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November 3, 2003

Office of the Comptroller of the Currency
250 E Street, SW, Public Information Room
Mailstop 1-5
Washington, DC 20219
Attention: Docket No. 03-14
Fax: 202-874-4448
regs.comments@occ.treas.gov

Jennifer J. Johnson, Secretary
Board of Governors, Federal Reserve System
20th Street and Constitution Avenue, NW
Washington, DC 20551
Re: Docket No. R-1154
Fax: 202-452-3819, 202-452-3102
regs.comments@federalreserve.gov

Robert E. Feldman
Executive Secretary,
Federal Deposit Insurance Corporation
550 17th Street, NW
Washington, DC 20429
Attention: Comments
Fax: 202-898-3838
Comments@FDIC.gov

Regulation Comments
Chief Counsel's Office
Office of Thrift Supervision
1700 G Street, NW
Washington, DC 20552
Attention: No. 2003-27
Fax: 202-906-6518
regs.comments@ots.treas.gov

*Re : Risk-Based Capital Rules
Proper Treatment of Affordable Housing Equity investments*

Dear Ladies and Gentlemen:

As you requested, we write to comment on the proposed Risk-Based Capital Rules (commonly known as the Basel II proposals), insofar as they relate to affordable housing and community development (AH&CD) equity investments.

In addition to recommended changes in your proposed treatment, our letter will provide what we hope will be useful context – technical, public-policy, and global – on *why* AH&CD investments deserve to be distinguished from other forms of equity.

OCC proposal circulated for comment. The proposed rules include AH&CD investments made by banks and other financial institutions in compliance with the Community Reinvestment Act (CRA) in the category subject to the broader risk test for determining capital charges for higher risk, non-CRA investments.

Recommend change. We recommend modifying the proposed rules to treat AH&CD equity investments that meet CRA equity tests or the Part 24 "Legislated Program Equity Investments" definition as exempt from being accounted in higher capital charges.

Executive summary: reasons for making the recommended change. This proposal is inappropriate on technical grounds, counterproductive on public-policy grounds, and will do harm in other nations beyond the US:

1. *Technical.* AH&CD investments are *much less risky* than typical equity, for reasons both structural (program features) and historical (failure rates far below conventional equity).
2. *Public-policy.* AH&CD investments are enabled, encouraged, credit-enhanced, and subsidized by deliberate federal policy. These funds are part of the US affordable housing financial delivery system and a critical element in production and preservation nationwide.
3. *Global ramifications.* Other nations take their lead from the US not only on financial-market transparency but also on housing-finance delivery. An OCC decision against AH&CD investments will hurt affordable housing in other developed and emerging nations.

Our credentials in AH&CD finance. Recap and I have national credentials on both *practice* of affordable housing and *policy and program development* in this arena.

1. *Practice: investment banking \$1.2 billion of AH&CD investments.* In the 14 years since its founding in 1989, our company, Recapitalization Advisors, Inc. (www.recapadvisors.com), has closed AH&CD transactions involving over \$1.2 billion in real estate value encompassing 288 properties representing more than 38,000 apartments. These activities include: equity and debt; new properties and preservation of existing properties; acquisition, refinancing, rehabilitation, and disposition. We are active across the full spectrum of HUD multifamily programs; our clients have accessed all available resources, including HOME, CDBG, volume-cap tax-exempt bonds and Low Income Housing Tax Credits (LIHTC's).

As Recap's founder and president, I personally have 28 years' experience in AH&CD finance, as further outlined in my professional biography (attached).

2. *Policy and program development.* For more than a decade, Recap has provided nationally recognized unbiased quantitative evaluations on AH&CD, including the following work:

- 1994: HUD business process redesign working group.
- 1995: Presentation to the Financial Accounting Standards Board (FASB) of quantitative analysis of LIHTC residual value expectations. (FASB rule subsequently modified.)
- 1995: Co-author (with Ernst & Young) of a study on the LIHTC's first ten years.
- 1996: Senate Housing Subcommittee, development of mark-to-market legislation.

- 1998: Conceptualization and program analysis at the request of Congress in the creation of enhanced Section 8 vouchers, a critical tool in preserving at-risk affordable housing properties.
- 2000: Millennial Housing Commission, author of its paper on the Low Income Housing Tax Credit. www.mhc.gov/papers/lihtc.doc.
- 2003: Extensive public commentary on the potential impact of dividend tax exemption (DTE) on AH&CD equity investments.

With over 100 articles published in national AH&CD professional journals, our work is frequently cited and referenced among legislators, administrators, and stakeholders.

