FEDERAL RESERVE BANK
OF SAN FRANCISCO

Community Investments Vol 15, Issue 2 Announcing the Launch of the Center for Community Development Investments

Author(s): John Olson, Community Affairs Specialist, Federal Reserve Bank of San Francisco
August 2003

In this issue of *Community Investments*, we are pleased to introduce the Center for Community Development Investments, an online clearinghouse of community development investment resources. On the Center website, you will find:

- a listing of community development investments with explanations of how they work and how they are booked;
- comprehensive regulatory resources on the Investment Test, the CRA exam process, and investment authority;
- directories of investment opportunities gleaned from actual CRA examinations;
- original research on Investment Test performances and ratings; and
- links to community development investment training opportunities and conferences.

An advisory committee made up of a group of industry experts helped us create the Center and will work with us to ensure it is relevant to you.

Financial institution investors and others have become increasingly knowledgeable about community development investments, and the field continues to grow in size and complexity. The continued growth of the industry will depend not only on the regulatory environment, but also on the efficient dissemination of information and resources to all parties interested in community development investments, including financial institutions, insurance companies, investment banks, community-based and not-for-profit organizations, and regulatory agencies. It is our aim for the Center to serve as a unique vehicle for the dissemination of this information and as a forum for rich discussion.

To help kick off the Center, this issue is in part dedicated to community development investments. In this issue, we build on an existing series (see the March 2002 issue of *Community Investments* on our website) with an article on the New Markets Tax Credit and with information on Variable Rate Demand Notes and Auction Rate Securities. We have also included highlights of a lively panel discussion from a Federal Reserve conference earlier this year, where industry leaders were brought together to discuss the future of the community development investment industry.

We hope you enjoy this issue of Community Investments, and that you'll take a moment to look at the Center for Community Development Investments on the web at www.frbsf.org/cdinvestments. Please let us know what you think by sending us an e-mail to SF.CommunityAffairs@sf.frb.org.

FEDERAL RESERVE BANK OF SAN FRANCISCO

Community Investments Vol 15, Issue 2 New Markets Tax Credits Hit the Community

Author(s): Scott Turner, Senior Community Investment Specialist, Federal Reserve Bank of San Francisco
August 2003

"The New Markets Tax Credit (NMTC) program was enacted in December 2000 as part of the bipartisan Community Renewal Tax Relief Act. The purpose of the NMTC is to spur private investment in low-income urban and rural communities. The program is based on the idea that there are viable business opportunities in low-income communities and that a federal tax credit would provide attractive incentive to increase the flow of investment capital to such areas" (excerpt from *Making the New Markets Tax Credit Conference*). In his article, Robert Rapoza provides a comprehensive overview about how the credits are intended to work and where they went. He also explains how to become certified as a Community Development Entity in order to apply for credits, how the CDE must market the credit to investors, what investments qualify for the credits, and what limitations exist on the use of the credits. Don't miss the detailed charts that provide information about the distribution of the first round of credits by geography and entity.

Robert A. Rapoza is president and principal of Rapoza Associates, a public interest lobbying and government relations firm located in Washington, D.C. Mr. Rapoza most recently successfully steered the New Markets Tax Credit program to enactment and has also been responsible for numerous legislative accomplishments including saving federal rural housing and community development programs from budget cuts and establishing the Intermediary Re-lending Program at the Agriculture Department.

In 2003, Phoenix, AZ received the largest allocation of tax credits in the country. How did they do it and what will it take to make this program that holds tremendous promise to revitalize low-income communities work? The Story of Phoenix's NMTC Allocation answers these questions.

Roberto Franco led the Phoenix team in applying for the New Markets Tax Credit program and currently manages the program's development and implementation. He has 22 years of professional experience with emphasis in contract administration, strategic planning, negotiation, finance, marketing, management, and administering and developing economic development projects.

Want to know more? See The New Markets Tax Credit: A Promising New Tool for Community Revitalization by Stockton Williams in *Community Investments*: April 2001.

FEDERAL RESERVE BANK OF SAN FRANCISCO

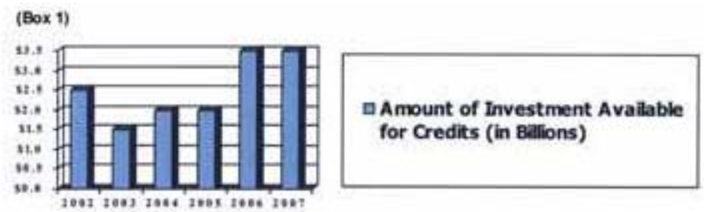
Community Investments Vol 15, Issue 2
Making the New Markets Tax Credit Count

Author(s): Robert Rapoza, President, Rapoza Associates
August 2003

The New Markets Tax Credit (NMTC) program was enacted in December 2000 as part of the bipartisan Community Renewal Tax Relief Act. The purpose of the NMTC is to spur private investment in low-income urban and rural communities. The program is based on the idea that there are viable business opportunities in low-income communities and that a federal tax credit would provide attractive incentive to increase the flow of investment capital to such areas. Between 2002 and 2007, the NMTC will provide for up to $15 billion in investments in low-income communities. The Community Development Financial Institutions (CDFI) Fund of the U.S. Treasury Department administers the NMTC program.

What is a Community Development Entity (CDE) and how are CDEs certified?

The investment vehicle for the NMTC is a Community Development Entity (CDE). An organization must be certified by the CDFI Fund as a CDE to be eligible for NMTCs. Two important considerations for certification are that the organization must have a track record and demonstrate accountability to the community. After receiving certification, a CDE may then apply for credits through an annual competition conducted by the CDFI Fund.[1] CDEs successful in receiving an allocation must have a strong business plan, good management, proven track record of working with investors and proposed projects that will have a substantial impact in low-income communities. In March 2003, the CDFI Fund made its first allocation of $2.5 billion in NMTCs to a total of 66 CDEs. Over 300 Community Development Entities (CDEs) applied in the first round, requesting $26 billion in credits.[2]



How does a CDE market the credit to investors?

Once an allocation has been awarded, a CDE must then seek private investment in exchange for the credit. The CDE has five years to place the credits, after which time the credits can be recaptured and transferred to another CDE. Corporate and individual taxpayers may receive a federal tax credit of 39 percent over seven years in return for their equity investment in a CDE. With the proceeds from these equity investments, CDEs must provide investments of equity, loans, lines of credit and technical assistance to qualified businesses. CDEs have one year to place the funds in qualified investments. In general, if *substantially all* (i.e. 85%) of the proceeds from the credit are not placed in qualified investments, the CDE would be out of compliance. At that point, recapture penalties would be applied to the investor.

An equity investment qualifies for the tax credit if:

1. such credit is acquired by the investor at its original issue solely in exchange for cash;
2. *substantially all* of such cash is used by the CDE to make a *qualified low-income community investment*; and
3. the investment is designated by the CDE as a *qualified equity investment* which may also include the purchase of a qualified equity investment from a prior holder.

What is a Qualified Low-income Community Investment?
Qualified low-income community investments may include loans, lines of credit, debt, direct equity investments, purchase of certain loans made by other CDEs, related services to other businesses, and counseling to other CDEs.

Substantially all of the investment must be used, meaning 85 percent of the cash received from the taxpayer in return for the tax credit must be directly traceable to a qualified low-income community investment, or 85 percent of the aggregate gross assets of the CDE must be deployed in qualified activities.

What areas are eligible for the tax credit?
Areas eligible for the tax credit are low-income communities defined as a census tract with a poverty rate of at least 20 percent or with median income of up to 80 percent of area median or statewide median, whichever is greater; or for non-metro census tracts 80 percent of statewide median. The NMTC may also be used in target areas. A target area is a community within a census tract that does not meet the poverty or median income standard. The target area provision allows certain communities located in ineligible census tracts to participate in the program. Such communities must have pre-existing boundaries such as established neighborhoods, or political or geographic boundaries; meet the poverty rate or median income standard; and have a demonstrated lack of investment capital.

What businesses qualify for investments?
Businesses eligible to receive qualified low-income investments are those corporations or partnerships (including sole proprietorships or unincorporated trades or businesses) that are active and located in low-income communities. The business must derive at least half its gross income from activity (i.e. sales, manufacturing) in the eligible area. In addition, a substantial portion of its tangible property as well as services performed by

employees of the business must be in an eligible community. CDEs may also provide investments to *qualified active low-income businesses* that are owned in whole or in part by the CDE.

Are there any other investment limitations?
Financing of low-income rental housing is not allowed under the NMTC, and the NMTC may not be combined with other federal tax subsidies, including the Low-income Housing Tax Credit. Rental property that derives 80 percent or more of its income from residential tenants is not eligible. However, a mixed-use development, where less than 80 percent of the property's gross income is rental income from dwelling units is allowed under NMTC.

Conclusion
The broad distribution of NMTCs from the first round of allocations allows for any community in America—both urban and rural—to take advantage of this unique opportunity to build a stronger and more diverse economy. Of the 66 CDEs receiving allocations, 16 target a specific city or county, six target more than one city or county, 17 will conduct statewide programs, and 27 will work in more than one state. Of those 27, 15 are nationwide. The following graphs provide a partial look at how the allocations were distributed and which jurisdictions they will serve. Now that the opportunity has been made available to these previously undercapitalized communities, the challenge is to make it work.

