ABA Stonier Graduate School of Banking

Evaluating the Profitability of Affordable Housing Lending

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EXECUTIVE SUMMARY

Zions Bank has become increasingly active in affordable housing lending throughout the company's footprint. The product type has been proven in local markets to be desirable and successful. The goal of this analysis is to evaluate the potential for the program to also be utilized in a way that will result in maximum profitability for the bancorporation. This will be accomplished primarily by comparing 4% and 9% LIHTC loans via a Bancorporation valuation tool.

The assumption within the organization is that affordable housing loans are not profitable, but are necessary for Community Reinvestment Act regulations by the Office of the Comptroller. However, affordable housing lending may have unanticipated positive financial impacts, in addition to the recognized positive non-financial impacts.

Zions Bancorporation does not currently originate and sell affordable housing commercial real estate loans to the secondary market. It does originate affordable housing commercial real estate loans, and it does originate residential mortgages for the secondary market. Additionally, the bancorporation syndicates commercial real estate loans with other lending institutions.

A side-by-side comparison of four hypothetical LIHTC loans (including two 9% LIHTC loans and two 4% LIHTC), resulted in ROE's of XX% or greater. The tax-exempt loans (4% LIHTC) produced returns that were XX% better than their taxable loan counterparts. See page 11 and Appendix B for analysis and details. [Note: Appendices have been redacted for confidentiality.]

Due to limitations, the author was not able to run profitability scenarios on loans originated for the secondary market, but has learned from industry resources that, upon the sale of the credit, the originating lender is paid an ongoing management fee of 10 to 15 bps, if they maintain the loans they originate.

Consideration was also given to the impact of HVCRE (High Volatility Commercial Real Estate). Affordable housing loans can be held on the balance sheet at a ratio of 1 to 1, vs. 1 to 1.50, which translates to more lending with the same amount of Tier 1 Capital. There is no difference between 9% or 4% LIHTC projects, with respect to HVCRE. If LIHTC loans were to be originated, sold, and only serviced by Zions Bank, the entire Tier 1 Capital burden would transfer to the purchasing bank, and Zions could redeploy funds for new loans to be held on the balance sheet.

The non-financial impact of affordable housing lending is predominately measured by two outcomes: CRA evaluations and market reputation. CRA evaluations for Zions are currently on a three-year cycle, with the most recent examination period ending June 2018, and yielding the following results on the Lending Test: Low Satisfactory, High Satisfactory, and Substantial Noncompliance, for Utah, Idaho, and Wyoming, respectively. This examination included home mortgages, small business loans, small farm loans, and other loans outside the scope of the author's area of expertise which were not contemplated herein.

The impacts to market reputation experienced by the organization, employees, and customers from the Real Estate Banking Group's performance since December of 2016 have been overwhelmingly positive and are identified on page 16.

Over the past three years, the Real Estate Banking Group has booked more than $XX in affordable housing loans in an effort to benefit Zions Bancorporation, both financially and non-financially.

Until further analysis can be completed, or if that analysis yields contradictory results, Zions should continue originating LIHTC loans, specifically 4% LITHC loans, where Zions will purchase the associated bonds, as this resulted in the most favorable ROE in the analysis provided earlier.

It is recommended that loans be originated up to levels that will accomplish Satisfactory or better CRA Evaluation ratings. While it is understood that these loans provide an acceptable return to the bancorporation, there is no additional fiscal benefit to holding ***excess*** CRA-eligible loans on the balance sheet; nor is there notable CRA evaluation benefit to this. In fact, it is possible that those funds could instead be lent at greater returns with shorter obligation periods/loan maturities, which would improve ROE as well as non-interest income in the form of origination fees.

Therefore, it is recommended that Zions Bank originate quality affordable housing loans up to approximately $XX, to be held on the balance sheet, and either sell any additional loans on the secondary market, or focus on market rate loans that are more profitable to the institution.

PART I: INTRODUCTION/BACKGROUND

ORGANIZATION OVERVIEW

Zions First National Bank was founded in Salt Lake City, Utah in 1873. The bank currently supports a network of 122 full-service financial centers across Utah, Idaho, and Wyoming[1].

As the largest division of Zions Bancorporation, N.A. (NASDAQ: ZION), Zions offers a product suite including, but not limited to, commercial loans, international banking services, mortgage and home equity loans, credit cards, private and executive banking services, and online and mobile banking. The bancorporation is a member of the Federal Deposit Insurance Corporation (FDIC), is regulated by the Office of the Comptroller (OCC), and operates under multiple brand names in 11 states throughout the western United States and Texas.

LOW-INCOME HOUSING TAX CREDIT (LIHTC) PROGRAM

The Low-Income Housing Tax Credit (LIHTC) program subsidizes the acquisition, construction, and rehabilitation of affordable rental housing for low- and moderate-income tenants. Enacted in 1986, the LIHTC program has supported the construction or rehabilitation of approximately two million units since inception[2].

The federal government issues tax credits to state and regional governments, which are then awarded by state housing agencies. In Utah, the Utah Housing Corporation (UHC) runs this program. In Idaho, the Idaho Housing and Finance Association (IHFA) issues these awards. For Wyoming, the Wyoming Community Development Authority (WCDA) fulfills this task. In all states, private developers apply for these credits through a competitive process.