3. *International.* In addition to Recap's work in the United States, the Affordable Housing Institute (www.affordablehousinginstitute.org), a non-profit I founded, works worldwide to help people create, improve, sustain and preserve affordable housing. As such, we have given presentations to AH&CD professionals from over fifty countries. AHI is active on three continents and is working closely with host-country stakeholders in the United Kingdom and South Africa on fiscal initiatives to stimulate affordable housing:

- 2002: Participation in the UK Liverpool symposium. Co-developer of proposed UK Housing And Regeneration Tax (HART) Credit. www.hartcredit.org.uk.
- 2003: Facilitation with the Banking Council, South Africa on black empowerment enterprise (BEE) financing of affordable housing initiatives in conjunction with the released published financial sector Charter.

The technical case: AH&CD equity investments have substantially lower risk. At their very name implies, the Risk-Based Capital Rules seek to cause financial institutions to reserve adequate capital commensurate with risk; hence proper assessment of risk categories is essential.

Though classified as equity, AH&CD investments have substantially lower risk than traditional equity. This is demonstrated by track record, performance that is no fluke but a logical outcome of the risk-mitigation elements government has specifically built into AH&CD programs.

Economic characteristics: track record and yield volatility. AH&CD equity investments have a long and highly successful track record: *de minimis* failure rate coupled with reliable yield.

1. *Track record performance: failure rate de minimis.* The principal form of AH&CD equity is investment in properties that generate Low Income Housing Tax Credits (LIHTC's). Enacted in 1986 (in the very same Tax Reform Act that eliminated spurious tax 'shelters'), the LIHTC has produced over 1,000,000 apartments nationwide. LIHTC equity investment today generates about \$6 billion a year of new equity capital that is responsible for more than 90% of all multifamily affordable housing production nationwide.

In 2002, Ernst & Young (E&Y) published a report entitled, *Understanding the Dynamics: A Comprehensive Look at Affordable Housing Tax Credit Properties*. After reviewing 7,824 properties with a cumulative investment of \$13.67 billion, E&Y found that:

[F]oreclosures are exceedingly rare in housing credit properties:

- Of the 7,824 properties surveyed, only 14 had either been foreclosed upon or tendered a deed in lieu of foreclosure to their lender. Thus, only 0.14% of these properties had been lost to foreclosure during the period surveyed (1987-2000), or 0.01% on an annualized basis.
- On this basis, the foreclosure rate in housing credit properties would be approximately 100 times lower than it is for commercial real estate. [page 2]

To repeat: the foreclosure rate is fewer than 1½ properties per 1,000.

Most debt wishes it had a failure rate as low as this 'equity.'

2. ***Investment yield reliable: more like debt.*** The foreclosure rate is particularly relevant because *the LIHTC equity investor receives its full LIHTC yield so long as the property avoids foreclosure*. Investors in LIHTC properties receive three benefits: (a) LIHTC's, (b) tax deductions (arising principally from depreciation), and (c) future cash flow or residual value. On a net-present-value basis, LIHTC's represent more than 90% of the total benefit.

Moreover, LIHTC annual yield is *not* volatile. LIHTC's are earned over 10 years in amounts that are established – quantified and invariant – at property completion, and measured simply by eligible basis times applicable percentage. In other words, *the annual LIHTC yield works much more like an annuity than like equity*. Indeed, LIHTC investments are structured as equity, rather than as subordinated debt, simply because §42 of the Internal Revenue Code mandates that the LIHTC's must be allocated commensurate with ownership (as defined by P&L shares).

In short, LIHTC investment has all the economic indicia of annuitized debt but must be structured as equity to comply with applicable law.

Structural features: program risk mitigators and equity guarantees. Beyond the delivery features – low foreclosure rate, reliable yield – AH&CD equity investments mitigate risk in two critical ways: (1) intrinsic program resilience available to affordable housing as a property type, and (2) investment structure with sponsor guarantees to insulate equity investors.

1. ***Program resilience: competitive advantages and structural corrections.*** Public-private affordable housing (of the kind that uses AH&CD investments) is a deliberate construct of continuous and philosophically consistent federal government policy. Since 1968, the federal government has used favorable financing (on debt) and tax benefits (on equity) to channel private capital into AH&CD. The resulting affordable housing properties have some or all of the following critical features:

- *Rent bargain.* Resulting rents are at or below market levels, usually calibrated to be affordable to low, very low, or extremely low income households.¹
- *Cheap debt.* Loans have interest rates below market either because they are tax-exempt, government credit-enhanced, or from a government entity (usually a state or locality).
- *Favorable-payment debt.* Often the government provides 'soft debt' – with accruing or deferred payment financing – to fund some of the cost-value gap.
- *Resident rent-paying subsidy.* To support affordability for very low or extremely low income households, government provides rent-paying subsidy, usually in the form of Section 8.

Taken together, these features mean that affordable housing properties run higher occupancy and have a much greater ability to cope with market softness or other swings than do conventional properties.

These design choices are deliberate – the government, having invested so much in affordable housing (\$350 billion in 2003 dollars, according to our estimate), wants that housing to be successful over the long term.