CDEs with the Largest Allocations
Table 1 shows the five CDEs with the largest allocations. Combined, they will receive 31 percent of the NMTC funds. Four of the five have a nationwide service area while the Phoenix Community Development and Investment Corporation will serve only Phoenix, AZ.

Table 1

	CDE	HQ STATE	ALLOCATION (x $1 million)	SERVICE AREA
1	Phoenix Community Development and Investment Corporation	AZ	$170.0	Phoenix and surrounding area
2	National New Markets Tax Credit Fund, Inc.	MN	$162.5	National, with focus on CA, CO, MN, NY, OH, PA, TX
3	Community Development New Markets I, LLC	OH	$150.0	National, with focus on CO, IN, ME, NY, OH, OR, WA
4	Wachovia Community Development Enterprises, LLC	NC	$150.0	National, with focus on CT, FL, GA, NC, NJ, VA, PA
5	KHC New Markets CDE, LLC Series A	CA	$134.0	National, with focus on CA, FL, NY, OR, TX, UT, WA
		TOTAL	$766.5	

States with the Greatest Allocations to Their CDEs

Table 2 shows the top five states in terms of combined allocations to their CDEs. Note that a large portion of these allocations is designated for multi-state or nationwide use. The table shows that while the CDEs located in these five states received 55 percent of the allocated funds, just 17 percent of these funds will be dedicated solely to in-state uses.

Table 2

All dollar amounts x $1 million					
STATE	TOTAL ALLOCATION TO CDEs BASED IN STATE	ALLOCATION FOR IN-STATE ONLY	ALLOCATION FOR MULTI-STATE USE	ALLOCATION FOR NATION-WIDE USE	ALLO-CATION TO RURAL AREAS
CA	$428	$236	$58	$134	$87
OH	$313	$88	-	$225	$68
NC	$225	-	-	$225	$41
DC	$213	$86	-	$127	$32
NY	$201	$21	-	$180	$33
TOTAL	**$1,380**	**$431**	**$58**	**$891**	**$260**

CDEs Contributing the Most to Rural Communities (Table 3)

Rural areas stand to gain $509 million in NMTC investments. The CDEs listed in the table below are the five that will allocate the greatest amount of credits to rural communities. REI New Markets Investment, LLC will focus on one state, Oklahoma, while the other four CDEs will conduct multi-state or national programs.

Table 3

	CDE	HQ STATE	ALLOCATION (x $1 million)	SERVICE AREA
1	REI New Markets Investment, LLC	OK	$54.0	Oklahoma
2	Border Communities Capital Company, LLC	CA	$40.0	Oklahoma
3	Coastal Enterprises	ME	$39.0	Northern Forest Belt of ME, NH, VT, NY
4	Community Development New Markets I, LLC	OH	$30.0	National with focus on CO, IN, ME, NY, OH, OR, WA
5	National New Markets Tax Credit Fund, Inc.	MN	$24.4	National with focus on CA, CO, MN, NY, OH, PA, TX
		TOTAL	**$187.4**	

Allocations by State

Table 4 summarizes the allocations to each state and shows totals designated for rural areas.

Table 4

(All dollar amounts x $1 million)						
STATE	TOTAL ALLOCATION TO CDEs BASED IN STATE	ALLO-CATION FOR IN-STATE USE ONLY	ALLO-CATION FOR MULTI-STATE USE	ALLO-CATION FOR NATION-WIDE USE	ALLO-CATION TO RURAL AREAS	PERCENT OF TOTAL ALLOCATION FOR RURAL AREAS
AK	$5	$5	-	-	$4.3	85%
AL	$40	$40	-	-	-	-
AZ	$170	$170	-	-	-	-
CA	$428	$236	$58	$134	$86.6	$0
DC	$213	$86	-	$127	$31.8	15%
DE	$15	$15	-	-	$3.8	25%
GA	$22	-	$22	-	$22.0	100%
IL	$35	$20	-	$15	$3.5	10%
IN	$6	$6	-	-	-	-
KY	$30	$30	-	-	$13.5	45%
LA	$160	$160	-	-	$16.5	10%
MA	$26	$26	-	-	-	-
MD	$161	$10	$36	$115	$15.3	10%
ME	$65	-	$65	-	$39.0	60%
MN	$162.5	-	-	$162.5	$24.4	15%
MS	$15	-	$15	-	$9.8	65%
NC	$225	-	-	$225	$41.3	18%
NJ	$15	$15	-	-	$0.8	5%
NY	$201	$21	-	$180	$32.5	16%
OH	$313	$88	-	$225	$68.0	22%
OK	$134	$134	-	-	$72.5	54%
PA	$8.5	$0.5	-	$8	$4.0	47%
TN	$10	$8	$2	-	$8.8	88%
VA	$15	$15	-	-	-	-
WI	$21	$21	-	-	$8.4	40%
WV	$4	$4	-	-	$2.6	65%
TOTAL	**$2,500**	**$1,111**	**$198**	**$1,192**	**$509**	**20%**

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[1] September 30, 2003 is the application deadline for the next round of tax credit allocations. For more information, go to www.cdfifund.gov.

[2] The law provides $1 billion in NMTC investments in 2001 and $1.5 billion in

2002. No credit allocations were made in 2001, thus $2.5 billion are available in 2002. Also, 2003 and 2004 are being combined for $3.5 billion in allocations to be available in 2004.

Biography

Robert A. Rapoza is president and principal of Rapoza Associates, a public interest lobbying and government relations firm located in Washington, D.C. and established in 1984. Mr. Rapoza has more than two decades' experience as a professional lobbyist and is an expert on the federal budget and appropriations process, with special expertise in federal housing and community development policy. He has been responsible for numerous legislative accomplishments that include saving federal rural housing and community development programs from budget cuts, establishing the Intermediary Re-lending Program at the Agriculture Department, sustaining and increasing funding for community development programs at the Department of Health and Human Services, promoting the creation of a YouthBuild program at the Department of Housing and Urban Development and, most recently, successfully steering the New Markets Tax Credit program to enactment. He first became involved with community development issues while serving with the Massachusetts Department of Community Affairs. A graduate of Boston College and the University of Massachusetts at Amherst, Mr. Rapoza has served on the boards of several housing and community development organizations and has been profiled in the Washington Post and in the authoritative Beachman's Guide to Key Lobbyists.

FEDERAL RESERVE BANK OF SAN FRANCISCO

Community Investments Vol 15, Issue 2 The Story of Phoenix's NMTC Allocation

Author(s): Roberto Franco, Vice President, Phoenix Community Development and Investment Corporation
August 2003

Phoenix is honored to receive the single largest allocation of tax credits representing $170 million in equity for the inaugural application of 2002. Along with 345 other applicants, Phoenix anxiously awaited the allocation announcement in early 2003. In March 2003, CDFI selected 66 organizations to receive the first $2.5 billion in tax credit allocations, which represents a small fraction of the $15 billion equity investments that will be raised over the next seven years. And while most recipients will target their services statewide, multi-state, and even nationally, Phoenix will focus on low-income communities only within the city's boundaries.

Application Success

The city of Phoenix sponsored the application by creating an independent, nonprofit corporation, Phoenix Community Development and Investment Corporation (PCDIC), to become a certified Community Development Entity (CDE). We speculate that the city of Phoenix's application was successful because of our international reputation for excellence in management and community service delivery, access to capital, and pipeline of potential projects. To demonstrate the city's success in managing other programs that assist Phoenix's underserved communities, several key city departments including, community and economic development, finance, neighborhood services, and housing and equal opportunity, provided documentation for the application. The application was further bolstered by strong support from local and national financial institutions, commercial developers and large corporations that had a history of conducting business with the city.

Allocation Utilization

The primary mission of the Phoenix Community Development and Investment Corporation is to improve the economic conditions in Phoenix's underserved communities, which encompass over 32 percent of the city's geographic area. Out of the city's 138 low-income census tracts, 63 are designated as economically distressed areas-meaning census tracts with poverty rates exceeding 30 percent or median family income less than 60 percent of the Phoenix AMI of $51,126. The primary beneficiaries of PCDIC's activities will be residents and businesses located in these targeted areas. Residents will benefit from new and higher quality employment opportunities created by business development activities and from additional community services such as retail development. These areas will also benefit from increased property values and a reduction of blighted properties through commercial revitalization activities.

Through the PCDIC, Phoenix is offering three programs to reach our goal of improving the quality of life of those individuals who live and work in the most underserved areas of the community (table 1). Recipients of NMTC financing or investments must demonstrate that their business or project accomplishes one or more of the following:

- Creates jobs for residents or persons below the poverty level in the designated area
- Increases wages or benefits for residents or persons below the poverty level in the designated area
- Targets job creation in areas of severe economic distress
- Provides services to the designated area
- Attracts higher income residents to live and work in the urban core
- Raises local property values

- Is committed to remaining in the community long-term

Community Representation

We recognize the stewardship that CDFI has granted Phoenix, not only as an entity implementing the NMTC, but also as the only municipality awarded an allocation. To ensure that all the funds distributed have the community impact intended by the NMTC, a five-member board of directors will evaluate and approve projects. Those projects that best demonstrate the ability to meet the goal of our program to improve underserved communities while meeting the regulatory requirements will have a greater chance for funding approval. The PCDIC Board has representation from several key organizations, including Chicanos Por La Causa, Greater Phoenix Urban League, and Phoenix Community Alliance, all of which have a primary mission of providing services to individuals and businesses in low-income communities. PCDIC is also represented by two members from the city of Phoenix.