Although developers are entitled to the tax credits upon receiving an award, they generally sell the credits to private investors in exchange for equity for the awarded project. LIHTCs give investors a dollar-for-dollar reduction in their federal tax liability (annually for 10 years, beginning at stabilization), in exchange for capital used to develop affordable rental housing. Investors' equity is typically contributed at the following stages: loan origination, certificate of occupancy, stabilization, and at the time of their first tax return filing. The additional capital provided by the investors subsidizes these low-income housing developments, allowing many of the units to be leased at below-market rates. The benefit to such affordable rents, is that projects typically lease-up much faster than market rate developments, and turnover is much lower. The drawback is that the lower rents decrease available cash flow to service debt. Without the tax credit incentive, affordable rental housing projects would not generate sufficient income to make the developments feasible.

There are two types of LIHTC awards: 4% and 9%. The 4% award subsidizes 30% of the low-income unit costs in a project. The 9% award subsidizes 70% of the low-income unit costs. The name of each program is representative of the actual percentage of tax credit that each program provides to the investor. The credits are calculated in the following way[2]:

Total Eligible Basis (project costs subject to depreciation) x Applicable Fraction (percentage of affordable units) = Qualified Basis

Qualified Basis x Tax Credit Rate (4% or 9%) = Annual Tax Credits

Annual Tax Credits x 10 (years) = Total Value of Tax Credits

Total Value of Tax Credits x Investment Per Tax Credit Dollar (e.g. $0.95 to $1.10, determined by market) = Net Equity Investment

EXAMPLE:
$13,659,503 Total Eligible Basis x 80% of units rent restricted = $10,927,602 Qualified Basis
$10,927,602 x 9% Tax Credit Rate = $983,484 Annual Tax Credits
$983,484 x 10 years = $9,834,842 Total Value of Tax Credits
$9,834,842 x $1.025 per credit = $10,080,713 Net Equity Investment

1. "General Information" https://www.zionsbank.com/personal-banking/about-us/

2. Tax Policy Center, "What is the Low-Income Housing Tax Credit and how does it work?" https://www.taxpolicycenter.org/briefing-book/what-low-income-housing-tax-credit-and-how-does-it-work

LIHTC LENDING AT ZIONS BANK

While Zions Bancorporation has extensive experience with LIHTC lending, it's lead subsidiary, Zions Bank (headquartered in Utah), has applied limited focus on this commercial real estate specialty over the past decade, until recently.

Utah is a notoriously competitive state for LIHTC financing, due to the high concentration of industrial banks, who also need Community Reinvestment Act (CRA) credit, but do not offer the same products as retail banks, and are therefore willing to pay above market pricing on LIHTC projects in order to capture these investments and loans. While the recent federal tax reform has impacted Utah's market for tax credits, bringing it more in line with national standards, it remains one of the more competitive markets in the nation.

A more significant recent change was the implementation of a competitive affordable housing policy within Zions Bancorporation. Without a defined credit policy, it is difficult for Credit Administrators, the individuals with the authority to approve lending facilities, to operate confidently within the OCC guidelines surrounding safe and sound lending practices. In December 2016, when Zions Bancorporation memorialized a competitive affordable housing lending policy, new opportunity for the commercial real estate group was created, which has allowed the division to increase lending in this area. Since inception, the commercial real estate group has underwritten and closed 10 loans, totaling more than $XX dollars, for affordable housing projects.

Now that the loan program has been proven in the market, attention should be given to how best to utilize this program to maximize profitability. Is it more advantageous to hold these assets on the bancorporation's balance sheet, for up to 18 years, as policy permits, or would it be more profitable for the bancorp to originate and service such loans on behalf of the secondary market, for an agency such as Freddie Mac, Fannie Mae, or HUD? Furthermore, does the type of LIHTC (4% vs 9%) impact that decision?

LOAN PROFITABILITY

Many factors are evaluated when determining whether or not to extend credit and whether to hold a loan on a bank's balance sheet, sell it off, or sell the debt but maintain loan management responsibilities. Three significant factors in this decision include: loan concentrations, loan pricing, and loan profitability.

The FDIC and the OCC issue guidance related to lending concentrations. This guidance sets thresholds for CRE loans as a percent of risk-based capital. Under this guidance, banks who allow their CRE loans to exceed the thresholds, will be considered "concentrated in CRE and could be subject to further supervisory analysis".[3] One exception to concentration limits is CRA lending. Affordable housing loans are CRA eligible, due to their rent restrictions, which accommodate low- to moderate-income individuals. A competitive program (like Zions'), in a segment which is not subject to lending concentrations (such as affordable housing), offers unlimited potential income for the bank without risk of exceeding concentrations.

Loan pricing is another determinant of bank profitability. Affordable housing projects may require below-market pricing in order to keep debt service at a lower level so that the restricted income of the project can cover said debt service. Additionally, competition for affordable housing projects is high, due to the low risk of the product type, which benefits from strong occupancy and the partnership of the tax credit investor who will work to ensure the success of the project. While this would seemingly make LIHTC deals less profitable for the lending institution, to date, Zions has been able to accomplish market rate construction loan pricing on the majority of the LIHTC loans closed.

