September 3, 2009

Matthew Josephs
NMTC Program Manager
Community Development Financial Institutions Fund
U.S. Department of the Treasury
601 13th Street, NW
Suite 200 South
Washington, DC 20005

Re: Comments on NMTC Allocation Application

Dear Matt:

This letter is in response to the Request for Comments on the NMTC allocation application. By way of background on my experience with the NMTC program, I have advised twelve successful applicants with allocations totaling $777 million on their initial NMTC business plans, allocation applications and subsequent deployment into QLICIs, so I am intimately familiar with the day-to-day workings of the program.

The CDFI Fund has done a truly outstanding job over the years in developing a comprehensive and thoughtful application that has been instrumental in awarding allocations to high-impact organizations. Thus, these comments are in the context of making what is already a good application better.

There are two significant ways in which the application can be improved that would significantly increase the impact of the NMTC program.

Questions 16 and 17 Focus on Interest Rate Subsidy

Questions 16 and 17 of the Application, and the subsequent allocation agreement, focus on interest rate subsidy to QALICBs, when in fact the majority of NMTC transactions deliver subsidy to QALICBs through what is the economic equivalent of partial forgiveness of the QLICI after 7 years. The investor and QALICB markets drive most NMTC transactions to be structured as “A/B” transactions. In an A/B transaction, the QLICI is divided into two notes. The “A” note has a principal amount, interest rate and term that generally match the leverage loan to the upper tier investment fund (Upper Tier Fund) in the transaction. After 7 years, principal repayment of the A note is distributed up through the NMTC structure to ultimately repay the leverage loan.

The “B” note generally equals the amount of equity invested by the tax credit investor in the Upper Tier Fund minus fees and expenses associated with closing the transaction. The B note usually carries a nominal interest rate. Much more importantly, the B note can be repurchased by the QALICB or an affiliate after 7 years for a nominal sum, because the Upper Tier Fund’s equity investor is repaid through the NMTCs it receives over the 7-year period. This purchase option effectively results in a permanent infusion of equity into the project after 7 years, because the QALICB repurchases the B note for a fraction of its face amount. (Tax rules unfortunately may not allow a loan to be directly forgivable, which is why the repurchase mechanism was developed.)

While investors and QALICBs have driven the A/B structure, public policy should also favor the A/B structure over interest rate subsidy for two reasons. First, the A/B structure makes it more likely that the NMTC subsidy will go to projects that truly need the subsidy. As part of their underwriting, a leverage lender requires a QALICB to demonstrate that it can refinance their QLICI at a market rate in 7 years when the NMTC subsidy disappears. (This assumes the leverage loan has a 7-year term, which is true for the majority of NMTC transactions.) If the QALICB cannot afford a market interest rate for the first 7 years, it is unlikely that they will suddenly be able to carry market rate debt after 7 years. Thus, leverage lenders will drive the NMTC program to finance many projects that could otherwise be financed at market rates, since they will want to know that the NMTC financing can be taken out after 7 years by market rate debt. The A/B structure avoids the issue, because the project has the proven ability to service the A note (which matches the terms of the market rate leverage loan) and the B note in effect is converted to project equity after 7 years. Thus, the borrower in the A/B scenario has no debt service issues in refinancing its debt after 7 years, and thus is more likely to be a project that truly needs the NMTC subsidy for permanent project equity.

The second reason that public policy should favor the A/B structure over interest rate subsidy is that project equity is the key barrier to development in low-income communities, not interest rate subsidy. Interest rate subsidy provided by the NMTC program disappears after 7 years, leaving any projects that require it in jeopardy. Project equity provided through the A/B structure is a permanent investment in the community. The initial impetus behind the NMTC program recognized the importance of equity investments in low-income communities, and the A/B structure does exactly that.

Question 16 should be expanded to include the A/B structure as a flexible term, and Question 17 should favor the subsidy provided through the B Note over, or at least equal to, interest rate subsidy. The allocation agreement should also be changed to reflect the market realities and public policy benefits of the A/B structure.

Question 56 Compensation and Profits

Question 56 (compensation and profits of the allocation applicant) was an excellent addition to the application, but is currently structured in a way that unfairly favors applicants that are investing in their own tax credits over nonprofit applicants (such as CDFIs) that will be raising QEIs from banks and other investors.

Question 56 appropriately asks nonprofit and other applicants to detail their fee structures, but does not ask investor applicants to detail what price they will pay for the tax credits for which they are applying for their own investment. An investor applicant can accurately state in response to Question 56 that they will charge zero fees, and thus will score substantially better than a nonprofit applicant who has to charge fees. In reality, however, an investor applicant can earn substantially above market IRRs on the NMTCs they are awarded by simply paying less for the credits they are awarded. Take two investors, one of which pays 50 cents on the dollar for the tax credits they are awarded and another investor that pays 65 cents. Assume the QEI is for $10 million. One investor “pays” $1.95 million (the amount of its equity investment in the Upper Tier Fund, or 50% times 39% times $10 million) for the tax credits. The other investor invests $2.535 million (65% times 39% times $10 million) in the Upper Tier Fund. The investor who pays $1.95 million for $3.9 million in tax credits will earn substantially more profit on its allocation than the investor who pays $2.535 million for the same $3.9 million in tax credits, yet there is nothing in the application that would favor the investor applicant who is willing to pay more for the tax credits. Moreover, a nonprofit applicant could use its allocation to raise capital from the investor who will pay $2.535 million, charge a $235,000 fee, and the QALICB would still benefit from $2.3 million ($2.535 million minus $235,000) in subsidy. This is substantially greater than the $1.95 million in subsidy that would be provided by the other investor through its own allocation, even though that investor can honestly answer Question 56 by saying they charge no fees.

CDFI and other nonprofit applicants add substantial value to the NMTC program by shopping for the best possible pricing for the tax credits and seeking maximum subsidy for the community development project. By shopping for investors that will maximize the price they will pay for the tax credits, CDFI applicants can produce a net benefit to the QALICB that is substantially higher than an investor applicant that is in effect buying their own credits at a much lower price. To be clear, investor applicants are important participants in the NMTC program and have been extraordinarily fair in their pricing, including during the current severe recession. However, to create a level playing field among applicants, Question 56 should look not only at fees for nonprofit applicants, but also the price at which investor applicants will be paying for allocations they are awarded directly.

Again, the CDFI Fund has done an outstanding job of developing and improving the NMTC allocation application over the years. Thank you for the opportunity to provide additional input in how the application could be further improved. If you have any questions, please feel free to call or email.

David J. McGrady
301-588-6410
davidmcgrady@hotmail.com