Another element critical to the success of the NMTC program is participation from residents and businesses in low-income communities. Phoenix has already initiated public participation by holding numerous information sessions to educate potential investors, lenders, and users of our program. Phoenix's program has been shaped and enhanced by the feedback received during these sessions. Patrick Grady, president of PCDIC, "We felt strongly that our business community could help us identify how to make this program better so that they would be encouraged to develop and grow in areas of Phoenix that they normally would not consider."

Where We Are

We are currently working with the local lenders, investment firms and developers that supported us during the application process. Participation thresholds and projected investor returns will be determined on a project by project basis. However, we are accepting pre-applications from businesses to add to our list of possible projects. Perhaps the most challenging aspect of the program at this time is ensuring that those small business borrower's who do not have a strong financial background are bankable. To eliminate the barriers that may limit their access to capital, PCDIC will secure technical assistance contractors to help them develop business plans, set up basic accounting systems, do a cash flow analysis and complete a loan application. For additional information on PCDIC's program, please contact Lynda Dodd at 602-261-8708 or email Lynda Dodd.

Table 1 - Phoenix Programs			
Program	**Objective/Type**	**Loan or Investment Range**	**Proposed Terms**
Business and Commercial Real Estate Development Loans (below-market terms)	·community retail projects ·commercial/industrial development projects ·transit-oriented developments ·corporate and regional headquarters for businesses locating in qualifying census tracts	$1,000,000 - $12,000,000	·senior and mezzanine loans ·loan-to-value (LTV) 90-95% senior & mezzanine · 100+ basis points below market ·debt service coverage ratio: senior - 1.20:1 mezzanine - 1.10:1
Small Business Loans (below market terms)	·business and/or commercial real estate acquisition · business expansion ·working capital · major equipment purchases	$35,000 - $1,000,000+	· LTV - Up to 90% ·based upon borrower financial history, but generally 1% below market · additional 5% reduction for businesses locating in particularly economically distressed areas ·rates for loans secured by second mortgages or by equipment will be somewhat higher than for loans secured by first mortgages ·debt service coverage ratio - 1.10:1

Venture Capital	· equity funding for companies in the life sciences and technology industry	varies	

Biography

Roberto Franco is the assistant director of community and economic development at city of Phoenix and vice president of the Phoenix Community Development and Investment Corporation. Mr. Franco led the Phoenix team in applying for the New Markets Tax Credit program and manages the program development and implementation. He has 22 years of professional experience with emphasis in contract administration, strategic planning, negotiation, financial, marketing, management, and administering and developing economic development projects. Mr. Franco earned his masters of business administration and bachelor of business administration from the University of Texas, El Paso.

FEDERAL RESERVE BANK OF SAN FRANCISCO

Community Investments Vol 15, Issue 2 Sounding Off About Investment Instruments

August 2003

Variable Rate Demand Notes and Auction Rate Securities offer investors the opportunity to invest in short duration assets that have community development as their primary purpose. These securities are an attractive alternative for investors that help satisfy CRA requirements, while mitigating interest rate risk. Given the current market environment, investors have an opportunity to take advantage of the spread between taxable and tax-exempt floating rate securities with only a small yield. Investors can maximize support for their community development by capitalizing on these highly rated, liquid securities.

Multifamily mortgage-backed securities issued by Ginnie Mae offer investors the opportunity to purchase AAA-rated securities that provide prepayment protection in times of falling interest rates. Ginnie Mae multifamily MBS increase the supply of mortgage credit available for housing by channeling funds from the capital markets into the mortgage market. Ginnie Mae guarantees the timely payment of principal and interest on the securities. Ginnie Mae securities are full faith and credit obligations of the U.S. Government and carry zero percentrisk-based capital weightings.

Barbara VanScoy describes these instruments in detail in two articles, including an analysis of the size of the market for these instruments, how they work, and how they can be used for community development for CRA Investment Test credit.

Barbara Rose VanScoy is a principal at CRAFund Advisors, the registered investment advisor for the CRA Qualified Investment Fund. Ms. VanScoy is the portfolio manager of the CRA Qualified Investment Fund, and is responsible for researching and documenting qualified investments on behalf of the Fund's shareholders. Prior to joining CRAFund Advisors, Ms. VanScoy was the director of research at SunCoast Capital Group. She also headed SunCoast's Community Development Initiative, in which she assisted their depository clients with community development investing.

Want to know more? See Investing in CRA-qualified Municipal Securities by Barbara VanScoy and Mortgage-backed securities and Collateralized Mortgage Obligation: Prudent CRA Investment Opportunities in Community Investments, March 2002.

Special feature: excerpts of an interview with community development professionals about the future of the Investment Test.

FEDERAL RESERVE BANK OF SAN FRANCISCO

Community Investments Vol 15, Issue 2 Variable Rate Municipal Securities

Author(s): Barbara VanScoy, Principal, CRAFund Advisors
August 2003

The Community Reinvestment Act (CRA) requires regulated banks and thrifts to meet the credit needs of their communities. Of the three performance tests large banks are subject to—lending, service and investment—the investment test can create the most confusion as to what constitutes a qualified investment.

Under CRA, an investment qualifies that has as its primary purpose community development, which means affordable housing, community services targeted to low- and moderate-income individuals, small business finance and activities that revitalize or stabilize low- or moderate-income geographies. This flexible definition allows banks and thrifts to invest in the communities they serve through creative means rather than dictated measures.

Two instruments that such low-rate municipal securities may offer a solution. Variable Rate Demand Notes (VRDN) and Auction Rate Securities (ARS) offer investors short duration assets that have community development as their purpose.

These liquid securities have been around since the advent of money market funds in the 1970s, with ARS just recently increasing in popularity over the past five years. Currently, there are approximately $120 billion VRDNs and $120 billion ARS outstanding in the marketplace. These securities have longer maturities—typically 30 years—but they offer variable interest rate reset periods, usually 7 to 35 days, resulting in a shorter duration asset.

Variable Rate Demand Note (VRDN)
A Variable Rate Demand Note is a long-term taxable or tax-exempt bond that bears a floating interest rate and that provides investors the option to tender or put securities at par on seven days notice—or in some cases within a day's notice. The bonds tendered are then resold by the remarketing agent in the secondary market to other investors. VRDNs can be converted to a long-term fixed-rate security upon appropriate notice by the issuer.
Also known as Variable Rate Demand Obligations (VRDOs), these securities are designed to meet the needs of investors requiring liquidity, flexibility, and competitive short-term rates. The interest rate resets daily or weekly, depending upon the security. The reset rate is based on comparable securities with similar maturities and credit ratings, as well as on supply and demand.

The investor continually earns the market interest rate because of the reset feature and is guarded against principal loss because of the par tender feature. Bond holders have the right to tender their bonds for payment at par plus accrued interest at any time with appropriate notice to the remarketing agent. In addition, most VRDNs are highly rated due to credit enhancements, which guarantee the principal and interest, as well as the liquidity for bonds tendered.

Following are two examples of VRDNs whose primary purpose is community development:

Weekly Tax-Exempt VRDN (Westchester County, New York)
The County of Westchester issued industrial development bonds to finance the acquisition, construction and renovation of Levister Towers—a Section 8 and low income housing tax credit project. The bonds were structured as a

tax-exempt VRDN that will mature August 1, 2033. The security is rated Aa2/VMIG1 with a letter of credit from the Bank of New York.

Weekly Taxable VRDN (Nevada)

The Nevada Housing Division issued multi-unit housing revenue senior bonds to finance the acquisition, construction and furnishing of a multifamily rental housing project. Under the terms of the regulatory agreement, 100 percent of the units will remain available for persons or families with incomes at or below 60 pecent of the median gross income for the area at all times during the qualified project period. The taxable security is rated Aaa with credit support from Fannie Mae. The bond's maturity is October 15, 2035.

Auction Rate Securities (ARS)

Similar to daily and weekly floaters, Auction Rate Securities (ARS) trade at par. ARS are sold through a Dutch Auction, which is a competitive bidding process used to determine rates on each auction date. Bids are submitted to the auction agent. The winning bid rate is the rate at which the auction "clears", meaning the lowest possible interest rate that equals the cumulative total of securities demanded (buyers) to the amount auctioned (sellers).

New buyers wishing to purchase ARS may submit a bid at a specified rate on the day of the auction. Holders of the bonds will be notified of the indicative market rate. All accepted bids receive the same interest rate.

Owners of ARS have the option to:

- Hold: elect to hold an existing position regardless of what the new rate might be
- Bid: submit a bid to hold an existing position at a specified rate
- Sell: request to sell an existing position regardless of the rate set at the auction

Interest rates are generally reset every 7 or 28 days for taxable issues and every 35 days for tax-exempt issues. Most ARS pay interest on the business day following the auction; however, some may have quarterly or semi-annual coupons and trade with accrued interest. ARS settle on the business day following the auction. There are no liquidations between auctions.

Following are two examples of ARS whose primary purpose is community development:

35-day Taxable ARS (Abilene, Texas)
The Abilene Health Facilities Development Corporation financed a loan to Hendrick Medical Center to help support a family health clinic. This clinic serves the indigent and provides educational training for nurses and residents. It is also a member of the Texas Association of Public and Nonprofit Hospitals, which provides a disproportionate share of uncompensated healthcare and has an institutional mission that includes a strong commitment to care for the indigent or needy. In fact, Medicare and Medicaid account for over 60% percent of gross patient revenues. This security is rated AAA by S&P with credit support from MBIA and matures September 22, 2025.

