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Financial Innovations Lab Report

Financial Innovations for Economic Recovery and Development in Northern Israel

FINANCIAL INNOVATIONS LAB REPORT



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Financial Innovations Labs bring together researchers, policy-makers, and business, financial, and professional practitioners for a series of meetings to create market-based solutions to business and public policy challenges. Using real and simulated case studies, Lab participants consider and design alternative capital structures and then apply appropriate financial technologies to them.

This report was prepared by Glenn Yago and Teresa Magula, with supplemental legal materials provided by the law firm of Arnold & Porter.

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The Milken Institute is an independent economic think tank whose mission is to improve the lives and economic conditions of diverse populations in the United States and around the world by helping business and public policy leaders identify and implement innovative ideas for creating broad-based prosperity. We put research to work with the goal of revitalizing regions and finding new ways to generate capital for people with original ideas.

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We are nonprofit, nonpartisan and publicly supported.

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A map of the Israel-Lebanon border region is shown in the background, overlaid with a green semi-transparent rectangle. The map includes labels for various cities and locations: Beirut (Bayrūt), Sidon (Sidon), Tyre (Ṣaydā), Akko, Zefat, Hefa, Nazerat, Tel Aviv, Tulk, Banyas, Al Q, Zahlah, and Jubayl. The word 'LEBANON' is written in large letters across the top, and 'ISRAEL' is written in large letters across the bottom. The text 'According to the Finance Ministry, the Second War in Lebanon will ultimately cost Israel up to \$5 billion.' is written in yellow italics within the green rectangle.

According to the Finance Ministry, the Second War in Lebanon will ultimately cost Israel up to \$5 billion.

INTRODUCTION

In September 2006, a month after the United Nations brokered a ceasefire in the Second War in Lebanon, the Milken Institute held two Financial Innovation Labs to address recovery and development in northern Israel.

From July 12, when the war began, until the August ceasefire, more than 4,228 Hezbollah-launched missiles landed inside Israel against civilian targets. The explicit objective, as stated by Hezbollah's Secretary General Hasan Nasrallah in an interview at the time, was to bring the entire economy of northern Israel—home to Jews, Arabs, and Druze, and roughly 40 percent of the nation's population—to a halt.¹

According to the Finance Ministry, the war will ultimately cost Israel up to \$5 billion. The Federation of Israeli Chambers of Commerce estimates that businesses in northern Israel lost approximately \$1.4 billion in revenues.² Rocket attacks leveled nearly 6,000 homes throughout Haifa, Nazareth, and Tiberias. Dozens of kibbutzim, moshavim, and Druze and Arab villages were made temporarily uninhabitable.³ Fires destroyed up to 9,000 acres of forest.⁴

While unable to curb Israel's technology-driven macroeconomic growth, which continues at a robust pace,⁵ the attacks did accomplish the Hezbollah objective of further weakening the regional economy in the north, which had entered the war with a weak labor and housing market, and was lagging behind the national average in other areas of commercial and industrial activity.⁶

During the war, the Milken Institute was forced to cancel a conference on financing economic development in the Galilee, scheduled at The Western Galilee College in Acre. During subsequent meetings with colleagues at the Koret Israel Economic Development Funds and The Portland Trust, as well as with Knesset members and Israeli cabinet officials, plans were undertaken to convene U.S. and Israeli experts for Financial Innovation Labs in order to define new strategies for breaking the logjam of project funding for northern Israel development and to facilitate postwar recovery in the region.



Source: Uzi Rubin, "Hezbollah's Rocket Campaign Against Northern Israel," Jerusalem Center for Public Affairs, August 31, 2006

Representatives from the banking, investment, legal, philanthropic, and government sectors attended the two September Labs, held at the Milken Institute in Santa Monica and at the corporate headquarters of Bloomberg in New York. An October meeting, at which findings from the Labs were presented, took place in Acre with local leaders in the public, private, and nonprofit sectors. More sessions were held in January 2007 at the Israeli Ministry of Finance and the Ministry of Industry, Trade, and Labor. A list of all the participants and their affiliations can be found in appendix I.

THE LABS EXPLORED ALTERNATIVE FINANCING OPTIONS:

- ***Develop a Northern Israel Recovery and Redevelopment Bond Authority for infrastructure and public-private projects.*** Participants reviewed the possibility of using pooled-revenue bond models issued by (a) U.S. governmental authorities to access the U.S. tax-exempt municipal bond market or (b) Israeli local and regional authorities, to attract investment from philanthropies, governments, private investors, and public-private partnerships. The group examined regulatory, tax, and credit incentives, and the ability to leverage emergency philanthropic and government funds for credit enhancement. A regional bond authority would provide for a sub-sovereign issuing facility to issue bonds and notes for revenue producing facilities and infrastructure to accelerate northern Israel's economic development.
- ***Expand the Koret Israel Economic Development Funds for small-business development.*** Representatives of KIEDF presented Koret's successful revolving loan fund model, which provides greater liquidity to borrowers and benefits small-business entrepreneurs who would have difficulty securing bank financing on reasonable terms, especially in outlying areas and regions of high unemployment.
- ***Develop a northern Israel small-business collateralized loan obligation.*** Participants explored the potential benefits and challenges of developing a targeted collateralized loan obligation (CLO), a financial security whose underlying assets and related cash flows to investors consist of a diversified pool of business loans. (CLOs are identical to collateralized mortgage obligations, CMOs, or other asset securities except that their underlying assets are loans.) By securitizing pools of higher-risk small-business loans and using credit-enhancement/loan-loss reserve structures, a CLO could increase liquidity for Israeli banks and increase lending to entrepreneurs.
- ***Develop a northern Israel capital access program: an expanded loan-loss reserve program for recovering businesses.*** The quick implementation of low-cost, non-bureaucratic loan mechanisms was addressed. These would be similar to U.S. programs that provide accelerated credit to hard-hit businesses. Potential funding sources include U.S. philanthropies and the Israeli government.
- ***Develop northern Israel community investment notes.*** Participants explored the feasibility of adapting community investment products—unsecured, fixed-rate instruments with flexible terms, denominations, and interest rates—for funding affordable housing, facilities, and small-business loans. Potential sources of capital include individual and institutional philanthropic investors to create a sustainable base of low-cost capital for nonprofits and businesses in the region.