Loan profitability is also impacted by the amount of overhead required to underwrite and manage the loan. While LIHTC loans are complex, Zions controls these costs by training subject matter experts to underwrite and manage all affordable housing loans, and by passing on the increased costs related to financing (such as higher than typical legal and title fees from third-parties), to the borrower, as is standard practice when financing market rate projects. Additionally, while some loans have been offered reduced origination fees (in order to win the deal), most have garnered a XX% origination fee for

3. Maria Tor and Venkatesh Iyer, "As more banks exceed concentration guidance, regulators issue warning on CRE growth" (December 22, 2015), http://m.bankingexchange.com/images/Dev_SNL/122815_AsMoreBanksExceed.pdf

construction. Where term loans were also offered, origination fees of approximately XX% were included, where possible, (again, depending on concessions required to win the business).

Based on the above preliminary analysis, LIHTC construction loan origination appears to fit well within the goal of increasing production for the bank, without exceeding concentration limits or requiring cost-prohibitive activity. However, the question remains: is there a business case for balance sheet lending for term LIHTC loans, or would it be better to originate and sell those loans to the secondary market? Furthermore, does the type of LIHTC loan (4% or 9%) impact profitability?

Interest earned by the bank on affordable housing loans affects the bank differently if the project either does not have any LIHTCs or has 9% LIHTCs, than if the project has 4% LIHTCs. Interest earned on loans without tax credits, or with 9% credits is treated the same as interest earned on market rate projects, with respect to Zions Banks' taxable income. However, 4% tax credit projects rely primarily on tax-exempt bond financing, and when the lending institution also purchases the bonds (which Zions has done thus far), all interest paid on the term loan (the bond) is free from federal income tax.

This paper will examine these options for term affordable housing lending in an effort to evaluate the most profitable and practical strategy for Zions Bank.

PART II: STRATEGY/IMPLEMENTATION

CHANGE BEING CONSIDERED

While Zions Bancorporation has been engaged in affordable housing lending for several decades, Zions Bank has recently (over the past several years) become increasingly active in affordable housing lending throughout the company's local footprint of Utah, Idaho, and Wyoming.

With nearly three years of concentrated effort, the affordable housing loan program has been proven in local markets to be desirable and successful. At this time, consideration should be given to the possibility of utilizing this program to maximize profitability.

This paper seeks to determine the most profitable approach to affordable housing lending. This project is being considered because, while the primary goal of affordable housing lending is to satisfy OCC CRA requirements, it is also the bank's responsibility to create sustainable profits through safe and sound lending practices. The author expects that, regardless of findings herein, the bank will continue to prioritize affordable housing lending. The goal of this analysis is to determine if this can be accomplished while also contributing to profitability.

EXPECTATIONS OF CHANGE AND HOW IT FITS WITH THE ORGANIZATION'S OVERALL STRATEGY

The assumption within the organization is that affordable housing loans are not profitable, but are necessary, for the reasons noted above. Making such assumptions is conservative, however, affordable housing lending may have unanticipated positive financial impacts, in addition to the understood positive non-financial impacts. The financial vs. non-financial impacts will be analyzed in more detail later.

While Zions Bank does not currently originate affordable housing loans for the secondary market, it does originate residential mortgages for the secondary market and syndicates commercial real estate loans with other lending institutions. Therefore, originating loans for the secondary market could fit within existing channels and bank strategy. Zions is a for-profit corporation, that is not only required to offer community development loans (per OCC regulations), but is also passionate about affordable housing. Community development focus is part of the culture at Zions Bank.

THE ROLE OF THE AUTHOR

The author's role is to evaluate the profitability proposition from the perspective of a relationship manager, who is responsible for originating and servicing affordable housing loans for Zions Bank, with the acknowledgement that the author is also a bank shareholder and a member of the community at large.

This exercise is outside the scope of day-to-day activities for a production officer, who is primarily focused on maximizing yield for the bank utilizing *existing* resources, such as rate indexes, loan origination fees, and margins that are approved by the bank and considered to be competitive in the marketplace. Production officers are not tasked with evaluating high-level analysis of product profitability.

EVALUATING THE PROFITABILITY PROPOSITION

The competitive advantage to originating loans (for any institution) is the ability to control aspects such as pricing, terms, and loan concentrations. At Zions Bank, this can largely be accomplished at the bank level (as opposed to being governed by headquarters in another location). This allows Zions to react quickly to market needs. In short, Zions is able to "win" most any deal by adjusting pricing or other such terms, though all loans go through the same Credit Administration approval policy, to ensure consistency in safety and soundness.

Another competitive advantage is limited competition. Tax credits are complicated facilities, which come with a significant learning curve. Due to the time and cost associated with training staff to identify, underwrite, obtain approval, book, and service these loans, not all financial institutions offer LIHTC loans. Furthermore, life insurance companies and credit unions (two current sources of competition for market rate lending) are not required to abide by CRA standards, therefore, those institutions typically do not offer affordable housing loans.

