FEDERAL RESERVE BANK of MINNEAPOLIS

Community Affairs Officer's note - Fall/Winter 1997

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Community Affairs Officer

We have heard from many lenders and community organizations that the availability of decent and affordable housing is a critical issue in their communities. This edition of *Community Dividend* was planned with just those comments in mind. Specifically, we will be examining ways to develop, finance and protect housing stock.

Our cover story on the successful completion of Hills Apartments in Deadwood, South Dakota, by Neighborhood Housing Services of the Black Hills offers insights into the challenges and opportunities for affordable housing development in small communities. An informative article on bank CDCs explores an innovative way for lenders and communities to form partnerships for housing and community development. Flood insurance is the topic of our third feature article. Although flood insurance is always an important issue for lenders, it is especially timely with the possibility of flooding still a concern in parts of the Ninth District.

As a special feature, we have included excerpts from a recent speech given by Nicolas Retsinas, assistant secretary for Housing-Federal Housing Commissioner for the U.S. Department of Housing and Urban Development. In Retsinas' speech, given at a South Dakota housing conference, he reminds us of the limits of today's prosperous economy and challenges us to redouble our efforts to reach the people who have been left behind.

A community's housing stock is one of its most valuable assets. We hope the information contained in these articles helps develop your understanding of the importance of investing in and protecting that asset.

Small town addresses big housing shortage

A Deadwood, S.D., housing organization works to satisfy the increasing need for affordable housing for local residents and commuting workers.

December 1, 1997

Deadwood, S.D., center of the Black Hills gold rush of the 1870s and '80s, is a community with a historic past and a thriving presence in the state's economy. Deadwood's economy is still driven by people seeking riches, but of a different sort. The state's legalization of limited-stakes gambling in 1989 has revitalized Deadwood by attracting tourists who enjoy gambling and appreciate the recreational opportunities and historical character of the community. Today, the streets of Deadwood are lined with more than 50 casinos, and the gambling industry has created hundreds of jobs. A portion of the gambling revenues goes to support Deadwood's historic preservation and local community services.

While the jobs and revenues from gambling have been substantial, the benefits have not been shared equally across the community. Escalating land and property values have made it difficult for casino workers to find decent and affordable housing in the community. Neighborhood Housing Services of the Black Hills (NHS), a nonprofit housing organization based in Deadwood, recognized an urgent need for affordable multifamily housing in the community. NHS, in partnership with a private developer, recently completed Hills Apartments in Deadwood to help meet that need.

Although the apartment project has been successfully completed, NHS faced many challenges and delays that highlight an affordable housing developer's need for patience and persistence. The difficulties the developers faced—among them the existence of a historic property on the site, not to mention the troublesome topography of the area—tell an interesting story about how to make affordable housing development happen in even the most challenging of circumstances.

Economic effect of gambling

Deadwood is a community of approximately 2,000 persons located in the heart of South Dakota's Black Hills. As the site of an 1876 gold rush, Deadwood gained notoriety for its prostitution and gambling, as well as for some of its more infamous residents, including Wild Bill Hickok and Calamity Jane. Most of the gold was exhausted by the late 1880s, and Deadwood underwent several boom and bust cycles over the next 100 years.

The latest boom cycle began in 1989 with the South Dakota legislature's legalization of limited-stakes gambling. William Ackerman, an assistant geography professor at Ohio State University's Lima campus, has studied the current "rebirth" of Deadwood. According to Ackerman, gambling in the community generated more than $43 million in taxes and fees from 1989 to 1995, and more than half of these revenues have been used for historic preservation activities in Deadwood. 1/

Gambling in Deadwood created many jobs quickly; estimates have ranged from 1,500 to 1,800 new jobs created by the casinos. 2/ About a third of these jobs were filled by Deadwood residents, and the balance was filled by commuters from surrounding towns, including Lead and Spearfish, S.D. While these jobs were and still are plentiful, they are also relatively low-paying. Ackerman estimates that the average annual wage of a casino worker in 1994 was $15,519, including tips. 3/

This combination of high job growth and modest wages has placed a substantial strain on Deadwood's affordable housing supply. Property values have increased with the booming economy, making homeownership even less affordable for first-time buyers and those of modest means.

The site's existing historic property was preserved and serves as an attractive front for this multifamily housing project.

Forming a community housing organization

The Deadwood Community Housing Organization (DCHO) was formed in late 1992 to address the community's growing housing shortage and affordability problems. DCHO members began meeting in early 1993 to discuss how to provide safe, decent and affordable housing in the city. They decided that a new rental housing development was needed to meet the needs of the substantial number of commuting casino workers.

According to Joy McCracken, DCHO executive director, the organization's vision for an affordable rental housing development received strong support from the community. The site of the proposed apartments did not disrupt any existing single-family-home neighborhoods, a fact that helped to limit any community opposition to the project.

In 1996, DCHO changed its name to Neighborhood Housing Services of the Black Hills and became a member of the NeighborWorks® network. NeighborWorks network is a national organization that includes Neighborhood Housing Services, mutual housing associations and similar community-based development organizations. NeighborWorks members receive technical and financial assistance from the Neighborhood Reinvestment Corp., established by Congress in 1978 to promote the creation of affordable housing across the country.