Aid from government agencies or foreign entities is typically too cumbersome to access for long-term infrastructure and development projects.

ISSUES & PERSPECTIVE

The overall economic situation in northern Israel has long been neglected but, prior to the war, became the target of renewed public policy interest in the wake of Gaza disengagement and the need to address internal economic security issues. The region is characterized by relatively high unemployment (11.5 percent, compared to 8.3 percent nationally), high poverty rates (36 percent below the poverty line, compared to 24 percent nationally), and low average income (77 percent of the national average). Furthermore, the region experienced five years of negative out-migration, which continued unabated prior to the war.

Residential housing starts declined steadily after 1996 and have remained flat since 2005. While total sales of new apartments have increased gradually in Israel, this has not been the case in the north. Real estate price declines persisted from 2004 to 2006. During the three years of national macroeconomic recovery (2003–2006), the northern region's employment lagged behind the national average. The total unemployment rate began to decline in 2005 and continued to drop nationally in 2006, but unemployment rose in 2005 in the north and only began a slight decline in 2006. Unemployment rates there are still above the pre-*intifada* recession rates.⁷

THE FUNDING CHALLENGE

Northern Israel requires a rapid influx of capital for postwar recovery, business formation, infrastructure development, and job creation to attract and retain population, and to integrate into the country's core growth economy. The region will remain increasingly vulnerable to economic deterioration without the completion of long-delayed infrastructure and business development projects in water, transportation, communications, energy, environment, and urban revitalization.

The task of job creation will depend entirely on the speed with which the north's regional economy is rehabilitated and how quickly the rate of economic development moves beyond prewar levels. The inability to integrate the Galilee and northern Israel economically, physically, and demographically could now, as happened before, undermine Israel's national security.⁸

Since the Second War in Lebanon, emergency aid offers have poured into Israel. However, aid from government agencies or foreign entities is typically insufficient or cumbersome to access for longer-term infrastructure and development projects. For this reason, the region needs to focus on alternative funding options—leveraging available government funds through the capital markets to meet project costs on credit-enhanced terms while cutting the time to market for project implementation. This will involve private-sector initiatives and public-private partnerships.

THE FINANCIAL INNOVATION LABS

The two Financial Innovation Labs featured half-day sessions during which teams of participants examined funding-gap scenarios and solutions for specific kinds of finance and infrastructure projects.

In late October in Acre, the results of the Labs were presented to representatives of the Confrontation Line Forum (Forum Kav Ha-Imut), an organization of administrators, mayors, and representatives of kibbutz industries, businesses, and various other public, private, and nonprofit enterprises active in northern Israel. Vice Prime Minister Shimon Peres, who serves as minister for the development of the Negev and Galilee, addressed this conference about economic development in northern Israel. In January, additional meetings were held at the Ministry of Finance and the Ministry of Industry, Trade and Labor, and at the Public-Private Partnership office of the Finance Ministry (hosted by Inbal, the government-owned insurance corporation). These sessions were scheduled to advance the identification and approval of projects, and the facilitation of inter-ministerial assistance.⁹

Over the course of the Labs, participants concluded that of the alternative financing ideas put forward, three were the most feasible and pressing:

- Develop a Northern Israel Recovery and Redevelopment Bond Authority for infrastructure and public-private projects.
- Expand the Koret Israel Economic Development Funds for small-business development.
- Develop a northern Israel small-business collateralized loan obligation.

Finally, Lab participants recommended using the Chicago Climate Exchange (CCX) Offset Program as an innovative means of financing. By replanting trees in the decimated forest area of northern Israel and participating in CCX, the region stands to gain an estimated \$3.5 million over twenty years.¹⁰

In the following section, we detail the three selected financing options. For each, we recommend action items and a timeline for steps leading to implementation.

FINANCIAL INNOVATIONS FOR ECONOMIC RECOVERY AND DEVELOPMENT IN NORTHERN ISRAEL

Possible Solutions

SOLUTION

1

Develop a Northern Israel Recovery and Redevelopment Bond Authority for infrastructure and public-private projects

Although the United States has long issued bonds for infrastructure and regional development (typically called municipal or revenue bonds), the practice is fairly new in Israel. In the U. S. and many other countries, governments, local and regional authorities, and nonprofit organizations issue the bonds, which may be taxable or tax-exempt, to access financing for essential social services, such as housing and physical infrastructure. Municipal bonds can also be made available for public-private partnership or for private commercial and industrial development. The use of such bonds can attract investment from philanthropies, other governments, private investors, and public-private partnerships. Using a private-sector operator to manage such projects and private investors reduces the risk to public capital.

A private activity bond is used in public-private partnerships in which the government does not necessarily pledge its credit but issues a security for qualified projects whose public purpose benefits a private entity. The potential use of such bonds would result in an influx of capital to repair and develop northern Israel's failing water, transportation, communications, education, energy, and environmental infrastructures, and accelerate much-needed economic development projects. For example, bonds could be issued for upgrading and modernizing regional hospitals, thereby expanding emergency and other health care. Wastewater and alternative energy projects could also be targeted. Similarly, tourism-related economic development projects (e.g., coastal protection of the Kinneret) could benefit, as would industrial parks and incubators focused on competitive advantages of the region (clean technology and biotechnology). Finally, transportation projects that support the overall level of economic activity, both within the region and between the north and the central part of Israel, could be advanced with additional funds. New infrastructure would spur economic growth, attracting new jobs and capital to the region.

Figure 1 depicts the private activity bond model recommended for the proposed Northern Israel Recovery and Redevelopment Bond Authority. In this model, a public conduit, such as a regional authority, would act as the bond issuer. A private-sector operator, either existing or established specifically for this purpose, would contract to operate the infrastructure development and receive net operating revenue. In turn, the operator would assume a large portion of the project development risk.

