Notes Prepared By: Bruce Reed
Paul Weinstein

Remarks
Date: March 24, 1993
Time: 3:00 pm

BACKGROUND

On March 24, the National Community Action Foundation (NCAF) will begin its annual legislative conference. The Foundation is very interested in how they can utilize their network of agencies to help implement the Clinton Administration's anti-poverty and outreach agenda. 400 to 450 of the people will be in attendance, including board members, directors, and staff from community action agencies around the country.

NCAF represents nearly one thousand community action agencies that operate a variety of programs, including Head Start, fuel assistance, weatherization, and housing. The organization would probably be interested in your experiences with community action agencies in Arkansas.

EXPECTATION'S ABOUT YOUR REMARKS

You are scheduled to speak to the conference from 3:00 to 4:00 pm, however, David Bradley, NCAF's Executive Director, says you should feel free to talk as little or as much as you want. They would like to have a Q&A following your remarks. David Bradley assures me that the questions will be softballs, such as will the administration support community action agencies. There is considerable goodwill among the NCAF membership, who are relieved to have a Democrat in office after twelve years of Reagan and Bush. David Bradley emphasized to me that the membership will be satisfied if all you say is that the Reagan-Bush era is over, and President Clinton is open to the ideas of NCAF.

TALKING POINTS

- Putting people first means putting people back in control -- of their lives, their neighborhoods, and their country. There are plenty of ways to do it. Community development banks, Head Start, low-income energy assistance programs.

- President Clinton has stated that to restore our cities and encourage rural economic development, we must create a partnership at all levels, committed to excellence and community service. The federal government must get involved again, working hand and hand with state and local governments. Non-profit organizations have a major role to play. But most important, community groups and local citizen organizations must serve as the backbone of our rural and urban improvement efforts.

- President Clinton recognizes the need to develop innovative ideas to promote growth in low-income communities. The Working Group on Community Development and Empowerment is already at work developing proposals.

- The President has committed to investing in communities, people, and grass root organizations. His economic plan includes additional funds for Head Start, low-income housing, weatherization assistance, and community development banks.

- President Clinton understands the effectiveness of community action agencies. He used them innovatively as Governor of Arkansas in implementing welfare reform. Our door is open to your ideas on how to utilize the community action agencies in encouraging community development, opportunity, and empowerment.

FACT SHEET

Community Action Agencies Program

- President Bush tried to eliminate the Community Action Agency program. He proposed zeroing out its budget for Fiscal Year 1993. Congress was able to fund the program at $372 million, in great part due to the efforts of the National Community Action Foundation

- For Fiscal Year 1994, the Community Action Program's funding will be frozen at last year's level -- $372 million. The program is funded out of HHS as part of the Community Service Block Grant. The NCAF is comfortable with this level of funding.

- The program is up for reauthorization this year. To the best of my knowledge, I do not believe the Administration has taken a position on the legislation yet.

- The Community Action Agency Program was founded in 1964, as part of Lyndon Johnson's war on poverty.

Head Start

- Around 700 community action agencies operate Head Start programs.

- The Clinton Administration's economic package proposes to increase funding for Head Start by $3.2 billion by 1997, $8 billion over four years, achieving full funding for an estimated 1.4 million eligible disadvantaged children by 1999.

Weatherization Assistance

- As part of the stimulus package, the weatherization assistance program for low-income citizens will receive an increase of $60 million in 1994, and $100 million per year in 1995-1997.

- With a leveraging ratio of 1:1 from the states, an additional 450,000 homes will be weatherized over the currently projected number for the 1994-97 period.

Community Development Banks (CDBs)

♦ CDBs, community credit unions, revolving loan funds, microenterprises, go to neighborhoods that traditional financial institutions won't serve. Their leaders get to know the people there. They provide money for capital to start small business, for technical aid to keep their businesses going, for loans to rehab a gutted building. The President's economic plan includes $354 million (FY94–FY97) for development of a CDB network.

DEPARTMENT OF AGRICULTURE
OFFICE OF THE SECRETARY
WASHINGTON, D.C. 20250

April 16, 1993

To: NEC/DPC Enterprise Zone Working Group

Fr: Secretary Mike Espy

Re: Why we need ESOPs in Enterprise Zones

In 1985, White Pine, Michigan, an isolated copper-mining town of 1200 people, teetered on the edge of economic collapse. To keep the last working mine in Michigan's Upper Peninsula open, employees agreed to wage cuts in a $9 a share employee buyout of Copper Range, Co., owner of the mine.

According to the Wall Street Journal, "the timing couldn't have been better." In 1989 a West German concern paid $80 a share for Copper Range - putting $83 million into the hands of area residents. The 1017 employees of Copper Range pocketed an average of $60,000 each... Overnight, White Pine was transformed from one of Michigan's poorest places into one of its richest."

I relate this story because it demonstrates the unprecedented possibilities available to working Americans via ESOPs. Certainly every ESOP company is not bought out and workers don't accumulate $60,000 in assets overnight everyday. There are far more examples of ESOP companies where workers steadily accumulate assets. To be sure, there are also others where the ESOP is only a tool for the "real" owners to exploit tax breaks.

But when one considers the economic distress that characterized White Pine, Michigan, with scores of people on welfare, small businesses collapsing, families breaking up, and then comprehend the resulting resurgence, this kind of growth potential cannot easily be dismissed.

The essence of the White Pine, Michigan story is that average working Americans were empowered through an ESOP to become equity owners in a free market economy. Like all successful owners, when the value of their holdings increased (in part through their own sweat equity) they made a handsome profit. As we work to craft legislation that can really empower other Americans in communities where the economy collapsed long ago, White Pine, Michigan is powerful example and a success story waiting to be replicated. Within this success story are lessons that we should not ignore.

The ESOP allows hourly wage workers to participate in an aspect of the economy that is foreign to the vast majority. In the best run ESOP companies workers not only have significant stock holdings, they have full voting rights, enjoy access to financial data, and the companies rely on the workers' knowledge and input in the decision making process. In the best ESOP companies workers are empowered in every sense of the word.

In these companies workers not only become part owners, they are educated to think like owners. Most importantly they begin to act like owners. In his book, Paying for Productivity, Alan Binder observes, "It appears that changing the way workers are treated may boost productivity more than changing the way they are paid, although profit sharing or employee stock ownership combined with worker participation may be the best system of all." This is why 43 out of 100 companies on the Inc. Magazine 100 list have ESOPS.

Though ESOPs are not widely popular - there are only 10,000 in the United States - business pages have many examples of companies where shared ownership and responsibility with workers has greatly boosted productivity, profits and income.

For example, ConSonics, a high tech firm in the Shenandoah Valley with 119 employees, recently grew by 269 percent over a five year period. The reason: an ESOP set up over a decade ago under which employees have acquired about 45% of the stock and a system of participatory management that encourages all employees to help solve company problems.

Or take the example of the Michael Baker Corp., an engineering company in Pittsburgh. The company's ESOP, which kept the company from going under, was born in 1984 when Baker was piling up a $2 million annual loss. Since then, the company has turned around in a move the Chairman attributes to the ESOP. Between 1985 and 1991 Baker's revenue surged an average of 20% annually. Employment increased almost ten fold since 1984 to 2,040. More than 1,000 workers have interest in the ESOP which owns 61% of the company.

In June 1992 Inc. Magazine reported on another tremendously successful ESOP. In 1983 Springfield Remanufacturing Corp, in Springfield, Missouri, then owned by International Harvester, faced an uncertain future. IH was cutting loose operations like SRC in a desperate attempt to stay afloat. That's when the managers and 119 workers used an ESOP to buy the company - with stock worth 10 cents a share. The new management's philosophy was that the most efficient, most profitable, way to operate a business is to give everybody a voice in saying how the company is run and a stake in the financial outcome, good or bad.

From 1983 to 1986, sales grew by 30% a year. SRC went from a loss of $60,500 to a pretax earning of $2.7 million. The workforce increased to 650. The stock's value soared to $18.30, an increase of 18,200% in eight years. Hourly workers who had been with the company from the beginning had holdings in the ESOP worth as much as $35,000 per person - the price of a home in Springfield.

Yet another example is Oregon Steel. According to an April 1992 article in the Commerce Business Daily, employees doubled productivity after using an ESOP to purchase 16% of the company. In 1991 their share of company profits came to about 40% of base salaries. In the early 1980s the same company was saddled with high labor costs, outmoded technology and increased competition from foreign companies. Today, it is one of the most profitable companies in the industry.

Another example is Weirton Steel where an ESOP saved 8400 jobs and revitalized the town of Weirton, West Virginia. At Avis, 12,500 workers acquired 100% of the company in a $1.7 billion buy out. They are ahead of schedule at paying off the debt and may have already passed Hertz as the number one rental car company.

There are many similar success stories of companies rebounding, jobs saved, workers empowered, and distressed communities revitalized through employee stock ownership combined with creative management.

Of course there are also risks: some ESOPs replace conventional pension plans so workers risk losing everything if the stock becomes worthless. However, most small companies don't have pension plans anyway. Others are closing them down. We should protect against abuses by giving workers control over their own assets by requiring full disclosure and voting rights.

But the risk factor should not be a deterrent. Our goal is to put residents of distressed areas in position to take risks. At present, they have nothing to lose. I believe strongly that the potential benefits of ESOPs for residents of distressed areas far outweigh the risks. These workers typically have no jobs, no pension plans, and no assets. Diversification is not an issue because there are no savings to diversify. To forsake a financing tool that has proven successful because of risk or the possibility of abuse is tantamount to throwing the baby out with the bath water.

The key issue is whether or not the 100% interest exclusions we have proposed for special Zone ESOPs, coupled with the ESOP provisions already in the law, will attract sufficient capital investments to create jobs and equity ownership opportunities for residents of Enterprise Zones.

Experience already demonstrates that a 100% interest exclusion, coupled with other benefits for ESOPs already in the tax code, is a powerful tool to attract capital investments. The 100% interest exclusion has the same tax benefit as a tax free municipal bond. Bankers and other commercial lenders would make loans directly to Zone ESOP companies. However, unlike trickle down approaches, the expanded growth would be financed through a mechanism (ESOP) that creates ownership opportunities for employees.

Investments in Zone ESOPs will also be attractive because with financing through ESOPS workers know they will gain more take home income through productivity gain and increases in profits - therefore reducing pressure to increase labor costs. As shareholders, workers can increase their income levels through profit sharing and dividends without increasing fixed labor costs. When workers share equity growth and profit sharing companies can produce at lower costs and therefore become more competitive in the global marketplace.

Moreover, if workers have a substantial equity stake in their companies, they are unlikely to agree to the transfer of operations outside the community and more likely to do whatever is necessary to keep the company viable. The result would be a reduction of capital flight.

Clearly, if distressed areas are to reverse their economic decline and enter the economic mainstream sufficient capital must be attracted into those areas. Relying on microenterprises, mom and pop stores, and only small businesses, while helpful, simply won't get the job done. Further, there is simply no way government can spend enough money to "fix" all of the problems. Government can, however, utilize the tax code to direct capital to distressed areas in a way that truly empowers zone residents.

We must create an atmosphere where viable companies, especially our best run companies, will want to invest within enterprise zones - rather than abroad. That means reducing the cost of credit, lower than average market wage rates, a crime free environment (with community policing), and a highly motivated workforce - motivated by a real ownership stake and profit sharing in their jobs and communities.

Government can creatively utilize tax breaks (which almost universally benefit those who already have sufficient capital) to empower those who do not. The ESOP is not perfect. However, it has proven to be the best financial tool to marry capital with workers and, in the best cases, improve productivity, promote growth, and most of all enhance the incomes of working Americans.

There are too many places like White Pine, Michigan and Weirton, West Virginia that are still locked out of the economic mainstream to just ignore what has already happened in those communities. These are success stories waiting to be replicated.

I am convinced that a genuine empowerment strategy must focus on helping people acquire real ownership opportunities. People don't burn what they own. They do their best to protect and enhance it. The fundamental problem within distressed areas is that residents do not have enough opportunities to become owners - real stakeholders - in our society.

With enterprise zones we have an opportunity to start reversing this trend. ESOPs are not the total solution, but an important piece that, in many, many cases, has already succeeded in promoting economic growth, empowering people and revitalizing distressed communities.

THE WHITE HOUSE

WASHINGTON

APRIL 19, 1993

MEMORANDUM FOR THE PRESIDENT

FROM: BRUCE REED
GENE SPERLING

SUBJECT: ECONOMIC EMPOWERMENT AGENDA

Almost one year ago, you toured Los Angeles after the riots and predicted that despite all the media attention and Presidential fanfare, a year would pass and nothing would change. You were right. Across the country, poor communities from South Central LA to the Mississippi Delta are still reeling from a decade of declining opportunity and rising social and economic isolation.

Shortly after you took office, Bob Rubin and Carol Rasco asked us to set up a joint NEC–DPC interagency working group on community development and empowerment. We wanted a joint effort spanning economic and domestic policy that could look at the problems of economically distressed urban and rural areas -- not only to prepare specific proposals that could be passed this spring as part of your initial Budget, but to develop a framework that could incorporate other new ideas over the course of your administration.

Our first task was to focus on the economic empowerment portion of your community development strategy. Job and enterprise development are only a portion of what your administration hopes to accomplish in distressed areas, through health care reform, welfare reform, education reform, family policy, Head Start, and so on, but your campaign commitments and your stress on economic growth necessitated that we come forth with these proposals for FY1994.

To create this economic empowerment proposal, our group brought together policy people from half a dozen agencies, and met with members of Congress, community leaders, entrepreneurs, and federal, state, and local government officials. We agreed in principle on a comprehensive, three-part strategy with a strong economic focus:

1. Enterprise Zones: A two-tier plan to create 10 resource-intensive Economic Empowerment Zones and 100 less expensive Enterprise Neighborhoods around the country. These 110 communities would be targeted for economic development, reinventing government, community development banking and microenterprise, community policing, and the administration's other empowerment initiatives.

Bill [illegible]

2. **Community Banking:** A national network of community development banks and other community lending institutions, spurred on by a federal Community Banking and Credit Fund and perhaps by requiring major banks to start community development banks in return for limited interstate branching. We also propose ways to strengthen enforcement of the Community Reinvestment Act and fair lending requirements.