Although there are more than 170 NeighborWorks organizations nationwide, NHS is the only Neighborhood Housing Services organization in South Dakota and one of only two NeighborWorks member organizations in the state. According to McCracken, who continues to serve as executive director of NHS, the Neighborhood Reinvestment Corp. and the NeighborWorks network are important sources of technical assistance to NHS. They provide training, access to resources and assistance during the development process, which are critical to nonprofit organizations, especially small ones like NHS.

Site selection

After deciding that multifamily rental housing was the most critical need, NHS had to choose an appropriate site for the project, a challenging task indeed. Because Deadwood is located in the center of the rugged Black Hills, any new development is naturally constrained by the topography. Most of the city is built into the sides of hills, and the downtown area is in the valley. Furthermore, Deadwood is designated as a national historic landmark, making it nearly impossible to tear down any buildings for redevelopment.

NHS experienced significant limitations in selecting a development site. For example, it had to be large enough to accommodate 27 units and close enough to downtown to meet casino workers' needs. The site selected was one block from the main street, an ideal location for workers. However, the lot had a historic building on it that NHS wanted to preserve. Because of the community's strict historic preservation standards, the home (built by General George Custer's private secretary) had to be incorporated into the development and retain its historic character.

Assembling financing

After identifying an appropriate site, NHS began seeking funding from several sources. It took two years for the organization to assemble the entire financing package. The main source of funding was a $1.3 million, zero-interest mortgage using Home Investment Partnerships Program (HOME) funds provided by the South Dakota Housing Development Authority (SDHDA). Other sources of funding were historic tax credits, a grant from the Deadwood Historic Preservation Commission, an Affordable Housing Program grant from the Federal Home Loan Bank of Des Moines, a capital improvement grant from Neighborhood Reinvestment Corp., tax-increment financing (TIF) from the city of Deadwood and NHS's own equity investment.

Private lenders also participated in the project financing. Norwest Bank South Dakota, N.A., Deadwood branch, provided a loan for the TIF funds, and First Western Bank provided a construction loan for the project. The total development cost of the project was approximately $1.7 million.

Lessons learned

Neighborhood Housing Services of the Black Hills (NHS) learned several important lessons as a first-time developer of a rental housing project. First, the organization's staff members realized that they lacked the skills to serve as the project developer. According to NHS staff, the addition of a private development partner was critical to the project's success.

Second, dealing with site problems was expensive and time-consuming. NHS recommends completing a thorough site evaluation as soon as possible, and advises other developers not to be surprised if problems crop up that cost significant time and resources.

Third, the staff was surprised by the enormous amount of time and organizational resources the project consumed. According to NHS Executive Director Joy McCracken, the organization plans to do future projects on a smaller scale. Although the NHS is pleased with the project, it will probably focus more on homeownership training in the future and may consider developing single-family homes that are affordable to first-time buyers.

Development challenges

Although assembling the financing was difficult, NHS faced its real challenges after beginning the development process. It had originally planned to serve as the developer for the project, but the organization's staff members quickly realized that they lacked adequate expertise about design and construction issues to complete the project effectively. They decided to form a partnership with MetroPlains Development Inc., a private developer from St. Paul, Minn., to complete the project.

NHS originally approached MetroPlains for advice on the project and eventually decided to hand over the design and construction responsibilities entirely. Experience with historic rehabilitation was an important selection criteria for NHS, and MetroPlains had already renovated a historic hotel in Deadwood.

MetroPlains reevaluated the development plan created by NHS and determined that the original development budget was too low. Higher costs for labor and material meant that additional HOME funds had to be secured through SDHDA. MetroPlains uncovered several additional site challenges that added to the total development cost. These site difficulties delayed the completion of the project, which took four years from the initial planning to the finished apartments.

The topography of the Black Hills region and the site in particular created substantial design and development challenges. Site grading and drainage needed to be fixed, and the timing of these problems cost MetroPlains an entire winter of work. A creek that runs through the property interfered with a planned parking lot, so large culverts had to be installed to create adequate parking. The HOME funds paid for the culverts and parking, but they cost more than NHS originally estimated. In all, the site problems MetroPlains identified added $107,000 to the original budget.

The split-log-style facade of Hills Apartments complements the rugged natural surroundings.

Hills Apartments

After four years of planning and development, Hills Apartments were completed in mid-1997. The project has 27 units, including two one-bedroom units, 19 two-bedroom units, and six three-bedroom units; one unit is specially designed to be handicap-accessible. The apartments range in size from 350 square feet for the smallest one-bedroom unit to 960 square feet for a three-bedroom unit. Each apartment has a private entrance, new appliances and mini-blinds on all windows.

The project consists of the historic property (a rehabilitated triplex) and 24 new units built behind the historic home. The new apartments, handsomely adorned with split-log siding on the lower half to blend with the natural surroundings, are bordered on three sides by national forests, making for a beautiful view in a convenient location.

The units rent for $225 to $425 per month. According to McCracken, these prices are very low compared with similar rental units in the area.

Because of the constraints of some of the funding sources, the units have specific income targets. Fifty percent of the units are targeted to individuals or families with incomes at or below 50 percent of the area median income (AMI). Forty percent of the units are targeted to people below 60 percent of the AMI, and 10 percent are targeted to people at or below 80 percent of the AMI. The median income for a family of four in the Deadwood area is $37,500, so a family of that size must have an income of less than $30,000 to reside in the project.