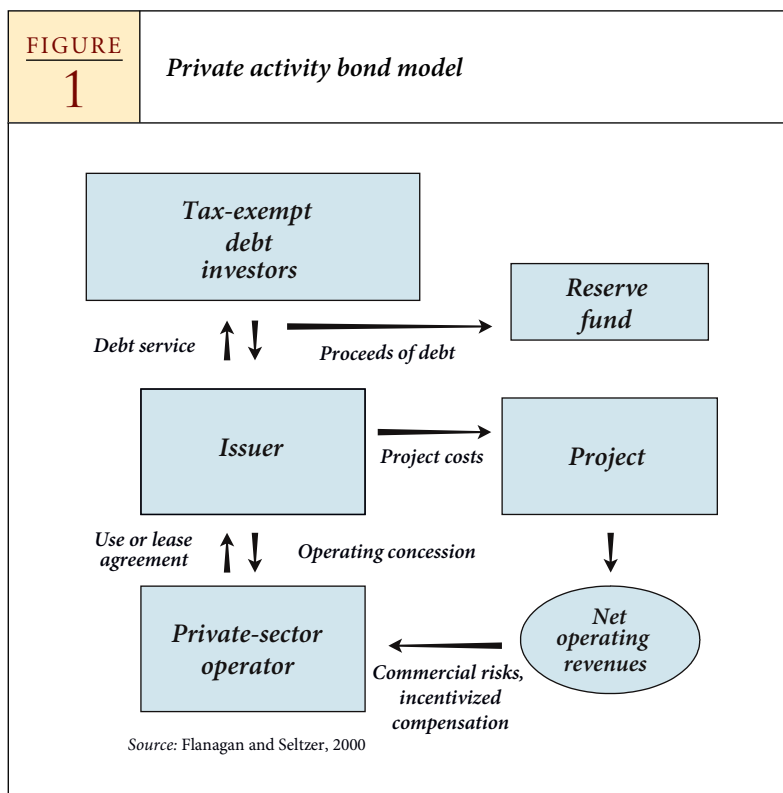
To mitigate risk further, a credit-enhancement pool (a reserve fund) might be established by joining government and philanthropic entities. Again, the use of a private-sector operator and private investors would reduce risk to public capital.

The remainder of this section addresses specific implementation components of Solution 1 and the model, based on discussions during Lab sessions.

STEP 1: IDENTIFY THE ISSUER

A number of approaches could improve the credit-worthiness and time to market of Israeli-issued project financing through either private activity or conventional sub-sovereign public issuance. However, one additional idea was to access U.S. tax-exempt bond financing, either through a state or municipal conduit, issued in parallel to an Israeli bond issuance, thereby attracting investors not normally available to Israeli projects. Under this scenario, a U.S., state or municipal conduit would issue the bonds to finance the cost of development project(s) located in northern Israel. This would allow access to the well-established U.S. market for municipal bonds. Properly structured, the financing would satisfy U.S. tax laws so that the interest paid on the bonds would be exempt from federal and state income tax, thereby lowering the cost of borrowing for the project.

U.S. tax-exempt bond financing issued in parallel to an Israeli bond issuance could attract investors not normally available to Israeli projects.



According to preliminary guidance provided by the law firms Orrick, Herrington & Sutcliffe LLP and Arnold & Porter LLP, some U.S. state or municipal entities do issue bonds to finance cross-border projects if the issuer can demonstrate that the project has a “domestic tie” or provides a “local benefit.” A local benefit can be as simple as a fee charged for the bond issuance or limited job creation. A relationship between the project’s private-sector operator and a U.S. domestic entity (e.g., a nonprofit, such as the United Jewish Communities, Jewish National Fund, Friends of the Galilee Regional Authority, Society for the Protection of Nature in Israel, Israel Bonds, etc.) could provide the necessary domestic tie and local benefit. Further, the financing structure must be approved by a local agency in the issuance state.

*A sponsor bank
would have
financial interest
in moving the
project forward
and might provide
a large source of
senior debt.*

Precedents exist for cross-jurisdictional issuance. To date, state or local agencies in Arkansas, California, Colorado, Missouri, Indiana, Arizona, and Delaware have issued bonds to finance projects located in other states. There is also precedent for adopting this structure internationally; a California authority issued bonds for capital projects at scientific research sites in Chile, where the facilities were owned by the University of California.

In 2006, the Dormitory Authority of the State of New York (DASNY), which provides financing and construction services to public and private universities, not-for-profit health-care facilities, and other institutions, investigated a similar international issuance structure for a facility to be located in Israel. DASNY sought legislation to clarify its authority to issue hospital reconstruction bonds for Hadassah Women's Zionist Organization of America. Although a review of the legal and tax requirements produced generally favorable findings, the legislative effort was not completed in the last legislative session but may be pursued under the new gubernatorial administration.

Lab participants from Orrick, Herrington & Sutcliffe noted that the Internal Revenue Service has been grown more vigilant in auditing municipal bond issues, particularly those perceived to "stretch the envelope." Thus, any U.S. tax-exempt issue may require obtaining a "private-letter ruling" from the IRS, approving the tax-exempt status of the bonds. A detailed review of legal issues, prepared by Arnold & Porter, appears in appendix II.

Nonetheless, Lab participants remained convinced that using a U.S. conduit was a feasible option for issuance of Israel infrastructure bonds. If not a U.S. municipality, the conduit might be a nonprofit entity created for the purpose of the issuances. Similarly, an existing 501(c)(3) organization, such as Jewish National Fund (JNF), the American Technion Society (ATS), or supporters of the Galilee Regional Authority, could serve this purpose. Such an organization might partner with an existing municipal agency to fulfill the "local benefit" requirement. The nonprofit might, for example, partner with the East Coast-based electronic toll-gathering company E-ZPass when building a toll road in Israel. A portion of the revenue would go to E-ZPass, providing a local connection and benefit. Similarly, a water-treatment facility could partner with a water-treatment company (e.g., U.S. Filter) to construct similar facilities in Israel.