28-day ARS Private Placement (San Diego, California)
The San Diego Family Housing, LLC issued military housing revenue obligations to help provide housing for lower-pay grade enlisted personnel. Pursuant to a lease by the United States Navy, the notes finance a portion of the acquisition, construction, and renovation of housing units at 20 different properties in San Diego amounting to a total of approximately 3,200 units. Both existing and proposed housing units are targeted at personnel earning below 80 percent of median family income (for San Diego County, the 2003 HUD median family income is $59,900). This security is rated AAA by S&P

with credit support from MBIA, a municipal bond insurance company. It is a private placement, maturing July 1, 2035.

Conclusion

Many banks invest solely in taxable or bank-qualified municipal securities, rather than tax-exempt securities. While there are taxable variable rate demand notes, the market is considerably smaller. Given the current interest rate environment, the spread between taxable and tax-exempt floating rate securities allows taxable investors a wider array of potential community development investments with only a small sacrifice in yield.

Variable Rate Demand Notes and Auction Rate Securities offer investors the opportunity to invest in short duration assets that have community development as their primary purpose. These securities are an attractive option for investors that help satisfy CRA requirements, while mitigating interest rate risk.

Biography

Barbara Rose VanScoy is a principal at CRAFund Advisors, the registered investment advisor for the CRA Qualified Investment Fund. Ms. VanScoy is responsible for researching and documenting qualified investments on behalf of the CRA Qualified Investment Fund's shareholders. Prior to joining CRAFund Advisors, Ms. VanScoy was the director of research at SunCoast Capital Group. While there, she also headed SunCoast's Community Development Initiative, in which she assisted their depository clients with community development investing. Ms. VanScoy was previously employed with Raymond James Tax Credit Funds as the director of debt placement, and as a vice president in fixed income research. She is a graduate of the University of Florida with a BSBA in finance, and a specialization in Latin American studies. She can be reached through CRAFund Advisors at 877/272-1977 or directly at 800/519-7065.

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OF SAN FRANCISCO

Community Investments Vol. 15, Issue 2 Ginnie Mae Project Loans Maintain Affordability

August 2003

Introduction

Multifamily mortgage-backed securities issued by Ginnie Mae offer investors the opportunity to purchase AAA-rated securities that provide prepayment protection in times of falling interest rates. Because many of these securities finance affordable rental housing for low-and moderate-income families or nursing homes for low-income patients, banks can garner positive consideration under the Community Reinvestment Act (CRA).

Ginnie Mae project loans are one of the most prevalent affordable multifamily mortgage-backed securities (MBS) available in the primary and secondary market. In fiscal year 2002, HUD provided approval to insure 1,104 properties totaling 146,991 units and amounting to almost $6.5 billion in mortgages. Ginnie Mae issues typically finance Section 8 rental housing, Low Income Housing Tax Credit (LIHTC) projects, or Medicaid-assisted nursing homes.

Ginnie Mae Project Loans

Ginnie Mae project loans are backed by a pool of one or more mortgage loans. Each multifamily mortgage is secured by a completed project, insured by the Federal Housing Administration (FHA) and administered by the Department of Housing and Urban Development (HUD). Mortgage insurance covers the lender if the borrower defaults on the insured loan. Ginnie Mae multifamily mortgage-backed securities increase the supply of mortgage credit available for housing by channeling funds from the capital markets into the mortgage market. Ginnie Mae guarantees the timely payment of principal and interest on the securities because the securities are full faith and credit obligations of the U.S. Government that carry 0% risk-based capital weightings.

Program Descriptions - Rental Housing
Ginnie Mae multifamily mortgage loans are insured under various programs.

Sections 221(d)(3) and 221(d)(4) insure mortgage loans to facilitate the new construction or substantial rehabilitation of multifamily rental or cooperative housing for moderate-income families, the elderly, and the handicapped-often projects using LIHTCs. Section 221(d)(3) is used by nonprofit sponsors and Section 221(d)(4) is used by for-profit sponsors. In fiscal year 2002, under the 221(d)(3) and 221(d)(4) programs, HUD insured mortgages for 207 projects totaling $2.5 billion.

Section 220 insures loans for multifamily housing projects located in urban renewal areas and other areas where local governments have undertaken designated revitalization activities. Because of the termination of urban renewal and the general decline in the number of revitalization areas, the Section 220 program is used much less than the basic multifamily new construction and substantial rehabilitation program {i.e. Section 221(d)(3) and (4)}. In fiscal year 2002, only five Section 220 projects totaling $76.9 million were insured.

Risk-sharing Program allows qualified state and local housing finance agencies to originate and underwrite affordable housing loans using municipal bond funds. The program provides full FHA mortgage insurance to enhance the HFA bonds to investment grade.

Section 232 insures mortgage loans to facilitate the construction and substantial rehabilitation of nursing homes, intermediate care facilities, and assisted living facilities. Section 232/223(f) allows for the purchase or refinancing with or without repairs of existing facilities not requiring substantial rehabilitation. Nursing homes and assisted living facilities that have a large percentage of patients receiving Medicaid assistance may be considered as community development activities for the purpose of CRA. Clarifying documentation for the CRA regulation extends community development beyond housing and small business to include health facilities, or social services targeted to low- or moderate-income persons.

Section 223(f) allows loans for refinance or purchase of existing apartments, both conventionally financed and FHA insured. No 232 health care facilities are included. Section **223(a)(7)** allows existing apartments already FHA insured to be refinanced. Of the 363 **223(a)(7)** loans closed during fiscal year 2002, 232 (64%) were OMHAR transactions.

OMHAR: Mark-to-Market Program
The Office of Multifamily Housing Assistance Restructuring (OMHAR) was established by the Multifamily Assisted Housing Reform and Affordability Act of 1997 (MAHRA) to administer the Mark-to-Market (M2M) program. OMHAR works with property owners, participating administrative entities, tenants, lenders, and others with a stake in the future of affordable housing. The M2M program was created to reduce above market Section 8 rent payments on thousands of privately owned, federally subsidized rental units to rates more in line with prevailing market rents, while preserving a critical part of the nation's affordable housing stock.

Under M2M debt restructurings, owners of subsidized properties refinance part of their mortgage balance at lower interest rates and with deferred payments. This enables owners to continue to provide affordable housing even after HUD's Section 8 subsidies are reduced. In conjunction with the

M2M refinance, the Section 8 rents will be reduced to HUD fair market rents, and will remain on the project for the term of the loan. The debt restructuring plan also requires that the project remain affordable for at least 30 years. Ginnie Mae and OMHAR developed a security that enables Ginnie Mae to securitize loans originated under the M2M program. This security increases the liquidity of investment capital available to the multifamily mortgage finance market.

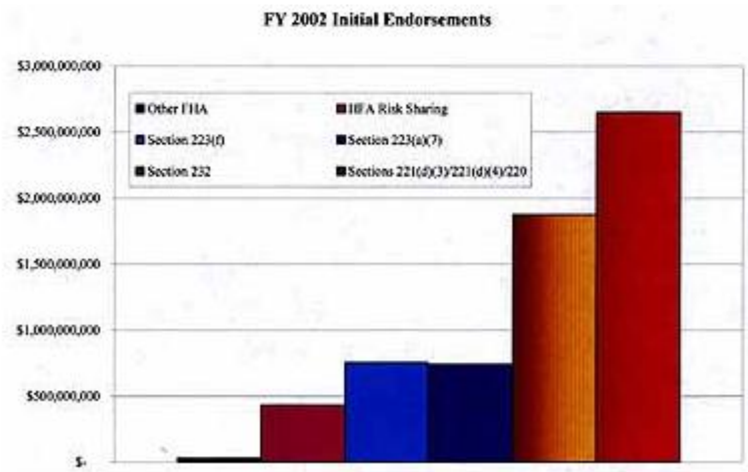
Prepayment Protection

Multifamily mortgage-backed securities often offer investors more prepayment certainty than MBS backed by single-family loans. Typically, multifamily MBS offer prepayment protection either through lock-outs, prepayment penalty periods or yield maintenance periods. During a lock-out period, the borrower is prohibited from voluntarily prepaying the underlying mortgage. With Ginnie Mae project loans, it is common for a security to carry either a ten-year lock-out period, or five years of lock-out protection coupled with declining prepayment penalties. Typically, the prepayment penalties start at five percent of the outstanding principal balance and decline one percent each year.

Given the current historically low interest rates, multifamily MBS provide investors with varying levels of prepayment protection. However, as interest rates increase, investors should understand that these securities could trade to their stated final maturities, instead of to the end of their lock-out or prepayment penalty periods. For Ginnie Mae projects loans which commonly have 30- to 40-year state final maturities, this could result in extending the securities duration by 20 years.

Market Availability

Ginnie Mae project loans are liquid, fixed income securities. Investors may purchase new issue securities in to-be-announced (TBA) form for forward settlement, usually 30 to 60 days from purchase. Currently, the CRA suitability of specific issues coupled with their favorable prepayment characteristic have increased the demand for Ginnie Mae project loans.