3. **Community Policing:** We included Community Partnerships Against Crime (COMPAC) -- a HUD initia~~tive to improve safety in public~~ housing — along with nationwide efforts to promote community policing with economic ~~development.~~ Communities will need to demonstrate progress against crime if they are to attract and maintain enterprises.

CONGRESSIONAL OUTREACH:

We have invited the major Congressional leaders in these areas to meet with us and with Bob Rubin and Carol Rasco -- including Maxine Waters, Floyd Flake, Charlie Rangel, Chairman Gonzalez, Bill Bradley, Chairman Rostenkowski, Chairman Riegle, Paul Sarbanes and Chairman Moynihan. We have also received copies of the bills pending in Congress and will continue to see which of their ideas can be incorporated.

By way of example, pursuant to our discussions with Representative Rangel and his staff, our Enterprise proposal includes a comprehensive approach to public and private investment and coordinated provision of government services, a mix of tax targeted tax incentives and Enterprise grants, and a major emphasis on safe streets. We also have included drug prevention and rehabilitation-to-work among the new initiatives which the Agencies are actively exploring for the Enterprise proposal.

With respect to the Community Reinvestment Act, our recommendation to move to performance-based standards for all bank lending (including for small business and commercial loans) adopts much of the direction and emphasis of Representative Waters' bill. In addition, Representative Waters has also suggested exploring the possibility of making the Federal Reserve Discount Window available for Community Development Banking to spur reinvestment in the inner cities. Although this would require a major rethinking of the Fed's long-established policy and practice, we have proposed including the Fed on the Board of the CD Banking Fund so that such institutional issues may be fully considered by the Fund with full input from the Fed.

Treasury and the FDIC are exploring the impact and cost of Representative Flake's proposal under the Bank Enterprise Act to appropriate funds to subsidize a discount in insurance premiums paid by banks (including CD Banks) to the extent of their loans in distressed communities. If you choose to require major BHCs to participate fully in the attached Community Banking proposal, the potential impact will be far greater; and the issue of providing additional support for bank lending in distressed communities can then be addressed more fully in this new context by the Fund and by you.

Finally, our Community Development Banking, Community Policing and Enterprise initiatives incorporate many of central components of the Bradley bills: incentives for personal savings and investment in the community, cops on the block and safe streets, a CD Bank fund to nurture a network of community development financial institutions, true Community Schools, and mobility and access to opportunity throughout the local labor market.

After you have agreed to a preliminary proposal, we will consult with these members of Congress and come back to you with additional ideas of theirs that can be included.

MESSAGE:

The attached memos present the proposals for enterprise zones and community development banks. These memos lay out the options and decisions you need to make for both proposals.

We also wanted to let you know our own view of how these proposals support the themes that you ran on and now form the underpinning of your economic plan.

First, these proposals offer a new, innovative approach. They move beyond the old left-right debate by taking an activist approach to empowering those in distressed areas without assuming that the answer to every problem is more federal spending on the one hand or more tax breaks on the other. They offer real opportunity to real people: a savings account, a cop on their block, an employment voucher that will reward any business for giving them a job, a local banker willing to invest in new jobs in the community. And we believe they represent a new direction for poor communities across the country in several other important respects:

* **Reinventing Government:** The working group makes reinventing government a centerpiece of our enterprise proposal. No community will get help unless they develop a comprehensive strategic plan that involves the private sector, builds on existing community institutions, and coordinates government efforts across program and jurisdictional lines. The solutions to these problems must come from the bottom up, from individuals and communities willing to help themselves. These proposals will change the way government does business -- including the federal government, which will conduct a competitive grant process through a single point of contact.

* **Accountability for Results:** Communities will receive unprecedented flexibility to design their own plan, but will be held accountable for real, measurable results in return.

* **Laboratories of Democracy:** Communities that show the initiative to make the most of these efforts will become natural targets for other initiatives in the administration's agenda. In exploring our proposals with other agencies and major private sector institutions, we've found a number that want to take part.

* **Comprehensive Growth Strategy:** These proposals foster efficient and entrepreneurial government that promotes both private investment and increased public investment in human and physical capital.

* **A Bold New Experiment:** Some will point out that there is no conclusive evidence that enterprise zones work, and that only three community development banks have been created in the history of the republic. They're right on both counts — because no one has been trying such new approaches with any federal support or leadership. Our proposals are designed to give these ideas a fair test, by targeting resources in a limited number of places and providing clear measures of success or failure. If these new approaches don't work, we can give up or try something else — but we shouldn't quit before we start just because the old answers have failed.

Whatever options you choose to put forward, we believe that these proposals provide you with a tangible platform to inspire hope and show your commitment to a new spirit of opportunity, responsibility, and community that will empower people from Watts to Mount Pleasant to believe in the promise of America again.

THE WHITE HOUSE

WASHINGTON

April 19, 1993

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MEMORANDUM FOR THE PRESIDENT

THROUGH: BRUCE REED
GENE SPERLING

FROM: THE NEC-DPC INTERAGENCY WORKING GROUP ON COMMUNITY DEVELOPMENT AND EMPOWERMENT

SUBJECT: ENTERPRISE ZONES

I. ACTION-FORCING EVENT

The legislative calendar and the continuing distress in many places in rural and urban America call for announcement of the first parts of your economic empowerment initiative.

II. BACKGROUND

Over the last two months, the NEC-DPC Interagency Working Group on Community Development and Empowerment has been considering several elements of an initiative to empower distressed communities to join the economic mainstream. HUD, Treasury, Agriculture, Commerce, Justice, OMB, CEA, NEC, and DPC have worked together to develop a new, comprehensive empowerment agenda which includes enterprise zones, community development banks, strengthening of the Community Reinvestment Act and Fair Lending requirements, and community policing and Community Partnerships against Crime.

This memorandum presents the Enterprise Proposal. While members of the Working Group differed on the merits of particular components, there was general agreement -- except for OMB -- on a two-tier proposal to create 10 resource-intensive Economic Empowerment Zones and 100 less expensive Enterprise Neighborhoods. OMB has proposed a minimal-cost alternative and recommends using the savings in budget authority to pay for other, unfunded priorities, including Campaign Finance Reform and Family Support. (OMB's views and suggested alternative are attached at Tab A.)

In Section III of this memorandum, we summarize the key components of a two-tier Enterprise Proposal. In Section IV we present the key options for your decision, including OMB's alternative option.

III. THE TWO-TIER PROPOSAL

This proposal seeks to go beyond more traditional enterprise zone proposals in three fundamental ways: One, it makes reinventing government a centerpiece of the entire proposal. Two, it seeks to concentrate a combination of resources (tax incentives and public investment grants) in 10 economic empowerment zones, while having a second tier of 100 enterprise neighborhoods which grant considerable flexibility -- and some limited resources -- to areas that come forth with comprehensive proposals for economic development. Zone population is limited to 100,000 persons in order to achieve this focus and to ensure opportunities for demonstrated success. (The objective criteria for eligibility are attached at Tab B.) Three, the zones are designed to be platforms for local experimentation at both the federal and local level. Finally, the proposal takes an expansive view of the need for comprehensive growth strategies -- ones that take account of the need for both public and private investment.

The proposal has three main goals:

1. Increasing business and jobs within the zones so that they become engines of economic growth within the region.

2. Empowering zone residents to join the economic mainstream -- by owning and managing enterprises and assets within the zones and by connecting them to jobs and opportunities throughout the region.

3. Changing the way government does business in distressed areas -- by streamlining regulations and paperwork, encouraging local flexibility and innovation, and targeting resources so we can measure results and learn what works.

CORE ELEMENTS OF ECONOMIC EMPOWERMENT ZONES:

A brief summary of the key and distinctive components of the proposal include:

A. REINVENTING GOVERNMENT

Competitive Grant Process: The proposal is designed to streamline federal rules and regulations that discourage initiative at the local level -- and at the same time, to challenge communities to develop a coordinated, comprehensive strategic plan to spur economic empowerment. Communities will apply for zone designation through a federal challenge grant process. The winners will qualify for tax incentives that encourage job creation, investment, and individual empowerment and will receive an Enterprise Grant they can use in any way that advances the three goals stated above.

Coordinated, Bottom-up Planning: To be considered, an applicant must form partnerships with the affected community and the private sector in the region to develop a comprehensive strategic plan. The plan must detail how the applicant will coordinate all complementary state, local and federal program resources and incentives with private sector commitments and community initiatives to meet the three goals.

One-Stop Federal Responsiveness: An Interagency Council ("Enterprise Board") will develop criteria for selection. In consultation with the Enterprise Board, HUD will designate the urban zones, Agriculture the rural zones, and Interior the Indian zones -- based on the quality and promise of the strategic plan submitted by each applicant. The Designating Secretaries, in cooperation with the Enterprise Board, will serve as a single point of contact to allow local applicants to coordinate federal programs and incentives in the zone.

B. TWO TIERS OF INCENTIVES AND INVESTMENTS. We recommend a two-tier approach that focuses most resources on a limited number of zones where we can measure and achieve results, but gives a larger number of communities an incentive to take part. The larger number of Enterprise Neighborhoods may make it more palatable for members of Congress to support the concentration of resources in the 10 zones.

10 Economic Empowerment Zones will be designated and will be given discretion to use all available tax incentives, a substantial (e.g., $30 million per year) Enterprise Grant, and one-stop federal responsiveness based upon their approved strategic plan. In addition, each Economic Empowerment Zone will participate, based on its approved strategic plan, (a) in a community development banking initiative, (b) in community policing and HUD Community Partnerships Against Crime, and (c) in a DoEd Enterprise School Community initiative to implement the National Education Goals for school readiness, lifelong learning, and competitiveness.

100 Enterprise Neighborhoods will be designated and will receive a few of the tax incentives, a smaller Enterprise Grant (e.g., $3 million per year), and one-stop federal responsiveness. In addition, these Enterprise Neighborhoods will also be eligible to participate in the Community Policing, Enterprise School, and Community Development Banking initiatives.

C. TAX INCENTIVES AND INVESTMENT PROVISIONS

TAX INCENTIVES:

The tax expenditures are designed (a) to reduce the costs of doing business in the zone, (b) to provide incentives for employing zone residents both within the zone and throughout the local labor market, (c) to provide incentives for investment in new equipment and expansion of qualified zones business, (d) to finance new construction and renovation within the zone, and (e) to empower zone residents with the opportunity to work, save and invest, and obtain a real ownership stake in their own communities and economic destiny. The proposal includes:

SUMMARY OF INCENTIVES AND INVESTMENTS

10 ECONOMIC EMPOWERMENT ZONES

INVESTMENTS
- Enterprise Grants ($50-175 million)
- Community Development Banks
- Community Policing
- Coordination and Flexibility with Existing Funds
- Education Enterprise Funds
- Eligible for Participation in a Range of Innovative Federal Experiments

EMPLOYMENT TAX INCENTIVES
- Employment and Training Credits (ETCs) for zone residents:
  - A multi-year ETC for employers located in the zone
  - Targeted Empowerment ETC ("TETC") for all employers
- An ETC Opportunity Card for zone residents

CAPITAL INCENTIVES
- Increased property expensing under Section 179
- Accelerated depreciation for all investments in tangible property in the zone.
- Tax-exempt Private Activity Bonds for investments in tangible property in the zone.
- Expansion of the Low Income Housing Tax Credit

EMPOWERMENT INCENTIVES
- Resident Empowerment Savings
- Resident Community Investment Corporations (CICs)
- Small, Worker Controlled Enterprises (WCEs)
- Zone ESOPs

100 ENTERPRISE NEIGHBORHOODS

INVESTMENTS
- Enterprise Grants ($5-15 million)
- Eligible for Community Development Banks
- Eligible for Community Policing
- Coordination and Flexibility with Existing Funds
- Eligible for Education Enterprise Funds
- Eligible for Participation in Innovative Federal Experiments

EMPLOYMENT TAX INCENTIVES
None

CAPITAL INCENTIVES
- Tax-exempt Private Activity Bonds for investments in tangible property in the Zone
- Expansion of the Low Income Housing Tax Credit

EMPOWERMENT INCENTIVES
- Resident Empowerment Savings Account

<u>Economic Empowerment Zones</u>	<u>FY 94-98 cost in $Billions</u>
Property Expensing	.2
Accelerated Depreciation	*
Flat Employment and Training Credit (ETC)	1.4
Targeted ETC	.5
Community Investment Corporations	*
Worker-Controlled Small Enterprise	.3
Zone ESOP	*
	2.6
<u>All 110 Zones</u>	
Savings Plan	*
Private Activity Bonds	.1
Low Income Housing Tax Credit	.1
	2.8

(The asterisk means that the cost is less than $50 million.) The Working Group would prefer to use $1.3 billion of the tax incentives funds set-aside in the Budget for investments. Yet, it is important to note that additional tax expenditures might be required if, for example, the population limits of one or more zones were increased (as discussed in Section IV below) or if more tax incentives had to be added to make the 100 Enterprise Neighborhood more attractive.[1]

INVESTMENT PROVISIONS:

- **Enterprise Grants.** As noted, beyond mere tax incentives, the ten economic Empowerment Zones will receive a substantial Enterprise grant, on the order of $150-175 million per urban zone and $50-75 million per rural zone over five years. In addition,

[1] The two-tier proposal calls for approximately $3 billion in tax expenditures and approximately $3 billion in investments through Community Policing and Enterprise Grants (plus investments from several of the Agency budgets.) Your proposed budget provides for $4.1 Billion in tax expenditures, plus $500 million for Community Policing (appropriated in FY93 but not authorized) and $500 million for community investments in FY 94. In addition, HUD and Agriculture have agreed to contribute up to $900 million from their existing budget authority.

<u>Any</u> enterprise proposal you submit will require careful coordination with Congress for purposes of authorization, the Budget Enforcement Act, Budget Reconciliation, and annual appropriations. We will need bi-partisan support to secure the sixty votes in the Senate that will be necessary for approval of many issues, including our enterprise proposal.

matching state and local resources and private sector commitments will be expected for all zones. The second-tier, enterprise neighborhoods will receive $15-20 million for urban zones and $5-10 million for rural zones over five years.

