Using New Markets Tax Credits to Mitigate the Impact of Foreclosures on Communities

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Across the country, committees have been established to come up with ways to mitigate the impact of foreclosures on lower-income communities. A few are exploring the feasibility of having community-based organizations use the New Markets Tax Credit (NMTC) Program to facilitate the purchase of foreclosed residential properties for rehabilitation and resale to low- and moderate-income families.[2] In theory, these organizations could use the tax credits to help recover their costs for purchasing, fixing up, and selling homes at a price that is affordable to lower-income buyers. Moreover, the tax credits could help community-based organizations attract appropriate amounts of capital to conduct transactions at a scale that would stem disinvestment in troubled neighborhoods.[3]

We interviewed numerous community development finance practitioners and asked them to identify: (1) organizations across the country using or considering using the NMTC Program to mitigate the community impact of foreclosures, and (2) the potential barriers that organizations need to overcome when seeking to use NMTCs for these purposes. Below we have incorporated their responses into a brief discussion of the potential for using the NMTC Program to promote neighborhood stability in communities with concentrated foreclosures.

1 A version of this article appears in New England Community Developments, Issue 3 (2008), Federal Reserve Bank of Boston, available at http://www.bos.frb.org/commdev/necd/index.htm.

2 The NMTC Program, established by Congress in December 2000 and administered by the CDFI Fund at the U.S. Department of Treasury, gives individuals and corporations the opportunity to receive a credit against income taxes by investing in businesses located in or serving low-income communities. The CDFI Fund (http://www.cdfifund.gov) and Coastal Enterprises Inc., available at http://www.ceimaine.org.

3 In an NMTC deal, the capital flows to a business through a special-purpose financing LLC, known as a Certified Development Entity (CDE). A bank, private equity investor, or other capital source can invest directly in the CDE or through an upper-tier conduit LLC as a means of leveraging the equity capital and bifurcating the tax credits. In the leveraged transaction, investors can provide the debt, equity, or both. Community partners often provide debt capital alongside other investors in a leveraged transaction. The equity provider would most likely receive its return using the available tax credits calculated on the basis of the combined total investment amount (debt and equity), thereby assuming nominal project risk. The 39 percent tax credit on the amount invested is realized over seven years. The business gets the capital on favorable terms and the investor gets the tax credits. Any debt financing in such a leveraged NMTC model could be at market rates if the available tax credits are mostly allocated to the equity investors. Alternatively, some tax credits could be allocated to the debt provider as incentive to make the capital available at more attractive financing rates and terms.

Four Models

Enterprise Community Investment Inc. and Columbus Housing Partnership's NMTC Transaction

We identified four examples of organizations planning to make use of NMTCs to promote neighborhood stabilization in areas with high foreclosures. Only one of these models has been implemented so far: A NMTC transaction by Enterprise Community Investment Inc. and the Columbus Housing Partnership (CHP) to build and rehabilitate single-family homes.

The transaction involved capitalizing a $9.5 million investment fund leveraging $3 million in NMTC equity. The proceeds from the fund were used to make low-cost loans totaling $9.5 million to CHP for the purpose of financing the construction and rehabilitation of up to 700 homes targeted to households earning less than 80 percent area median income (AMI) in the Columbus, Ohio, area. Using this model, the $9.5 million helped to fund and create capacity for a project that could reach $80 million in total development costs. To date, CHP has purchased and rehabilitated 29 foreclosed properties under the program, of which ten have been sold.

The strength of the model lies in the support of key partners. CHP will offer home-buyer education and counseling services and buyer financing incentives made possible with funding from City of Columbus sponsored programs. The public funding is provided as part of the city's Home Again program, which was established in 2006 to stimulate home development in areas close to employment, to encourage homeownership, and to stop neighborhood deterioration. CHP has also partnered with local financial institutions, including Huntington Bank, to offer mortgage financing to targeted homebuyers. Many homes are also located in Columbus Neighborhood Investment Districts (NIDs), which enjoy 15-year property-tax abatements.

City First Homes Housing Trust Model

The community housing trust City First Homes (CFHomes) Inc., part of the City First Enterprises family, will manage a $75 million fund to create 1,000 units of permanently affordable workforce housing in Washington, DC. CFHomes will leverage both a $10 million grant from the District and NMTCs to raise an additional $65 million in capital to create the pool of second mortgages for use by low- and moderate-income buyers. In addition, the program leverages operational grant funds from a variety of supporters, including DC United Way, HSBC, F. B. Heron Foundation, Ford Foundation, Fannie Mae, NeighborWorks America, and Living Cities.