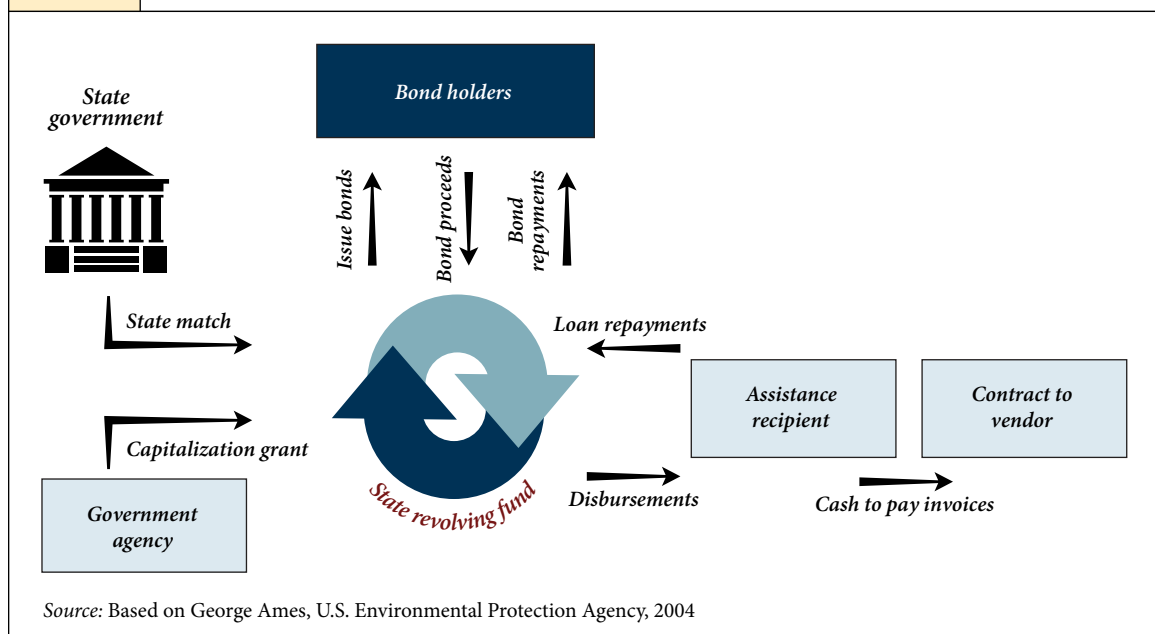
Any U.S.-issued bond would require an Israel-based sponsor. Some Lab participants suggested the option of using the Israeli government, which participated in the successful construction of the Trans-Israel Highway (Highway 6). The government has already completed a number of feasibility studies for infrastructure projects, and its expertise is essential.

A second option is enlisting an established Israeli bank as project sponsor. A bank would have financial interest in moving the project forward and might provide a large source of senior debt for the proposed basket of transactions that could include railway, highway, hospitals, educational facilities, energy, waste treatment and other projects.

Discussion also centered on a taxable, shekel-denominated, sub-sovereign Israeli issue to create the regional infrastructure investment facility. Participants emphasized that tax exemption should not be a primary objective, and that many methods existed to further credit-enhance existing projects in northern Israel.

FIGURE
2

State revolving funds model



Based on the U.S. model of state revolving funds (SRFs, depicted in figure 2), government grants could serve as equity in these bond structures, with additional debt tranches subordinated through a combination of U.S. and Israeli government guarantees, as well as complementary credit enhancements or bond issuance by philanthropic foundations.

Several of the foundations present expressed interest in participating as credit enhancers. This interest has since been confirmed from other philanthropic organizations to participate in methods of enhancing credit worthiness of Israeli sub-sovereign issues on a *pari passu* (equal) basis with the Israeli government.

Action Items: Identify the Issuer

- Understand the legal and financial issues of using a U.S. conduit to issue the bond(s). Study interstate and international issuances, and analyze applications appropriate to Israel issuance.
- If necessary, work to change laws of at least one state to allow issuance to benefit Israeli entities. Obtain possible IRS ruling.
- Identify ability to create a nonprofit to act as the conduit, and/or reach out to appropriate nonprofits. Define legal needs to obtain either a separate sub-sovereign authority (e.g., Galilee Development Authority) or facility (e.g., credit facility for Israel Railroads or Northern subsidiary of Highway 6 Corporation, *Derech Eretz*) for issuing notes and bonds.
- Identify an Israeli sponsor; if the government is the sponsor, identify liaison for project(s) and issuing organization(s).

STEP 2: IDENTIFY INFRASTRUCTURE PROJECTS

The Israeli Ministry of Finance and the Galilee Development Authority have evaluated several promising but unfunded infrastructure projects that would accelerate northern Israel and Galilee development.

These include:

- Highway 6 extension to the Cabri and Amihad junctions
- a central Galilee wastewater treatment plant for environmental remediation
- solid-waste and recycling plants in the Galilee
- railroad upgrades (coastal line) and new construction (Nahariya-Carmiel and Emek lines)
- urban revitalization projects in the Galilee (Acre, Nahariya, Safed, Tiberias, Kiryat Shemona)
- Kinneret coastal development
- alternative energy projects
- industrial parks
- incubators
- a Galilee research park

Action Items: Identify Infrastructure Projects

- Gather list of projects and feasibility studies from Israeli Finance Ministry and Galilee Development Authority.
- Assess the accuracy of government studies. Do outside factors exist that government studies do not identify? (Word of mouth, for example, resulted in increased use of Highway 6, but this was not accounted for in the original study).

A task force must assume responsibility for assessment and evaluation, and should be required to issue periodic reports.

STEP 3: EVALUATE THE PROJECTS

Lab participants noted that a main constraint of bond issuance is construction and financing feasibility. If a project (or project bundle) is too time consuming, politically unfeasible, or too cumbersome, interest in investment will fade. And failure of first-round projects may hinder investments in subsequent bond issuances. It is essential therefore to conduct an evaluation of each project's statutory status (i.e., its satisfaction of legal entitlement), feasibility, cost, and return on investment. Projects should be ranked according to ease of implementation and economic/developmental impact.

One proposal called for dividing the project portfolio by use (transportation, urban revitalization, environmental and water projects, energy, tourism) to promote investment by mission-related groups and/or foundations. In addition, a task force could identify project combinations or the most promising projects in terms of feasibility, cost, time, and revenue.

Fortunately, some feasibility studies already exist,¹¹ among which are a number of feasible, “off-the-shelf” projects that will have a large impact on the region's development—for example, railroad and highway upgrading and construction, and energy, environmental, and tourism projects.