Community Policing: All zones will be eligible for additional support for Safe Streets from the $500 million of the FYs 93-94 baseline which has been reserved to meet your pledge of 100,000 additional cops on the beat. (Our enterprise legislation could address whether these monies will go exclusively to communities with enterprise zones).

Community Development Banks: The 10 Economic Empowerment zones will be given first priority on having a Community Development Bank. The other zones will be eligible to participate in your community lending initiative in order to access private capital, financial services, and support for microenterprises.

Education Enterprise: DoEd has asked to include, and to provide funds for, a comprehensive Enterprise School Communities initiative to implement the National Education Goals. DoEd will provide sufficient funding for Enterprise School Communities in each of the 10 Economic Empowerment Zones, plus up to another 10 to 30 enterprise school communities for Enterprise Neighborhoods.

Eligibility for Participation in Innovative Federal Experiments: The Enterprise Neighborhoods and Economic Empowerment Zones can serve as platforms for experimentation. This experimentation function serves a dual purpose: First, it aids the federal government by giving it laboratories to experiment with new innovations designed and implemented from the bottom up. Several Agencies believe that the designated zones provide a unique opportunity to offer new initiatives that local communities may use to complement their own economic empowerment and community development strategies. Second, it allows the zones and neighborhoods to have an even more comprehensive investment strategy. The 10 zones and 100 neighborhoods will be eligible to participate through the challenge grant process in a range of other economic, human and community development and access-to-opportunity initiatives that are likely to be sponsored by various Agencies during the operation of the zones.

Possible initiatives include: foreign trade centers, microenterprise and venture funding, and entrepreneurial assistance (Commerce and SBA); school-to-work, apprenticeship, youth build, juvenile justice and drug prevention and rehabilitation-to-work (DoEd, DOL, HHS, HUD and DOJ); unemployment-to-work training and support (DOL); time-limited welfare and work supports (HHS); and access and moving to opportunities (HUD and DOT). (A list of possible federal initiatives is attached at Tab C). States, localities, and the private and non-profit sectors will be challenged to add their own initiatives. These human development and access-to-opportunities initiatives, coupled with the Fair Housing and fair lending components of your CD Banking and Community Reinvestment Act proposals, should send a clear message that enterprise zones will not be isolated garrisons but will strive to integrate distressed communities and poor people into the economic mainstream.

D. EVALUATION OF PERFORMANCE AND RESULTS: The enterprise zones will run for ten years. Each year the Designating Secretaries will review the performance and results of the zones in achieving the benchmarks set in the zone's strategic plan. Mid-course corrections will be permitted and encouraged.

At the end of the fourth and seventh years, the Designating Secretaries will conduct a full review of results. Based thereon, they may terminate the designation, withhold or reduce enterprise funds, or require appropriate changes in the comprehensive strategic plan of any zone that is not making satisfactory progress in meeting its benchmarks to achieve the three goals of the enterprise proposal.

The National Academy of Sciences will contract for an independent evaluation of all aspects of enterprise zones. A full report will be given to the President and Congress at the end of five years and again at the end of ten years. We expect to learn what works from the performance and results in both the Economic Empowerment Zones and the Enterprise Neighborhoods. The entire enterprise legislation will sunset at the end of 10 years so that the lessons learned from actual experience can be included in any reconsideration.

In sum, the two-tier proposal seeks to improve the opportunities and competitiveness of both people and places. It challenges affected local communities to reinvent themselves, to join with the private sector in strategic public-private-community partnerships, and to strive to integrate distressed communities and poor people into the economic mainstream.

IV. ISSUES, RECOMMENDATIONS AND DECISIONS

A. TWO-TIER PROPOSAL OR OMB LOW-COST OPTION?

OMB proposes an option that adopts much of the two-tier proposal's emphasis on the coordination and reinvention of government, but without spending any funds beyond what is already provided in the baseline or the other new investments proposed in your overall budget. In particular, OMB's proposal would spend only $110 million of the $4.1 billion included in your budget for tax expenditures.

OMB has serious reservations concerning the use of any tax incentives or new Enterprise Grants. OMB argues that tax incentives will not be very effective in stimulating new business development and jobs in distressed areas or, if successful, will be too costly to be widely replicated in other areas. Or they fear that enterprise zone tax incentives will draw employmentfrom other economically depressed areas. In addition, OMB believes the two-tier proposal focuses too much on moving jobs into small areas that are not very hospitable to business investment, rather than preparing people in those areas for work opportunities. OMB is also concerned that the almost $6 billion that would be absorbed by the two-tier proposal will benefit a very small fraction of the heavy poverty areas in the country.

OMB, therefore, proposes a "low cost" option which, in its view, meets your campaign promise to create enterprise zones while preserving the opportunity to use some of the resources originally committed to enterprise zones for other budget priorities. Attached at Tab A is a summary of OMB's concerns and its alternative, low-cost option.

If you decide to devote additional new budget authority to enterprise zones, as does the two-tier proposal, OMB offers three additional alternative options, as described in Tab A. One of these options does not rely on tax incentives and proposes an increase in the Enterprise Grant instead; the second and third would give localities greater flexibility in choosing between direct spending and a menu of tax incentives.

RECOMMENDATION: With the exception of OMB, the Working Group uniformly supports the two-tier proposal for the following reasons. (There are differences of opinion on certain aspects of the proposal, as described below.) First, we believe that we have tailored and targeted the tax incentives to encourage investments in both places <u>and</u> people. Second, tax incentives form the basis of the enterprise zone concept and have strong bi-partisan support in Congress. <u>If you do not include tax incentives, you will not be entertaining an "enterprise zone" proposal.</u> Agree

Third, we believe that the two-tier proposal will produce some real success stories in distressed areas in rural and urban America. OMB's criticism that the cost of replicating tax incentives is too great may miss the point. We do not have enough money on the discretionary spending side <u>or</u> the tax incentive side to improve every distressed area. Instead, the mix of tax incentives, investments and reinvention of government in the two-tier proposal will challenge public-private-community partnerships to develop effective strategies in the lower-cost Enterprise Neighborhoods as well as the Economic Empowerment Zones. If we are successful, we believe more resources from the public <u>and</u> private sectors will be forthcoming for what works. Finally, we are concerned that OMB's "low-cost" proposal may be perceived as a retreat from your commitment to distressed areas, particularly urban areas.

Agree

OMB's three additional alternatives offer ideas for reinventing government and investing in people. The two-tier proposal incorporates both concepts. With respect to OMB's proposal to offer localities a menu of tax incentives, the Working Group considered and rejected such an approach because of its administrative infeasibility and our decision to target tax incentives that would be used to invest in <u>both</u> people (e.g. labor and empowerment) <u>and</u> places (e.g. cost-recovery).

DECISION

___ "Low-cost" OMB Proposal

Frame the $1.3 Billion as –

Make consolation prize bigger – spread

– $1.3 billion over ~ 100 second prize.

– package

– flexibility w/existing moneys

___ Other OMB Alternatives

✓ Two-tier Proposal

✓ Discuss Further

B. DECISIONS RELATING TO THE TWO-TIER PROPOSAL

If you select the two-tier proposal, a number of other issues must be resolved, as will be described in this section of the memorandum.

1. WHETHER TO NAME THE TEN ZONES IN ADVANCE?

As set forth in Tab A, OMB Director Panetta fears that Congressional expansion of the number of zones may be unavoidable. To limit the likelihood of such expansion, he suggests that you designate in advance the ten communities that would receive the Economic Empowerment Zones. Presumably, you would justify naming these ten by stressing that they are "hardship" communities, e.g., South Central Los Angeles, that warrant targeted attention. Other communities would be reminded that they may compete for Enterprise Neighborhoods and that all communities will benefit from the stimulus package should the stimulus pass.

RECOMMENDATION: The Working Group opposes this suggestion. First, naming the "ten worst" communities in advance undermines central tenets of the two-tier proposal. We want to use the challenge grant process to spur all communities to put forth their best efforts in designing a coordinated strategic plan. We also want localities to make a real effort to reinvent government and involve community residents and the private sector in the planning process. We feel the competition of the challenge grant process is critical to ensuring successful zones. Through the challenge grant, we will have an opportunity to reward innovation and pick the ten communities that have the best opportunity to succeed in achieving the enterprise mission.

Second, naming ten communities in advance may doom the proposal from the outset, either by alienating the 80 senators and 425 congresspersons whose districts will not benefit from these designations or by encouraging Congress just to name additional zones. We believe that we have a better chance of defending the two-tier proposal against congressional expansion.

DECISION

___ Name Ten Zones in Advance

✓ Rely on Challenge Grant Process

✓ Discuss Further

3 w/ 200,000

2. POPULATION LIMITS

The Working Group agreed that we should focus resources (and the energies of the Designating Secretaries) on smaller targeted areas. As a result, we placed a 100,000 population limit on any zone. Los Angeles clearly will be very disappointed with such a limit. California representatives have lobbied hard for larger zones. The issue, therefore, is whether to provide for a different limit for very large population cities (e.g., over 2.5 million persons, New York, L.A., and Chicago).

The following are three options for larger population limits in some of the six urban economic empowerment zones, while keeping the total tax expenditure costs around $ 3 billion.

- One zone with 250,000; four with 100,000; one with 50,000.
- Three zones with 200,000; three with 25,000.
- Two zones with 250,000; two with 50,000; two with 25,000.

upto 3 w/ 200,000

up to 2 w/ 250 k
up to 2 w/ 100 k
at least one city of
than 500,000

PFD
- over 2.5 million - maximum of 250,000
- over 1 million - maximum of 100,000
- over 500 k - maximum of 50 k
less than 500 k
25,000

RECOMMENDATION: The Working Group recommends that you apply the 100,000 population limit to all zones but be prepared to compromise during the legislative process if it proves necessary. If we are to ensure some measure of success, we feel it is essential to target our limited resources to a relatively small area.

DECISION

___ 100,000 Population Limit

___ Allow one to three zones with 200,000 to 250,000

____ 1-250,000, 4-100,000, 1-50,000

____ 3-200,000, 3-25,000

____ 2-250,000, 2-50,000, 2-25,000

✓ Discuss Further

PFD
2-250,000, 2-100,000, 2-25,000

301-619-3183
515-1589

3. POVERTY CRITERIA

There is some disagreement among the Working Group as to how we should target the poverty criteria for enterprise zones. H.R. 11, the enterprise zone bill passed by Congress last year (and vetoed by Bush), required only that all of the census tracts in the zone be at 20% or more of poverty level. This requirement would apply to tens of millions of people and perhaps give communities too much discretion in designating zone areas.

The more liberal the poverty criteria, the higher the risk that communities will designate areas that are not most in need of assistance. On the other hand, the Working Group does not wish to hamstring communities by making them pick only hard-core poverty areas that have little chance of being successful in meeting the enterprise goals.

Two options that attempt to address these competing values have been offered.

- <u>Option 1</u>:
  50% of census tracts at 35% or more of poverty;
  90% of census tracts at 25% or more of poverty;
  100% of census tracts at 20% or more of poverty;
  plus limited discretion in Designating Secretary to permit limited variation from criteria to fit existing state-designated enterprise zones.

- <u>Option 2</u>:
  90% of census tracts with 30% or more of poverty;
  100% of census tracts with 25% or more of poverty.

Option 1 has the advantage of being targeted but offering communities a degree of flexibility. It also addresses the possibility that a community may wish to overlay state-designated and federal enterprise zones that have slightly different qualifying criteria.

Option 2 is more targeted but less flexible. It has the advantage of ensuring that only truly needy communities will be designated as enterprise zones. But, this set of criteria could knock out some prime candidates for enterprise zones. In New York City, for example, a budding commercial area in Harlem that would qualify under Option 1 would be excluded under Option 2.

RECOMMENDATION: The Working Group has not reached a firm recommendation on this issue. HUD supports Option 1. Treasury supports Option 2.

DECISION

✓ Option 1

____ Option 2

____ Discuss Further

applicants that try to involve poor, integrate them into jobs —

change name

4. MECHANISMS FOR REINVENTING GOVERNMENT

a. New Enterprise Funds. The new Enterprise Grants will be vehicles for reinvention and innovation because localities will have considerable flexibility in using this money to address unique local needs. An issue arises, however, as to how we will ensure that the zone communities adhere to the enterprise mission in developing their strategic plans and in spending Enterprise funds to implement these plans.

There are essentially two alternatives. The first approach is to state general federal objectives and vest the Designating Secretary with discretion to choose among applicants based on the specifics of each strategic plan in implementing the three enterprise goals. The Designating Secretary would make sure that Enterprise funds are not used to supplant existing federal funds and programs and would measure results against the benchmarks established in the strategic plan. This approach may be most in keeping with the objective of reinvention, but it risks providing insufficient federal direction in local planning and too much discretion in the Designating Secretaries.

The second approach is to state specific federal requirements and objectives in the legislation which will guide local spending and plan implementation. Last year, for example, the Senate version of H.R. 11 simply listed all the federal programs that zone communities could spend funds on. However, if the stated criteria are too specific, it could limit a community's ability to innovate, for example, in establishing its own matching venture funds and other public/private economic empowerment partnerships.

The Working Group has no firm recommendation on this issue, which, may have to be resolved in the legislative process.

DECISION

✓ Challenge Grant Process and Performance Review

___ State Specific Compliance Criteria in the Legislation

✓ Discuss Further

give creativity

b. Existing Federal Programs and Funds. Time and again, mayors and governors have complained that they would be in a better position to meet our enterprise objectives if they were free to deploy existing federal programs and resources to implement their own strategic plan. Former President Carter made much the same point when he visited with you last month about the Atlanta Project: we would not need to invest much more federal money to revitalize urban America if we empowered local communities to apply existing federal funds flexibly in conjunction with State and local resources, and private enterprise.

Although we propose to eliminate all burdensome strings from the new Enterprise Grant funding, such radical deregulation of existing federal programs is a formidable challenge. We believe there are at least three approaches to providing greater flexibility and responsiveness with respect to existing federal programs:

- Broad, Pilot Waiver Authority: seek statutory waivers in the Enterprise legislation that would vest the Enterprise Board with authority to grant any waivers it deems necessary for a specified list of programs relevant to promoting enterprise in each zone. A municipality with an enterprise zone might be allowed, for example, to aggregate all funds it receives from the specified range of programs and spend these funds on a new type of activity to implement the strategic plan approved by the Designating Secretary for the zone.