To quantify the analysis, the author will utilize available loan pricing models within the bancorporation to analyze the expected profitability of holding four affordable housing loans (two 4% loans, and two 9% loans) on the balance sheet, and will lean on internal and external resources to evaluate the relative profitability if these loans were to be sold to the secondary market and serviced by Zions. Because the bancorporation does not currently originate commercial real estate loans for the secondary market, the author will research the potential income, as well as the potential expense associated with such activity, via external resources. The author will rely on experts in loan syndication and secondary market loan origination.

Resources:
XXXXX, Syndications Director at Zions Bancorporation
XXXXX's role is to support senior leaders in the negotiation of large, syndicated loan transactions in partnership with the relationship management teams. She and her team make recommendations on terms and conditions, in order to win business and execute successful syndications. Her team is also responsible for negotiating with the syndicate banks regarding pricing and loan terms. XXXXX's experience with other financial institutions is expected to provide insight into the lending and pricing requirements of the secondary market.

XXXXX, Director at Deutsche Bank
XXXXX's background includes work at institutions including Fidelity Investments, Wells Fargo Bank, Key Bank, and Deutsche Bank. Her experience with affordable housing loan production, equity investment, and purchase/sale transactions is expected to provide perspective of institutions who originate and sell, as well as purchase, LIHTC loans.

XXXXX, First Vice President of Affordable Housing Lending at California Bank & Trust
XXXXX has been a loan originator for Zions' affiliate, California Bank & Trust (CB&T) for nine years. He originates and syndicates 4% and 9% LIHTC transactions. Although part of the same corporation, each affiliate has different tools for evaluating loan profitability. The bancorporation is currently working to consolidate these methods into one tool to be used globally across the enterprise, however, at this time, the author will utilize the CB&T tool, as Zions Bank's tool does not contemplate LIHTC loans.

FUTURE OPPORTUNITIES

It is anticipated that the resulting information from the research will indicate some potential for profitability, which would open up a number of future opportunities, including, but not limited to:

- *Increased fee income from origination fees*
  Whether originating loans to hold on the balance sheet or loans to sell to the secondary market, origination fee revenue will increase as the number of loans underwritten and booked increases.

- *Improved balance sheet quality*
  As the originator, Zions could determine, on a credit-by-credit basis, which loans to hold on the bancorporation balance sheet and which to sell off. As a regulated institution, Zions employs regular controls to manage and adjust for risk. Tax credit loans have a very low risk profile (due to the tax credit investor). "The program's structure as part of the tax code ensures that private investors bear the financial burden if properties are not successful. This pay-for-performance accountability has driven private sector discipline to the LIHTC program, resulting in a foreclosure rate of less than 0.1%."[4]

  As with all risk-weighted assets, Tier 1 capital requirements exist for affordable housing loans. However, due to system limitations, wherein Zions does not have a risk analysis system capable of contemplating the nuance of LIHTC loans, the higher Loan to Cost and Loan to Value ratios grade affordable housing loans more conservatively, rather than accounting for the strength of the tax credit investment partner and the historically low risk of default. A strong-performing portfolio decreases costs associated with underperforming assets.

4. "What is the Low-Income Housing Tax Credit and how does it work?" http://lihtec.com/what-is-a-lihtc-how-does-it-work/

- *Increased deal flow*
  One unintended benefit of affordable housing lending is the increase in good will from the community toward the bank. In a tertiary market (such as Zions Bank's footprint), word travels quickly. Within a matter of months of rolling out the Affordable Housing Policy in December of 2016, Zions Bank saw an increase to credit requests for LIHTC financing. Similarly, it is anticipated that, upon successful execution of a couple of credit facilities being sold on the secondary market, Zions Bank will be sought out for lending opportunities. More deals in the pipeline creates an opportunity to book more loans.

The opportunities identified above would hold true whether the loan product was a 4% or a 9% LIHTC loan. Regardless the type of product, origination fees are typically charged and, though often determined by the complexity of a project, it would be unlikely that there would be a significant difference in fees charged between these two types of LIHTC loans. Similarly, regardless of product type, lending is strengthened by a strong balance sheet (balance sheet performance impacts overall bank profitability), and increased deal flow (to have the opportunity to select the best available projects on which to lend).

PROCESS CHANGES

Processes impacted by originating loans for the secondary market would not be different depending on the LIHTC type (4% vs 9%). The difference, and therefore impact to overall process, would be originating for other financial institutions, rather than for the bancorporation balance sheet.

If originating for another institution, all processes of loan origination and management would be impacted, beginning with credit policy. Zions Bancorporation has a credit policy for underwriting and managing affordable housing loans, but does not have a policy specific to underwriting loans for sale to other lending institutions. In order to provide guidance for secondary market loan origination, Credit Administration would need to draft and obtain approval for a new credit policy specific to loan origination for other institutions.

While generally similar in underwriting metrics, each lending institution has their own set of requirements against which loans are evaluated, prior to offering credit. Purchasing institutions would need to be identified in advance, with a thorough understanding of their underwriting metrics, in order for Zions to underwrite loans that would be acceptable to the purchasing institution. This is the first step toward implementation.