Foreclosure response has emerged as a key component in the larger effort and will account for at least ten percent of homes placed in the trust over the next 24 months. CFHomes will purchase real estate owned (REO) properties, complete necessary renovations, and place the properties back in service, selling them to eligible buyers, who will agree to the accompanying deed restrictions.

Partnering with qualified developers and trusted realtors, CFHomes will offer newly built as well as rehabbed homes for sale. Homes will be located in mixed-income neighborhoods throughout all eight wards of the city. CFHomes will assume stewardship responsibilities for the portfolio of homes, provide ongoing support to homeowners, manage resales, and maintain the permanent affordability of the homes.

As a housing trust, CFHomes provides low-interest second mortgages to qualifying purchasers in exchange for agreeing to share any future appreciation. Sellers retain 25 percent of any increase in value accruing to the property, as measured appraisal to appraisal, thus maintaining affordability over the long-term life of the property without the need for future subsidy. The second mortgages will consist of 40-year subordinate mortgages averaging $75,000 with a fixed 3.99 percent mortgage that is interest-only for seven years and then amortizes for years eight to 40. The deal includes mandatory homeownership counseling incorporating best practices of the NeighborWorks America full-cycle lending model, with a focus on shared equity and post-purchase support.

Clearinghouse CDFI's NMTC Single-Family Model

The model proposed by Clearinghouse CDFI in Lake Forest, California, is different from the others in that it aims to help homeowners avoid foreclosure in the first place. The program would use NMTCs to help finance a rescue loan product for low-income homeowners who are unable to repay their subprime mortgage and/or to finance first-time homebuyers of single-family homes.[4]

Clearinghouse would finance a home aggregator, an entity engaged in the purchase and resale of single-family homes. In the case of occupied properties, the home aggregator would purchase the home from the owner, retire the existing mortgage on the property, and then sell it back to the family while providing a new fixed-rate, 80/20, regularly amortizing mortgage. The aggregator would provide favorable financing to the family by using NMTCs to finance the 20 percent second loan. For low-income families seeking a loan on their first home, the home aggregator would purchase the home and then immediately sell it to the family, also providing favorable financing made possible by leveraging NMTCs for the second mortgage.

Clearinghouse estimates that when factoring in a conservative loss rate, NMTC investors would receive an acceptable market-rate after-tax IRR. The returns become more attractive when even a small amount of foundation or government resources are factored in and as the performance of the second loans increases. Currently, the CDFI sees an opportunity in using Neighborhood Stabilization Program (NSP) resources as leverage under an NMTC structure.

4 Clearinghouse CDFI received feedback from the IRS indicating that a rescue-loan product may constitute a "refinance" and therefore may not be allowable under the current NMTC program. The CDFI will seek additional clarification on this point while continuing to pursue both the rescue-loan product and financing for first-time homebuyers.

The organization was successful in obtaining a $90 million NMTC allocation in 2008, which it plans to apply toward such a program. In spite of the obstacles that would need to be overcome in order to develop a feasible program, the Clearinghouse CDFI is optimistic that it will be able to develop an application for NMTCs that can help troubled borrowers and first-time purchasers of single-family homes.

The Rhode Island Statewide Community Land Trust's "Rebuilding Equity and Ownership Fund of Rhode Island"

The Housing Network of Rhode Island has proposed offering NMTCs to investors who own REO properties. These tax credits would allow the investors to sell the properties to the Network's nonprofit affiliate, the Statewide Community Land Trust (SCLT), at a reduced sales price. The SCLT has undertaken a demonstration fund that would purchase up to ten vacant properties and rehabilitate and sell them to low- or moderate-income homeowners. The demonstration fund does not make use of the NMTCs; rather, it is intended to illustrate the strengths of the various partners for bringing the program to scale.

As originally envisioned, the SCLT would leverage the success of the demonstration fund to implement a larger program using the tax credits. The SCLT would create a for-profit Community Development Entity (CDE)–Rhode Island Rebuilding Equity and Ownership Fund (RIREO)–that would raise $20 million in debt and $10 million in equity from up to five banks under the NMTC Program. Because of the revolving nature of the CDE portfolios, the REO Fund should be able to purchase, rehabilitate, and sell more than 1,000 units in the state over the seven-year period of NMTC eligibility. Participating community development corporations would be able to purchase vacant properties from the investors in the RIREO and borrow acquisition funds and rehabilitation funds from the RIREO at low rates.

The effort was initiated and funded by NeighborWorks America and developed by them and several private-sector experts in discussion with staff of the CDFI Fund.