- Limited Waiver Authority: allow the Enterprise Board to develop one set of categorical criteria that municipalities must meet to receive funding from existing programs that are relevant to promoting enterprise in each zone. The enterprise legislation would specify, for example, 10 to 12 existing programs -- e.g., CDBG, Jobs Training Partnership Act, Job Corps, Youth Apprenticeship, JOBS -- for which one set of categorical criteria will be developed. Municipalities that receive enterprise zones, therefore, would be relieved of some of the burdens of meeting uncoordinated, fragmented program requirements. Municipalities would not, however, have the flexibility to redirect funds to their own spending priorities.

- Expand the Enterprise Grant Program: beginning with the FY 95 budget request, increase the Enterprise Grant by an agreed amount and seek lower appropriations from a range of existing programs. For example, if total federal spending on a range of separate categorical programs averages $25 million per zone, then the budget request for Enterprise grants in each zone could be increased by a proportionate share. At the same time, the budget requests for these categorical programs would be reduced by this amount. This approach approximates the effect of the broad, pilot waiver approach.

RECOMMENDATION: We do not have a firm recommendation with respect to the three options.

The first approach -- pilot testing broad regulatory relief in the enterprise zones -- is most in keeping with our basic goal of reinventing government and would be strongly supported by the mayors and governors. It may complicate passage of the Enterprise legislation. We do not know whether Congress would be as willing to go along with such a radical restructuring. It may also give pause to some of the Secretaries as they work with you to make plans to initiate new national programs. HUD strongly recommends this approach.

The second approach -- limited waiver authority -- will provide substantial flexibility and responsiveness for those programs specified for uniform categorical treatment. Congress should be receptive to such narrower statutory waiver authority as a part of the Enterprise package. But many localities and public-private partnerships will argue that we should go further because the costs of compliance with the multitude of federal requirements ultimately defeats their purpose.

The third approach provides a means to approximate, roughly, the result of the first approach: it increases the enterprise grant by the amount that would be available to focus on implementing the zone's strategic plan if full waiver authority were available. It does so, however, by reducing a range of programs throughout the country by the small amount necessary to achieve this result. It will also require careful budgeting (and negotiation with Congress) each year.

Close consultation and cooperation with Congress and interested constituencies may provide the best approach to resolving this issue. Given the uncertainties and the need for full Congressional cooperation to implement any of the three approaches, it may be prudent to explore this issue fully with Congress and constituency groups before making a final determination.

DECISION

✓ Broad, Pilot Waiver Authority begin w/Broad pilot authority —

___ Limited Waiver Authority

✓ Expand Enterprise Grant through Annual Budgeting — Tack on in addition

✓ Consult with Congress and Constituencies

✓ Discuss Further

Pilot if move to

5. DISAGREEMENTS AS TO EMPOWERMENT TAX INCENTIVES

a. Resident Empowerment Savings. Following on your campaign pledge to establish Individual Development Accounts to empower low-income Americans to move toward economic self-sufficiency, the Working Group recommends a 50-percent tax credit for employer contributions to a Defined Savings Plan ("DSP") on behalf of zone employees. Participating zone residents could also contribute to the DSP on a tax deferred basis. These savings could be withdrawn (or borrowed against) without penalty to pay for education, purchasing a first home, starting a small business, or investing in a Community Investment Corporation.

In addition, the CEA has recommended that you also consider encouraging short-term savings that would help zone residents avoid excessive credit costs on large consumer purchases such as furniture and cars. We could offer a special-issue U.S. Savings Bond with an above-market rate of return and allow this interest to be fully tax exempt to zone residents. These bonds could be purchased through payroll deductions and excluded from taxable income reported by the employer, making tax preparation easier for the saver. Treasury opposes this savings incentive.

While the Working Group generally favors having some form of resident empowerment savings, Treasury is skeptical about whether our limited resources might be better spent on incentives for employment and business activity rather than savings. The tax expenditures for such resident empowerment savings and investment in all 110 zones, however, total less than $50 million over five years.

RECOMMENDATION: We recommend that you include empowerment savings incentives in your enterprise zone proposal.

DECISION

____ Resident Empowerment Savings Accounts

____ Add Resident Empowerment Savings Bonds

____ No Resident savings incentives

✓ ____ Discuss Further

b. Community Investment Funds or Corporations. Owned 51% by zone residents, CICs could be spurred through tax advantages to lenders for loans made to CICs for purchase of qualifying zone tangible assets and firms. The CIC would be a for-profit, resident-driven community investment fund or developer which could, for example, invest in a number of zone businesses or acquire and develop land and buildings within the zone. The CIC would provide a way for zone residents, as shareholders, to accumulate assets, invest in zone businesses, share in profits from development, and gain control of their communities and their economic destinies. Although Treasury and CEA are concerned that zone residents should diversify their investments, most members of the Working Group support the CIC concept as an essential means to give zone residents a real stake in their own economic futures.

The tax advantage for investment in CICs could be provided either (a) through the exclusion of interest from the income of banks and other lenders who make loans to finance CICs or (b) through the issuance of special CIC tax-exempt bonds. Such tax exempt bonds could also be made available through local banks or community development lenders who will then make loans to a CIC based on their own underwriting criteria, including the requisite technical, accounting, and management assistance and expertise. Such Enterprise Zone Tax-Exempt Bonds could be exempt, either in whole or major part (e.g., 75%), from state volume caps. Treasury believes that existing rules for review by a local bond authority would help assure compliance with applicable law, prevent abuse, and involve the local community, without requiring the creation of a new set of anti-abuse rules for a new interest exclusion.

RECOMMENDATION: We recommend that tax incentives for CICs be included. Such tax expenditures for the ten Economic Empowerment Zones would total $140 million over five years. No tax advantaged loan would be made unless the underlying asset, whether a business or land, supports the loan. Making such character loans to CICs should be among the financing mechanisms that banks have to economically empower zone residents.

DECISION

____ Interest Exclusion on CIC qualifying loans

____ Tax Exempt Bonds only for CIC financing

____ No CIC Financing

____ Discuss Further

c. Small, Worker Controlled Enterprises -- Owned 51% by zone resident employees, worker controlled small businesses (less than $5 million in gross annual receipts) could also be encouraged through tax incentives. First, interest on loans to permit resident workers to start or to acquire WCEs could be excluded from taxation to a lender. Second, repayment of principal and interest on the loan could be a deductible business expense to the WCE. With full disclosure, full voting rights, worker control, annual reporting of individual share values to each zone shareholder, and deferral of taxes to the worker until a sale of shares, the WCE will empower resident employees with a full ownership stake in their own businesses, while curbing abuses common to ESOP's.

Secretary Espy strongly supports incentives that empower residents to gain an ownership stake in the businesses in which they work. Others in the Working Group join Agriculture in supporting such employee stakeholding. Treasury and CEA are concerned that WCEs are risky investments for zone residents and are subject to tax shelter abuse in which the benefits go to outside investors rather than to zone residents. As with CICs, Treasury therefore proposes that the tax advantage be financed only through tax exempt bonds, issued by an independent State or Municipal Bond Financing Authority, which can be exempted from State private activity bond caps. As with CICs, these tax exempt bonds could finance loans made by CD banks and other lenders based on their own underwriting criteria, including the requisite technical, accounting and management assistance and expertise.

RECOMMENDATION: We recommend that tax incentives for WCEs be included. Such tax expenditures for the ten Economic Empowerment Zones would total $300 million over five years. No tax advantaged loan would be made unless the underlying small business being started or acquired supports the loan. Making such character loans to WCEs should be among the financing mechanisms that banks have to economically empower zone residents. If successful, WCEs could effectively implement the Grameen bank, microenterprise lending approach in distressed communities throughout rural and urban American.

DECISION

____ Interest Exclusion on WCE qualifying loans

____ Tax Exempt Bonds only for WCE financing

____ No WCE Financing

____ Discuss Further

Tax exempt bonds

d. Employee Stock Ownership Plans (ESOPs). Secretary Espy also strongly supports a modified ESOP structure for larger zone businesses. He recommends providing enhanced tax incentives for special Zone ESOPs. Under current law, eligible lenders may exclude 50% of the interest income they receive on certain loans to an ESOP from taxable income, provided the ESOP has the requisite stake (more than 30%) in the sponsoring employer. The interest exclusion would be raised to 100% for loans to Zone ESOPs which have a 30% stake in the company. In addition, the sale of existing stock to Zone ESOPs would qualify for tax deferred rollover status provided the proceeds are reinvested in securities of other domestic companies. To meet concerns about abuse, all participants in Zone ESOPs would be entitled to the same voting rights on all matters voted upon by other stockholders possessing the highest voting rights.

The Treasury Department opposes any increased tax incentives to Zone ESOPs. Treasury reasons that ESOPs are inherently risky for employees because of lack of diversification of the plan assets. It also argues that traditional ESOPs have not been effective in transferring to low-income employees a significant voice in management decisions or a significant share of the economic appreciation in the value of the employer's stock. It believes the Defined Savings Plan incentive, together with qualified zone private activity bonds (that could be used to finance CICs and WCEs), provide appropriate empowerment incentives for zones.

RECOMMENDATION: Attached at Tab D is Secretary Espy's defense of Zone ESOPs. It is possible that the Treasury proposal for using tax-exempt bonds to finance empowerment incentives could also be used here to alleviate concerns about abuse of Zone ESOPs. Such tax expenditures for Zone ESOPs in the ten Economic Empowerment Zones would total less than $50 million over five years.

DECISION

✓ Interest Exclusion for Zone ESOPs

____ Tax Exempt Bonds only for Zone ESOPs

____ No Financing for Zone ESOPs

✓ Discuss Further

6. "FLAT" vs. "INCREMENTAL" EMPLOYMENT AND TRAINING CREDIT

Employment and training tax credits (ETCs) provide an effective means of lowering the cost of doing business for employers and incentives for hiring zone residents. When combined with a coordinated private sector campaign to secure the acceptance and support of employers, they also empower residents to seek employment, to obtain and hold jobs and to receive training. The two-tier proposal recommends allowing employers outside the zone to take advantage of a one-year Targeted ETC ("TETC") -- 40% of the first $6,000 in the first year of each new zone resident employee's wages and qualifying expenses for education and training.[3]

With respect to the ETC, you must decide whether to adopt a flat or incremental approach. The flat ETC provides employers within the zone with a credit of 25% of the first $20,000 in qualified wages and training costs for each zone employee. The credit would remain at 25% for the first six years and then be phased out proportionately over the remaining life of the zone. This credit applies to all resident zone employees.

By contrast, the incremental ETC is applicable only to increases in employment of zone residents (where total employment also increases) over a stated base. It therefore costs

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[3] The TETC is substantively identical to the Targeted Jobs Tax Credit (TJTC), which will preclude the administrative burdens of having separate criteria and credit amounts. However, we believe we should distinguish the TETC from the TJTC, where certification of eligibility in one of the 10 categories by DOL has too often operated to stigmatize prospective applicants as inferior in the eyes of employers. An education campaign for prospective employers is therefore essential with respect to the Enterprise TETC. The extent of private employer commitment to participate should be one of the factors used by the Secretaries in the Challenge Grant Process to judge the merits of any zone applicant's strategic plan.

Every qualified zone resident will receive an empowerment card in the mail which can be presented to a prospective employer to qualify for the ETC or TETC once place of residence has been verified. The same card will allow zone residents to open a Resident Empowerment Savings Account and a checking account with the nearest Community Development Bank. It also could be used in future experiments with electronic delivery of food stamps, AFDC and job-training and with providing rewards for zone residents who succeed in finding and keeping a job.

substantially less in tax expenditures than the flat ETC.

The flat ETC is simpler for zone employers to use and more effective in lowering total costs of doing business for a zone firm. Though less expensive, the incremental ETC is much more complicated to use and is often ignored by small employers. In addition, the incremental ETC would give a competitive advantage to new businesses over existing zone businesses.

RECOMMENDATION: For the above-stated reasons, the Working Group unanimously favors the flat ETC, but believes this is a close call.

DECISION

✓ Flat ETC

___ Incremental ETC

✓ Discuss Further

The members of the NEC-DPC Enterprise Zones Working Group include:

AGRICULTURE	Robert Nash Ron Blackley Mike Alexander	CEA	Joe Stiglitz Kevin Berner
COMMERCE	Johnathan Sallet Larry Parks	DPC	Bruce Reed Paul Weinstein
HUD	Andrew Cuomo Bruce Katz Jacquie Lawing	NEC	Gene Sperling Paul Dimond Sheryll Cashin
TREASURY	Maurice Foley Val Strehlow Edith Brashares	OMB	Chris Edley Ken Ryder Steve Redburn
V.P.	Greg Simon		

We have also received important contributions from:

DoEd	Mike Smith Anita Estelle Tom Fagan
HHS	David Elwood
LABOR	Larry Katz Carolyn Golding

OMB Views and Suggested Alternative Approach

OMB supports the two-tier approach to Enterprise Zones but has reservations about the proposed incentives. These concerns are briefly summarized below, and a more flexible alternative is suggested that OMB believes deserves careful consideration.

Concerns About the Proposed Approach

The Enterprise Zones approach to urban and rural development proposed by the NEC would spend $5.5 billion over five years, one-half of this for tax incentives to stimulate new business investment and jobs, primarily in 10 designated zones. This may not be the best use of our limited Federal budget for an urban and rural development initiative.

First, we are concerned that the proposal relies too heavily on apparently costly and largely uncontrollable tax incentives. The emphasis on labor-side as opposed to capital-side incentives is an improvement over previous versions of Enterprise Zones. Nevertheless, using the Treasury's assumptions about revenue losses and job growth in the Zones, it will cost the Treasury about $80,000 in revenues for every job added in that period in the 10 super-zones. *This is four times the cost per job created in the Urban Development Action Grant program.* Previous research on tax incentives to stimulate jobs and development also suggests that, compared to spending approaches, they are expensive and less likely to work. Tax incentives are a blunt instrument, but there may be ways to increase their flexibility as discussed below.