IMPLEMENTATION SCHEDULE AND RESPONSIBLE PARTIES

1) Zions Bancorporation Senior Management: Identify and task Subject Matter Experts (SMEs) with researching market appetite and expectations related to loan originations for sale.
2) Zions Bancorporation Credit Administration: Draft additional language in existing policy on Affordable Housing to address the parameters under which new loans should be originated when they will not be held on the balance sheet.
3) Zions Bancorporation Credit Administration: Present proposed changes to policy at the bancorporation's Corporate Credit Administration Committee (CCAC) meeting for consideration/approval.
4) Zions Bancorporation Senior Management: Upon approval from CCAC, identify the appropriate bancorporation employees who will manage the sales, and the employees who will be responsible for the ongoing management of the newly-originated loans.
5) Zions Bank Regional Management: Identify and train lending teams in appropriate markets (consisting of Relationship Manager, Portfolio Manager, etc.) to understand the nuance of this product type to be proficient in identifying and underwriting loans.
6) Zions Bank Regional Management: Utilize bancorporation SMEs to cross train Bank business partners to identify and refer business development opportunities to the appropriate Real Estate Relationship Managers.

PART III: FINANCIAL IMPACT

SIZE AND TYPE OF INVESTMENT REQUIRED

If the bancorporation were to decide to increase affordable housing lending, it is anticipated that the initial investment required would be minimal, and would consist of personnel (aka Full Time Employees, or FTE), and Tier 1 Capital (if loans are to remain on the balance sheet). As long as loans are profitable (detailed and analyzed further below), this would result in a net positive profitability scenario.

FTE

Zions Bank has already invested in an Affordable Housing Lending Team, consisting of one Relationship Manager, one Portfolio Manager, and one Assistant Relationship Manager to cover Utah, Idaho, and Wyoming. Because it is the focus of this group to originate and service affordable housing loans, there would be no additional employee overhead to continue to originate and service loans for the secondary market, whether or not said loans remain on the balance sheet. If/When loan production exceeds manageable standards, additional entry-level FTE could be added for loan servicing. If the book of business proves profitable, additional FTE could be added as needed, with the expectation that the profitability of the portfolio would cover the additional FTE burden.

Manhours required to originate both types of LIHTC are relatively commensurate. While there may be some additional work related to the bond portion of the 4% LIHTC, those loans are typically two to three times the size of 9% LIHTC loans, and therefore, any additional time could be argued to be offset by higher outstandings. It should also be noted that hours per deal are not currently tracked, and data is not available for analysis. Furthermore, some 9% LIHTC projects can become very complex, and therefore time-consuming, and could easily take more manhours to originate than a straight-forward 4% LIHTC deal.

Tier 1 Capital

Every federally-regulated financial institution is required to maintain a certain level of cash or liquid assets, as a ratio of its risk-weighted assets, to back loans they are extending. The cost of capital to produce LIHTC loans is the same as market rate loans, however, high volatility commercial real estate exposure (HVCRE) exposure, which impacts the ratio of capital required for each loan, does not apply to affordable housing lending.

In 2013, a revised regulatory capital rule, was adopted by the financial agencies in the United States (i.e. OCC, FDIC, etc.), in response to the 2007/2008 financial crisis. The intention of the framework was to better assess the risk of certain kinds of real estate exposures by defining HVCRE exposure. HVCRE applies to acquisition, development, and construction of real property, which are considered to have increased risk characteristics and therefore are assigned a heightened risk weight of 150% under the capital rule.[5] However, community development loans, such as affordable housing/LIHTC loans, are *not* classified as HVCRE.

Because affordable housing loans can be held on the balance sheet at a ratio of 1 to 1, vs. 1 to 1.50, this translates to more lending with the same amount of Tier 1 Capital. And more lending translates to increased profitability.

There is no difference between 9% or 4% LIHTC projects, with respect to HVCRE, therefore, no impact to profitability. If, however, LIHTC loans were to be originated, sold, and only serviced by Zions Bank, the entire Tier 1 Capital burden would transfer to the purchasing bank, and Zions could redeploy funds for new loans to be held on the balance sheet.

Because the primary goal of affordable housing lending is a positive CRA evaluation by the OCC. Zions Bancorporation has utilized prior OCC evaluations to ascertain that 9% of Tier 1 Capital should be allocated to community development loans (also referred to as "CD, CDL, "CRA", "LIHTC" or "affordable housing" loans). As detailed in the Zions Bancorporation 2019-2020 Allocated Tier 1 Capital for CRA Lending table in Appendix A, the goal for the

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[5] Regulatory Capital Treatment for High Volatility Commercial Real Estate (HVCRE) Exposures, 11/29/19 https://www.federalregister.gov/documents/2018/09/28/2018-20875/regulatory-capital-treatment-for-high-volatility-commercial-real-estate-hvcre-exposures,

bancorporation for the 2020 evaluation is $XX. The target investment for Utah, Idaho, and Wyoming for the current OCC evaluation totals $XX. This amount will vary each exam cycle by the base deposits within the bank.