Project update

The project received its occupancy certificate August 5, 1997, and 70 percent of the units were leased by mid-October. Most of the residents had lived outside Deadwood, which means that the project is meeting its goal of providing adequate housing in town for commuting casino workers.

Hills Apartments resident Leotta Keyser is a good example of the positive effect of the project. Keyser had been commuting from Sturgis, S.D., for the past two years, which could be a long and stressful trip, especially during poor winter weather conditions. Not surprisingly, Keyser was excited to move into Hills Apartments in August, and she now enjoys walking to work rather than having to drive. What's more, she can work more hours—and earn more money—since her daily travel time declined from 50 minutes to 5 minutes.

According to Keyser, the benefits of residing in Hills Apartments are many. "I like living in a brand new apartment. It's so convenient and I feel more stable in my position at work since I know I'll be able to get there if they need me," she says.

With attractive and affordable homes in a convenient location, demand for Hills Apartments promises to be high among the residents of Deadwood and its surrounding communities.

Related links

NeighborWorks®

South Dakota Housing Development Authority

1/ William Ackerman, *Rural Development Perspectives*, vol. 11, no. 2

2/ Ackerman. Interview with Joy McCracken.

3/ Ackerman.

Assistant Secretary Retsinas' speech highlights housing conference

Community Dividend presents excerpts from a speech that Nicholas Retsinas, HUD Assistant Secretary for Housing-Federal Housing Commissioner, delivered to a South Dakota housing conference.

December 1, 1997

AUTHOR

Nicholas Retsinas

Nearly 200 housing professionals from across South Dakota and neighboring states attended the Seventh Annual South Dakota Housing Development Authority (SDHDA) Statewide Housing Conference held Oct. 16-17 in Pierre, S.D. The conference was cosponsored by the SDHDA, USDA Rural Development and the Federal Reserve Bank of Minneapolis.

The conference keynote speaker was Nicolas Retsinas, assistant secretary for Housing-Federal Housing Commissioner, U.S. Department of Housing and Urban Development. Community Dividend *is pleased to present excerpts of Retsinas' speech.*

I was pleased to note the title of your conference today, "Partnering for Housing Development . . . One Community at a Time." The key word, of course, is "partnering."

I've been with this department a little over four years, and as I reflect back, what I think I've learned the most is how humbling the responsibilities are. And how naïve for any one entity, even the federal government, to think that it and it alone could address the diversity and depth of needs throughout the country.

Changing roles

I wish I could tell you today that we could turn the clock back 20 years and if you had a peach of a project to do, all you need to do is to apply to one place, get the money, do the project and walk away happy. But it doesn't work that way anymore. I go to ribbon-cutting ceremonies and groundbreakings all the time. It seems every time I go to one, there are more and more people—partners—standing up there with me. You almost need a scorecard to keep track of all of them. I understand the transaction costs to putting all of the partners and programs together. But the reality is that's how it works today.

The other big difference today from 10 to 15 years ago is that the leadership responsibility is now yours. It wasn't always that way. If you look at the history of community development in this country, in many ways most of the new ideas—and certainly most of the new money—came from Washington. The antipoverty programs, the urban renewal programs, the Federal Housing Administration, which revolutionized the mortgage industry in this country—all of them were federal government initiatives. But in 1997, the leadership has to be at the local level. You have to figure out what you want to do and how you want to do it. The challenge for us in the federal government is to be there with you.

When we talk about the role of the federal government being changed to more of a partner and less of a leader, that is not an excuse for us to abandon our responsibilities. We still have a role to play. I recall two years ago the debate in Washington about whether the Department of Housing and Urban Development, among other departments, was to be eliminated. My position on that was and is very simple. I would be happy to support eliminating HUD when every American family lives in decent, safe and sanitary housing, when every community is revitalized and when there are equitable opportunities for all. When that day comes, then I'll go home. But we are a long, long way from that day.

Maintaining focus

These are fascinating times. Every day we read about our booming economy. Generally speaking, it *is*booming in terms of job growth and the employment rate, and we seem to have inflation under control. It is a wonderful economy. While there are pockets that are not booming and how long this boom can be sustained is a matter of some debate, certainly in the near term it has been remarkable. Yet

something is still missing.

A booming economy cannot be the only measure of greatness of a country. It's wonderful that we've passed 8,000 in the Dow Jones index. And maybe we're on our way to 9,000 and maybe even 10,000. That's wonderful for all of your 401(k)s and your stock market investments, but when I visit communities, I still see people struggling. I see families and the elderly wondering what is going to happen to them. I see single parents somehow trying to balance two jobs and raise their children. And when I talk to them about the Dow Jones, it doesn't seem to resonate. I'm almost embarrassed to talk about it. There has to be a different measure, and that is what you are about. It's one community at a time, one family at a time, one household at a time.

If we can't figure out these issues, if we can't address these issues of affordable housing and community development in the current economic environment, then shame on us. Because some day, the business cycle will turn. And as difficult as the choices are now, they will become much more difficult in the future. The challenge for us is not to lose sight of that, not to be lulled into what we have been doing, but to understand that now is the time to redouble our efforts.

In closing, I'd like to remind you of a quote from the great Senator Hubert Humphrey, who once said, "The moral test of government is how it treats those who are in the dawn of life—the children; those who are in the twilight of life—the aged; those who are in the shadows of life—the sick, the needy and the handicapped."

I wish I could say to you, "I'm here from Washington, not to worry." No. I'm here from Washington to say, "Yes, we will be with you, but you need to tell us where we need to be. We'll be listening, but you need to lead us."