[1] Federal Financial Institutions Examination Council
Community Reinvestment Act; Interagency Questions and Answers Regarding Community Reinvestments; Notice, Thursday, July 12, 2001, §§ _____.12(h)-563e.12(g)-1

FEDERAL RESERVE BANK OF SAN FRANCISCO

Community Investments Vol. 15, Issue 2 The Future of Community Development Investments

August 2003

(Excerpts from a panel discussion)

2003 Federal Reserve System's Community Affairs Officers' Conference
Dallas, Texas, May 21, 2003

On May 21, 2003, the Officers, Managers and selected staff of the Community Affairs Offices of the Federal Reserve System held a conference on community development issues which included a panel entitled "The Future of Community Development Investments." Panelists included Bob Taylor, Senior Vice President at Wells Fargo Bank and President of the Wells Fargo Bank Community Development Corporation, Dan Sheehy, President of Impact Community Capital, Frank Altman, President of the Community Reinvestment Fund, and Jim Reid, President of the Texas Mezzanine Fund. The panel was moderated by John Olson, Community Investment Specialist, Community Affairs Office of the San Francisco Federal Reserve Bank.

John Olson: To explore the issue of "the future of community development investments," we invited four distinguished panelists to offer their unique perspectives: Bob Taylor of Wells Fargo, to cover the perspective of a CRA-motivated investor, Dan Sheehy from Impact Community Capital, to cover the perspective of community development investors who are not motivated by the CRA, Frank Altman from the Community Reinvestment Fund, to share his views as a secondary market practitioner, and finally Jim Reid from the

Texas Mezzanine Fund, to give us an understanding of the "other side" as a CDFI recipient of community development investment. My thanks to each of you for participating today. I'd like to start with a broad overview from each of you on your role in the industry and trends that you're seeing—what are your reactions to some of the current issues we've been discussing today, such as possible changes to the CRA regulation and the impact of the proposed elimination of the tax on dividends.

Bob Taylor: I work for Wells Fargo and centrally manage community development investment activity for the bank in 23 states. The investments are centralized at Wells Fargo for a variety of reasons, but opportunities are identified within a decentralized management structure. We have a portfolio of $1 billion, roughly $500 million in Low Income Housing Tax Credits, $125 million in housing-related bonds, $125 million in real estate, and $150 million in equity equivalent investments. Our 2003 investment budget is $325 million, roughly the annual commitment in place since 1996. Prior to that, we had not done much investing, and at that time—when the new regulations came into effect—the industry didn't really know how much investing was going to be enough.

Over the last seven to nine years things have changed a lot. There's been an amazing increase in efficiency in the capital markets, not just nationally but internationally, and with that has come certain standards. People now put money at risk and expect a return; previously these activities had been thought of as "give-aways"—doing what we had been taught not to do in banking school. We have a staff of 50 on the ground, folks in cities and in rural markets to say what's going on and we try to address needs that are uncovered. Before, people said that this is CRA investing, just do it. Now, you must make investments that make good business sense—a whole financial discussion with both pricing and loss estimates. CRA's the right thing to do and it's growing—an emerging market with groups seeking opportunities. Benevolence is rewarded with cross-selling opportunities for the bank. Especially considering competition from brokerage houses and others, it's a very competitive world. The motivation for an outstanding rating is still there, although it doesn't buy a safe harbor from protests in mergers.

If CRA went away and/or the investment test were scaled back, we would continue with Low Income Housing Tax Credits as we'd still get the tax relief as well as the potential for lending associated with the projects. We would still do intermediary-type lending as we have an active small business franchise and these firms also have needs for checking accounts and other banking services. As for the impact of the elimination of the tax on dividends, the result is more up in the air. We pay some $3 billion in taxes, and there would be some impact as a result of the change. But we do have profits needing offsets, so it's unlikely we would get out of the tax credit business.

It's an interesting business to be in. I continue to be amazed that there are still people in the bank who don't know what we do in the community development investment area. I'm proud to do it! You have to pick partners like Frank Altman or Jim Reid; people you can trust, so you don't have to spend a lot of time "underwriting" the people involved. If you give people money, you have to be able to trust them to re-loan it appropriately, to utilize it efficiently in real estate development, etc. It comes back to deals and pricing.

John: Thanks, Bob. To press further, there are various pressures at play in the investment decision-making process. It seems that CRA's not quite the same motivating force that it once was. How have community-based organizations responded to that shift? Have they had to reform the way in which they propose things to you?

Bob: Jim will have to answer part of that. To share an interesting analogy, my father was a 'beat cop' at one time and whenever he was accused of trying to meet a quota in writing someone a ticket, he always responded "no, I can write as many tickets as I want." The point is that we will occasionally stretch or bend things, but ultimately we want to make a difference in a community. Before, there was a big hammer over our head, but now there's some rationality in how we respond. In part it's because there are now fewer banks and even more cooperation in our responses.

John: Jim, let's turn to you to follow up on this. Have you had to approach banks differently than before?

Jim Reid: First, from our perspective, at the very start we developed a strategic plan for self-sufficiency. We set our own performance objectives before the CDFI Fund specifically required it of us. We welcome standards and accountability and we respond to trends in financing. There seems to be a tendency in the CDFI industry to say "more is better," with, for example, the number of certified CDFIs growing to some 637 now. However, as we've seen in the CHODO and SBIC industries, more is not necessarily better. We need to aggregate in certain markets in order to serve them more effectively.

Secondly, although the CDFI Fund has given us two awards, which we've appreciated, in the end this money is "chump change." The fact is that if there were as much priority in Washington placed on community developments as on tax breaks, then we'd have major funding for these activities. We need a national focus on community and economic development. The jury's still out on the New Markets Tax Credit (NMTC); certainly more players are brought to the table because of it. Moreover, if you look at the world of community development organizations around the country who have been slugging it out since the 1960's, none of them received credit allocations. And in terms of whether the NMTC will benefit communities, I went to the first NMTC conference last year and saw none of the usual faces. I saw people from investment houses, attorneys, and tax credit professionals. It made me wonder how much of this money goes to those organizations that need it.

Third, in thinking about community development, we have a tendency to think only in terms of actual places, specifically bank assessment areas. However, while our fund targets incomes, specifically below 60% of area median, we also target minorities. National studies have shown that minority businesses have less collateral, less access to capital, yet the CDFI Fund said we needed a special Texas study to prove this. In thinking about the future of community development, there is a tendency to think about places like low-income communities. We also try to target African-American and Hispanic businesses and are still arguing with the CDFI Fund about the importance of this. We've even used a recent Milken Institute study to try to explain. Given that we will be a majority-minority country, how can we ignore the minority community?

John: To follow up just a bit, Jim, a couple of times in this conference people have mentioned some fear on the part of CDFIs of working with institutional investors. What's your take on that?

Jim: I have no fear. We don't just take money because it's available. We only do if the earnings objectives and the other objectives of the investors are in line with the mission of our organization—even without CRA as a motivation. We want more players at the table—especially players looking at business needs not related to the CRA. For example, we're looking at setting up a business fund for minority contractors here in Dallas.

John: Now let's bring Dan into the discussion. You're a relatively new player, representing insurance companies through your organization, Impact

Community Capital. What's motivating insurance companies to do this without a regulatory requirement?

Dan: I first want to say that I've been quite stimulated by the conversation thus far and, to a certain extent, the issues we're discussing are a prime example of why Impact's in the community investing business. For example, Bob says that he doesn't need CRA to motivate much of his community investment work. Impact and its insurance company investors don't need a form of CRA inducement either.. Impact's first deal in 2000 was a $40 million transaction. We now have direct investments or firm investment commitments at the $750 million level. Impact was formed by three nationally-focused insurance companies; they have been joined by seven others, all interested in demonstrating that there is a way to engage in community investing profitably and without regulation. However, insurance companies have felt perhaps a hint of the possibility of the imposition of some CRA-type mandate. And, of course, there are 50 different state insurance regulators. Pure altruism? Not necessarily, but the companies have a strong desire to create a connection between our community investment initiatives and the communities in which these companies write policies.

The Impact companies have a necessary focus on risk-based capital requirements and risk-adjusted investment returns. Their community investment dollars are sourced from each company's investment account, not from a charitable giving budget line. Insurance regulators look at safety and soundness of a company and its investments to ensure that, for policyholder protection, invested assets are safe and liquid. So, Impact's investment strategies needs to be consistent with those requirements and regulator attitudes. Some $600 million of our $750 million total funded and committed investments is or will be securitized with a significant portion of the resulting securities receiving investment grade ratings. In a typical transaction, each single loan purchased (one-off investments) will be pooled and securitized; Impact's investors will include these rated certificates on their balance sheets, and Impact will hold the non investment grade piece. Credit enhancement (or the "securitization subsidy") is provided by the insurance companies via their funding of Impact's purchase of the non investment grade portion of the securitization.

We seek ways to purchase assets (mortgages) from CDFIs and from organizations like Frank's that work with CDFIs. We also rely on the banking community. For example, we're talking to Bob regarding a novel way of financing health care centers. In this situation, Wells would originate and service the loans and Impact would provide the permanent take-out.

John: Isn't it hard to buy a bunch of loans made by CDFIs; aren't they one-off, "story" loans? How do you bundle and securitize them?

Dan: You're correct; it's very difficult, at times. It is difficult for an investor to purchase 'one-off' community loans, in general, and that degree of difficulty varies among asset types. Community development loans and asset or loan types are more likely than not to exhibit aspects such as insufficient historical performance track record, poor credit history, high leverage, etc. However, once these loans, and asset classes, prove themselves, they can then be more readily pooled and sold to institutional investors. It's a process; it doesn't just happen. And there are a variety of reasons. Chief among them is the community development originators themselves, and specifically, the degree to which each possesses the capacity to produce investments palatable to the investment community. The community development world's undergoing significant change.