A second concern is that, because the tax approach is so costly, the high costs of extending the proposed approach beyond 10 areas to any significant share of distressed communities may be prohibitive. This is just not the time to be investing very limited budgetary resources in an idea that has a limited chance of payoff or, if it succeeds, could not conceivably be extended to reach more than a small percentage of distressed communities.

An even more fundamental problem with the proposed approach may be that it focuses too much on moving jobs into small areas that are not very hospitable to business investment rather than preparing people in those areas for the work opportunities offered by the regional economy. After all, relatively few people both live and work in the same neighborhood. ~~The most effective~~ strategies to address chronic poverty and urban distress may be those that invest in human capital and in linking people to jobs through transportation, opportunities for relocation, and other means.

One choice would be to save the $2.8 billion now proposed for tax expenditures to fund other critical priorities that the Administration has proposed but are not funded, such as family preservation and campaign finance reform (see Attachment 3 on the final page of this Tab). In that case, the 110 communities could still receive the following:

- In the 10 economic empowerment zones, substantial challenge grants from a pool of $2 billion created by earmarking two percent of planned spending over five years in a number of relevant domestic discretionary programs;

- Grants to plan and reorganize services in the 110 zones (these can be funded from the already appropriated $500 million in 1993 Community Investment Program funds);

- Money to promote community policing and put more cops on the beat in the zones ($500 million in Community Investment Program funds);

- Waivers of CDBG, HOME, and other Federal program regulations to facilitate coordinated, more flexible service delivery;

- Priority for Community Development Banks, provided they meet other qualifying criteria; and

- Designation as "difficult to develop" areas where the eligible basis for computing the value of the Low-Income Housing Tax Credit would be 130 percent of the cost basis.

However, if the President feels that now is the time to put forward a major urban and rural development program, the following is probably a better approach.

An Alternative Approach

OMB supports the component of the NEC's plan which proposes a competitive process for planning grants and other limited assistance to 100 "Enterprise Neighborhoods." If the $4 billion in resources ($2.8 billion in tax expenditures and $1.2 billion in spending) now proposed for the 10 economic empowerment zones is retained, then we suggest the following approach:

A. Designate the 10 superzones up front. Rather than undertaking a lengthy review and selection process, the Administration could identify 10 superzones and could work closely with State and local officials in the designated areas to develop attractive plans quickly. Naming the superzones has political pluses and minuses. Those not named will be disappointed, but the ability to point to a defensible selection of distressed areas and well-conceived action plans will be a plus. The key point is that we want to defend the proposal against dilution. An amendment to add an 11th superzone will have a more apparent cost -- either in terms of the price of the package, or the erosion of assistance to the 10 we have designated. It's not an easy sell, but it may be our best chance of holding down the number of zones and focusing the resources.

B. Provide communities with maximum flexibility. (1) To give communities maximum flexibility to fit local needs, across both the mandatory and discretionary spending elements, the funds could be provided as a single new comprehensive grant with a broad range of authorized uses. (2) If some part of the funds must be used as tax expenditures, then OMB would prefer an approach that gives the communities flexibility to choose a mix of tax items that they believe best supports their own development strategy. (3) A third option would allow communities to vary the mix of spending and tax expenditures as well. More information on how we think these options would work is provided in Attachment 1.

While preserving flexibility, we also may want to suggest to the communities (but not require) that they emphasize the development of human resources in the zones. In that case, we believe that there are at least two promising emphases, as reflected in Attachment 2.

Whatever the approach, OMB supports the proposal for a strong, independent evaluation of the experiment so that, whatever the result, we capture insights that can be used for the next round of efforts to address these very difficult problems.

Attachment 1: Flexible Funding Options for Enterprise Zones

Option 1: A Capped Mandatory Entitlement

Reduce $2.7 billion (5 year) tax expenditure component for the 10 Economic Empowerment Zones (superzones); use these "savings" for a mandatory spending program targeted to 10 distressed cities. This program would authorize spending of the funds in the zones for a broad purpose (economic development) by combining the general authorities now provided under HUD's Community Development Block Grant program, HHS's AFDC waiver authority and Headstart, Education's chapter I, Labor's JTPA and other training and employment programs, and others. Communities would submit plans for use of the funds identifying a coordinated development strategy and the planned mix of programs the community intends to pursue in the zone. Plans would be subject to approval by the Federal government, which could encourage a substantive focus such as those outlined in Attachment 2. Funding for the superzones would be spread over 5 years and could be allocated by on a zone-by-zone basis annually (reflecting both need and relative strength of the zone strategies).

Option 2: A Capped, Flexible Tax Expenditure Pool

In contrast to Option 1, Option 2 preserves the $2.7 billion in tax expenditures. However, the ten superzone communities would be given broad flexibility in using the $2.7 billion earmarked for tax expenditures (in addition to the spending component). Each locality could then shape a tax preference package best suited to its objectives: some might emphasize wage credits to encourage labor-intensive businesses; others might emphasize capital incentives to promote construction, rehabilitation, and equipment modernization.

Each community could be given a tax expenditure "budget" or overall cap and a menu of individual tax preferences with "price tags" attached. It could choose its unique mix of preferences, subject to the zone's overall cap. To ensure that the cap was not exceeded, the community would need to suballocate tax expenditure vouchers to the targeted economic activities of firms and individuals (hiring, construction, other capital spending) qualifying for each tax preference. This is similar to the way the Low-income Housing Tax Credit program works at the State level (i.e., an overall cap and individual project prior review and approval). It would allow a locality to target preferences to a particular job category (e.g., no credits for dead-end jobs), approved training, or socially preferred capital investments (e.g., worker-owned firms, high technology companies).

Option 3: A Capped Blend of Mandatory Entitlement and Flexible Tax Expenditures

This option would establish a $4 billion pool of resources, which the 10 superzones could use either for spending authorized under the mandatory grant program or to award selected tax expenditures, as under option 2. This option would still be consistent with the budget resolution that allows Ways & Means and Finance committees to reallocate up to 20 percent of their reconciled spending and revenue increase targets between the two categories. This would be scored by making an initial estimate of the mix of spending and tax expenditures that the 10 communities would be expected to choose. Even though actual decisions may result in a different mix, so long as the aggregate spending total stays within the capped amount, there would be no adverse deficit effect.

Attachment 2

Focus 1: Education/Personal achievement

Rationale: Excellent schools can be the institutions that focus community renewal, attract new people and investment.

Essential elements:

- Systemic reforms (Schools 2000) reinforcement
- facilities, systems retrofitting
- teacher training
- foster program integration between school districts, local communities
- school-to-work demonstrations
- "Do the Right Thing" vouchers
- support rigorous education/training opportunities/requirements for AFDC recipients

Discussion: The President's proposed systemic reform (Schools 2000) is about to be launched but is in some trouble with traditional liberal advocacy groups. They argue that imposing national standards on city/rural schools that lack resources to meet the standards is unfair. Not all localities will receive a share of States' funding allocation. An initiative that concentrated aid for facilities upgrading (computers, lab equipment, security), retrofitting electrical and telecommunications systems to support the hardware, and released time (teacher substitutes) for training all-curriculum teachers in software applications would be one answer to these critics. States/localities can be required to include zones' schools in the systemic reform process. To foster program integration between local governments and independent school jurisdictions, both can be given incentives to coordinate their services to protect children outside the school and support the education process. School-to-work demonstrations are in the budget and can be done under current law; some would be targeted to zones. The Administration's major 1995 school-to-work initiative is being drafted, will emphasize minimum competencies, choice at 10th grade level of college or vocational prep., apprenticeships. "Do right" vouchers (which would offer a significant financial reward to all high-achieving high school grads with clean records and no kids, which they could use to go on to college or for rigorous job training) also complement this focus. The current education requirements for AFDC mothers are not fully enforced; grants to States for enforcement in zones would require additional AFDC spending.

Focus 2: <u>Job creation/employment/capital investment/mobility</u>

<u>Rationale</u>: Jobs and income are keys to stabilizing families and normal community life. Closest to original Enterprise Zones concept in focus and political support.

<u>Essential elements</u>:

- wage supplementation (current authority or strengthened)
- guaranteed jobs, training, supportive services to noncustodial parents (Boren Amendment to H.R. 11)
- last resort public service jobs for AFDC recipients
- wage credits to contractors hiring community residents for public construction in the zones
- extra Job Corps slots/other training
- job search assistance for AFDC recipients
- capitalize microenterprise loan funds
- housing rehabilitation; Youthbuild; LIHTC
- infrastructure investments
- reverse commuting

<u>Discussion</u>: The goal is maximizing residents' access to existing private sector employment opportunities. Wage supplementation programs can be conducted under current law by States without triggering PAYGO. However, experimenting with longer duration (max. now 9 months) or Federal enrichment would require new AFDC spending and may or may not have PAYGO consequences depending on details. AFDC or other funds could be used to pay absentee fathers for community service, on the condition that they pay child support. AFDC JOBS participation requirements for job search and employment would be reinforced by new AFDC spending for last-resort community service (housing rehab., child care) and by reverse commuting subsidies. Wage credits would reduce the cost of hiring zone residents and allow contractors to reduce their bids on public projects, would leave a long-lasting public works legacy. HUD could target some public housing modernization, other rehabilitation funds to zones.

Administration Priority
Unfunded/Mandatory Programs
(in millions of dollars)

04/19/93 -
02:34 PM

	1994	1995	1996	1997	1998	1994-98
OUTLAY INCREASES						
1. Family Support* Proposal in 94 Budget..........	48	91	260	538	597	1,534
2. U.S. maritime industry initiative 1/ DOT proposal to subsidize 90 ships over ten years...........	340	340	315	265	220	1,480
3. Medicare premiums Loss in savings since Feb.....	0	0	1,145	1,720	1,990	4,855
4. Campaign Finance Reform*......	50 - 100 2/	50 - 100 2/	50 - 100 2/	50 - 100 2/	50 - 100 2/	250 - 500 2/
Outlay Increases Subtotal.............	438 - 488	481 - 531	1,770 - 1,820	2,573 - 2,623	2,857 - 2,907	8,119 - 8,369
REVENUE LOSSES						
1. Proposal assumed in OMB baseline (but not CBO):						
Uruguay round 3/.................	0	313	795	1,267	1,694	4,069
2. Proposals endorsed:						
NAFTA................................	333	476	521	562	607	2,499
GSP 4/................................	529	501	526	548	564	2,668
Revenue Losses Subtotal..............	862	1,290	1,842	2,377	2,865	9,236

Memo Entry

	1994	1995	1996	1997	1998	1994-98
1. Urban enterprise zones Proposal in 94 Budget and Budget Resolution................	73	347	772	1,228	1,699	4,119

* Possible candidates for funding with some/all of enterprise zones tax expenditures. Both of these spending programs have reserve funds in budget resolution.

1. Low estimate would subsidize based on defense needs only (25 ships for 7 years): 5 year costs total $286 million.
2. These are estimates only; numbers still being developed.
3. Budget resolution based on CBO baseline; revenue offset therefore needed.
4. GSP also has $158 million paygo cost in 1993.

ELIGIBILITY CRITERIA
ECONOMIC EMPOWERMENT ZONES
ENTERPRISE NEIGHBORHOODS

Minimum Population		
Urban	15,000	> change?
Rural	5,000	> omit?
Maximum Population	100,000	lesser of 200,000 or 10%
Maximum Area in Square Miles		
Urban	20	
Rural	1000	
Maximum number of non-contiguous areas		
Urban	3	
Rural, if within state	3	
Rural, if multi-state	0	
Maximum number of States		
Urban	2	
Rural	3	
Minimum % of Households in Poverty		
In 50% of tracts	35%	
In 90% of tracts	25%	
In 100% of tracts	20%	

Additional Poverty Rules:

1.CBD may be included if at least 35% poverty rate
2. 0 population tract may be included
3. Tract with 2000 or fewer residents may be included iff zoned 75% or more commercial or industrial (unless CBD)
4. Secretary discretion to waive if substantial compliance with criteria and targeted area boundaries coincident with state enterprise designation prior to January 20, 1993

LIST OF EXAMPLES 0F FEDERAL CHALLENGE GRANTS FO ENTERPRISE ZONES MAY BE ELIGIBLE TO APPL'

Community Development Banking

Cops on the Street and Community Partnership against Crime (DOJ and HUD)

Enterprise School Communities (DoEd with HUD, DOL, HHS, Commerce)

Youth Fair Chance, YouthBuild, and School-to-Work Transitions--link youth apprenticeship, job training and education to economic and community development projects in the zone and job-apprenticeship partnerships throughout the local labor market (DOL, HUD, HHS, DOJ, National Service and DoEd)

One Stop Shopping and Opportunity Cards for job search, retraining and other services (DOL)

Access to Opportunties, including transportation, job matching throughout labor market, and Moving to Opportunities (HUD, HHS, DOT)

Foreign Trade Zones and Technical Assistance (Commerce)

Minority Business, Small Business, Microenterprise and Venture Funding (SBA and Commerce)

HOME and PHA Tenant economic empowerment, management, ownership (HUD and HHS)

McKinney Homelessness Act, Personal Development and Training (HUD and HHS)

JOBS Make Work Pay--earnings supplement, medical protection, child care and transportation, like New Hope Project (HHS, Treasury, DOL)

JOBS Distressed Area Demonstration--intensive, longer term training and community support, job matching throughout labor market, with many more immediate benchmarks, like Project MATCH (HHS)

Drug education and rehabilitation-to-work (HHS, DOL, DoEd, DOJ)

Final

THE WHITE HOUSE

WASHINGTON

PRIVILEGED & CONFIDENTIAL
JGP 8/12/04

April 20, 1993

MEMORANDUM FOR THE PRESIDENT

THROUGH: BRUCE REED, GENE SPERLING

FROM: THE NEC-DPC INTERAGENCY WORKING GROUP ON COMMUNITY DEVELOPMENT AND EMPOWERMENT

SUBJECT: COMMUNITY BANKING PROPOSAL

I. ACTION-FORCING EVENT

Across the country, rural and urban communities are starved for affordable credit, capital, and basic banking services. Millions of Americans in low-income neighborhoods have no bank where they can cash a check, borrow money to buy a home, or get a small loan to start a business or keep one going. Perhaps more than any other proposal, the network of community development banks you promised in the campaign -- coupled with reform of the Community Reinvestment Act (CRA) -- have the potential to transform these communities by empowering people and businesses to join the economic mainstream.