Bank CDCs: Building partnerships for community development

Bank CDCs are tools for promoting economic and community development that have gained popularity in communities across the country.

December 1, 1997

What community development tool is (1) a potential source of untapped private equity capital in many communities; (2) may result in Community Reinvestment Act (CRA) credit for lenders; and (3) has a history of success in economic development, small business creation and affordable housing development in both rural and urban areas?

The answer is the bank community development corporation, known as the bank CDC. A bank CDC is a tool for promoting economic and community development that has gained popularity in communities across the country. Although the use of bank CDCs has expanded in the past several years, many banks still hesitate to pursue forming and investing in a CDC because of perceptions about complexity and cost.

Although there are costs and risks associated with a bank CDC, this type of organization can offer many benefits to a community with unmet credit and investment needs. For example, the bank CDC structure allows banks and holding companies to make equity investments in community development projects. These equity investments are subject to limits specified by the bank's regulator. Bank CDCs can also develop innovative debt instruments or provide near-equity investments tailored to the development needs of the community as well as to the financial and marketing needs of the bank.

Detailed below are the major considerations involved in the formation of a bank CDC. They include who should be involved in a bank CDC, why it makes sense to form a bank CDC, how a bank CDC might be organized, what the challenges are and how to get started.

Who should be involved

Banks with an interest in new opportunities for community development lending and with resources to invest should consider involvement in a bank CDC. Bank CDC investors can begin with debt-financing or equity-investment instruments, depending on the needs of CDC partners and the goals of the organization. Many bank CDCs offer a combination of debt and equity instruments to balance risk and return, as well as to meet the needs of the prospective clients. Banks do not have to be large or have substantial staff and resources to become involved in a bank CDC; they can choose their level of involvement in a bank CDC based on available resources.

Reasons to form a bank CDC

Banks, communities and local businesses have several reasons to work together to form a bank CDC. One of the most important reasons is that it is good business. There have been many success stories of profitable and effective bank CDCs in the areas of housing, small business creation and economic development. For example, equity contributions from the First Bank System CDC, based in Minneapolis, have assisted in the creation of many units of affordable housing in communities across the First Bank System service area. For example, the First Bank CDC has provided $2.7 million in equity to a Dakota County project to build 30 units of affordable housing in Eagan, Minn., and $2.3 million to help build 48 units of senior affordable housing in Hibbing, Minn.

Another important feature of the bank CDC model is that it works well in both distressed urban centers and struggling rural communities and for a wide range of community development projects. For example, Minnesota's Community Development Corporation (MCDC) is a multi-investor CDC in Park Rapids, Minn., a city of 2,800 people in northwestern Minnesota. MCDC completed construction of a 12-unit affordable rental townhouse project in Menagha, Minn., that is fully leased and has a waiting list. MCDC is also building a single-family home in Badger, Minn., and hopes to build more affordable homes in MCDC investor communities. In economic development, MCDC participated in financing the purchase of a large snack food company that preserved more than 250 jobs for the local area.

For many investor banks, the bank CDC is an important component of their obligation to address unmet community credit needs under CRA. Bank CDC lending and investments in low- and moderate-income geographies are viewed favorably under CRA, especially to the extent that the investments are complex or innovative in addressing the credit needs of the target businesses and communities.

Although investors should not enter into a bank CDC for the sole purpose of obtaining CRA credit, bank CDC investments can serve as evidence of the bank's commitment to meeting its obligation under CRA.

CitiHousing, Inc., a CDC of Citibank (South Dakota), N.A., is an example of another success in this arena. It has formed three equity pools that have made $20 million available to purchase tax credits for affordable housing development in South Dakota during the past four years. By October 1997, CitiHousing, Inc., made equity investments in three projects that helped provide 128 units of affordable multifamily housing. In all, the three equity pools have made equity investments in eight projects that helped provide 359 units of affordable multifamily housing across South Dakota.

According to Gene Rowenhorst, CitiHousing, Inc.'s senior vice president, "Tax credits provide a good return to investors and provide quality, affordable housing to South Dakota communities."

Investment in a bank CDC also offers banks a unique opportunity to highlight their commitment to the community and attract new customers. The marketing benefits of CDC participation can be significant. Bank investors are often positively associated with community development, and new customers may be attracted to the participating banks. Increased visibility in low- and moderate-income geographies may result in penetration into new markets and an expanded customer base.

How bank CDCs are organized

Bank CDCs may be structured in a variety of ways, depending on the needs of the investors and communities they serve. The costs and benefits of each organizational structure are evaluated by possible investors. Items potential investors consider include start-up and operational costs, amount of control over loans and investments, level of risk and expected return.

A CDC may be structured as a subsidiary corporation of a bank or it may be managed by a parent bank holding company. For example, the Anoka/Sherburne County Capital Fund (highlighted in the Summer 1997 issue of *Community Dividend*) is structured as a subsidiary of Norwest Bank Minnesota, N.A., although Norwest is only one of several bank and private investors in the CDC. Southern Development Bancorporation, Arkadelphia, Ark., well known for its success in rural economic development in Arkansas, is structured as a bank holding company that invests in not-for-profit and for-profit corporations.