Banks work to meet the CRA lending parameters needed for a strong evaluation, however there is no noted fiscal or CRA evaluation benefit to holding excess CRA-eligible loans on the balance sheet. If all originated loans are held on the bancorporation's balance sheet, then the size of the investment would be limited by the available Tier 1 Capital. If loans are originated, sold, and serviced, then the only additional potential investment, long term, would be FTE.

REVENUE AND EXPENSE ESTIMATES

Balance Sheet Loan Origination

Revenue can be best quantified by utilizing the CB&T SVA (or Shareholder Value Added) tool mentioned earlier. XXXXX, First Vice President of Affordable Housing Lending at California Bank & Trust originates and syndicates 4% and 9% LIHTC transactions. As mentioned previously, although part of the same corporation, each affiliate has different tools for evaluating loan profitability. The CB&T tool is equipped to account for the parameters of LIHTC loans (such as amortization and tax-exempt status), and was therefore utilized herein.

Using data points provided by the author, XXXXX ran scenarios for four LIHTC projects: two 9% LIHTC loans and two 4% LIHTC.

Input parameters:

- Two loan amounts were utilized: $XX (Loans 1 and 2) and $XX (Loans 3 and 4).
- A tax exempt rate classification was applied to two of the four loans analyzed (Loans 2 and 4). These are the 4% LIHTC loans. One is at the larger commitment amount, and one is at the smaller commitment amount. The other two loans (also one large and one small commitment amount) were not given the tax exempt distinction, and represent 9% LIHTC loans.
- For the purposes of this analysis, variables that would impact profitability, but would distract from the examination herein (such as risk grade, loan term, origination fee, etc.), were applied consistently across the four loans, so as not to arbitrarily impact the results.
- Expenses were calculated in the SVA model based a combination of fixed and variable expenses as determined by Zions Bancorporation's Corporate Finance Division.

Results:

Loans 1 and 2 (the larger loan amounts) were the most profitable based on SVA, while Loans 2 and 4 (the tax-exempt loans) reflected the highest Return on Equity (ROE).

SVA, or profitability, is a net result of the income and expenses associated with a loan. The higher the SVA, the more profitable the loan.

All loans reflected an acceptable ROE (XX% or greater), suggesting that both types of affordable housing loans (4% and 9%) are a profitable product for the bancorporation. Loans 2 and 4 (the tax-exempt loans) produced returns that were XX% better than their taxable loan comparisons.

Please see Appendix B for the Pricing Tool details.

Secondary Market Loan Origination

A variable that would impact revenue, but not expenses, is originating loans for the secondary market. When a loan is originated and sold, the same due diligence and underwriting processes are completed as those for originating a loan for the balance sheet. However, upon the sale of the facility, the originating lender no longer bears the rate and performance risk of the loan, but *is* paid an ongoing management fee of 10 to 15 bps. Based on interviews with XXXXX, Director at Deutsche Bank, a global financial institution that both originates and purchases LIHTC loans, it can be very lucrative for banks to originate and sell this product.

Additional expense would ultimately be incurred if additional FTE were required to origination, or to place these loans in the secondary market. However, as Zions Bancorporation already employs personnel completing both functions, it is unknown if/when that threshold would be met.

With employees seated in Houston, Texas, and San Francisco, California, Zions Bancorporation currently employs a staff of seven, led by XXXXX, in the Loan Syndications Group. As noted earlier, XXXXX's team is tasked with supporting senior lenders in the negotiation of large, syndicated loan transactions. By partnering with the production officers, the Loan Syndications Group negotiates with the secondary market to place loans underwritten at Zions. Because this is an existing group, additional expense for FTE would not initially be incurred. Furthermore, the expense for future FTE would be expected to be offset by the increased revenue of completing a higher volume of syndications.

Regardless of the type of lending being completed, employee salary, benefit, and occupancy expenses, and the revenue produced by the lending team are considered to be commensurate. For example: if the author were not focused on affordable housing lending, the bank would not eliminate the position, the lending focus would simply shift to another product type.

RISK EVALUATION AND MANAGEMENT

Credit risk is the possibility of loss from the failure of a borrower, guarantor, or another obligor to fully perform under the terms of a credit-related contract. Credit risks (whether on- or off-balance sheet) may occur. In order to mitigate this risk, underwriting on commercial real estate properties is primarily based on the economic viability of the project with heavy consideration given to the creditworthiness and experience of the involved parties.[6]

Zions thoroughly analyzes developers, general contractors, and loan guarantors, including experience in the specific market and with the product type for which the loan is being requested. The bancorporation relies primarily on a project's ability to service debt, with the backstop of sponsors with sufficient cash flow to support any gaps. Specific, detailed analysis of the guarantor's financial statements, leverage, liquidity, global cash flow, global debt service coverage, contingent liabilities, etc. All loans include standard remargining requirements, should a loan fail to perform as agreed.

Real estate appraisals are ordered in accordance with regulatory guidelines and are validated independently of the loan officer and the borrower, by Zions' internal appraisal review department.

