. From the builders’ perspective, regulations at the municipal level inhibit their ability to produce affordable housing through exclusionary zoning practices. Requirements for large minimum lot sizes, large minimum house sizes, mandated exterior finishes and excessive parking requirements force construction cost up, which in turn raises the final sales price or rental rate for apartments. Here is the common ground that we found: by helping to eliminate exclusionary zoning practices, we could help to open up housing markets for the builders. MICI also works to ensure that inclusionary zoning ordinances feature incentives to make it more profitable for builders and developers to include below-market-rate units. An example of an incentive could be a density bonus to allow more units on a parcel than might otherwise be permitted.

Communicating key messages

Communicating key messages effectively to targeted audiences calls for a fundamental position statement that provides a framework to keep the communications plan focused on the core issue. This statement includes a primary message that defines community impact, supporting messages that show results, and customized messaging for different audiences.

For MICI, the business case for mixed-income and mixed-use housing was central and consisted of three broad categories that reflected the interests of the MICI committee members: data, policy and communications.

**AFFORDABLE HOUSING ISSUES
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A structure was established around these three categories and ultimately research was carried out to address these areas of interest. Delivery of these messages was based on a plan crafted by MICI’s communications subcommittee, which included professional public relations and communications input from Porter Novelli of Atlanta and PolicyLink of New York City. Messages were condensed, crafted and repackaged for the Case Executive Summary by a professional writer, David Goldberg of Smart Growth America.

Connecting the dots: land use, economics, transportation, housing and health

The next step in MICI’s housing work is to make one of its underlying principles explicit: namely, that affordable housing issues are closely connected to other concerns such as transportation, health, quality of life and economic development. The most recent version of MICI’s “Making the Case” document, available from

ANDP in April 2007, addresses the connection between housing and healthy environments as an economic development, business case.

Health issues are a perfect demonstration of the connections that link land use, economics, transportation, housing and a lack of social equity. Land use planning cases in which lower income housing is located in the least attractive areas of cities are all too common. Some of these locations may seem innocuous but really prove to be quite problematic.

For example, locating affordable housing near highway interchanges can have health implications. Recent studies have shown that children with asthma and the elderly are especially susceptible to particulate matter that exists in the air in extremely high concentrations near interstates and on/off ramps. This is an issue of social equity, but the implications for business development help to make the connection from highway design to city/regional planning, to business and to public policy.

This method of land use planning, which may seem cost-effective on the surface, can actually cost constituents more. For example, city residents may face higher taxes for public health care services because of increased emergency room visits, as lower income residents who cannot afford the high cost of health insurance tend to use the emergency room as their primary means of health care. From a more long-term perspective, affordable housing solutions that ignore healthcare issues can cost a municipality jobs. Companies won't want to locate people in cities deemed unhealthy.

Those concerned about public health can learn from the strategies that have helped the "green building" movement, which is starting to catch on because advocates have been presenting the issue from an economic, business point of view. Environmental organizations have understood this strategy of making a business case for ecologically sound decisions. Green building, once seen as a fringe issue, is now entering mainstream corporate culture.

To move an agenda effectively, it's important to help people look beyond their own professional expertise or life experiences to a bigger picture—a picture that enables them to see ways to make their job and lives easier. Organizations and research think tanks like

SMARTRAQ, CQGRD, Southface Energy Institute, the Georgia Conservancy through their BluePrints process, and the Health Policy Institute at the Joint Center for Political & Economic Studies in Washington, D.C., are all supporting similar cases. ANDP/MICI is pursuing its goals with the support of all of these other entities which have worked with MICI and helped us to operate from that place of a shared vision.

Conclusion

MICI moved its agenda through five key methods: building a good financial base, making the case, meeting people where they are, communicating key messages and connecting the dots. Leading an agenda, whether large or small, requires an understanding of these methods.

It is also important to convey how one concern ultimately affects others and that problems cannot be solved as separate issues but rather require a collective effort. In the MICI case study, analysis of land use, economics, transportation, housing and health were all shaped by concerns about the lack of social equity. MICI's role has been to help foster this understanding of connections and demonstrate those linkages to the community at large. ♦

This article was written by M. von Nkosi, president and CEO with The MXD Collaborative, Inc. in Atlanta. Mr. Nkosi is an architect and returned to private practice in February 2007 after leading the Mixed Income Communities Initiative (MICI) at ANDP since 1998.

FLORIDA



CREDIT UNIONS OPEN DOORS TO HOMEOWNERSHIP

An innovative organization in Florida's Tampa Bay area is providing home ownership opportunities for low- and moderate-income families. The Credit Union Housing Partners LLC has created a unique collaborative to bring Florida-based credit unions together with developers, community organizations and government agencies to support affordable housing initiatives.

In 2003, two Tampa credit unions, GTE Federal Credit Union and Suncoast Schools Federal Credit Union, joined forces to create a limited liability company, Credit Union Housing Partners (CUHP). The National Credit Union Foundation awarded a three-year matching grant to the organization in 2004 to provide homeownership opportunities for first-time homebuyers. Two additional partner credit unions, MacDill Federal Credit Union and Tampa Bay Federal Credit Union, have now come on board as well.