A bank CDC can be wholly owned by a single bank or it can be structured as a multibank CDC with several bank investors. Like MCDC, it can also be structured as a multi-investor bank CDC, which brings utility companies, governmental entities, local corporations and others in partnership with lending institutions. Creating a consortium of investors in a multi-investor or multibank CDC can be an effective strategy for smaller banks or communities. This organizational form allows all investors to share the costs of establishing and staffing the CDC, and the CDC will have access to more resources than if it had been funded by only one investor.

The challenges

Although CDCs can create positive opportunities for lenders and communities, there are costs and challenges that should be carefully considered before beginning a CDC. Starting and operating a CDC can be time- and resource-intensive. If the CDC will be involved in purchasing tax credits, legal and tax advisors must be hired, which can be quite expensive.

Staffing the CDC can be another substantial expense, even if the costs are shared among several investors. Some CDCs are run by a volunteer board to reduce staff and operating expenses, but the board members may lack time to meet all the needs of the organization. One example of a board-run CDC is the Rapid City CDC, Rapid City, S.D., which has six investors but no paid staff. Board members are fully responsible for the operation of the CDC.

According to Bonnie Hughes, Rapid City CDC chair, the organization has been able to assist in the development of several units of affordable housing in Rapid City. However, board members' limited time makes it difficult to expand the activities of the CDC in new directions and consider other opportunities for the organization.

How to get started

Bankers

Begin the process with an assessment of your area's economic and community development needs as well as the demand for loans and equity investments in local projects. Talk with the local economic development association, small-business owners and your customers about needs and opportunities in the community. Consider the loan requests that have crossed your desk that could not be approved under traditional underwriting standards, but which you believe have a community development purpose and good potential for success. Consider your financial position and the resources you would be willing to commit to a CDC. Analyze your relative interest in making equity investments versus offering debt financing and the levels of risk and return you expect. If you are interested in forming a CDC but would like partners, talk with other bankers, utility companies, local corporations and other potential investors in your community about getting involved.

Finally, discuss your plans with your federal banking regulator to be certain your activities will meet regulatory guidelines. The common thread among all bank CDCs is that their investments must have a community development purpose. Requirements for meeting this standard vary somewhat by regulator, but all regulators require some type of public, civic, community or economic development purpose before the CDC will be permitted under banking laws and regulations. Common eligible purposes include the creation of jobs and affordable housing for low- and moderate-income individuals and lending and investment for small business creation and expansion.

Economic development associations

Recognize that a CDC can be an important new source of funding to address unmet credit and investment needs in your community. To show the potential value of a CDC to the community, develop an assessment of the area's financial needs from the perspectives of a wide range of community members. Gather bankers to discuss the CDC and why you think it would work in your community. Make an effort to commit some resources to get the project started. Economic development association support—especially technical assistance—during the initial phases of the project can be a valuable contribution to the success of the bank CDC. Finally, consider ongoing involvement in the CDC, depending on the needs of the investors.

Conclusion

Bank CDCs offer communities and banks an important opportunity to build partnerships and use scarce resources for local development more effectively. Although it is not a solution for all community development needs, a bank CDC is worth investigation for those bankers and other partners committed to improving their communities through increased access to lending and investment.

CD-ROM with CRA aggregate and disclosure data is available

The Federal Financial Institutions Examination Council (FFIEC) has announced the availability of a CD-ROM with 1996 data on small business, small farm and community development lending reported by large commercial banks and savings associations subject to the Community Reinvestment Act (CRA). The CD-ROM is inexpensive ($10), easy to use and provides instructions on how to retrieve aggregate and disclosure reports.
The regulations that implement CRA were revised substantially in 1995 to make CRA assessments more performance-based, more objective and less burdensome. One of the more significant changes to the regulation requires larger commercial banks and savings associations to collect and report data regarding the geographic locations of their small business and small farm loans. From these data submissions, FFIEC prepares an electronic disclosure statement for each institution, as well as an aggregate disclosure report for each metropolitan statistical area and nonmetropolitan county in the United States and Puerto Rico.

The 1996 data reflect originations and purchases of small business and small farm loans from 2,078 institutions, including 1,744 commercial banks and 334 savings associations. These organizations include independent institutions with total assets of $250 million or more and institutions of any size if owned by a holding company that has assets of $1 billion of more.

Reported for 1996 were 2.4 million small business loans totaling $147 billion and 216,000 small farm loans totaling $10 billion. The majority of small business loans (56 percent) and most small farm loans (88 percent) were extended to firms with revenues of $1 million or less. The vast majority of small business and small farm loans (about 87 percent) were for amounts less than $100,000. Regional variations in the number and amount of small business and small farm loans closely follow the differences in the number of business establishments, farms and farm revenues across the nine U.S. Census regions. Variations in small business lending across census tracts grouped by income generally align with the distribution of the population across these areas. The majority of small farm lending occurs in middle-income areas.

For 1996, 1,156 of the 2,078 lenders reported community development loans that totaled nearly $18 billion. A community development loan has as its primary purpose community development as defined by CRA and has not been reported as a home mortgage (under the Home Mortgage Disclosure Act [HMDA]), small business or small farm loan (unless it is a multifamily dwelling loan). Community development as defined by CRA includes affordable housing for low- and moderate-income individuals, activities that promote economic development by financing small businesses and small

farms, or activities that revitalize and stabilize low- and moderate-income geographies. The typical community development loan ($542,000) was relatively large compared with the average small business and small farm loans ($61,000 and $48,000, respectively).