Careful and continuous oversight will ensure that the projects stay on track and will provide valuable information to investors and key stakeholders. Detailed reporting throughout each phase of a project will provide “lessons learned” for future bond issuances. At the onset of the project, a task force must assume responsibility for assessment and evaluation. The team should be allotted a budget for this process and should be required to issue periodic reports. Lab participants recommended the immediate organization of this task force, with participation and approval of the Israeli government, but led by private-sector foundations and investors.

Action Items: Assess and Evaluate the Project

- Evaluation of statutory status, feasibility, cost, return on investment of projects.
- Rank projects on level of development, ease of implementation, economic impact, and financial return.
- Create a Northern Israel Regional Task force to identify the best combination of projects. Create a task force responsible for ongoing project evaluation based on financial returns and ease of implementation.
- Identify funding to ensure ongoing oversight, including status checks, and regular reports issued to investors and key stakeholders.
- Identify funding for additional research and development as needed.

STEP 4: DEVELOP FINANCING OPTIONS

A number of options were discussed for optimizing the capital structure for the portfolio of infrastructure projects. In most cases, options can be developed in conjunction with one another to maximize financing, enhance capital market creditworthiness, and accelerate project completion. This list of financing ideas is by no means exhaustive. Future meetings may result in additional, or more appealing, funding options.

» OPTION A: *Use tax increment financing (TIF) bonds or tax-credit bonds to pay project startup expenses*

Because it can take five years or more to see revenue from a project (tolls from a toll road, for example), the sale of tax increment financing (TIF) or tax-credit bonds could support debt financing up front for the project. Proponents argue that it is relatively easy to find investors for TIF bonds and that tax-credit bonds have been proposed for financing redevelopment after Hurricane Katrina.

This option would provide tax credit to private investors. Tax credits could be structured and pooled as part of the financing structure, attracting local and foreign investors. No explicit TIF legislation exists in Israel, but the Israel Tax Authority has improvised approval of assignment of property tax (*arnona*) and improvement taxes (*tel hasbacha*) for increment financing purposes. These revenues could assist in bond repayment. The legal structure under Israeli law must permit an absolute pledge of the tax increment or other revenues to secure bondholders.

» OPTION B: *Explore credit-enhancement alternatives*

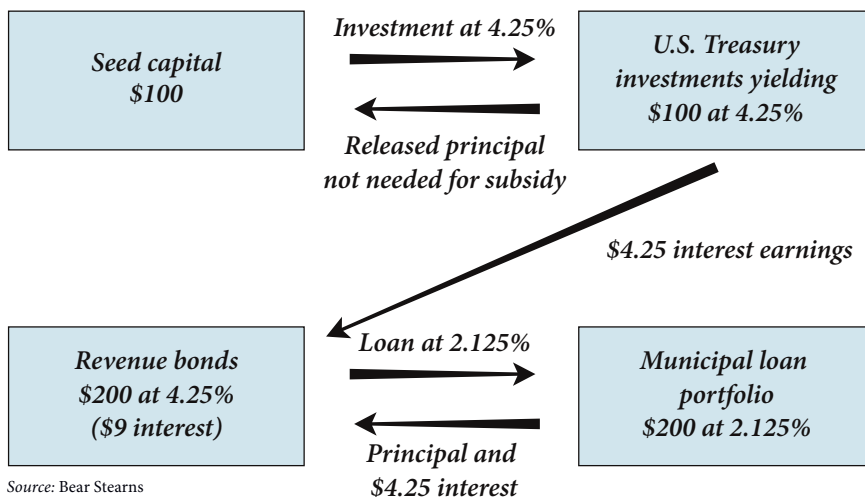
Participants agreed that credit enhancement is essential to the financing program. Credit enhancement can take a number of forms, including guarantees, insurance, and collateral; moreover, multiple forms of credit enhancement can support a single transaction.

Guarantees are common in project financing and can come from governmental or private-sector sources. Federal guarantee programs, such as those administered by the U.S. Export-Import Bank and the Overseas Private Investment Corporation (OPIC) may be available. The Israeli government has also issued guarantees in support of particular projects. Insurance products may be available from governmental sources (OPIC offers an insurance product, as well as guarantees) or from private-sector firms, such as MBIA. To give a recent example, an Israeli natural-gas pipeline project was financed through a credit facility guaranteed by the Israeli government, with OPIC insurance backstopping the sovereign guarantee.

Bond collateral can include physical or financial assets. One way to use financial collateral is to set aside cash or bonds in a “defeasance pool” to service the debt, a fairly common practice in municipal finance. A variation of the defeasance pool was used in the Israeli government’s foreign military sales refinancing, in which Israel’s payment obligations were partly secured by a pool of zero-coupon bonds purchased at deep discount and designed to mature at the exact dates and in the exact amounts necessary to support each payment obligation.

FIGURE
3

Leveraged reserve fund program



Source: Bear Stearns

One participant noted that for certain projects it may be possible to have a series of “custom-issued” U.S. Treasury zero-coupon bonds or Treasury “strips” designed to meet the particular project requirements. As shown in figure 3, these can also be used to leverage the state revolving funds model depicted earlier, in figure 2. Excess repayments (in this example, totaling \$100) are used as seed capital for U.S. Treasury bonds. The interest earnings subsidize loans.

Another form of financial collateral, the credit reserve fund, is discussed in greater detail in the following section.

»» **OPTION C: *Ask the United States to provide investment credit assistance rather than direct aid***

A representative from the Israeli Embassy in Washington, D.C., suggested that U.S. aid to Israel be used to provide investment credit assistance for infrastructure projects. He noted that the U.S. government has promised monetary aid to Israel; with this aid, the Israeli government could provide a guarantee, or credit enhancement, toward select projects. Current unutilized U. S. loan guarantees could be deployed for projects in northern Israel.

Conversely, the aid money might go directly toward specific projects. This funding could also help persuade the Israeli government to act as a sponsor. Participants suggested the possibility of tapping into a portion of unutilized loan guarantees for this purpose. These measures could enable a shift from foreign assistance toward a foreign investment model, thereby leveraging U. S. guarantees through private-sector solutions to public infrastructure financing gaps.