II. BACKGROUND

Over the last two months, the NEC-DPC Interagency Working Group on Community Development and Empowerment has been developing a community banking initiative that tries to fulfill the basic principles you outlined during your campaign. This memorandum reflects ideas from HUD, Treasury, Agriculture, Commerce, OMB, CEA, NEC, and DPC, as well as outreach efforts to community groups and the banking industry.

A. The Problem. As you know, low-income communities face several chronic banking problems:

- Inadequate Basic Banking Services -- Millions of poor Americans have no access to nor relationship with a bank. They live in neighborhoods with no ATM machines, no drive-through windows, no checking or savings accounts.

Instead, they are forced to deal with cash-checking operations that charge an exorbitant fee for a simple service;

- No Loans for Small Borrowers -- Most commercial lenders shun low-income communities because small loans have higher transaction costs and lower profit margins, and require more labor and attention, if not more risk;

- Lack of Expertise Among Lenders -- Lending in distressed communities, particularly for small business, is difficult. It requires specialized underwriting expertise and knowledge -- of the borrower and the community, credit products, subsidies, and secondary markets;

- Lack of Expertise Among Borrowers -- Small businesses, particularly those in distressed areas, often lack expertise in the basics of small business management, including accounting, borrowing, managing and repaying money. When commercial lenders abandon these communities, there is often no place to turn for essential capital, credit or information;

- Discrimination -- Home Mortgage Disclosure Act (HMDA) data suggest that, deliberately or not, home mortgage lenders deny loans to middle- and upper-income minority borrowers more often than to moderate- and lower-income whites. Anecdotal evidence suggests that the situation is even worse for commercial and consumer loans;

- Shortage of Credit and Capital -- The unmet demand for credit and capital in poor communities is therefore substantial. In too many low- and moderate-income neighborhoods, loans are unavailable for even the most credit-worthy housing and business purposes. A recent study found $360 million in unmet demand for credit-worthy small business loans in the City of Oakland alone. In New York City's distressed communities, several billion dollars in demand for housing loans that would qualify for federal insurance went begging. Economic revitalization cannot take root in these communities where good risks and sound businesses cannot get loans.

B. Promising Responses to the Problem. Many enterprising communities have come up with their own ways to fill the void in community development and banking services. We have looked at a variety of promising alternatives under way around the country, including community development banks, credit unions, corporations, and loan funds; loan consortia and other community development intermediaries; and community reinvestment by mainstream commercial banks.

1. Community Development Banks (CD Banks): South Shore Bank in Chicago, Elkhorn Bank and Trust in Arkansas, and Community Capital Bank in Brooklyn offer a comprehensive range of assistance to the communities they serve. Through for-profit and non-profit affiliates, they provide basic deposit, saving, checking, and consumer and mortgage lending services; venture capital for small business; microenterprise loans; and technical assistance. They also develop rental and cooperative housing for low-income residents and commercial real estate for small businesses. Three such integrated, full-service financial community development bank holding companies have emerged over the last twenty years.

2. Community Development Financial Institutions (CDFI's): A variety of other community-based organizations have found their own financial service niche:

- Community Development Credit Unions (CDCU's) are regulated financial cooperatives owned and operated by lower-income persons to serve the deposit, check-cashing, and small consumer loan needs of their members. A growing number of CDCUs are making development loans for small business expansion and start-up. Like CD Banks, CDCUs can offer federal deposit insurance up to $100,000. The largest CDCU is the Self-Help Credit Union in North Carolina. With more than $40 million in assets, it is second only in size to South Shore Bank among community lending institutions. Self-Help is part of a larger holding company that includes independent, non-depository credit and support mechanisms. There are over 100 CDCUs across the nation, and one the newest was chartered in South Central Los Angeles last November;

- Over 1000 Community Development Corporations (CDC's) have been created by civic and community groups, local or state development authorities, and banks to provide small business or micro-enterprise lending, large community development projects, or affordable housing. Their sources of capital and loans include other banks, federal small business and housing programs, local corporations and foundations, and major national assistance corporations such as LISC or Enterprise;

- Scores of specialized Community Development/Micro Loan Funds (CDLF's), both for-profit and non-profit, aggregate capital and contributions from socially conscious banks, investors, and foundations to provide equity, bridge loans, or below-market financing for affordable housing, revitalization of retail stores, or small businesses in distressed communities. Much or their lending is to microenterprises -- small businesses of five or fewer employees, with owners that have income no higher than twice the poverty level.

3. Community Development Intermediaries (CDI's): A number of state and local governments, community groups, and financial consortia provide specialized services that link communities, CDB's, and CDFI's to mainstream banking, credit, capital, and government insurance and subsidy programs and secondary markets. These intermediaries underwrite, guarantee, or repackage credit-worthy business and individual loans in distressed areas.

4. Community Reinvestment by Mainstream Banks: Either in response to pressure from community groups to meet their obligations under the Community Reinvestment Act or out of their own self-interest to learn how to better serve underserved markets, many mainstream commercial banks and thrifts have begun to provide essential financial services to distressed communities. Some have formed loan consortia, loan loss reserve funds, and community lending networks; others provide capital, loans, or contributions to the community development institutions described above. A few Bank Holding Companies (BHC's) have recently created and capitalized Community Development Banking subsidiaries to serve the financial needs of distressed communities.

In those low-income communities that are receiving credit, both lenders and borrowers have experienced a major uplift. Learning that low-income people will work to pay off a home mortgage or a small business loan can have a profound impact. As one of the founders of a CD Bank said, "One of the untold stories is that poor people with small loans can be better credit risks than rich people with large loans. And the personal reward to me is that my character loans provide a hand-up to enable the poor family to build a better life and a better community." That is what community development banking is all about.

III. PROPOSALS

Given the variety and promise of these local efforts, we advise against mandating any single model for community development banking — although the program should encourage CDFIs which have reached a certain size and level of sophistication to eventually become chartered depository institutions. Instead, we recommend a flexible community lending initiative based on the principles you outlined during your campaign.

The community empowerment strategy we have proposed includes four pillars: economic empowerment zones; community development financial institutions (CDFIs); strengthened Community Reinvestment Act and Fair Lending laws; and community policing and community partnerships against crime. Together, they will help to stimulate the public-private-community partnerships that are essential to empowering poor people to join the economic mainstream and businesses in distressed communities to become engines of economic growth. These four initiatives are the first in a series of proposals to address the unique needs of urban and rural America.

In this memorandum, we present detailed options (1) to strengthen CRA and Fair Lending requirements by demanding performance instead of paperwork, and (2) to develop a national network of community financial institutions — community development banks, credit unions, revolving loan funds, microenterprise loan funds, and more.

A. Community Reinvestment Act (CRA) Reform

1. History

The Community Reinvestment Act requires regulated financial institutions to "serve the convenience and the needs of the communities in which they are chartered to do business."[1] Under CRA, regulators of financial institutions -- the Fed, the Comptroller of the Currency (OCC), the Federal Deposit Insurance Corporation (FDIC), and the Office of Thrift Supervision (OTS) -- undertake periodic examinations of each federally chartered institution. Using a twelve-factor analysis, an examiner assesses the institution's lending practices and assigns the institution a CRA rating of "outstanding," "satisfactory," "needs to improve," or "substantial noncompliance." The examiner's CRA report is available for public inspection and an institution's CRA rating is taken into account in a regulator's evaluation of the institution's application for a charter, new branch, merger, or acquisition.

During the campaign, you promised to focus CRA evaluations on "performance, not paperwork." Both banks and community groups argue that current CRA policy suffers from several shortcomings:

- Vagueness -- The current evaluation process provides insufficient guidance for both regulators and regulated institutions on precisely which practices demonstrate CRA compliance. This vagueness is one source of the highly subjective nature of CRA evaluations and the "grade inflation" perceived by community groups;

- Paperwork, not results -- In the face of this uncertainty, both regulators and regulated institutions have focused on an institution's processes and paperwork,

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[1] CRA focuses only on a limited set of financial institutions. A considerable amount of basic banking, lending and other financial services are provided by other entities, including

- car loans extended by the credit arms of car companies
- personal and home loans by consumer finance firms
- commercial loans by commercial finance agencies
- basic deposit and checking by money market funds.

The total of such non-bank financing exceeds $1 trillion. The total assets of other financial sectors (insurance companies; investment companies, broker-dealers, mutual funds, money market funds; and pension funds) almost double the total assets of the regulated banks, thrifts, and credit unions. <u>None of these other financial institutions is subject to CRA</u>. At a later date, we will therefore explore how these other financial institutions might also play a constructive role in reinvesting in distressed communities.

such as meetings with community groups and minutes from board meetings, rather than on results. This has created substantial burdens for both regulated institutions and regulators, without any corresponding gain in CRA effectiveness;

- Poor performance -- Although more than 90% of all regulated institutions receive "satisfactory" or better CRA ratings, redlining persists in low- and moderate-income neighborhoods;

- Inequity -- Although some institutions reinvest heavily in their communities and others only lightly, almost all institutions receive passing CRA grades. This not only hampers the ability of regulators and community groups to monitor reinvestment practices, it also deprives responsible institutions of recognition for their performance.

2. Stronger, More Focused CRA Enforcement

We recommend three measures to improve CRA enforcement, none of which requires legislative action:

1) Better examiners: Many examiners lack experience in conducting CRA examinations. Bank regulators need to develop a well-trained corps of examiners who specialize in CRA examinations;

2) Stronger sanctions: Regulators should use supervisory letters, letters of reprimand, and civil money penalties to enforce actions against institutions with persistently poor CRA performance;

3) Performance-based standards: The most sweeping step we can take is to reform the CRA examination protocols to focus on quantifiable measures of an institution's actual performance in providing credit and other financial services to its community. Banks should be judged on the basis of the magnitude and distribution of affordable housing and community development lending and investment, especially in low- and moderate-income neighborhoods, and the provision of basic banking services. For example, banks should receive partial CRA credit for investing in community development institutions (see below). Banks should also be subject to fair lending examinations to determine whether they engaged in a pattern or practice of discrimination.[2]

[2]By the time of your announcement of your initial urban initiatives, we should also be able to include several other important contributions to augment community reinvestment and fair lending -- including new objectives and programs for the major GSEs like Fannie Mae and Freddie Mac.

The first two steps are relatively non-controversial. The third measure, performance-based standards, will draw criticism from some financial institutions who are worried about "credit allocation" and increased paperwork, and a few community groups who have used vague standards to pressure banks into more specific agreements on community lending.

We believe that neither concern is well-founded: The proposed regime does not prescribe lending or investment quotas, and remains sensitive to the varied needs and strengths of financial institutions. Over time, performance-based standards will reduce uncertainty and paperwork for banks and regulators alike, by giving them measurable goals and clear guidance. A streamlined examination procedure will be developed for the examination of small and rural institutions.

Most community groups will support the new standards because of their potential to increase access to basic banking services, as well as lending and investment. The real concern of community groups is that after 12 years of strained relations, they don't trust the regulatory agencies. Affected communities need to know they will have a strong voice in the examination process. In conducting CRA and fair lending examinations, regulators should actively solicit the views and comments of residents, small businesses, and citizen's groups.

B. A National Network of Community Development Institutions

To date, with almost no government support, community development financial institutions (CDFIs) have proved that it is possible to mobilize and lend significant amounts of capital for development in credit-deprived communities. We propose creating a Community Banking and Credit Fund (the "Fund") to provide federal capital assistance that will dramatically expand the amount of capital available for CDFI start-up and expansion without creating enormous financial liabilities for the federal government. The Fund would also serve as a national information clearinghouse and support system to help prospective CDFIs get off the ground and existing ones to expand, better meet their mission, and operate soundly.

1. The Community Banking and Credit Fund

In addition, HUD has prepared a proposed executive order to commemorate the twenty-fifth anniversary of the Fair Housing Act which is this month. The executive order would: (1) establish a Presidential Fair Housing Council consisting of selected cabinet members; (2) develop a pilot program to coordinate cabinet programs to promote equal housing opportunity; (3) mandate a review of all HUD programs to assure that they provide equal opportunity and promote economic self-sufficiency for their ultimate recipients; (4) direct the Secretary of HUD to issue regulations defining discriminatory practices in mortgage lending, the secondary mortgage market, property appraisal, and (5) property insurance; and update Executive Order 12259 to take account of changes made by the Fair Housing Amendments Act of 1988.

The Community Banking and Credit Fund would be a federally-chartered, quasi-public enterprise, responsible for overseeing the development of a nationwide network of community development financial institutions. The Fund would be governed by an eleven-member Board of Directors that would be appointed by the President and confirmed by the Senate. The Board would include the cabinet secretaries or designees of the Departments of Treasury, HUD, Commerce, and Agriculture, a representative of the Small Business Administration, two representatives of the CDFI industry, two representatives from community groups, and two representatives of the mainstream banking sector (including one of the regulators, e.g., the Federal Reserve or Federal Deposit Insurance Corporation). The Chairman would be appointed by the President. The Board would serve as a corporate board of directors to establish policy and would retain a full-time President/CEO to manage operations of the Fund. The size and composition of the Board could be expanded or altered to reflect the public purpose and the mix of public and private capital.

2. Selecting Network Participants

To receive financial or technical assistance from the Fund, an institution would have to be a member of the national CDFI network, and meet several stringent standards:

- Demonstrated ability to manage a CDFI;
- A primary, explicit and highly public commitment to community development. To qualify, a CDFI's loans and investments would have to go toward community development, and serve an area that needs it;
- A realistic, specific strategy to achieve the CDFI mission, consistent with the local community development plan, and become self-sustaining;
- Leverage -- private capital or other support to match Fund support. George Surgeon of Elk Horn recommends, for example, a one-dollar federal match for every two dollars of private money;
- Expertise in providing technical assistance to low income/small borrowers. Many small borrowers default not because their businesses are not viable, but because of a lack of knowledge about management, financial, and legal matters. Existing CDFIs have shown that with active guidance and credit counseling, low-income residents of distressed areas can be extremely credit-worthy.

Attached at Tab A is a summary of the criteria for eligibility.