Partnership provides loans and counseling services

The goal of CUHP is to match those who want to buy homes with member credit unions offering competitive mortgage products. To reach this goal, CUHP provides potential homeowners with one-on-one services such as:

- membership with the appropriate credit union partner, based on eligibility requirements;
- financial counseling and group financial education classes in basic budgeting, credit report analysis and household financial planning to assist with homeownership and wealth building;
- homeownership advisory services including personal financial analysis, mortgage readiness analysis and advice about the homeownership process from pre-purchase to post-purchase;
- referral to various city and county programs that assist with down payments, provide homeownership education classes and inform clients about affordable new home developments.

Developing affordable housing

In addition to working with potential homebuyers, CUHP also arranges commercial residential development loans through the preferred lenders for creation of affordable housing. The organization has collaborated with private, government and faith-based partners to support several developments:

InTown Homes is an affordable, workforce housing development located in historic West Tampa. Seventy houses are slated for construction through this partnership among for-profit developers, CUHP and the City of Tampa. West Tampa Community Development Corporation and North Howard District will also join with CUHP to develop housing in West Tampa.

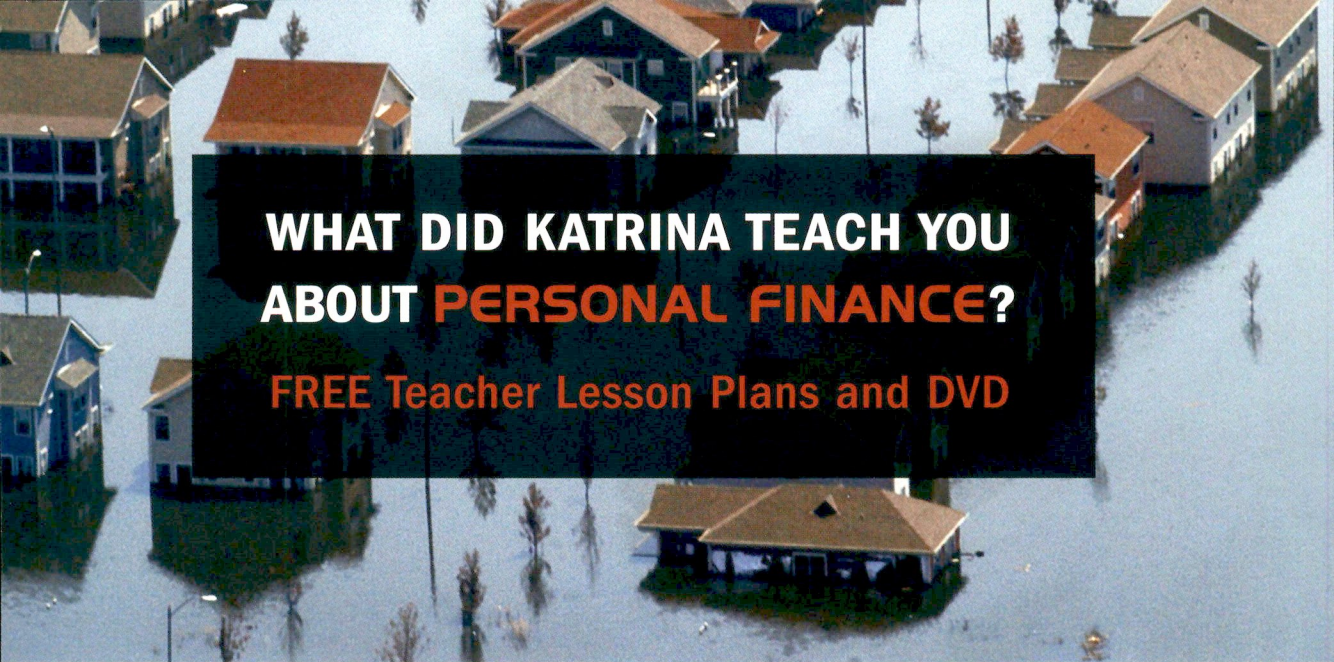
A USDA Self-Help housing development, Florida Home Partnership of Ruskin, will receive additional funding from Hillsborough County, and CUHP will provide some of the financing for homebuyers. To qualify, prospective homebuyers must earn 80 percent or less of the county median income. The development will include 205 homes.

Plant City Community Development Corporation, a partnership with a community-based nonprofit, is designed to revitalize an underserved rural community.

New Covenant Faith Initiatives Community Development Inc., located in Ocala, is a faith-based community organization working with CUHP to rebuild economically challenged neighborhoods with new homes.

Now completing its third year of operation, CUHP provides a model of best practices for other credit unions and financial institutions. By creating an organization staffed by housing professionals, this partnership enables Florida credit unions to participate in affordable mortgage lending. Such collaborations also support communities by providing additional resources for affordable, workforce housing development. ♦

This article was written by Janet Hamer, regional community development manager in the Atlanta Fed's Jacksonville branch.



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