Novogradac New Markets Tax Credit Report

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# Flexible Products – CDE Allocation Agreement

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The fourth and fifth round allocation agreements provide that new markets tax credit (NMTC) allocatees are required to provide 100 percent of their qualified low-income community investments (QLICIs) as "flexible products." The standard to qualify as "flexible" has been raised each year. The determination is made at the time the QLICI is made and the terms must be compared to the allocatee's underwriting guidelines for non-NMTC loans or investments or standard practice in the marketplace.

## Fourth Round Allocation Agreement Standard

In the fourth round allocation agreement, flexible was defined in summary as follows:

(a) equity or equity equivalents,

(b) interest rates at least 25 percent below prevailing market rates or the applicant's current offerings for the particular product, or

(c) the QLICI meets at least three of a list of criteria – (i) debt with equity features; (ii) subordinated debt, (iii) below market interest rates; (iv) lower than standard origination fees, (v) longer than standard period of interest–only loan payments, (vi) higher than standard loan–to–value ratio; (vii) longer than standard amortization; (viii) more flexible borrower credit standards; (ix) nontraditional forms of collateral; (x) lower than standard debt-service coverage ratio (DSCR); or (xi) lower than standard loan loss reserve requirements.

## Draft Fifth Round Allocation Agreement Standard

The draft fifth round allocation agreement (which should be final at the time of circulation of this article) defines flexible terms as (a) equity or equity-equivalent financing, (b) an interest rate that would have to be either 50 percent or 33 percent below market (presumably based on representations made in the allocation application), instead of 25 percent below market, or (c) a requirement that at least 5 or 4 of the list of flexible terms would be satisfied (again likely to be based on the representations made in the allocation application). The list of flexible criteria remains the same as in the fourth round allocation agreement.

## Supporting Documentation

The CDFI Fund collects this data through the allocatee's annual transaction level reports submitted through the Community Investment Impact System (CIIS). The allocatee is required to obtain supporting documentation at the time the QLICI is made, which the CDFI Fund stated in published guidance may include (and is not limited to) (i) published materials from financial institutions within the allocatee's service area and (ii) the allocatee's loan documents with respect to comparable non-NMTC subsidized loans.

An allocatee that is an affiliate of a financial institution that has a commercial market rate lending practice has a readily available source of information to support satisfaction of these requirements. Other allocatees may have to look to such financial institutions to provide market-rate benchmarks to determine that these requirements have been met. An allocatee that is a nontraditional lender in its non-NMTC loans and investments can compare the terms of its QLICIs to

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its standard lending practices. The comparison may not be as favorable as to the market-rate terms provided by commercial financial institutions. For all allocatees there are challenges in applying the tests, since the nontraditional nature of the QLICIs can make it difficult to determine, for example, the appropriate comparable market interest rate.

The CIIS reporting requirements are increasingly more extensive. Allocatees will be required to report to the CDFI Fund the comparable benchmarks used to determine whether the QLICI meets the flexible product requirements, as well as the source of the information, e.g., banks or an allocatee affiliate. Information beyond that required to establish compliance with the allocation agreement is included in the CIIS data to be provided to the CDFI Fund.

## A/B Note Structure

CDFI Fund published guidance (November 2006) provides that a community development entity (CDE) may combine separate loans for purposes of satisfying the flexible products requirement if the transactions are part of a simultaneous closing and the blended interest rate is at least 25 percent below market or at least 50 percent of the dollar value of the combined transactions and meets the concessionary rates and terms requirements. Based on the draft fifth round allocation agreement the blended interest rate would have to be at least 33 percent or 50 percent below market. This guidance was provided in response to concerns that the A Note in the A/B Note structure would not qualify as flexible. Generally, the A Note mirrors the terms of the economic leverage lender loan to the investment fund which is often a market rate loan.

Based on the CDFI Fund guidance, QLICIs provided by a CDE to a qualified active low-income community business (QALICB) at a single closing may be treated as one loan for purposes of determining compliance with these requirements. If the two (or more) notes combined have a blended interest rate that is 25 percent, 33 percent or 50 percent below market, as applicable, the flexible products requirement is satisfied. Alternatively,

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at least 50 percent of the principal amount of the two (or more) notes combined would have to satisfy the required number of concessionary rates and terms (3, 4 or 5, as applicable).

The examples provided in the CDFI Fund guidance leave certain issues open. Based on the examples, it may be concluded that in order for at least 50 percent of the principal amount of the combined loans to meet the concessionary rates and terms, the original principal amount of the B Note would have to be at least 50 percent of the total original principal amount of the QLICIs provided at a single closing. This would be true for certain criteria such as subordinated debt. Combining the notes will not increase the principal amount of the QLICIs that is subordinated debt. However, combining the notes will facilitate satisfaction of other concessionary criteria, such as below market interest rates, lower than standard origination fees, higher than standard loan to value ratio, lower than standard DSCR or lower than standard loan loss reserve requirements. The CIIS reporting requirements recognize that certain tests should be evaluated on a project basis, such as loan to value (LTV), DSCR and loan loss reserve requirements.

## Recommendations

- A CDE's underwriting of a potential transaction would include confirmation that the flexible products requirements will be satisfied.
- The CDE should confirm that the structure of the transaction as it evolves maintains compliance with these requirements.
- The CDE's compliance staff that prepares CIIS data should review the transactions and supporting documentation for satisfaction of the flexible product and CIIS reporting requirements.
- Obtain supporting documentation as a condition to closing.

*The information presented in this article is intended solely for informational purposes and should not be construed as legal advice by the author or Future Unlimited Law PC. Contact Ruth Sparrow of Future Unlimited Law at rsparrow@futureunlimitedlaw.com; 360-458-1720; futureunlimitedlaw.com for more information.*

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