2. *Ownership structure: sponsor guarantees.* LIHTC investment is not common stock or a similar equity, but in fact a structured-finance investment with both a *sponsor* and an *investment banker* playing a role. This is significant because the proposed rule includes Community Economic Development Entities ("CEDE's") which, in the context of AH&CD investments, are in fact risk-mitigating structures that build in additional investor protection.

- *Ownership: passthrough structured-finance entity.* Each affordable housing property receiving LIHTC's is owned by a single-purpose entity (SPE) that is not taxed for itself but rather passes through its tax consequences to its partners/ members.
- *Sponsor: specialist organization that makes guarantees.* The SPE always has a sponsor – the real estate development/ operating company that arranges financing, constructs the property, and then operates it thereafter. With 35 years' use of public-private vehicles, there has emerged a strong population of specialist developers – some for-profit, others non-profit – and an infrastructure of skills and best practices. The sponsor not only brings that expertise, but makes significant financial commitments as negotiated by the investment banker.
- *Investment banker: boutique originator.* Capital raising for LIHTC equity investments is normally done by investment bankers,² specialized boutiques who on a private-label or fund basis structure the investments by negotiating with sponsors.

¹ In HUD parlance, low = 80% of area median income (AMI) or below, very low = 50%, extremely low = 30%.

² Some large entities, such as the GSE's (Fannie Mae and Freddie Mac) may invest directly, but in effect these groups are neither ignorant nor naïve: they have simply pulled the investment banking function in-house.

(More recently, the investors themselves have banded together as the Affordable Housing Investors Council, www.ahic.org to share best practices.)

The whole delivery system has powerful checks and balances that in the end allocate the lion's share of the risk either to the soft debt, to the sponsor, or both. The equity investment made by financial institutions that would be subject to Basel II is thus significantly insulated from operating risk and financial downside.

The policy importance of AH&CD investment: domestic and international. Beyond the proposed rule's implications for particular investments and the financial sector, it will have a bearing on a larger priority – the flow of capital into affordable housing and community development, not just in the US but around the world.

1. *Affordable housing as an element of national policy.* Multifamily affordable housing has been an element of national policy since 1937, renewed (among other times) in 1949, 1968, and 1986. Using tax-motivated equity to channel private capital allows private partnerships to accomplish public goals at lower cost and higher quality than direct government involvement. LIHTC equity is the most recent, most durable, and most successful of these fiscal initiatives.

Aside from the technical reasons cited above, there are larger public-policy benefits of a robust housing finance system and a consistent set of rules that apply over long periods. In this context, you will have noted the letter (copy attached) from eleven members of Congress, including Ranking Minority Member Barney Frank, regarding the proposed rulemaking.

Grandfathering existing investments but disadvantaging future ones would also be a wrong outcome because it would signal that the investments *are* indeed risky but are being exculpated by accident of timing.

2. *Worldwide: the use of fiscal initiatives.* The world looks to the United States to show leadership in many arenas, including fiscal policy, transparency and quality of financial reporting and securities market regulation ... and public-private partnerships and affordable housing. It is therefore incumbent on US regulators not simply to make an exception for AH&CD investments domestically, but also to press the case in the larger Basel II context.

Via the Affordable Housing Institute, I personally have direct experience with two nations – the United Kingdom and South Africa – that are moving toward or further into public-private affordable housing and are using or intend to use fiscal initiatives, chiefly tax credits (www.hartcredit.org.uk) or tax savings,³ as their vehicle of choice. In discussions among leading South African bankers, for instance, treatment of proposed new loans under Basel II's risk-capital ratios specifically came up, and it was stated in the

³ The South African paper on using Tax Relief Initiatives provides useful background. It is available on AHI's Web site at http://www.affordablehousinginstitute.org/learn/library/AHI_SA_TRI_Paper.pdf.

clearest possible terms that more money would flow if the risk-capital treatments reflected their true risk.

We urge the OCC, OTS, and US delegates at Basel II Capital Accords discussions, to advance the case for giving AH&CD investments favorable treatment, *regardless of nation of origin*, if they (a) benefit from government involvement, and (b) generally meet the tests outlined in "Legislative Program Equity Investments." It would signal countries seeking to advance their affordable housing that bank regulators recognize the importance of flowing capital into underserved neighborhoods and into long-term housing affordability.

Applicability to other investment forms. Our comments are limited to AH&CD investments, but no inference should be drawn that we think AH&CD are uniquely worthy of this treatment. We simply have expertise in AH&CD, and not elsewhere. Other initiatives may also benefit from the combination of governmental imprimatur, public-policy benefits, and inherent structural protections, and be worthy of exclusion from the risk-based capital tests.

Thank you for the opportunity to present our views.

Very truly yours,



David A. Smith
President, Recap Advisors, Inc.
Founder, The Affordable Housing Institute

Enclosures:

Professional biography, David A. Smith

Letter from Housing Financial Services committee minority members

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