»» **OPTION D: *Create a social-purpose fund without specific project ties***

Several Lab participants suggested issuing a social-purpose fund rather than waiting until projects are assessed and bundled. This would provide a pool of capital without restricting it to a specific project or group of projects. The fund could act as an anchor to funding because money would begin to pay returns before the projects were selected, creating additional startup capital. A social-purpose fund might benefit from the current political environment, which could prompt investment and donations to Israel and leverage a larger pool of capital market resources for Galilee regional development.

Such a fund might include the previously mentioned option of incorporating U.S. government commitments to Israel. The Overseas Private Investment Corporation (OPIC) could become involved to reduce overseas/cross-border risk, providing a U. S. credit backstop to Israeli government or foundation guarantees.

A social-purpose fund would provide a pool of capital without restricting it to a specific project or group of projects.

Action Items: Develop Financing Options

- Assess the likelihood of each financing option (plus additional options, as discussed by stakeholders) and how it might affect project completion.
- Focus on gathering startup financing for projects that will yield revenue.
- Explore U. S. loan guarantees and/or Overseas Private Investment Corporation insurance or credit back-stops for northern Israel infrastructure financing.

Foundations could provide credit enhancement through guarantees and deposits, a loan-loss reserve, over-collateralization, or the purchase of subordinated debt.

STEP 5: STRUCTURE CREDIT-ENHANCEMENT PARTNERSHIPS

The credit-enhancement portion of the financing model, participants agreed, is key to alleviating both startup and ongoing risk. Because infrastructure projects are long term, it was suggested that a credit-enhancement structure be based on targets (releasing investment, for example, after completion of the first phase). The credit enhancement would then revolve to the next set of projects, based on performance targets, and increase the value of credit-enhancement dollars.

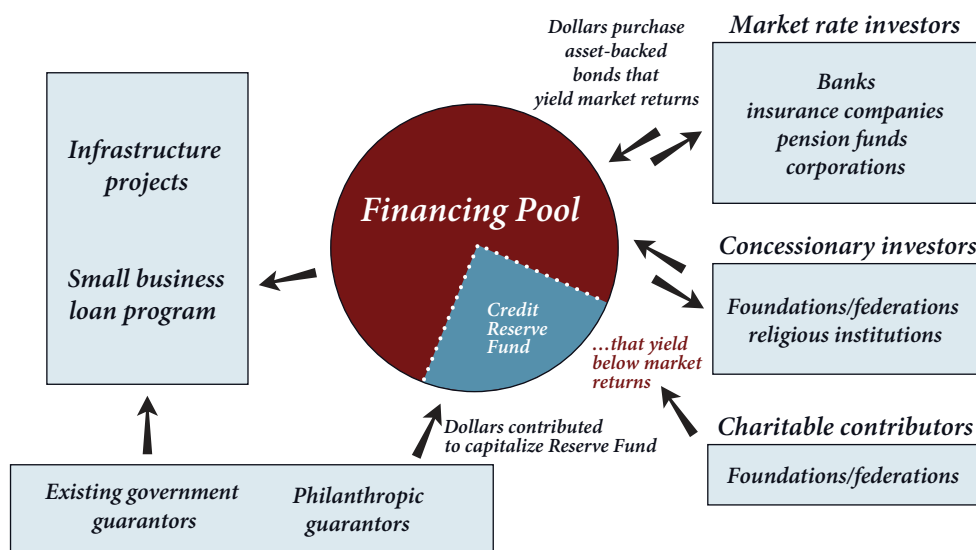
As detailed in Option B, credit enhancements come in a variety of forms, including guarantees, insurance, collateral, and defeasance pools. Further, as discussed in Option C, government contributions can play a role in credit enhancement. However, philanthropies and foundations interested in using program-related investments to further their mission can take an even larger role. Under the 5 percent distribution rule of the IRS, foundations may receive return on their investment if it is below market and in accordance with their program guidelines. This investment may be counted toward the annual payout requirement. This is particularly true for the small-business loan recommendations in Solution 2 and 3 (both expansion of revolving loans and their securitization) but might also apply to the infrastructure bond fund. Foundations could provide credit enhancement through guarantees and deposits, the creation of a loan-loss reserve, over-collateralization, or the purchase of subordinated debt at a concessionary rate of return or more junior tranche level.

Figure 4 depicts the participants in a typical credit-enhancement model, also known as a credit reserve fund.

Philanthropies at the Labs acknowledged that they are not generally interested in infrastructure investments; there is no direct connection between donated dollars and outcomes. And the length of time is too long to warrant investment. However, they acknowledged that a project sponsor could educate and attract philanthropic interest in such investments, especially if the projects are already selected.

FIGURE
4

Credit reserve fund for credit enhancement



Source: Milken Institute

Philanthropic boards would need to evaluate timelines, revenue, and anticipated benefits before committing to a credit-enhancement partnership. Their commitments may also depend on the kind of project selected; a hospital, for example, could be more appealing than a toll road.

Action Items: Structure Credit-Enhancement Partnership(s)

- Determine a structure for credit enhancements.
- Identify potential partners and, if appropriate, allocate amounts. This is especially important for government contributions (earmarked in budgets well in advance).
- Educate philanthropies that might be active partners; board members and foundation networks may become interested in a “mission-related” investment concept.

SOLUTION

2

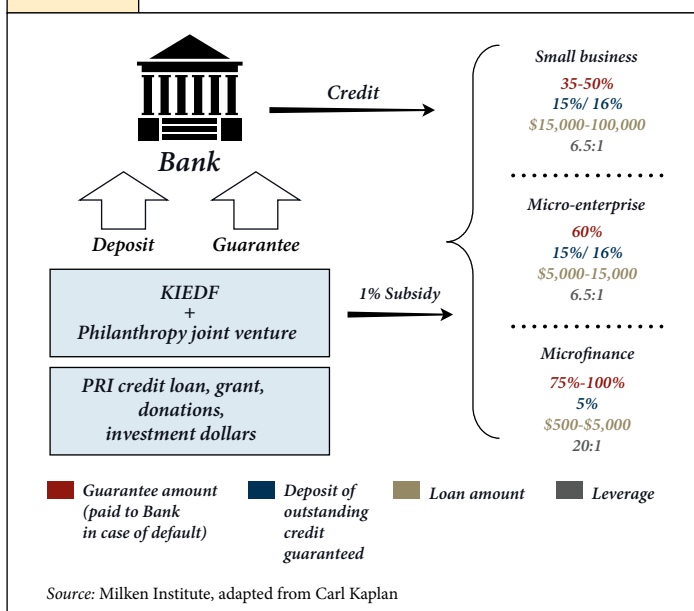
Expand the Koret Israel Economic Development Funds for small-business development