The aggregate disclosure statements underlying these summary statistics will be available for public inspection at central depositories throughout the nation. The HMDA/CRA data order form and the location of the central depository for a metropolitan statistical area are available on the Internet at http://www.ffiec.gov.

You can receive a CD-ROM order form by calling the Federal Reserve System's CRA Assistance Line in Washington, D.C., at (202) 872-7584. You can return the order form and $10 payment by mail or fax.

Flood insurance helps manage risk of financial loss

Answers to questions about the National Flood Insurance Reform Act of 1994's technical requirements.

December 1, 1997

AUTHOR

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Recall the spring of 1997. If you lived or worked in the Midwest, you undoubtedly will remember the floods that ravaged many Ninth District communities. As lenders and real estate owners recall the vast flooding, their thoughts eventually return to the property loss. Rightly so, according to Lesli A. Rucker, federal coordinating officer for the Federal Emergency Management Agency (FEMA). Rucker reminds us that "year in and year out, flooding is the leading cause of property loss from natural disasters in this country." 1/ As demonstrated last spring, while flooding presents various unknown risks to lenders and real estate owners, flood insurance offers one means of managing the potential risk of financial loss.

The U.S. Congress authorized the National Flood Insurance Program (NFIP) through the National Flood Insurance Act of 1968. At its inception, NFIP provided an opportunity for property owners to purchase voluntary, federal government-subsidized flood insurance protection for their structures and contents at or below actuarial rates. Because this voluntary flood insurance program lacked sufficient participation, Congress enacted the Flood Disaster Protection Act of 1973 (FDPA of 1973) to mandate flood insurance coverage for many types of properties. FDPA of 1973 was a direct response to findings that few people whose properties sustained damage during major flooding disasters had purchased flood insurance.

Despite the mandatory purchase requirement set forth in FDPA of 1973, program participation remained low. According to FEMA, statistics show that the new, weak-sanctioned mandatory program yielded still too few subscribers. This situation changed in the middle 1990s. Congress responded to the widespread flooding in the Midwest in 1993 by enacting the National Flood Insurance Reform Act of 1994 (NFIRA of 1994). NFIRA of 1994 not only continued the mandatory flood insurance program but established severe sanctions for those who fail to comply with the mandatory insurance purchase provisions, among others.

According to FEMA, NFIRA of 1994 has a provision that limits the future availability of disaster relief for some flood victims. FEMA says that as a condition of NFIRA of 1994, residents who live in a floodplain and have received disaster assistance must purchase and maintain flood insurance to be eligible for similar help in the future. 2/ Despite the mandatory purchase requirement and the disaster-relief limitation, participation in NFIP apparently remains low: only one in five homeowners with properties in flood-zone areas currently participates. 3/

NFIP is more than just a flood insurance program, however. It is also a hazard-mitigation program that awards communities that adopt plans to mitigate potential flood damage. These communities, known as participating communities, become eligible to participate in the NFIP by:

- adopting and enforcing floodplain management measures to regulate new construction; and
- ensuring that substantial improvements to existing structures within its special flood hazard areas (SFHA) are designed to eliminate or minimize future flood damage.

What is improved real property?

Improved real property is simply real estate upon which a building is located. Anyone who has tried to apply this definition, however, knows it is not quite so simple. FEMA provides more guidance by defining the term "building." For purposes of the National Flood Insurance Program, a building is separated from other buildings by intervening clear space or solid, vertical, load-bearing division walls; is walled and roofed; is principally above ground and affixed to a permanent site. The definition of building includes buildings in the course of construction, alteration or repair as well as manufactured (mobile) homes on foundations. The federal regulators have adopted the following definition of building: it means a walled and roofed structure, other than a gas or liquid storage tank, that is principally above ground and a permanent site, and a walled and roofed structure while in the course of construction, alteration or repair. Informal discussions with FEMA revealed that a structure must have at least two stiff walls to be considered a walled building.

SFHAs are areas within a floodplain that have a 1 percent or greater chance of flood occurrence within a given year. FEMA defines SFHAs and issues maps showing the location of such areas. Most owners of improved real property located within a participating community's SFHA are eligible to purchase NFIP flood insurance.

Different rules apply to people and businesses in nonparticipating communities. For them, NFIP insurance is not available at all. At one time, lenders were not permitted to extend conventional loans secured by improved real property in a nonparticipating community's SFHAs. Pursuant to a 1977 amendment to the law, lenders are now allowed to do so; however, some government loans are still not available in these communities. When extending loans in SFHAs in nonparticipating communities, lenders must give special consideration to the additional collateral risk presented by these loans. This potential flood loss risk occasionally results in the lender requiring the borrower to acquire flood insurance through a private provider.

This understanding of NFIP's evolution often prompts several questions about NFIRA of 1994's technical requirements. Although this article does not address all the nuances of NFIP, it does describe some of the more basic aspects of the program.

Who is subject to the mandatory flood insurance provisions of NFIRA of 1994?

Surprisingly, the answer is not the owner of an improved real property located within an SFHA. The law is directed at lenders. More specifically, it is directed at three classes of lenders: federally regulated lenders, government-sponsored enterprises (GSE) and federal agency lenders.

Federally regulated lenders are financial institutions regulated by the Board of Governors of the Federal Reserve System, the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the Office of Thrift Supervision, the National Credit Union Administration and the Farm Credit Administration. Since the enactment of NFIRA of 1994, the definition of federally regulated lender has been interpreted to include subsidiary service corporations of mortgage lenders.