John: Now's a good time to turn to Frank, the guru of secondary markets for community development lending.

Frank Altman: Since I last spoke to this group, we (the Community Reinvestment Fund, or CRF), had done maybe $10 million. Now, we're growing rapidly and are pleased to have many good partners. For example, Wells Fargo has been a major investor. What we do, basically, is aggregate loans, "onesies" and "twosies," from CDFIs, purchase them, and create a financial product that can be purchased by organizations like banks and insurance companies. Secondary market intermediaries match community demand with capital, but also mediate between different kinds of institutions seeking to diversify. On the one hand, it's balancing areas with capital with areas that need capital. And on the other hand, it's intermediating between different kinds of institutions such as retail and commercial finance companies. We seek CDFIs and others with community development missions, then we work with them to think about their unique competency, then find other organizations to assist them with what they do well.
While I do feel it's important to keep the regulation, I think that in the future, we'll be moving from an industry driven by regulation to a market approach where market mechanisms start approaching capital. The issue is segmentation—finding the right role for different investors. CRF is national, with a charter to support non-depository lenders such as CDFIs, public agencies, etc. with little access to capital. They depend on dollars from the CDFI Fund, USDA and others, which are dwindling and therefore they must make better use of these funds. These organizations are not competing with banks, but rather are complementary. There is a role for philanthropy—purely social motivation—but we want to find a product that works as an investment vehicle.

Secondly, socially-motivated investors want their principal back, and some interest, but they also want a social return. Such investors include socially-motivated mutual funds, religious organizations, and banks with an appetite for EQ2s (equity equivalent investments). We raised 15% of our capital from such organizations, which in turn attracted the other 85% from other banks, pension funds and life insurance companies in a range of sizes. The largest pension fund investor is the United Methodist Church, which has provided $100 million thus far. It's not the easiest product, but we're working to make it easier. So, we see the future of the community development investment industry as moving from regulations to markets, from funding to financing, and groups such as established CDFIs will have to learn how to finance themselves using market mechanisms.

The third area I want to touch on is CRF's work on advance commitments. With support from the Rockefeller Foundation, we are working to standardize documentation. Volume is growing significantly. The New Markets Tax Credit (NMTC) represents a recognition of what was going on, specifically what tax incentives can do. The NMTC will provide $15 billion in private investment over ten years, bringing a huge opportunity and I hope everyone will embrace it in a positive way. We think the credit will result in long-term loans and equity with a real exit strategy.

Audience question: Usually when securitization is done, it's a byproduct. With community development loans, what kind of portfolio mix is used: is it by different type of loan such as housing or small business, or by loan quality?

Dan: By loan or asset type. A bona fide cost effective, price efficient capital markets type securitization, is accomplished with one asset class. For example, loans to community development entities (CDEs), residential mortgages and small business loans van be separately pooled, but not cominglrd. However, there are less formal ways of achieving asset aggregations. They are commonly referred to as pools or participations, but are not, in the capital markets sense, securitizations. Frank has mentioned a successful approach to pooling which combined different asset types.

Frank: We do mix assets in pools because we have investors willing to buy them. It's a process of introducing an investment product that meets the requirements and builds scale. You want diversification in other ways rather than just using the same asset class, and that's usually achieved geographically or by using risk profiles. Dan's aimed at getting a rated security and there you can't mix the asset classes. Our securities are privately placed. Nevertheless, we are doing a fair amount of work educating the rating agencies about what we do.

Audience question: Regarding the previous point about a difficult loan needing time to season, who's problem is this, the Mezzanine Fund's or the investors'?

Dan: I believe the problem resides with the originator and the mezzanine lender, so it's their responsibility to nurture out of that mode to the next phase.

Jim: At the Mezzanine Fund, the big issue is getting deals done. There are lots of CDFIs who don't want to sell their portfolios because they don't have the tools to access additional capital.

Audience question: Without CRA, or with a de-emphasis of the investment test, will there be a scaling back of this activity and in relationship lending, too?

Bob: While it's hard for me to say, exactly, I think the answer is no, not on relationship lending or potential relationships. I think we'd continue to invest, especially where there's a clear need.

John: What could we in Community Affairs at the Federal Reserve do to assist?

Bob: We try to understand our markets, work with organizations to help quantify demand. Activists always say we're not doing enough, but how much is enough? We see lots and lots of organizations looking for good quality loans. What markets aren't being filled? The Fed would be a logical place to explore these questions.

Jim: CRA's helped show that there's money to be made in community development investing and in working with emerging markets.

John: What can we do to help with the growth of the industry?

Dan: The community development industry needs leadership, a focal point, a rallying point, a forum to discuss and devise ways to recast itself. And for those of us who are seeking to make community investments in scale, we would encourage this leadership. Without prodding and absent any CRA type mandate, Impact formed a community development entity (CDE) and received a $40 million New Markets tax credit allocation. The investments will be structured differently than our affordable housing investments. They'll be a little more return sensitive, and focused in areas such as health and child care rather than commercial real estate.

Frank: Most people look at CRA geographically. However, since CRF works because of its pooling, we then have to assign certain loans in order to get the geographic focus desired by the CRA-driven investors. Even still, we get lots of questions on whether these banks will in fact get CRA credit. There's three areas where we could use help. First, there's not liquidity in the securities, even though they've demonstrated that they're good credit risks, with less than half a percent in losses. Secondly, the portfolio's doing well, but the next step is getting a rated institution to put up a letter of credit to allow it. Finally, there's not a liquid marketplace. Banks could be a liquidity backstop. Wells Fargo has done a little bit of this—making a market in securities they already purchased.

John: Well, I know we could keep talking for hours on these subjects—there's so much to discuss, but our allotted time is coming to a close. We hope that the new Center for Community Development Investments can serve as one of the focal points for the discussion as it continues. Please join me in thanking our panelists, Dan Sheehy, Bob Taylor, Jim Reid, and Frank Altman.

FEDERAL RESERVE BANK OF SAN FRANCISCO

Community Investments Vol. 15, Issue 2
Incubated Businesses Thrive

Author(s): Bruce Ito, Associate Community Affairs Specialist, Federal Reserve Bank of San Francisco
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Successful and innovative incubators that serve a diverse clientele with a variety of products and services are located throughout the Fed's 12th District. Incubators are not limited to urban environments and cities; more and more, incubators are emerging in rural areas as a way to diversify and stimulate the economy. In this series of four articles, we go inside the places entrepreneurs go to get their business off the ground.

Incubators provide more than just office space for a start-up. The success of a business hinges on a multitude of factors. In the lead article by Linda Knopp of the National Business Incubator Association, she describes incubators as "service programs, not just buildings…no building can grow companies, provide mentoring and handholding, and assist an emerging company in meeting the benchmarks necessary for growth."

The Renaissance incubator in San Francisco serves over 700 entrepreneurs a year, and a remarkable 84 percent of businesses that have graduated from their program are in business today. Sharon Miller, CEO of the Renaissance Entrepreneurship Center writes about two graduates of their program whose high tech business flourished because of the assistance it received in Getting Off the Ground in San Francisco.

While one-third of incubators focus on technology companies, an array of businesses benefit from incubators. Dr. Myaing Thein describes the Culinary Business Incubator (CBI) on the island of Oahu, Hawaii in Cooking Up Business Aloha Style. CBI assists low-income immigrants and refugees in starting their own restaurants, helping to bring the cuisines of diverse cultures to the mainstream population from a state-of-the-art kitchen in an unlikely place.

Incubators are not only important vehicles to promote small businesses development, they can also provide a unique opportunity to revitalize communities. In Public/Private Incubator Produces Redevelopment, Judi Dohn writes about the genesis of the Henderson Business Resource Center (HBRC) of Nevada and its role in the revitalization of a declining downtown. Learn lessons from this exciting story about how leveraging public and private partnerships turned a financial institution into a historic mixed-use facility that serves the needs of blossoming small businesses.

FEDERAL RESERVE BANK OF SAN FRANCISCO

Community Investments Vol. 15, Issue 2 The Role of Incubators in Cultivating Small Business

Author(s): Linda Knopp, Public Relations Specialist, National Business Incubation Association
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While many people associate the term incubator with the dot-com era, business incubation programs actually trace their beginnings back to 1959, when the first program opened in Batavia, New York. Since then, the industry has grown dramatically, both in terms of the number of programs in operation and the depth and breadth of services they offer. Today, business incubation programs assist entrepreneurs in most industries. Nearly half of the incubators in North America are mixed-use programs that work with a variety of early-stage companies, while more than one-third focus specifically on technology companies. In recent years, some incubators have developed programs to work with specific industry clusters, such as specialty food producers, biotechnology and biomedical, environmental, and information technology.

Unlike many of the incubators that emerged during the dot-com period in the late 1990s to generate quick wealth for investors, the majority of incubation programs aim to create jobs, diversify economies, revitalize neighborhoods, or commercialize new technologies. Business incubation programs like the Business Enterprise Center in Corvallis, Oregon catalyze the process of starting and growing companies by providing entrepreneurs with the expertise, networks and tools they need to make their ventures successful. Sponsors of these programs include academic institutions, economic development groups, local governments, and community organizations. More than 950 of these programs now operate in North America, including approximately 200 in the Federal Reserve's 12th District. This article showcases the diversity of these programs and the many economic benefits they bring to their communities.

