Comptroller of the Currency
Administrator of National Banks

Community Developments

Summer 2002 | Community Affairs OnLine News Articles

Bank Enterprise Awards and New Markets Tax Credits: Two Tools to Increase the Flow of Private Capital in Targeted Markets

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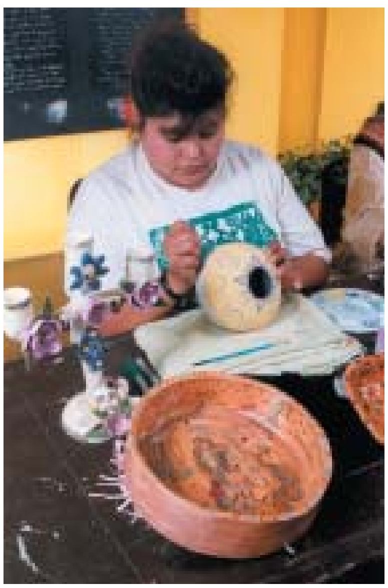


Started in 1995 and operating out of a little house on San Antonio's westside, MujerARTES is a pottery cooperative and one of the groundbreaking programs of the Esperanza Center, a beneficiary of Partners for the Common Good, which is an award recipient of the CDFI Fund.

One of Treasury Secretary Paul H. O'Neill's priorities is to see increased flows of private capital into economically distressed communities in ways that have quantifiable impact and are sustainable. The Community Development Financial Institutions (CDFI) Fund administers programs aimed at creating incentives for regulated institutions to provide capital, credit, and financial services to such communities. Here we'll look at two such programs — the Bank Enterprise Awards (BEA) and the New Markets Tax Credit (NMTC) — and how they can benefit participating financial institutions.

BEA: leverage at work

The Bank Enterprise Award (BEA) program is a well-established initiative that has enjoyed excellent participation by close to 400 banks and thrifts, to which the CDFI Fund has awarded some $180 million in recognition of their increased lending in economically distressed areas. These institutions, nearly a third of which have earned outstanding Community Reinvestment Act ratings, have some of the nation's best community development track records. They have done a superior job of leveraging their BEAs into almost 20 times that amount (close to $3 billion) in community reinvestment.

The BEA Program is the principal means by which the CDFI Fund achieves its strategic goal of expanding community development lending and investments by regulated banks and thrifts in low-income areas. The program provides incentives for regulated banks and thrifts to invest in CDFIs and to increase their lending and provision of financial services in distressed communities. Banks and thrifts can apply for the BEA Program award, usually in the fall of the year, and should watch for a Notice of Funds Availability (NOFA) on the CDFI Fund website in early September 2002, when approximately $16 million will be made available for competition.

In past funding rounds, the application has been submitted in two parts. In Phase I, a bank would report on the level of activity for a baseline period and provide an estimate of how much additional credit, capital, and financial services it plans to bring to CDFIs or the residents and businesses of economically distressed communities. In Phase II, applicants would report, in a prescribed manner for a given assessment period, on the actual level of activity that was completed. The fund verifies the reported activities and makes a *pro rata* award, of the increase in activity levels in dollars (between 5 percent and 33 percent depending on the type of activity and whether the applicant is a certified CDFI).

Awards have ranged from $1,100 to $3.6 million (although the Fund now caps awards at $2 million). Since the BEA Program is very competitive, the Fund (following a statutory directive) has identified priorities for funding awards from year-to-year. As directed by the BEA statute, the Fund will give priority to investments in CDFIs; then to support for CDFIs in the form of loans and deposits; then CDFI banks that carry out financing or service activities in targeted distressed communities; and finally to financing or service activities carried out by non-CDFI applicants in disadvantaged communities.

Recently we outlined some reasons why the BEA Program needed to change, and how the benefits could go in both directions — to institutions as well as to end customers. The CDFI Fund has reconfigured its staff, with the BEA Program now falling under the Depository Institutions function. This alteration was made to communicate that the whole question of deposits, loans, and investments is a broader one than the BEA Program encompasses. However, for now, we are suggesting that some program modifications will help focus award dollars to the most distressed communities.

With the help of financial institutions and CDFIs, we propose to take the BEA Program to a new and more meaningful level of activity. By effectively increasing the flow of private capital into target areas, the BEA Program will give direct assistance to financial institutions for activities that are complementary to their regulatory CRA goals, while emphasizing safe and sound lending practices and profitability targets.

