April 14, 2011

Hon. Lois Wolk, Chair
Senate Governance and Finance Committee
Room 5114, State Capitol
Sacramento, California 95814

Hon. Henry T. Perea, Chair
Assembly Revenue and Taxation Committee
Room 4112, State Capitol
Sacramento, California 95814

Dear Senator Wolk and Assembly Member Perea:

Chapter 580, Statutes of 2006 (AB 2831, Ridley-Thomas), extended until January 1, 2012, provisions of the state's personal income tax, corporation tax, and insurance tax laws that provide credits to individuals or businesses that make qualified investments in community development financial institutions (CDFIs). As you know, a bill currently under consideration by the Legislature—AB 624 (J. Pérez)—would extend these credit programs until January 1, 2017 and make certain changes to the program. Pursuant to Chapter 580, our office is required to prepare an analysis of the existing tax credits and specifically to address the credits' fiscal impact, the projects funded by CDFIs that were supported in whole or in part by the tax credits, and the resulting benefits to economically disadvantaged communities and low-income people in California. (Our submission of this analysis unfortunately was delayed due to our recent work on the 2010-11 and 2011-12 state budgets.)

What Are CDFIs? According to the California Department of Insurance (CDI), CDFIs are "mission-driven private financial institutions in California specifically dedicated to, and whose core purpose is, providing financial products and services to people and communities underserved by traditional financial markets." Community development loan funds, credit unions, banks, microenterprise funds, and corporation-based lenders or venture funds may be CDFIs. The California Organized Investment Network (COIN)—an office within CDI—plays a lead role in coordinating the CDFI tax credit program described below. The COIN office administers key aspects of the credit and generally approves applications on a first-come, first-served basis as long as paperwork related to CDFI investments is in order and the investment relates to an eligible CDFI that uses the proceeds for a purpose consistent with its community development mission and to benefit economically disadvantaged communities and people in California. The COIN office has some discretion in certifying CDFIs. The federal government also regulates CDFIs to some extent. The COIN staff notes that they have decertified CDFIs on rare occasions.

Tax Credits. The goal of this tax credit program is to provide incentives—through personal income, corporate income, and insurance tax credits—to attract private capital investments that otherwise would not be available to CDFIs. The credit is equal to 20 percent of the invested amount, and the statewide total for all credits for all recipients is capped at $2 million per year for the three taxes combined. Accordingly, each year, qualified investments in CDFIs of up to $10 million are eligible for the tax credits. State law, however, provides that if the aggregate amount of qualified investments made in any calendar year is less than $10 million, the difference between $10 million and the actual amount of qualified investments may be carried over to the next year and any succeeding year during which the credit remains in effect and added to the aggregate amount authorized for those years.

Qualified investments in CDFIs eligible for the credits include loans, equity investments, or "equity-like debt instruments" meeting certain specifications. All qualified investments must be equal to or greater than $50,000 and for a minimum term of five years.

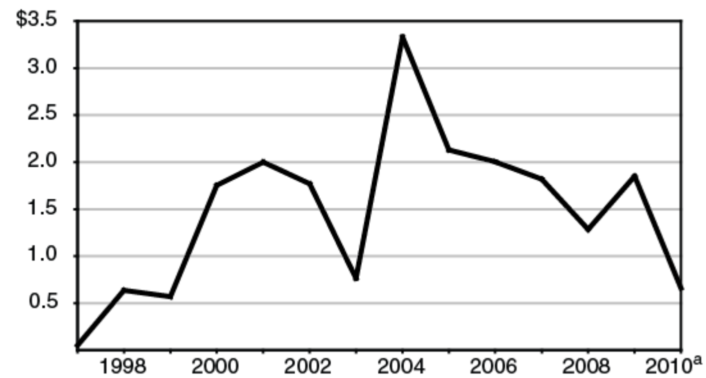
Fiscal Impact and Program Utilization. By law, as described above, the fiscal impact is capped at $2 million of new tax credit capacity each year, except that unused amounts under the cap may be carried over to future years and added to the aggregate amount authorized for those years. The COIN staff reports that the tax credit program has not fully utilized the full $2 million tax credit capacity in several recent years, as shown in Figure 1. On February 17, 2011, the Insurance Commissioner sent a notice to insurance company executives noting that $4.75 million in CDFI state tax credits were available due to underutilization of the credit in recent years. In the same notice, the Insurance Commissioner reminded insurance companies of new requirements concerning their community investment policy statements in Chapter 340, Statutes of 2010 (AB 41, Solorio).

While the legislative history of the CDFI credits—and the placement of its administration within CDI—suggest that a key goal of the program has been to encourage insurance company investments in these entities, a very small number of insurance companies have applied for the credits in recent years. In 2009, for example, of 23 CDFI tax credit qualified investments reported by COIN, 22 of these investments appear to have been made by banks and one or more individuals. The single largest CDFI tax credit investment in that year—a $5 million investment resulting in a $1 million tax credit—was made by the sole insurance company then receiving a credit, Metropolitan Life Insurance.

Figure 1

Community Development Financial Institution Tax Credits by Year

(In Millions)



[a] Includes both certified tax credits and tax credit applications received as of January 10, 2011.

Projects. We understand that the CDFIs are not required to specify the projects that credit-eligible funds will be used for, but in many cases they do. In such cases, it appears that these funds are used primarily for small business loans to lower-income and moderate-income people in less affluent areas who otherwise would struggle to qualify for loans and for loans for construction or purchase of owner-occupied or rental housing for similar clients in similar areas.

Economic Impact. It is very difficult to estimate the impact of the tax credits, although we suspect that in many cases investments in the CDFIs would not have been made in the credit's absence. It is true that some of the credits have benefited larger CDFIs that are capable of raising funds in other ways and for which the credit-funded investments represent a smaller portion of their total assets. Even in these cases it seems likely that the tax credits helped generate investment activity that otherwise might not have been funded.

LAO Comments. We offer the following general comments on this tax credit program.

- ***Credit Percentage Seems Reasonable.*** This credit is set up like most investment credits in that it refunds a percentage of the invested amount, and 20 percent is the equivalent of about 2.5 to 3 percentage points on a ten-year loan at prevailing interest rates. This is about one-half of the interest rate spread between a fairly safe investment and a very risky one. For example, recently, the difference between the rates on a BBB (low investment-grade) bond and a CCC ("junk") bond was about 6 percent. While we have no reason to believe that a 20 percent subsidy is too high or too low, it is possible that changing conditions in financial markets in the future could warrant a different subsidy percentage for this credit.

- ***Owned Versus Rental Housing.*** The CDFIs have supported both rental and owner-occupied housing, including both construction and mortgage loans. Credit standards for home purchase loans have increased markedly since the collapse of the housing market. In order to benefit lower-income individuals, it may make sense for housing development efforts to focus more on *rental* housing at least in the near future. Accordingly, the Legislature may wish to consider focusing the tax credit more on CDFI investments in rental housing opportunities to benefit low-income populations.
- ***First-Come, First-Served Tax Credits Can Be Problematic.*** In some prior years, the program has hit its annual cap. If the credit is retained in its current form, it may be advisable to authorize COIN or some other entity to award the credits competitively instead of on a first-come, first-served basis. This might allow the state to prioritize CDFI investments that best fit desired policy objectives—for example, by directly benefiting lower-income people instead of benefiting projects that merely are located in lower-income areas.

For more information, please contact Justin Garosi or Jason Sisney of my staff at (916) 445-4656.

Sincerely,

Mac Taylor
Legislative Analyst

cc: Hon. John A. Pérez, Speaker of the Assembly