A facility with appropriate amenities is one component of a successful incubator, but the backbone of these programs is the array of business support services they provide entrepreneurs. "Business incubators are service programs, not buildings," said Dinah Adkins, president and CEO of the National Business Incubation Association (NBIA), an international membership organization serving incubator professionals, consultants, university, government and economic development officials and others. "No building can grow companies, provide mentoring and handholding, and assist an emerging company in meeting the benchmarks necessary for growth."

Many incubation programs offer clients educational seminars covering a variety of business topics, from developing a marketing plan to locating potential angel investors. Others offer networking events to bring together entrepreneurs and local business and community leaders. Some programs even help clients develop advisory teams of seasoned business professionals to help entrepreneurs work through the challenges of starting and running a business.

In fact, one of the most notable changes in recent years is the sheer variety of business assistance services the incubation industry now provides to entrepreneurs. NBIA's 2001 survey of North American incubator managers found that today's incubation programs provide a rich mix of services to help start-up businesses succeed, including comprehensive business training programs, assistance with manufacturing processes and product design and development, and help with financial management and human resources development.

Another change has been the adoption of the business incubation model beyond the traditional mixed-use and technology incubators to more specialized industries, including ceramics, woodworking, arts and crafts, retail, and environmental technologies. Whatever the industry, business incubators share a common goal of producing successful graduates that are financially viable and freestanding when they leave the program.

And once they are ready to leave, many incubators help clients obtain the financing they need to grow their companies. According to a recent industry survey conducted by NBIA, about three-quarters of the business incubators in North America help clients access commercial bank loans and specialized noncommercial loan funds and loan guarantee programs[1]. Nearly two-thirds of the programs provide links to angel or venture capital investors, and one-third offer in-house investment funds.

On average, clients remain in an incubator for approximately three years before graduating into the community, although start-up businesses in biotechnology and other industries with long research and development periods often stay longer. To help determine when it's time for a client to leave the incubator, most programs have set graduation or exit policies. Some of the most common reasons for a clients to leave the incubator are that they have outgrown the available space, have spent the maximum allowable time in the program, have achieved mutually agreed upon milestones or have failed to meet certain benchmarks of the program.

While incubators are designed to help entrepreneurs build successful business ventures, most programs require potential clients to do their homework before applying. According to incubator managers, the most successful clients come to the program with a well-developed business idea, a viable market, a desire to learn and a strong entrepreneurial drive. Only then can incubator staff help an entrepreneur develop his or her business and the skills necessary to make it successful. And research shows that incubator graduates do have a good chance of success. A 1997 study by the University of Michigan, et al., revealed that approximately 87 percent of graduates from the nation's mature incubation programs were still in business[2]. At the time of the study, most of those firms had been in business at least five years, and many considerably longer.

Incubator companies also tend to stay in their communities after graduation, providing a stable source of well-paying jobs for local workers. Since 1980, incubator clients and graduates have created more than half a million jobs in North America. These jobs, in turn, spawn further economic growth; every 50 jobs created by an incubator client or graduate generate another 25 jobs in the community. In 2001 alone, North American incubators assisted more than 35,000 start-up companies that provided full-time employment for nearly 82,000 workers and generated annual earnings of more than $7 billion, which is welcome news for the many low- and moderate-income communities seeking to promote local economic growth.

While participating in an incubation program increases a start-up company's chances of success, creating a thriving new business remains challenging, especially during tough economic times. Many new businesses rely on a range of funding sources—including their local banks—to help them secure the money they need to start and grow their companies.

Whether it's a new incubator client that needs funds to help bring a promising new product to market or a soon-to-be incubator graduate that is looking to buy his own facility, these businesses provide potential funders with attractive opportunities for investments. Because of the screening procedures many incubators use to select clients and the training these companies receive while they are in the incubator, these businesses have a better-than-average chance of succeeding and bringing additional growth to the community.

For more information about the business incubation industry or to locate a business incubator in your area, visit www.nbia.org.

For academic-turned-entrepreneur John Gardner, the Business Enterprise Center of Linn and Benton Counties was the logical place to move his business, ViewPlus Technologies Inc., when it outgrew his garage. The Corvallis, Oregon, business incubator provided the growing company with the infrastructure to succeed, including on-site business counselors, a shared receptionist, office furniture, and high-speed Internet access-services that were invaluable to an entrepreneur with little previous business experience.

When Gardner, an internationally respected physics professor from Oregon State University, lost his eyesight in 1988, he wasn't planning to start a business. Yet, he knew he needed to do something to make it easier for him and others with visual disabilities to access electronic information. Noting that many visual objects—like the complex equations and flow charts common in math and science—cannot be described adequately with words, Gardner set out to develop tools to help himself and others with visual disabilities study and work in fields that traditionally had been out of reach for the blind.

With this goal in mind, Gardner founded both Oregon State Science Access Project (SAP), a National Science Foundation grant-funded project, and ViewPlus, a company to commercialize technologies that came out of the SAP. But while Gardner knew the technologies he was developing would fill a market need, he was not an experienced entrepreneur. "We knew technology, but we didn't really know business," Gardner said. "We recognized that we didn't always know what we were doing though, so we reached out for help."

When ViewPlus was ready to market its first product, Gardner decided to move the company into the Business Enterprise Center because he knew of the program's successes in helping other entrepreneurs succeed. In fact, he visited with the incubator's staff several times while starting his business from home. "Everyone in Corvallis knows about the Business Enterprise Center," Gardner said. "I always knew that when the time was right, we'd move into the incubator."

Gardner said ViewPlus has benefited from the advice he has received from the incubator's business counselors and board members and the opportunity to network and learn from other entrepreneurs. The company also has enjoyed the luxury of a flexible lease, which has allowed it to expand from a 328-square-foot office when it entered the program in 1999 to nearly 3,000 square feet of both office and light industrial space today.

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[1] Linder, Sally, 2002 State of the Business Incubation Industry, National Business Incubation Association, 2003. NBIA regularly surveys business incubators throughout North America to identify the latest trends in the industry. The 2002 State of the Business Incubation Industry report highlights NBIA's most recent survey data, collected in 2001.

[2] University of Michigan, NBIA, Southern Technology Council and Ohio University, Business Incubation Works, NBIA, 1997.

Biography

As a public relations specialist with the Athens, Ohio-based National Business Incubation Association (NBIA), **Linda Knopp** is responsible for increasing awareness of the association and the business incubation industry. Founded in 1985, NBIA conducts respected research, offers acclaimed publications and training opportunities, participates in effective consulting projects, and provides personalized service to its international membership of incubator managers and developers.

Ms. Knopp received a B.A. in journalism from Marshall University and has taken graduate courses in public policy studies at Duke University. She previously worked as a newspaper reporter and in educational, economic, and health care administration research.

FEDERAL RESERVE BANK
OF SAN FRANCISCO

Community Investments Vol. 15, Issue 2 Public/Private Incubator Produces Redevelopment

Author(s): Judi Dohn, Director; Henderson Business Resource Center
August 2003

History

Henderson, Nevada was founded to produce magnesium for World War II. The town's infrastructure was created quickly; buildings were small and few were multi-story. Over the years, Henderson grew from those small beginnings of 1000 houses to become the second largest city in Nevada with 25 master-planned communities and a population of over 220,000. It is located in the fastest growing metropolitan statistical area (MSA) in the country (Las Vegas/Clark County). At the same time, the original core of the city, while still the primary source of city services, was in danger of being left behind as the population moved west into newer communities.

In 1999, the Henderson Chamber of Commerce Foundation, a 501c(3) corporation, set out to create a business incubator to encourage business formation and to help revitalize "old Henderson," which was part of a large redevelopment area. The foundation originally considered building a small annex onto the existing chamber of commerce building. However, it was quickly determined that space would be too small to house both a support program and incubator facility; and raising money to finance a new building was not feasible. Still, the mayor and the city council wanted to keep the facility within the redevelopment area. The search shifted focus to existing buildings and soon settled on a 15,000 square foot building with 18-foot high ceilings, owned and occupied by Wells Fargo Bank.

Wells Fargo was going through a transition of taking banking to their customers and creating smaller, more accessible branch offices. The mayor and city council, while enthusiastically supporting the business resource center and incubator concept, did not want to lose a major banking presence in downtown Henderson. So negotiations with the bank began with the statement, "we want you to stay in the building." The final result was a win for both the bank and the city. The interior of the building was completely renovated, with the bank crafting a smaller, more inviting space for their customers in one-third the original space. The chamber foundation leased the remaining 10,000 square feet, creating a vibrant new presence in the downtown redevelopment area. Once the building was secured, the foundation had to raise funds to complete the improvements to its portion of the site. Further solidifying the public/private nature of this project, tenant improvement funds were contributed by the city of Henderson, the county commissioners, the Community College of Southern Nevada and the Henderson Public Improvement Trust, whose revenue comes from the bonds issued for major construction projects within Henderson city limits.

Partnerships

The Henderson Business Resource Center opened in June 2001 with the help of several partners. To fulfill the center's mission of serving new and growing businesses, partnerships were formed with several strategic partners, which include the Community College of Southern Nevada, the Nevada Small Business Development Center, SCORE, the Nevada MicroEnterprise Initiative and the Henderson district public library.