GSEs are privately owned, federally chartered corporations. The most familiar GSEs are the Federal National Mortgage Association (Fannie Mae), the Federal Home Loan Mortgage Corporation (Freddie Mac) and the Government National Mortgage Association (Ginnie Mae). These organizations support residential housing ownership by creating a secondary market for residential real estate loans. Any lender that sells loans to a GSE will be subject to the mandatory flood insurance requirements because these enterprises are required by law to implement procedures designed to ensure that borrowers using improved real property in an SFHA for loan collateral have flood insurance.

Federal agency lenders are public agencies. These agencies are familiar to most people involved in residential real estate or small business lending and include the Federal Housing Administration, the Small Business Administration, and the Department of Veterans Affairs. Although there are some exceptions, these agencies generally require flood insurance for loans secured by improved real property located in SFHAs. None of these agencies can subsidize, insure or guarantee any loan if the property securing the loans is in an SFHA of a community not participating in NFIP.

What is insurable under NFIRA of 1994?

The mandatory flood provisions apply to most improved real property that secures a loan. Generally speaking, the law applies to buildings and mobile homes, not raw land. It requires the lenders described above to ensure that any loan secured by improved real property in a participating community's SFHA has flood insurance covering buildings, mobile homes and personal property. More specifically, if a lender takes a security interest in an improved real property and the the contents of that property, both elements must be covered by flood insurance. Conversely, if a lender takes a security interest only in contents (which will be located in an SFHA) but does not take a security interest in the improved real property, no flood insurance is required. The latter situation raises questions about the soundness of such a loan, and FEMA encourages lenders to advise borrowers to include contents coverage for personal and business items when it is prudent to do so.

Note that it is the structures, not merely the land, that must be within the SFHA. Additionally, when securing a loan with a mobile home, the lender must require flood insurance regardless of whether the collateral includes the underlying real property. To qualify for flood insurance, however, the mobile home must be attached to a permanent foundation. In other words, if an improvement can float away, it is not insurable. (Finally, when taking a security interest in improved real property where the value of the land, excluding the value of the improvements, is sufficient collateral for the debt, the lender must nonetheless require flood insurance if the structure is located in a participating community's SFHA.)

Where must an improved real property be located to be insurable under NFIP?

The improved real property must be in a participating community to be insurable. FEMA issues maps through its Map Service Center, which can be reached at (800) 358-9619. The law now requires a lender to document its conclusions about whether improved real property securing a loan is located in an SFHA. FEMA has developed the Special Flood Hazard Determination Form for this purpose.

How do you calculate the amount of required flood insurance?

As noted, NFIRA of 1994 applies to structures, not land. Flood insurance is available only for potential losses to buildings and mobile homes. The law sets the maximum limits for buildings at $250,000 for residential structures and $500,000 for nonresidential structures. It sets the limits for contents of residential and nonresidential structures at $100,000 and $500,000, respectively.

To calculate the insurable value of improved real property located in an SFHA, a lender must determine the overall value of the property less the value of the land. FEMA recommends that lenders follow the same practice for determining coverage for flood insurance as they follow for establishing hazard insurance coverage. It is very important to calculate the insurable value of the property, otherwise the lender might inadvertently require the borrower to pay for too much or too little flood insurance coverage. For example, if the lender fails to deduct the value of the land when determining the insurable value of the improved real property, the borrower will incur unnecessary charges by paying for coverage that exceeds the amount NFIP will pay in the event of a loss. After calculating the insurable value of the improved real estate, the lender must compare that value with the outstanding principal balance of the loan and require flood insurance for that amount or the maximum amount of flood insurance allowable under NFIP, whichever is less.

In addition to the maximum insurable values, NFIP set additional recovery limits. For residential properties, NFIP pays losses on the basis of replacement value for primary residences where the insured has purchased insurance of up to at least 80% of the replacement cost of the structure. This policy is intended to include the full cost of repair or replacement without deduction for depreciation. For a nonresidential property, the recovery limit is the actual cash value, which is intended to include repair and replacement costs less depreciation.

When must lenders require flood insurance?

The general rule is lenders must require borrowers to obtain flood insurance when making, increasing, extending or renewing any loans secured by improved real property located in an SFHA. A refinancing of an existing loan is the equivalent of making a new loan for purposes of the mandatory flood insurance purchase requirements. The mandatory flood insurance requirement continues for as long as the loan is secured by improved real property located in a participating community's SFHA.

Some lenders might be presented with a situation where borrowers fail to maintain sufficient insurance during the life of the loan. In the case of an uninsured or underinsured property, the NFIRA of 1994 obligates the lender to force place the insurance once specific conditions are fulfilled. First, the lender must issue a notice that the borrower should purchase sufficient flood insurance at his or her own expense. The borrower is allowed 45 days to acquire sufficient flood insurance. If the borrower fails to comply within 45 days, the lender must purchase the flood insurance. If the improved real property is located in an SFHA, the law allows the lender to assess the cost of the insurance to the borrower.

Many lenders have third-party service providers conduct flood zone determinations during the underwriting process. Many of these service providers also monitor the status of their determination throughout the life of a loan. Although the life-of-loan monitoring is not required by law, it provides lenders with information about changes to the flood-hazard status of these types of loans secured by improved real property located in an SFHA.