A New Era of Investment Opportunity: New Markets Tax Credits

The New Markets Tax Credit (NMTC), enacted by Congress in December 2000 as part of the Community Renewal Tax Relief Act, is intended to create new opportunities for investment in underserved communities by allowing certified Community Development Entities (CDEs) to market tax credits to venture capitalists and other individual and corporate investors. The CDFI Fund is administering the new program under temporary regulations published in the *Federal Register* on December 20, 2001.

We're enthusiastic about this new community development initiative. Over 250 organizations have already registered as CDEs, which under the statute must be certified by the CDFI Fund as having a primary mission of providing investment in specifically identified low income markets and able to demonstrate their responsiveness and accountability to those markets. These certified CDEs, including CDFIs and banks, will be eligible to apply for allocations of tax credits under the program.

Increasing the flow of private capital into low-income areas is the primary objective of the NMTC Program. Whether or not your financial institution has received a BEA award, you'll want to investigate New Markets as the unprecedented opportunity that we believe it is — a first-time-ever tax credit for the stimulation of businesses in low-income communities nationwide.

The NMTC Program will promote increased capital and investment in low-income areas by allocating tax credits in support of for-profit enterprise development in such communities. Up to a total of $15 billion in tax credits will be available over the next six years for eligible taxable investors that make equity investments in CDEs. Over the life of a seven-year investment, investors will be able to realize a 39 percent tax credit. It's our hope that this innovative and rewarding approach will substantially increase the flow of investment capital to low-income communities and areas throughout the country.

To be eligible for an allocation of tax credits, a certified CDE must provide a clear explanation of its business plan for making investments in targeted communities through an application process to be made available soon on the CDFI Fund's website. The Fund hopes to begin awarding allocations by November 2002.

Participating in NMTCs may provide an ideal way for bankers to inject investment capital into deeply distressed communities. Two models illustrate the possibilities.

Model 1: Improved Profitability of Community Development Investments Under this model, the bank should review and identify eligible QLICIs in its pipeline of transactions. What's a QLICI? It's a *Qualified Low Income Community Investment* as defined by the Community Renewal Tax Relief Act. With QLICIs identified, you may want to encourage certain of your community partners (for instance, CDFIs) to become CDEs, since this will give you a known, trusted vehicle in which to invest. A third step, then, would be to make investments in and monitor these CDEs for the performance indicators that are important to you: community impact, CRA compliance, and — as specifically targeted by the NMTC — profitability. A CDE must invest or lend substantially all of its NMTC pool, and keep it invested during the critical seven-year period, in eligible businesses and activities (QLICIs) to avoid recapture.

Model 2: Commercial Real Estate Investment/Lending Model Under this model, in reviewing your portfolio, you would identify eligible community real estate assets that are in targeted low-income communities. You could then create a bank-owned CDE, and establish and advertise a NMTC/CDE investment fund to bank customers and developers. You could, thereby, offer an investment vehicle to customers, or to the bank, that could result in a tax credit allocation, while helping you amass a needed pool of capital for your commercial real estate customers. Similar strategies have proven successful under the Low Income Housing Tax Credit's multi-family program. For example, you could develop a similar loan fund to provide subordinated or more flexible underwriting of small business loans or investments.

The options are yours

Both the Bank Enterprise Awards and the New Markets Tax Credit Programs offer traditional banks and thrifts attractive vehicles with which to move capital into the nation's most investment-starved communities. Both programs offer many choices and relatively few drawbacks. You can invest in CDFIs or CDEs, or form your own investment pool.

We're counting on our partners in the banking community to help make the NMTC initiative a success. True, we've heard concerns that it may take awhile for investors to become comfortable with using NMTCs as a tax-advantaging tool. Our response is that, in all honesty, we don't have the luxury of time.

The need to increase the flow of investment capital into low-income communities is truly great.

One way to measure it is to reflect on the fact that 24,562 census tracts in the United States qualify for NMTCs. That's nearly 40 percent of all U.S. census tracts, representing 36 percent of the population — about 91 million people living in economically distressed communities and in need of help. You're likely to find many communities in your service areas that qualify for this program.