The community college agreed to build out, equip and staff a computer training room at the site that would be managed by its continuing and extended learning division. The training room has 12 networked computers that are linked back to the college through its Internet connection. Courses available at this site range from those requested by individual companies to open enrollment classes offered from morning through evening hours. Also domiciled in the resource center, the Nevada Small Business Development Center, SCORE and the Nevada MicroEnterprise Initiative will bring their training and counseling services to Henderson redevelopment area and the center's clients. The Henderson district public library provides seminars to increase the client's knowledge of on-line databases and will be installing video conference links this fall. All partners participate on the center's advisory board, which meets once a quarter to discuss issues and review progress. Through the array of services provided, the resource center is able to reach a range of clients, from applicants who have a dream of a business and little else to tenants and graduates, as well as affiliates with already established businesses who need support as they grow. In order to nurture prospective tenants while they are waiting for space to become available, a 'pipeline' program was created that enables prospective tenants to avail themselves of some of the center's services. And to help create a more seamless transition from the center to the real world, graduating tenants retain ongoing access to the center's services for as long as they need them.

Progress

The Henderson Business Resource Center just celebrated its second year of operation, after an especially challenging first year following the events of September 11, 2001, which took an enormous toll on the southern Nevada community and its major industry, tourism. As with any small business, the center had to ensure its survival first and foremost, which meant putting some initiatives on hold and working closely with partners to fill all the available spaces. The first incubator tenant graduated this spring, after outgrowing their 382 square foot space by hiring a fifth staffer.

As the center continues to support new businesses, which then graduate into the surrounding community, the vision of revitalizing "old Henderson" is being realized. The benefits are already numerous, including increased traffic to the downtown area and existing businesses, locally available support services for neighboring businesses and a renewed interest by businesses in locating to the downtown area. Neighboring storefronts, in partnership with the city's facade improvement program, have become more inviting. Center management attends the downtown association's meetings and serves as a liaison between the partner service providers and the association. Center tenants are also part of the association, creating another tie both into and out to the local business community.

For further information about the center's development and operation or about opportunities to support the center, please contact Judi Dohn at 702/992-7200.

FEDERAL RESERVE BANK OF SAN FRANCISCO

Community Investments Vol. 15, Issue 2
Getting Off the Ground in San Francisco

Author(s): Sharon Miller, Chief Executive Officer, The Renaissance Entrepreneurship Center
August 2003

Sammy Seo and Vince Young both knew they wanted to run their own businesses. Ever since the two met in college, they shared entrepreneurial dreams. By 1999, after spending several years—some frustrating—working for others in information technology, Sammy and Vince established Netspeed Solutions. Starting with two customers they set up operations in Sammy's living room, but quickly realized they needed some help.

A close friend introduced Sammy and Vince to the Renaissance incubator where he and his sister had together recently opened their own public relations firm. Netspeed Solutions joined the incubator in the fall of 1999 and proceeded to take advantage of every service Renaissance offered. By 2002, Netspeed Solutions, a converged voice and data provider for small and medium businesses, graduated from the incubator with annual sales of $750,000, six full-time employees, and over 50 regular customers—including Renaissance. Sammy recently spoke at a Renaissance graduation where he attributed Netspeed's growth and success to the training and support services received at Renaissance.

Applicants to the Renaissance incubator must attend an orientation, fill out an application, and undergo an interview process that includes meetings with the incubator director, senior business consultant and a current incubator tenant. Applicants must be in business for a minimum of three months, have an active customer list and either have a business plan, or commit to writing one within three months. Those who do not have a business plan are encouraged to attend Renaissance's business planning class.

Business incubation offers an effective solution to the challenges many new businesses face: high start-up costs, isolation, and lack of business management expertise. The Renaissance incubator is a supportive entrepreneurial community, offering low-cost, furnished office space; business consultation; access to financing; telephone, Internet and reception services; shared office equipment; meeting rooms and networking opportunities. Tenants representing such diverse industries as adventure travel, staffing services, housing management and fashion, share resources and ideas, create partnerships, and develop new markets. In addition, all tenants meet weekly with the incubator director and monthly with a business consultant to address a specific area of business development. Tenants receive further training through monthly group meetings and Renaissance's training classes, workshops and networking events.

The Renaissance incubator was launched in 1990 with five tenant businesses and expanded to 16 businesses in 1997 when Renaissance purchased its current building. In March 2003, Renaissance again expanded the incubator to include 17 additional offices and cubicles, wireless technology and the Business Assistance Center for home-based and start-up businesses that do not need a full-time office but can benefit from the incubator's services. Currently 84 percent of all businesses who come through the Renaissance incubator are in business today, and each business has created an average of one to three jobs. Sharon Miller, CEO of the Renaissance Entrepreneurship Center, said in explanation of their expansion, "the tremendous impact that these businesses are having on the local economy confirmed our decision to expand in the midst of an economic downturn."

Since its founding, Renaissance has consistently worked to maintain diverse funding streams. The CEO and the development director actively research new funding opportunities resulting in support from the San Francisco Mayor's Office of Community Development and Redevelopment Agency (32%); the US Small Business Administration Office of Women's Business Ownership and PRIME (11%); foundations, corporations and individuals (29%); services, program and building revenues (28%).

In addition to incubation, each year Renaissance serves approximately 700 entrepreneurs via:

- classes in business planning, introduction to business, and marketing to name a few
- the Women's Business Center—a partnership with the U. S. Small Business Administration to provide targeted services to women entrepreneurs;
- graduate workshops and seminars in sales, marketing, customer service, government and corporate business procurement;
- assistance with Minority/Women/Local Business Enterprise certification and individual consultation;
- an off-site facility—the Bayview Business Resource Center— located in a moderate-income census tract that provides training, consulting and business support services for new and emerging entrepreneurs; and
- the Financing Resource Center which offers technical assistance to help entrepreneurs become better financial managers of their businesses, package loans and identify funding sources. Since its inception in 1995, the FRC has helped 133 small business owners to secure financing of approximately $5,400,000 from local banks, the San Francisco Mayor's Office of Community Development and private sources

For further information about the Renaissance Entrepreneurship Center, contact Sharon Miller, CEO at 415/541-8580 or visit the website at www.rencenter.org. There you will find a directory of the business that have benefited from Renaissance's services.

FEDERAL RESERVE BANK OF SAN FRANCISCO

Community Investments Vol. 15, Issue 2
Cooking Up Business Aloha Style

Author(s): Dr. Tin Myaing Thein, Director, Pacific Gateway Center
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The Culinary Business Incubator (CBI) opened its doors in 2003 to entrepreneurs with an appetite for success and a mind for culinary innovations. CBI is situated in the heart of Kalihi, an economically depressed area on the island of Oahu, with a population of 25,000. CBI evolved from community meetings held with area residents to elicit economic development ideas. The participants engaged in the discussions consisted primarily of refugees from Southeast Asia, native Hawaiians and Pacific Islanders who were unemployed and living on public assistance. These individuals were desperately seeking revitalization and self-sufficiency opportunities. Overwhelmingly, a commercial kitchen emerged as the most popular suggestion and as an ideal medium to provide self-employment prospects in the food sector. Many of those interested in such ventures had been discouraged by regulatory provisions, which are not only capital-intensive but also cost-prohibitive.

In 2001, Pacific Gateway Center (PGC) engaged in a major capital campaign to get others who shared the same vision to complement the resources needed for the development of CBI. PGC was established in 1973 as a private nonprofit and has been a frontrunner in devising PGC is the only SBA intermediary lender and CBDO (community based development organization) in the state. PGC is also certified as a Community Development Financial Institution (CDFI) and Community Development Entity (CDE) by the U.S. Department of Treasury.

Boasting 20,000 sq. ft. of culinary equipment space, CBI is undoubtedly the nation's largest kitchen incubator. The setup includes 12 fully-equipped kitchens with everything imaginable from deep fryers to convection ovens, multi-range burners to chillers. These kitchens are ideally structured and well-suited to their purpose of providing a state-of-the-art facility for the "Iron Chef" aspirants of Honolulu to prepare their various ethnic cuisines. In addition to local outlets, the food will be available wholesale to establishments that cater to tourists and other high-end clients on other parts of the island.

With fifteen students currently enrolled in CBI, CBI is very close to its maximum capacity of twenty students. Applications are accepted on a first-come, first-served basis, with priority given to residents of the surrounding public housing complexes. Traditional entrepreneurship coursework such as marketing, business plan writing, finance and small business management is complemented by specific training related to the culinary industry such as safety and sanitation. In addition to the kitchen facility, a computer lab, day-care center and business center complete the "ready to cook" experience that CBI promises to the entrepreneurial hopefuls. We anticipate that students will remain enrolled with access to all of CBI's services for three-to-five years depending on their growth strategy, after which time they should be ready to take on bank loans to expand their business to its full capacity. Lending is only one of the opportunities available for banks to support the Culinary Business Incubator. Others include providing technical assistance in finance and accounting, basic budgeting, grants, etc. With PCG's 30-year track record of success, range of community development services and pool of 50 staff that speaks over 35 different languages, students enrolled in the Culinary Business Incubator are certain to find the ingredients they need for success.

To learn more about supporting the Culinary Business Incubator or other programs offered by the Pacific Gateway Center, email Dr. Myaing and visit the website at www.pacificgateway.org.