The Fund would solicit proposals for CDFI matching funds and other assistance on a competitive basis. Relevant federal agencies and existing CDFIs will be available to assist applicants in developing their strategic plans. A review board, comprised of agency, community and private sector representatives, would review and make recommendations for selection of applications.

3. Assistance Provided by the Fund

The Fund would provide the following types of assistance:

- Capitalization Assistance -- Matching equity that could be used to capitalize new CDFI's or expand existing ones;

- Technical Assistance -- Capitalization loans, grants, or technical assistance to applicants that present proposals in conjunction with new or expanding CDFIs, including grants for training for borrowers as well as lenders. This could apply to subsidiaries of CDFIs as well as community groups with technical assistance expertise, such as ACORN;

- Coordinated Access to Relevant Programs -- The Fund would set out to give CDFIs a single point of access for relevant technical assistance, lending, and subsidy programs. Depository CDFIs could also be encouraged to provide a telecommunications network for one-stop loan centers that would make SBA, FHA, FmHA and minority business loans and other public and private loan and credit programs available to targeted areas;

- Deposits -- Monies being held by the Fund would be deposited with eligible CDFIs;

- Voice for Community Development Banking -- By forming a network of CDFIs, the Fund could also become an important voice for Community Development Banking in the country -- to stimulate private support, to spur mainstream financial institutions and Wall Street to participate in CD Banking, to study and to promote new CD Banking products, services, partnerships and secondary markets.

4. How to Capitalize the National Network of CDFIs

A key question in establishing a national network of community development banks is how to make the most of the federal government's leverage. We present three basic alternatives, with no consensus recommendation. In the first approach, the Fund uses the federal appropriation to capitalize CDFIs on a matching basis with capitalization provided by each CDFI. In the second, the Fund would be given authority to request a loan from Treasury to leverage the size of the Fund's available capital based on the Fund's experience. In the third option, additional contributions to the Fund would be required or encouraged from mainstream banks; and mainstream banks would also be required or encouraged to create CD Bank subsidiaries.

The three approaches are not mutually exclusive and could supplement one another. Under all three, we could further stimulate the CDFI industry by:

- Providing partial CRA credit for bank investments and contributions to CDFIs;[3]

- Waiving the stock/purchase requirements for depository CDFIs that wish to join the Federal Home Loan Bank System (FHLB);[4]

- Earmarking a greater share of the FHLB Affordable Housing and Community Investment Programs for use by CDFIs or other lending in distressed communities;[5]

- Providing access to expanded community lending programs of SBA, Fannie Mae, and Freddie Mac.

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[3] As described earlier, a reformed CRA can steer more resources toward distressed communities. Under the current system, it is up to bank examiners whether to give banks CRA credit for investments in CDFIs. A simple regulatory change could assure banks partial CRA credit for investments or grants to CDFIs and community groups who work with CDFIs. If the banking regulators move to a performance-based system, assistance to CDFIs could be given a specific CRA weight -- large enough to increase investment, but not so great that banks could use contributions to CDFIs as a safe harbor to circumvent CRA.

[4] Another way to expand the pool of financial resources for community lending would be to make it easier for CDFIs to join the Federal Home Loan Bank system. FHLB membership would give CDFIs a liquidity facility (a "window") and access to longer term funds at below-market rates. Under current law, any financial institution can join (Community Capital Bank and South Shore are members), but the cost of membership is much higher for banks and credit unions than for S&Ls. We propose a waiver of the FHLB membership fee for accredited depository CDFIs and the removal of any other impediment to community lending.

[5] The Affordable Housing Program (AHP) and Community Investment Program (CIP) of the FHLB system were implemented as part of the 1989 FIRREA legislation. AHP required the Federal Housing Finance Board (the regulator for the FHLB) to set aside from the profits of the FHLB banks $50 million in 1993, $75 million in 1994, and $100 million in 1995 and subsequent years for a range of activities related to affordable housing. CIP is a complementary program that authorizes the 12 District Banks of the FHLB to make advances to members for use in making community and economic development, commercial and small business loans in low- and moderate-income neighborhoods. Since CDFIs serve the same purpose, and since the Federal Home Loan Bank system is now well-capitalized, a portion of these funds could be made available for qualifying loans of CDFIs. Currently the CIP is not as active as the AHP and has yet to develop the infrastructure to support small business lending. The CIP must become a champion of small business and entrepreneurial lending in order for the FHLB to become an effective support vehicle for CDFIs.With your leadership and, as appropriate, appointment of new members of the Federal Housing Finance Board, we believe that the FHLB system can be persuaded to cooperate fully in implementing your CD Bank initiative.

The three basic approaches for capitalizing the Fund are:

OPTION 1. DIRECT APPROPRIATION

In your budget proposal to Congress, you request $382 million for community development banks through FY97. This appropriation could be used for direct federal support to CDFIs -- equity capital with a reasonably firm but patient expectation of returns over time, more venturesome investments to test the full potential of community development banking, and grants to provide "glue" money for comprehensive CDFI financial service and development networks within communities, technical assistance and training. We expect that the Fund would make allocation decisions between such categories.

The appropriation alone represents a potential 50% increase in capitalization of the CDFI industry, which is currently capitalized at approximately $700 million and has extended almost $2 billion in loans nationwide. For example, on a matching basis of one Fund dollar for every two local CDFI dollars, the new federal funds could generate an additional $1 billion in capital -- which in turn could lead to $3-10 billion in new loans in distressed, low-income communities. There may be a practical trade-off here: the higher the local CDFI match, the fewer the number of CDFIs that may be able to raise the capital necessary to apply, particularly in the early years of the Fund.

OPTION 2. LEVERAGED CAPITAL

Up to $300 million of the $382 million in your budget proposal for CD Banks could also be appropriated to support a loan to the Fund of up to $1 billion from the Treasury. This would be handled in the same way that all federal credit programs are: the appropriated funds are set aside to cover the expected losses and any interest subsidy associated with a subsidized government loan. The subsidy would be in the form of reduced and deferred interest repayment as well as deferred principal repayment. The subsidized loan would allow the Fund to make matching equity investments in CDFIs that would earn below-market rate return and take more risks than other lenders. The amount of leverage available would depend upon the anticipated returns, the risks of default, and the amount of private capital invested in the Fund.

The appendix at Tab C illustrates two financial models with different amounts of private investment in the Fund and different amounts of leverage. In either illustration, the Fund would have sufficient funding to capitalize over 100 independent CD Banks which together would have the capacity to make a total of over $10 Billion in new lending available to distressed communities. Under either model, $82 million of the total appropriation of $382 million would be used for technical assistance, setting up the network, and for other purposes.

This approach may offer several advantages: It could leverage a substantial pool of CDFI equity. It would offer contributing banks and other investors a low but positive rate of return. The projected losses to the federal government from the loan to the Fund would be paid for up-front with the appropriated funds. This structure is based on the SBA's current Small Business Investment Company (SBIC) program. Treasury or a HUD/Government Sponsored Enterprise regulator would serve as regulator as a regulator to insure that the federal financial exposure is limited to appropriated levels.

In practice, although the financial experience of the two long-standing CD Banks is very encouraging, CDFIs are still a relatively new concept. As a result, there is limited data on which to project the performance of the Fund. If the rate of CDFI failure turns out to be higher (or the level of dividends lower) than anticipated by the Fund or its regulator, the Fund itself could run into financial trouble. Debt financing for the Fund might also pressure CD Banks and CDFIs to earn (and dividend) a higher return to cover the Fund's interest payments and thereby reduce their ability to meet their community development banking mission. At the outset, it may be particularly difficult for the Fund to determine the right balance between fostering sufficient financial profitability to attract capital, keeping the fund solvent, and meeting the extensive community development banking needs.

Because of these concerns, we recommend that the Fund examine the merits of leveraged borrowing based upon its actual experience with how CDFIs perform. The Fund should have the flexibility to seek authorization for such leverage down the road based on the real needs, risks, and potential of the Fund and the CDFI network.

OPTION 3: INCENTIVES TO MAINSTREAM BANKS

Another innovative proposal involves bank holding companies (BHCs) investing a small percentage of their equity capital in community development banking, in return for the opportunity to consolidate all of their bank operations on an interstate branching basis in states where they maintain a successful CD Bank subsidiary.

By way of illustration, BHCs could invest three quarters of 1% of their capital in setting up one or more community development bank (CDB) subsidiaries dedicated to lending in distressed communities. To qualify for the limited consolidation, the BHC would have to create a CDB subsidiary in its home state and another in each state in which it seeks consolidate all of its banking operations. Another quarter of a percent of equity capital would be invested with the Fund and retained on the BHC's books as an investment.

In exchange for these investments, each BHC would have the opportunity to apply for the right to consolidate all of its bank operations through interstate branching in any state where it maintains a successful CDB subsidiary -- if all of the components of the BHC also meet their CRA and Fair Lending obligations. This opportunity would be available only in those states that permit intrastate branching and have interstate banking agreements. [Banks in Arkansas would not qualify for the proposal under present state law because it does not permit unrestricted intrastate branching.][6]

Treasury recommends that the 50 largest BHC's be required to establish CD Bank subs and to invest in the Fund. Following the "three-quarters-of-1%" illustration described above, this would provide approximately $1 billion in capital for CD Bank subs.[7] In addition, $300 million would be available at the outset to finance the network of CDFIs. depending on the number, size and quality of the applications from CDFIs and the ability of the Fund to attract additional private investment, the Fund might be able to utilize the federal appropriation for alternative support activities, such as a venture capital fund, a loan loss reserve, technical grants, etc. The proposal could, however, be made voluntary for these BHCs as well as for the other banks and thrifts, although the extent of participation would then be less certain.

This proposal is based on the premise that distressed communities will never attract the financial resources they need until mainstream banks become full-partners in community development banking. It is designed to make use of the mainstream banks' considerable expertise and capital to generate a substantial number of CD Banks in a hurry. At an average capitalization of $5 to $10 million per CD Bank, a network of well over 100 subsidiary CDBs might be established at the outset of the program, with the potential capacity to make over $10 billion in community development loans. By contrast, direct appropriation funds would support only 8 to 10 CD Banks in the first year. As the founder of one CD Bank told us, the only practical way to make a major, visible impact in community development banking in the first few years is to get the mainstream banks effectively involved and committed.

Under this proposal, banks -- not taxpayers -- would bear the primary risks and put up the bulk of capital. The BHCs would also have a major stake in making sure that both the Fund and their CD Bank subs are self-sustaining and successful. Many major banks would probably support the idea because it represents an opportunity to consolidate existing interstate banking operations. McKinsey estimates that multi-state BHCs which currently

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[6] Currently, only four states prohibit statewide branching (AK, IL, IA, MN) and two states prohibit interstate banking (HI and MT). These six states would not be directly affected by this Option, but would be able to stimulate their own CDFIs to apply for matching capitalization from the Fund, whose own capacity to finance independent CDFI's could be increased substantially by investments from the BHCs.

[7] The headquarters of the 50 largest BHCs are located in 22 different states: each BHC would be required to locate a CDB subsidiary in its home state. Approximately 40 BHC's also now have bank subsidiaries operating separately in other states. Option 3 provides an incentive for these banks to establish CD bank subsidiaries in one or more additional states. (For BHCs that do not have such local banking operations in more than one state, flexibility in the mission of its newly established CD Bank sub could be encouraged. For example, a BHC that specializes in certain niches -- e.g., merchant banking or wholesaling -- could establish a CD Bank sub with a similar specialty to serve CDFIs across the country.)

operate interstate could save $400–$800 million a year from full interstate consolidation of all of their operations; savings from the limited consolidation provided here would be less. With technical assistance from the successful CDFIs and Community Development Intermediaries which have experience on the ground, CD Bank subs could begin to make the essential connections to the communities that need to be served by real character loans.

5. Political Analysis

Securing passage of any type of CDFI legislation this year will be difficult because of the short time available. Legislation to create a network of CDFIs on a large scale has never been proposed in Congress; Senator Reigle introduced a pilot program last year. But because this proposal was a major part of your campaign platform, Members seem willing to move on your legislative proposal this spring.

The three options described above are not mutually exclusive. You could offer a plan that encompasses any or all three proposals.

Direct Appropriation (Option 1) is the least controversial, and stands the greatest chance of passage this year -- assuring that some CD Banks would be up and running in the next few years. In fact, after four years of S&L bailout legislation and bad news for the Banking Committees, members of Congress are anxious for a victory of any kind. But Option 1 also provides the least leverage. Even with a stronger CRA and easier access to the FHLB, the effects of this proposal would be limited.

Leveraged Capital (Option 2) could raise a significant amount of additional capital for the CDFI network without opening the controversial issue of bank reform. But it could raise the specter of an increased federal liability for untried and inherently risky institutions, and concern over another S&L bailout. It might be more prudent to phase in such leveraging over time, based on how CD Banks perform over the next few years.

Mainstream CD Banking (Option 3) could potentially raise the greatest amount of capital for the network, and private capital at that, plus create a network of CD Bank subs of BHCs. Getting the proposal through Congress, however, will be difficult. First, it could become a vehicle for those who want more ambitious banking reform, which would engender strong opposition from smaller banks and thrifts and other segments of the financial service industry. Every President since Jimmy Carter has supported some form of interstate branching reform, yet Congress has been unable to reach a consensus amid the special-interest fervor. Second, some community groups may strongly object that mainstream banks don't have the ties or expertise to succeed at the grass-roots level in community development banking. Finally, even if such a limited consolidation is enacted this year, some argue that Congress might not have the political will to consider comprehensive reform of the banking and financial services industry that you may wish to propose next year. Others argue, however, that successful passage of this option would set the stage for major financial reform legislation in the coming years. In any event, Option 3 will require a major political commitment on your part.

6. Legislative Strategy

We see at least three possible legislative strategies:

- **Go All Out** -- Put considerable political weight behind Mainstream CD Banking in order to persuade Congress to pass this proposal.

- **Test The Waters** -- In advance of submitting any bill, consult the leadership of the banking committees (and John Dingell, who killed interstate branching legislation in 1991) to gauge the likely reaction. If the reaction is not lukewarm or hostile, we could begin building a coalition to support the proposal. Treasury strongly recommends this approach. .

- **Two-Stage Process** -- Submit the Direct Appropriation option to Congress, but lay the groundwork for possible comprehensive financial services reform later that would infuse additional capital into the Fund and involve mainstream financial institutions in CD Banking.