One of the most successful privately funded small-business development programs is the Koret Israel Economic Development Funds (KIEDF).¹² Through its revolving loan fund, KIEDF puts philanthropic funds to work in the private sector, providing small-business, micro-enterprise, and microfinance loans. Since its establishment in 1994, the revolving loan fund has helped create and strengthen small businesses in Israel that would have had difficulty securing bank financing on reasonable terms, especially in outlying areas and regions of high unemployment. KIEDF's program also provides technical assistance to entrepreneurs. Since its inception, KIEDF has facilitated more than \$125 million in new financing with partner banks to 4,000 new and expanding small businesses, and has created and sustained nearly 20,000 new and existing private-sector jobs.

Figure 5 depicts the revolving loan fund model.¹³ Its obvious success precluded much discussion of improvements or challenges, and participants encouraged KIEDF to expand its work. Particular emphasis, they noted, should be given to small businesses that, because of the war, have restricted bank accounts¹⁴ and need additional support to remain afloat. In recent months, the United Jewish Communities, the Jewish Agency for Israel, and the Tzafona Initiative for the North have selected KIEDF to implement small and medium-size businesses and micro-enterprises with funds raised in the Israel Emergency Campaign.

FIGURE
5

KIEDF revolving loan fund model



SOLUTION

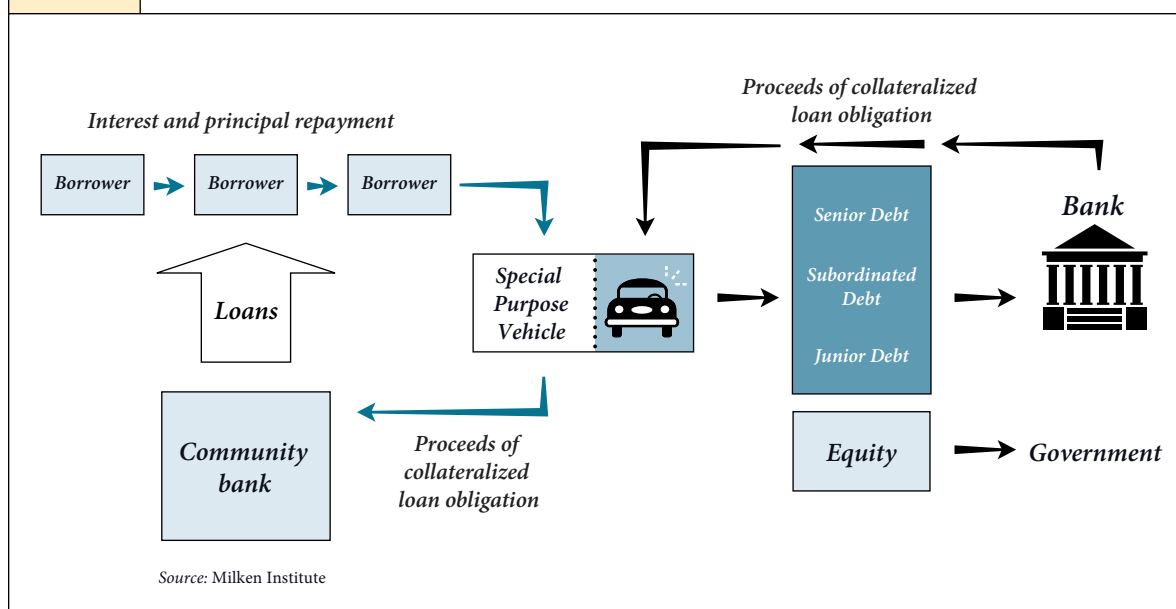
3

Develop a northern Israel small-business collateralized loan obligation

A collateralized loan obligation is a type of security appropriate to small-business and community development loans. It over-collateralizes the pool to provide additional security to investors. If loans are used as collateral, the security is considered a CLO. And Lab participants did recommend that the small-business loans provided by KIEDF, and small-business loans in general, be securitized in a targeted (northern Israel) CLO. A targeted CLO would allow KIEDF and banks to go “one step further” in lending providing liquidity in the constrained small-business credit sector. Securitization is a proven model that has increased credit flows in other sectors. With the participation of a foundation or government agency for credit enhancement, the structure could provide security to investors and enable smaller lenders, such as KIEDF, to restructure their balance sheets, lower their cost of capital, and increase lending.

The structure of a typical CLO is shown in figure 6. A special-purpose vehicle (SPV) is formed and assembles a loan pool through purchases of individual banks’ loans (or, in the case of securitizing KIEDF’s small-business loans, through purchases of KIEDF’s loan portfolio). A portion of the cash flow is used to issue securities, with the remainder used as a loss reserve. Depending on the complexity of the structure, investors may take different risk positions in exchange for varied potential return. Figure 6 assumes senior (traditionally, investment grade) and junior debt tranches, and an equity layer. Once the loan issuer has sold its loans, it is free to issue new ones, providing capital to new borrowers.

Providing a loan-loss reserve through a credit enhancement could be an additional attraction for investors to this higher-risk area. Such a credit reserve fund model is depicted in figure 4.

FIGURE
6*Northern Israel small-business CLO model*

Participants discussed two potential pools of credit enhancement:

- **The Israeli Government.** According to Finance Ministry representatives, the Israeli government may consider participating by providing a government guarantee. If the government becomes engaged, participants suggested, banks would be more willing to lend to higher-risk borrowers.
- **Philanthropy and Foundations.** Representatives from philanthropies expressed interest in their role as credit enhancements. KIEDF expressed willingness directly, and through the Koret Foundation, to participate in credit enhancement for a regionally targeted CLO. Other foundations have subsequently expressed similar interest both in providing credit enhancement through the CLO and through a recovery bond opportunity.