NFIRA of 1994 provides two exceptions to the general rule that flood insurance is required whenever a lender makes, increases, extends or renews any loan secured by improved real property located in an SFHA. The first exception is for small loans and provides that the mandatory flood insurance requirement does not apply to any loan made with an original outstanding principal balance of $5,000 or less and with a repayment term of one year or less. The other exception applies to certain state-owned property.

What notice must the lender provide to borrowers who secure loans with improved real property located in an SFHA?

Lenders must provide a Notice of Special Flood Hazard and Availability of Federal Disaster Relief Assistance to loan applicants who propose to secure the loan with improved real property located in an SFHA, regardless of whether it is in a participating community. Lenders must provide this notice within a reasonable time, interpreted as 10 days, before closing a loan transaction. FEMA has issued a model form for lenders.

What are the penalties for failing to comply with NFIRA of 1994?

With NFIRA of 1994, regulators can now assess civil money penalties if a lender engages in a pattern or practice of committing violations. Four types of violations are subject to civil money penalties. The violations include failure to:

- place insurance;
- escrow flood insurance premiums when required by law;
- provide notices; and
- force place insurance.

The statutory civil money penalties limit is $350 per individual violation; the aggregate penalty amount is $100,000 per year.
The flood insurance rules are complicated, but it is critical for people in the housing industry to have a sound understanding of these rules. To increase awareness of the flood insurance program, FEMA has published a pamphlet entitled "Mandatory Purchase of Flood Insurance Guidelines." It describes how NFIRA of 1994 extends the waiting period before NFIP insurance policies can become effective from five days to 30 days. Given the extended waiting period, people have less opportunity to purchase flood insurance when faced with imminent flooding. Perhaps now more than ever before, it is important for lenders to establish sound policies and procedures for requiring flood insurance.

Related links

FEMA

FEMA—NFIP

FEMA Map Service Center

NFIP Forms Room

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1/ FEMA News Desk: FEMA-North Dakota Flood 1997

2/ Ibid.

3/ FRB Boston *Regional Review*, Summer 1997

Community Reinvestment Resources (Community Dividend, Fall/Winter 1997)

For free copies of recent issues of Community Dividend, community development articles or newsletters from other Federal Reserve Banks, contact Community Affairs at the Federal Reserve Bank of Minneapolis at (612) 204-5074.
Community Dividend
Summer 1997: Recycling resources; Success of the Community Reinvestment Fund; Spotlight on Anoka/Sherburne County Capital Fund
Spring 1997: Credit scoring and small business loans
Winter 1996/1997: Ninth District corporation is awarded CDFI funds
Fall 1996: What is Community Affairs?

Housing Development
StoneSoup-The NeighborWorks Partnership Report is a free newsletter for public and nonprofit corporations striving to revitalize distressed communities by mobilizing public, private and community resources at the neighborhood level. To subscribe to *StoneSoup* or for more information on neighborhood reinvestment, contact Neighborhood Reinvestment Corp., 1325 G St. N.W., Suite 800,Washington, DC 20005; (202) 376-2000.

Housing Assistance Council
HAC News is a free biweekly newsletter that features information on rural, low-income housing issues. For more information on *HAC News* or the more than 100 other publications the council publishes, contact HAC at 1025 Vermont Ave., N.W., Suite 606, Washington, DC 20005; (202) 842-8600 or http://www.ruralhome.org.
Community and Economic Development
Community Development Investments-A Guide for State Member Banks and Bank Holding Companies is a brochure that provides guidance to state member banks and bank holding companies about the formation of community development corporations and other uses of equity investments for community development. Contact the Federal Reserve Bank of Minneapolis, Community Affairs, at (612) 204-5074.

The Economic Development Digest is a free report published 10 times a year for the economic development community by the National Association of Development Organizations Research Foundation (NADO). Contact NADO at 444 N. Capitol St., N.W., Suite 630, Washington, DC 20001; (202) 624-7806, or http://www.nado.org/pubs/digest.html.

Economic Development Where It's Needed: Directing SBA 504 Lending to Lower-

Income Communities, written by Daniel Immergluck and Erin Mullen, is a 22-page publication that analyzes lending patterns for the SBA 504 loan program. It also examines how many loans went to minority-owned businesses and to lower-income areas from 1992 to 1996. Nonprofit/government cost: $12 each, for-profit cost: $25 each. Contact the Woodstock Institute at 407 S. Dearborn, Chicago, IL 60605; e-mail woodstck@wwa.com; web site http://www.nonprofit.net/woodstock/.

Where to get lists of CRA ratings and future CRA evaluations

Listed below are Internet addresses through which you can obtain CRA ratings and schedules for upcoming CRA evaluations.

Federal Financial Institutions Examination Council (FFIEC)

http://www.ffiec.gov

(This site contains the CRA regulation, Interagency CRA Interpretive Letters, FFIEC examination procedures, and common questions and answers about CRA. It also provides links to the CRA home pages of each of the federal banking regulatory agencies.)

Federal Reserve Board

http://www.federalreserve.gov/
DCCA/CRA/examsch.htm

Federal Deposit Insurance Corporation

http://www.fdic.gov/
databank/qbp/excra.html

Office of the Comptroller of the Currency

http://www.occ.treas.gov
/cra/cra.htm

Office of Thrift Supervision

http://www.ots.treas.gov/
news.html

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