Consideration is given to the forecasted market acceptance of the product, location, strength of the developer, and the ability of the developer to stay within budget. Monthly inspections by qualified independent inspectors are required prior to hard cost disbursements being made.

Zions further mitigates the risk of commercial real estate construction loans by requiring that the owner's equity be injected prior to bank advances.

For affordable housing lending, the tax credit investor is also thoroughly analyzed and underwritten to determine their strength and ability to ensure that a project will be completed on time/budget. The investor adds a significant level of strength to a project, as they are fiscally motivated to ensure the success of the LIHTC project through construction, stabilization, a 10-year run period, and a five-year recapture period. LIHTC loans have significantly lower failure rates than typical real estate loans, at less than 1.0% annually, nationwide.

SOUNDNESS OF THE INVESTMENT

Based on the very low risk profile and high appeal of affordable housing loans, paired with the upside of gaining a management fee (after also earning an origination fee), compounded by the removal of project performance or interest

[6] Form 10-K Zions Bancorporation, November 30, 2019, https://www.sec.gov/Archives/edgar/data/109380/000010938016000345/zion-20151231x10k.htm

rate risk, the author believes that originating affordable housing loans for the secondary market would be a solid source of revenue generation, with minimal impact on expenses, and a way to decrease portfolio risk.

PART IV: NON-FINANCIAL IMPACT

LOGISTICAL AND ORGANIZATIONAL HURDLES AND HOW THEY CAN BE OVERCOME

As outlined above, Zions Bancorp does not currently originate affordable housing loans for the secondary market. However, it does originate affordable housing loans and it does originate residential mortgages for the secondary market. Additionally, the bancorporation syndicates commercial real estate loans with other lending institutions. Because each aspect of originating affordable housing loans and originating loans for the secondary market already have a place with the bancorp, the impact to the organization is anticipated to be minimal.

Zions continues to move toward centralizing loan production, with loan operations hubs in Salt Lake City, UT, and Houston, TX. The Syndications Group is based out of San Francisco, CA.

In order to communication this information, a detailed overview of the lending practices and identification of relevant parties could be easily disseminated to the enterprise via an email, a video, and/or management meetings.

MEASURES OF EVALUATION

The non-financial impact of affordable housing lending is predominately measured by two outcomes: CRA evaluations and market reputation.

There are four federal bank supervisory agencies: the Office of the Comptroller of the Currency (OCC), Board of Governors of the Federal Reserve System (FRB), Office of Thrift Supervision (OTS), and Federal Deposit Insurance Corporation (FDIC). Zions Bancorporation is supervised by the OCC.

Upon completion of a CRA examination, a CRA rating is assigned using a four-tiered rating system. These ratings are: Outstanding, Satisfactory, Needs to Improve, and Substantial Noncompliance.[7]

The consequences of failing to maintain a "satisfactory" or better rating on a CRA evaluation impacts a lending institution's ability to complete activities such as: open or close branches, acquire or be acquired, and hold municipal deposits. Therefore, it is essential that banks score well on the Lending Test (which comprises 50% of a bank's CRA score).

CRA evaluations for Zions are currently on a three-year cycle, with the most recent examination period ending June 2018. Utah and Idaho were rated Satisfactory, while Wyoming was rated Substantial Noncompliance. This rating takes into account the Lending, Investment and Service Tests. The Lending Tests (which are impacted by loans, such as those discussed herein) were rated as Low Satisfactory, High Satisfactory, and Substantial Noncompliance for Utah, Idaho, and Wyoming, respectively. It should be noted that, in addition to commercial real estate loans, the Lending Test contemplates home mortgages, small business loans, small farm loans, and other loans outside the scope of the author's area of expertise.

Additionally, market reputation is vital to the sustainability of any financial institution. Public trust in a bank can be the difference between getting an opportunity to win customers' business or not even getting an opportunity to make a pitch to win it. If confidence in a bank is low, it is unlikely that a borrower will approach that bank for a loan, let alone deposit funds there for safekeeping.

Per the American Banker's Association[8], who annually ranks banks by reputation, a "decline" in reputation "translates into less willingness to buy a bank's products and to recommend others to do so." The association went on to note that the best way that banks can counteract negative sentiment, is to demonstrate "ethical behavior and good citizenship/" Affordable housing lending, by nature of the product type, accomplishes both of these goals.

[7] FFIEC Community Reinvestment Act, December 2, 2019, https://www.ffiec.gov/craratings/ratings_faq.htm
[8] Garver, Rob, Bank reputations fall for first time in five years: 2018 survey, December 15, 2019, https://www.americanbanker.com/news/bank-reputation-survey

PROJECTED IMPACT ON THE ORGANIZATION/EMPLOYEES/CUSTOMERS

The non-financial impacts experienced by the organization, employees, and customers from the Real Estate Banking Group's performance since December of 2016 have been overwhelmingly positive.

The organization benefits from positive evaluations with regard to creative and innovate interpretation of the CRA policy. For example, in December 2017, an $XX multifamily loan was originated with a rent restriction that 20% of the units should be restricted, for the term of the loan, at 50% AMI or below. This was not a LIHTC loan, and only had one piece of subordinate debt for $XX. Typically, the OCC will only give credit for the portion of the project that is affordable (in this case $XX x 20% = $XX). However, in the most recent CRA evaluation, credit was given for the full $XX, due to the innovative approach of offering more favorable financing on a mixed income project, thereby allowing Zions to score more favorably toward the lending test.