We recommend that you hold private conversations with a few selected Members of the Banking Committees on Option 3. If their reaction is lukewarm or hostile, you will be able to shift to a two stage process.

IV. DECISION

A. CRA Options

____ Comprehensive Reform of CRA Examination Protocols to focus on Performance
____ Approve only process improvements to CRA
____ Reject options, discuss further

B. CDFI Funding Options:

____ Option 1 -- Direct Appropriation of CDFI Fund Only
____ Supplement with authority to request leveraged capital based upon experience
____ Supplement with BHC Contributions
  ____ Mandatory Contributions
  ____ Voluntary Contributions
____ Reject all options, discuss further

C. Legislative Options

____ Go All Out
____ Test The Waters
____ Two-Stage Process

The members of the NEC-DPC Working Group on Community Development Banking include:

Agriculture
Robert Nash

Commerce
Larry Parks

HUD
Bruce Katz
Mark Gordon
Clair Doyle

Treasury
Frank Newman
Brian Mathis
Dave Lebryck
Mark Bender

OCC
Gene Ludwig

OMB
Chris Edley
Ken Ryder
Steve Redburn
Jenny Main
Joe Firschein

CEA
Joe Stiglitz
Debbie Lucas
Chris Acito

V.P.
Greg Simon
Charlotte Hayes

DPC
Bruce Reed
Paul Weinstein

NEC
Gene Sperling
Paul Dimond
Sheryll Cashin
Peter Yu

TAB A

Eligible Institutions

Criteria

An eligible institution must serve either a target population as approved by the Board or one or more primary "Investment Areas" currently underserved by existing financial institutions. An area will be considered an approved "Investment Area" if:

(a) the area has the following characteristics:

1. is a contiguous geographic area, located within one State, and within either a local jurisdiction or otherwise identifiable community;

2. fulfills minimum and maximum population requirements as determined by the Board;

3. includes at least a majority of households which are "low-income families", as defined in Section 3(b)(2) of the United States Housing Act of 1937"; and

4. meets criteria of distress such as extent of poverty, unemployment and other factors determined to be appropriate by the Board; or

(b) the area meets the requirements of (a)(1) and (a)(2) above and the Board finds that the applicant institution has demonstrated that the area has substantially unmet credit needs or limited availability of basic services provided by existing financial institutions.

PLAN C for COMMUNITY DEVELOPMENT BANKS

A Community Development Investment Trust would make capital investments in community development banks (CDBs) and other community development financial institutions (CDFIs). The Trust would be funded with a combination of Federal and private resources that might support as much as $15 billion in new community lending. CDBs would be insured depository institutions, expected to meet existing safety and soundness regulations. CDFIs could take a wide variety of forms, including so-called community revolving loan funds.

The appropriated Federal contribution to the Trust would be in the form of a $300 million equity investment which the Trust could use to leverage up to $1 billion in subsidized debt financing. The appropriation thus serves to assure that the Trust's borrowings will be repaid, and also will provide a cushion allowing the Trust to use the $1 billion pool of resources to make below market investments in CDBs and CDFIs. The Trust's expectations regarding anticipated returns from individual CDBs, based on their submitted business plan, would be a large factor in determining the Trust's investment choices, and in turn, the amount of debt the Trust would leverage with its $300 million equity contribution. The riskier the Trust's investment and the lower the expected return, the more of the $300 appropriation must be set aside for reserves rather than to leverage the full $1 billion investment pool.

There are important possible sources of additional CDB capital beyond the $1 billion potentially leveraged by the Federal appropriation. Up to an additional $1 billion in community development funding might come from equity investments by existing depository institutions, state and local governments, and others. Some of those investments would flow through the Trust and others would flow directly to individual CDBs and CDFIs, perhaps to meet matching requirements in their business plans for private or local stakeholders. The Trust would have a goal of at least a 50-50 match in non-Federal capital in each supported CDB or CDFI, with some of that invested through the Trust and some contributed directly to approved CDBs and CDFIs.

The Federal equity contribution to the Trust would allow private and local investors to earn a modest positive return by investing in a geographically diversified portfolio of CDBs and CDFIs. Other incentives for these additional investments would include limited Community Reinvestment Act credit for existing depository institutions.

A competition to select and charter CDBs and CDFIs would be conducted by the lead Federal agency, in consultation with the Trust. The Trust would also make loans to CDFIs (although the risks and associated Trust reserves might be higher). Either the Trust or the lead Federal agency would administer a separate, federally funded technical assistance grant program, using appropriated Federal funds not set aside as reserves to leverage the borrowed $1 billion pool. The Trust would be governed by the contributing depository institutions with additional representation from the Federal government and community groups. Regulatory oversight of the Trust could be located in Treasury or HUD to ensure that the liability to the Federal government is within the appropriated funds.

COMMUNITY DEVELOPMENT BANKS: Plan C

A Community Development Investment Trust ("Trust") would be created to capitalize new and existing community development banks (CDBs) and other community development financial institutions (CDFIs) with private and Federal funds. Private investors would be encouraged to make equity contributions to the Trust, but these added investments would only serve to expand the range of financially feasible activities.

The Federal contribution to the Trust would be the flexible use of $300 million in appropriated funds:

- o the $300 million could be used as a direct equity contribution to the Trust; or
- o it could be used to leverage up to $1 billion in debt financing: conceptually, this makes the appropriation equivalent to the expected cost of a government guarantee and any interest reduction for the Trust's debt financing; or
- o a mixture of the two options could be designed, depending on experience and the range of investment opportunities presented by the CDB and CDFI applicants.

The Trust would determine, based on its expected investment returns and the level of private capital invested in the Trust, how much debt to leverage with the appropriated funds. The following discusses two numerical examples (see attached tables).

The first -- the *high leverage option* -- illustrates the Trust using all $300 million to finance a $1 billion Federal loan that becomes the core pool of investment resources for the Trust. This option further assumes $1 billion in 1:1 matching capital invested by: banks and other depositories, Federal Home Loan Banks, foundations and perhaps state or local governments -- with some of those resources flowing through the Trust, and the balance made in direct investments with individual approved CDBs and CDFIs. When fully operating, this would produce a network of 100 CDBs and additional CDFIs, making a total of $15 billion in new lending to distressed and credit-deprived communities.

The second example -- *the low leverage option* -- illustrates a less aggressive financial structure for the Trust. The Trust uses only $100 million in appropriated funds to leverage $400 million of debt financing, rather than $1 billion. Another $200 million from the appropriation would be a direct capital contribution by the Federal government to the Trust. Assuming another $400 million of matching capital contributions from chartered depositories and others would give the Trust total resources of $1 billion. If banks and others contributed another $400 million directly to CDBs and CDFIs, the resulting combined capital base of $1.4 billion would support at least $10 billion in new lending.

> NOTE ON CREDIT BUDGETING: Budget rules require that the present value cost of Federally supported credit be appropriated when credit is extended. In the first case, the estimated cost of extending the credit is 30 percent of the $1 billion face amount of the loan to the Trust, or $300 million, and includes foregone interest as well as an estimate of the potential likely loss if and when the Trust should fail or default. The credit subsidy estimate in this case

assumes that the loan will be for 10 years, with no interest for the first three years and reduced interest for three years thereafter and that there is a one percent chance the Trust could fail in any year after the first six years. If the Trust failed, the Government's loss would be the principal amount less recoveries from sale or liquidation of the Trust. In the second case, because the Trust would be less highly leveraged, the subsidy rate would be slightly lower, 25 percent of $400 million or $100 million.

Whatever the mix chosen for the $300 million, the Trust also would administer $10 million in Federal grants for technical assistance and other purposes annually from 1994 through 1998. This would account for the portion of the $350 million in appropriations not used to support either a loan to or equity investment in the Trust.

This plan is not inconsistent with Plan B; it is complementary. For example, banks and other depository institutions could contribute up to one percent of their capital to the Trust and an equal amount directly to CDBs or CDFIs. In addition to low-cost capital, incentives for bank participation would include partial credit toward their Community Reinvestment Act obligations. CDBs would have access to Federal Home Loan Bank advances and could qualify on an accelerated basis as SBA guarantors and FHA direct endorsers, thus increasing their attractiveness to potential equity investors. CDFIs could take a wide variety of forms, but all would be designed to be self-sustaining and pay dividends or interest to the Trust.

A competition to select and charter CDBs and CDFIs would be conducted by the designated lead Federal agency, in consultation with the Trust. Awards would go to the proposals that target unmet credit needs most effectively and demonstrate the strongest capital backing, community support, and management strength. CDBs would be expected initially to hold equity capital equal to at least the relative amounts required of small, non-diversified banks and to meet the same safety and soundness requirements as other depository institutions. They would be chartered as national banks and supervised by the Office of the Comptroller of the Currency.

The Trust would be governed by the contributing entities, including depository institutions, with representation from the Federal government and community organizations. Representation on the Trust governing board would be generally proportional to their interests. CDBs would be governed by the Trust and other capitalizing organizations in proportion to their contributions, but also would include elected representatives of the residents and businesses in the communities they serve. Financial oversight of the Trust would be provided by Treasury or by the new housing GSE regulator in HUD. This will guarantee that as the Trust develops or responds to creative ideas for financing, the Trust does not create any contingent liabilities in excess of what can be covered by the Federal appropriation and by other sources of private, state or local contributions to Trust capital.

Financial Analysis

To succeed, both the Trust and the network of local institutions it capitalizes must be financially viable. Otherwise, contributing depository institutions will be forced, in many cases, to write off their capital contributions and the Government will be forced to eventually liquidate its financial commitment.

The high-leverage and low-leverage financing alternatives described above are summarized in the two attached tables. In either case, it is assumed that the CDBs earn an average return on assets equal to the industry's long-term average (70 basis points). Because of the greater risk of lending to distressed communities, CDBs would experience more variable earnings and thus a higher risk of failure. This could be partly offset if they maintain a 10 percent ratio of capital to assets (higher than the current 9.5 percent average for small commercial banks). Nevertheless, once the CDBs are fully loaned up, one in a hundred is expected to fail each year (higher than the industry average in all but a few recent years).

The CDBs are expected to dividend 75 percent of their net earnings to the Trust and other shareholders. A higher rate of retained earnings would allow for more rapid growth, but this rate of dividend payments will be required to enable the Trust to repay the Federal loan.

With the larger scale, more aggressive financial structure, the Trust's return on equity would be 2.4 percent. With the less ambitious structure and scale, the return on equity would be 5.4 percent. In either case, then, the Community Development Investment Trust would earn a somewhat below-market rate of return on its capital. At a two percent annual failure rate (far higher than the long-term industry average), the Trust would lose money.

Pros

- o This approach builds a very substantial pool of CDB equity by leveraging the appropriated funds rather than by tying mandatory bank holding company (BHC) contributions to controversial banking reform issues.

- o The proposed financial structure is viable under conservative assumptions. It promises contributing banks and others a low but positive rate of return and presents the Government with minimal risk of default on its loan or guarantee.

- o The competitive approach to selection places initiative in the hands of communities and CDB entrepreneurs, and rewards those with the strongest local support and potential for business success.

- o The Trust could support BHC CDB subsidiaries, so Plan C is compatible with Plan B.

- o Using Treasury or the HUD GSE regulator as a watchdog will ensure that the Federal financial exposure is within appropriated levels.

Cons

- o To the extent that private equity capital receives little or no return (because earnings will be used primarily to pay dividends to the Trust or be retained and reinvested) the incentives for further private investment will be reduced.

- o If the incentives for depository capital contributions prove too weak, the initiative may have a smaller scale and impact than Plan B.

- The start could be somewhat slower than in Plan B because many more of the supported institutions will be new entities, rather than subsidiaries of existing institutions. Moreover, the Federal appropriation is spread over a four-year period.

- If the risk of CDB failure is higher than estimated, then the Trust could fail at some time in the future, requiring additional appropriations to cover its losses or to refinance the initial debt. However, OCC Comptroller-designate Gene Ludwig has made a commitment to be especially vigilant in proactively working with CDBs to strengthen their business and management capacities.

- The debt financing structure of the Trust may put pressure on the CDBs and CDFIs to earn and pay high dividends to cover the Trust's interest payments. This potential trade off between financial soundness of the Trust and flexible use of CDB retained earnings could limit CDB lending in more distressed areas and/or limit the CDBs' growth potential. [However, comparable pressure is likely to exist from "above" for subsidiaries of BHCs. To address this issue, one factor considered in the competitive selection process would be the level of applicants' private investment commitments, i.e., the private match.]

Community Development Investment Trust*
Maximum Scale Assumptions
($ in millions)

ASSUMPTIONS:

	Trust	CD Banks
Federal debentures	1,000	—
Equity capital	500	2,000
Total assets	1,500	20,000
Capital:assets (%)	33%	10%
Average ROA	—	0.7%
Average ROE	—	7.0%
Interest rate on debentures	5.20%	—
CDB annual failure probability (%)		1.0%

COMMUNITY DEVELOPMENT INVESTMENT TRUST

($ millions)

Income		Expenses	
Dividends	78.75	Interest	52.0
Federal grants	10	TA, other services	20.0
Private grants	10	Provision for loss	15.0
NET INCOME	11.75		
ROE	2.35%		

* This summarizes the expected financing and financial performance of the Trust after year five, when fully funded and operational.

Community Development Investment Trust*
Lower Scale Assumptions
($ in millions)

ASSUMPTIONS:	Trust	CD Banks
Federal debentures	400	--
Private contributed capital	400	1,400
Federal contributed capital	200	--
Total assets	1,000	14,000
Capital:assets (%)	60%	10%
Average ROA	--	0.7%
Average ROE	--	7.0%
Interest rate on debentures	5.20%	--
CDB annual failure probability (%)		1.0%

COMMUNITY DEVELOPMENT INVESTMENT TRUST

($ millions)

Income		Expenses	
Dividends	52.5	Interest	20.8
Federal grants	10	TA, other services	20.0
Private grants	10	Provision for loss	10.0
NET INCOME	21.7		
ROE	5.43%		

* This summarizes the expected financing and financial performance of the Trust after year five, when fully funded and operational.

Proposed Financial Structure for Plan C
Community Development Banks