However, the Housing Network has tabled the proposal for the time being because of the challenge of getting all the parties together for a statewide effort, the fluctuating economic position of the target banks, and the difficulty in securing properties that need to be aligned with the target banks. The group is instead going with a program involving three CDCs and one lender that holds a large amount of REOs in the state, Fannie Mae. But since Fannie Mae is not in a position to find the NMTC attractive, this option is not being pursued.

Key Issues

Our interviews identified several potential barriers to using the NMTC Program to promote neighborhood stabilization. Below we highlight the most frequently cited issues. The first three pertain to the requirements and/or limitations of the NMTC Program. The others pertain to current conditions in the housing and financial markets.

1. **The difficulty obtaining an NMTC allocation.** Some organizations are reluctant to invest the up-front time and effort needed to develop a viable model for using the program to address neighborhood stabilization because they may not be able to obtain an allocation from the CDFI Fund or be able find current allocatees willing to use their allocations for nontraditional uses.
2. **The need to secure a strong pipeline of deals and a solid exit strategy for those deals.** Under the NMTC Program, any return of capital needs to be redeployed within 12 months. Therefore, partnerships must include organizations with a strong capacity for identifying properties for purchase and rehabilitation, as well as organizations with a strong capacity to identify and educate potential homeowners and connect them with affordable financing.
3. **The need to combine the NMTCs with other subsidies in the cases where groups intend to purchase foreclosed properties.** While the NMTC Program can help offset the costs organizations would incur for purchasing and reselling foreclosed properties, in many scenarios the tax credits may not be sufficient and would need to be supplemented with other subsidies.
4. **The current appetite for tax credits, given bank losses. Banks are large users of NMTCs, and many NMTC transactions are dependent on these institutions' demand for tax credits.** At present, there is a lot of uncertainty over banks' appetite for these tax credits in the near to medium term, in light of recent financial losses at these institutions. The consolidation in this sector may be an even bigger issue because some of the formerly large players in the NMTC market will not continue to exist in 2009.
5. **The impact of housing market trends on project goals.** A further downslide in housing prices or a prolonged slump in housing prices could hamper the ability of projects to meet production and sales goals and/or adversely affect organizations' ability to redeploy funds.
6. **The impact of housing market trends and tightened credit on the ability to refinance distressed borrowers.** Many mortgage refinancing programs rely on the willingness of lenders to undertake principal write-downs or modify existing loans in other ways. As of the end of 2008, the Hope for Homeowners program (part of the Housing and Economic Recovery Act of 2008 passed by Congress)–designed to help homeowners by encouraging lenders to voluntarily write down loan principal–has had lighter volume than anticipated. Lenders largely view write-downs as harming the net present value to end investors and so assert that the contracts that govern mortgage-backed securities do not allow for such write-downs. Moreover, many homeowners have taken out a second lien on their property; second-lien holders have to consent to principal write-downs and so far have been slow to do so. In addition, tighter credit standards are affecting the ability of potential new homeowners to acquire mortgages.

7. **The holding costs of rehabilitating foreclosed properties.** These costs, including property taxes and utility bills, increase the longer properties stay vacant. Any financing vehicle needs to account for these holding costs and have a clear exit strategy to minimize its holding time.

Conclusion

In our interviews, community development practitioners suggested several areas for policy action that could facilitate the use of NMTCs for promoting neighborhood stabilization. Some groups are advocating for changes to the NMTC Program itself. A number of groups have suggested legislation that would create a separate, additional allocation of tax credits that would be used for the purchase, rehabilitation, and resale of foreclosed properties in low-income areas. Clearinghouse CDFI believes there is an opportunity for clarification about whether the tax credits can be used to refinance mortgages when the credits are intended to help families who might otherwise face foreclosure. Many groups have also lamented the complexity of navigating the NMTC Program requirements. Some of the organizations interviewed for this article suggested bringing together stakeholders from various sectors, including the public sector, investors, and community development groups, for targeted conversations on how to use the NMTC Program to help neighborhoods that are facing high levels of foreclosure.

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Douglas J. Bystry, President & CEO, Clearinghouse CDFI

Linda Davenport, formerly the Deputy Director of Policy and Programs, the CDFI Fund

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Ray Neirinckx, Coordinator, State of Rhode Island Housing Resources Commission

Alazne Solis, Vice President, Public Policy, Enterprise Community Partners Inc.

Charlie Spies, Managing Director, CEI Capital Management LLC

Charles D. Tansey, Senior Adviser, Office of the Chief Executive Officer, NeighborWorks America

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