Employees, specifically production officers and local management, have also experienced a positive response to this mission-based approach to lending. Invitations to ground-breakings and ribbon cuttings are standard in commercial real estate, but every LIHTC ground breaking or ribbon cutting (for projects located in Utah) to date have included media coverage and, typically, the participation of the Mayor of the local municipality. At each event, Zions Bank has been represented with signage and has been verbally acknowledged for their participation, which has been noted as "making the project possible".

Longer-term community and employee benefits have included invitations to participate on the committees/commissions/working groups that are directly responsible for forming and enacting state-wide policies on affordable housing. Examples of such groups include, but are not limited to:

- 2017 Salt Lake City Mayor's Blue Ribbon Commission
- 2018 - 2019 Utah Commission on Housing Affordability
- 2018 Utah Banker's Association Affordable Housing Forum
- 2019 Mayor-Elect Mendenhall's Housing Transition Committee
- 2018 - 2020 Utah Banker's Association CRA Committee and Reform Working Group

Customers have been notably vocal about Zions' dedication to affordable housing. One recent article published by "Building Salt Lake" specifically praised Zions Bank for "being willing to structure longer-term financing that makes a project pencil.[9]"

Social media sites, such as LinkedIn, provide an additional platform where the Bank can and does spotlight high-profile projects, such as a recent multifamily project in Jackson Hole, WY, which will provide much-needed affordable and workforce housing for local employees who previously had to commute up to two hours each way because they could not find housing, or could not afford what was available within the city. View, likes, and reshares of such posts translate into free (and positive) publicity of affordable housing projects.

Employees of Zions Bank who are based in Utah benefit from the strong community-oriented reputation that Zions Bank has enjoyed for many decades. The affordable housing work being done in Utah, Idaho, and Wyoming, has only served to increase the positive feedback to employees. Zions' employees are often drawn to the bancorporation's history of literally, "putting their money where their mouth is". Because affordable housing does "good" while it does "well", employees can take pride in knowing that their company is supporting the communities within its footprint.

IMPACT TO LONG-TERM PROFITABILITY

Over the past three years, the Real Estate Banking Group has booked more than $XX in affordable housing loans. When affordable housing loans include tax credit investors, they provide long term debt at a low risk.

Construction loans, in particular, seem to attract more attention in the market, and are further promoted via bank signage on the project site. As the community notes new projects going in, and who is lending on those projects, more business

[9] Garrott, Luke, Affordable housing: Three local developers dish on the biz, December 30, 2019, https://www.buildingsaltlake.com/local-developers-dish-on-the-biz/

comes to the bank (i.e. more active lending = more awareness of the bank's appetite to lend = more loans coming in without the production team having to source them out). Though not easily quantifiable, the financial impact the public relations opportunities create is a result of actively supporting affordable housing projects and should not be overlooked.

CONCLUSION

The analysis herein resulted in the observation that there are not sufficient resources within the bancorporation to determine if originating 4% or 9% LIHTC loans for the secondary market would be a profitable strategy for Zions. Therefore, it is recommended that additional research be completed to evaluate the profitability of originating and selling these types of loans.

Should it be determined that originating affordable housing loans for the secondary market proves profitable, it is anticipated that this change could fit well within existing bank channels and strategies. Because Zions Bank originates residential mortgages for the secondary market and has an existing Rolodex of syndicate banks to whom originated loans could be sold, additional expense could be limited to additional FTE.

Based on the low risk profile and high appeal of affordable housing loans, paired with the upside of gaining a management fee (after also earning a loan origination fee), compounded by the removal of project performance and interest rate risk, the author believes that originating affordable housing loans for the secondary market could be a solid source of revenue generation, with minimal impact on expenses, as well as an opportunity to decrease portfolio risk.

Until further analysis can be completed, or if that analysis yields contradictory results, Zions should continue originating LIHTC loans, specifically 4% LITHC loans, where Zions will purchase the associated bonds, as this resulted in the most favorable ROE in the analysis provided earlier.

It is recommended that loans be originated up to levels that will accomplish Satisfactory or better CRA Evaluation ratings. While it is understood that these loans provide an acceptable return to the bancorporation, there is no additional fiscal benefit to holding ***excess*** CRA-eligible loans on the balance sheet; nor is there notable CRA evaluation benefit to this. In fact, it is possible that those funds could instead be lent at greater returns with shorter obligation periods/loan maturities, which would improve ROE as well as non-interest income in the form of origination fees.

Therefore, it is recommended that Zions Bank originate quality affordable housing loans up to approximately $XX, to be held on the balance sheet, and either sell any additional loans on the secondary market, or focus on market rate loans that are more profitable to the institution.

APPENDIX A

Zions Bancorporation 2019-2020 Allocated Tier 1 Capital for CRA Lending

[Redacted]

APPENDIX B

SVA Pricing Tool Results

[Redacted]

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