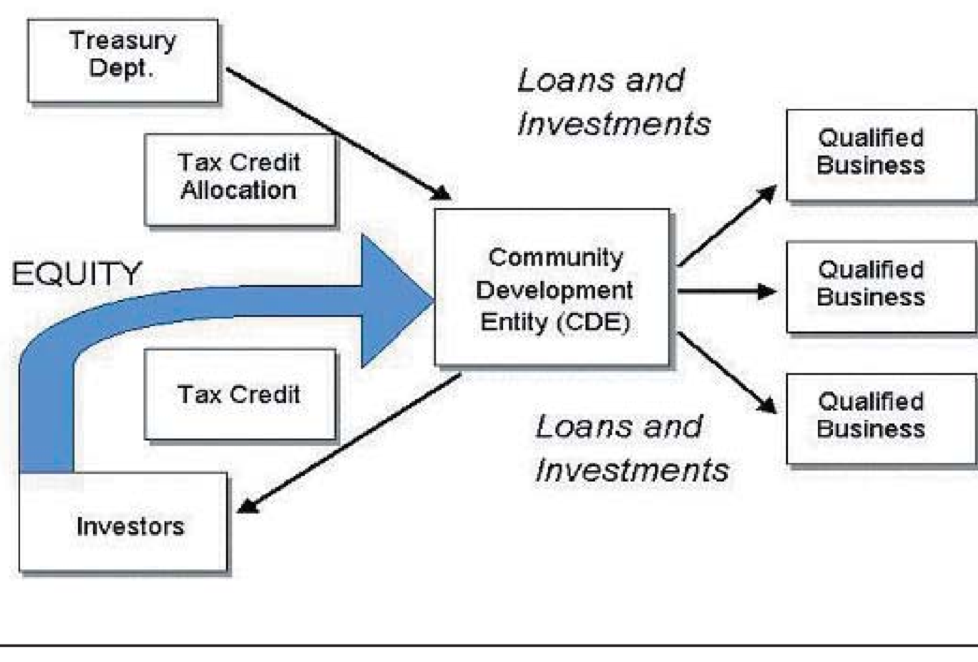
Many of our nation's financial institutions have been on the leading edge in providing assistance to businesses that create jobs for low-income people and help revitalize low-income communities. The market opportunities are tremendous, and Treasury is committed to help you make the most of them. Think of the CDFI Fund as a resource and partner in bringing the benefits of capital investment to every corner of the United States.

For additional information, contact Tony Brown, Director, CDFI Fund, at (202) 622-8662 or by e-mail at brownt@cdfi.treas.gov. Web site: www.cdfifund.gov.

New Markets Tax Credits Case Study - Bank Owned Subsidiary Operating as a Community Development Entity

A bank currently has an active for-profit subsidiary that focuses on investments in low-income communities and is willing to target its activities to areas that lack access to capital. This subsidiary successfully applies to the CDFI Fund for designation as a CDE, and then applies for and receives the authority to offer tax credits for $10 million worth of equity issuances. The CDE could then offer those tax credits to investors, which may include the parent bank. Investors would then be entitled to $3.9 million in tax credits over seven years, provided that the CDE uses substantially all of the $10 million in equity to fund qualifying activities. Qualifying activities include, for example: development of commercial real estate projects in low-income communities; loans to or investments in qualified businesses in low-income communities; loans to or investments in other CDEs; and the purchase of qualifying business loans from other CDEs.

How New Markets Tax Credits Work



Bank Enterprise Awards Program

- The Bank Enterprise Awards Program provides monetary incentives to banks and thrifts for financially supporting CDFIs and for increasing lending, investments, and services in distressed communities Award amounts are calculated based on increases in these activities during a 6-month Assessment Period in excess of activities that occurred during a 6-month Baseline Period.
- Award amounts for **CDFI Equity Investment Activities** — such as grants and equity investments in CDFIs — are generally 15 percent of the increase in these activities.
- Award amounts for **CDFI Support Activities** — such as loans and deposits in CDFIs — are 11 percent of the increase in these activities for most banks carrying out these activities.
- Award amounts for **Development and Service Activities** — such as services that the bank provides and loans that the bank makes in a distressed community — are generally 5 percent of a score calculated in a multi-step procedure that assigns weights to various types of activities.

For a detailed example of how these awards are calculated, please visit the OCC's CDFI and CD Bank Resource Directory at http://www.occ.treas.gov/cdd/cdresource.htm