To successfully securitize loans, a local partner must act as the financial sponsor. Participants suggested Israeli banks for this role, and a representative of Bank Hapoalim noted that his bank might participate in the model. Lab participants suggested that Cohen & Company LLC, which is based in New York and specializes in unusual CLOs, might be persuaded to become involved.

Action Items: Expansion of KIEDF Model and Creation of Small-business CLO

- Continue to identify funding for KIEDF's revolving loan fund model to expand the program. Continue to provide technical assistance and research for the Koret Foundation.
- Identify local sponsor to establish a Special Purpose Vehicle. Identify appropriate CLO structure and key stakeholders. Check status of combined KIEDF/Government Small Business Loan program synthetic CLO. Contact Cohen & Company LLC for assistance in developing the model.¹⁵
- Contact appropriate bank connections. The representative from Bank Hapoalim suggests that the bank may help in this capacity.
- Identify role of credit-enhancement partners, such as the Israeli government, philanthropies, and foundations.

RECOMMENDATION

Use the Chicago Climate Exchange offsets program

The emerging market for carbon reduction credits offers new and innovative possibilities to help finance reconstruction of northern Israel. Emissions reduction and trading markets are supplemented by credits from projects that result in sequestration or destruction of carbon dioxide. These environmental markets are transforming the traditional role of agricultural and forestry activities.

During the course of the war, nearly 9,000 acres of northern Israeli forest were destroyed. By replanting these forest areas, the Israeli government has the potential to earn income while mitigating greenhouse gas emissions that contribute to global climate change. The income source from mitigating carbon emissions could help Israeli producers and foresters reduce risk, diversify their income streams, improve productivity, and promote the long-term sustainability and health of regional environment.

For these 9,000 destroyed acres, estimates suggest revenues in the range of \$3.5 million through the CCX marketplace over a twenty-year period.

One immediate avenue to these markets is through the Chicago Climate Exchange (CCX). CCX is a self-regulatory exchange created to develop and administer trading in environmental markets. The CCX offsets portfolio includes forestry, agricultural soil sequestration, methane capture and destruction, renewable fuels, and fuel efficiency. Through its agriculture soil sequestration program, CCX provides an effective vehicle for farmers to deliver greenhouse gas emissions reduction credits from conservation tillage and grassland planting to the market place. To date, more than a million acres of conservation tillage and grassland in the United States and Canada have been “sold” through the exchange as carbon offsets.

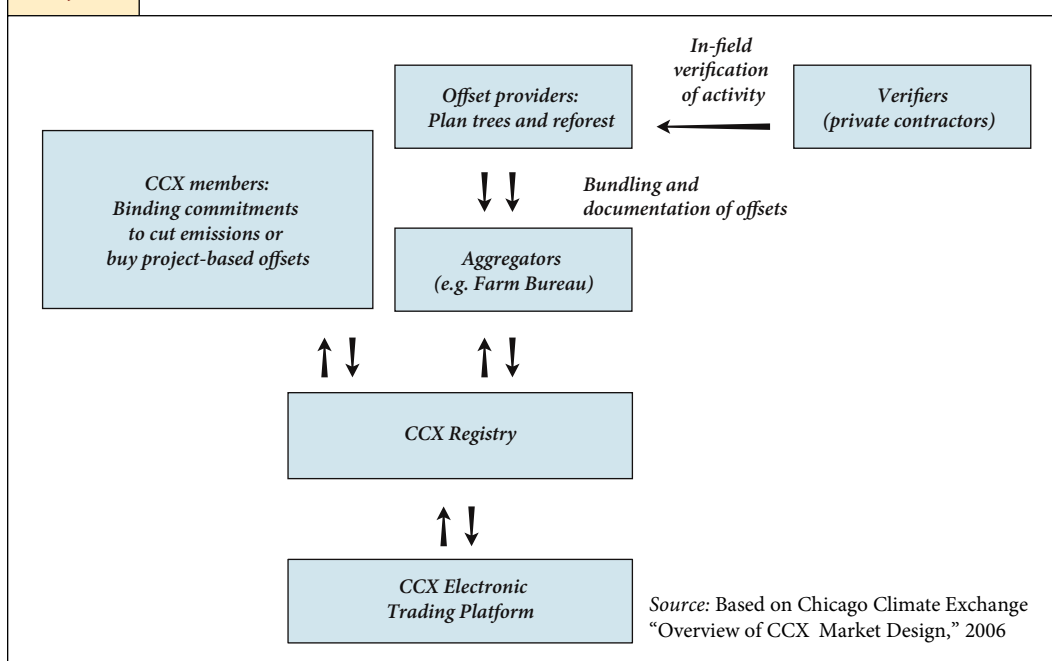
The CCX forestry offset program includes standardized protocols for reforestation. In addition to several commercial forest companies, CCX has registered forest offsets from multiple U.S. states, Costa Rica, and Brazil. General criteria for eligibility in CCX forest program include:

- forestation and forest enrichment projects initiated on or after January 1, 1990, on unforested or degraded forest land
- demonstration that entity-wide forest holdings are sustainably managed
- demonstration of long-term commitment to maintain carbon stocks in forestry
- use of approved methods to quantify carbon stocks
- independent third-party verification of carbon stocks where required

Figure 7 depicts an overview of the CCX market design. An aggregator (e.g., Farm Bureaus) bundles, documents, and trades the offsets of the various offset providers (local farmers, reforestation advocates). These bundles of offsets are posted on the CCX Registry, an electronic database that holds records and transfer information for all account holders. Using the CCX Electronic Trading Platform, the aggregator can interact with other CCX members, thereby trading credits.

FIGURE
7

Overview of CCX market design



Representatives from the CCX used damage estimates to consider the revenue potential from reforestation to the reconstruction effort. Using conservative figures for forest carbon sequestration, reforestation, and maintenance under sustainable forestry of these 9,000 destroyed acres, preliminary estimates suggest revenues in the range of \$3.5 million (an average of \$176,985 annually) through the CCX marketplace over a twenty-year period.¹⁶

Israeli agriculture and forestry stand to gain financial benefits as active participants in the CCX offsets program through monetizing “best management” environmental practices. Through aggregation and use of pre-existing community and civic structures in Israel, it is quite possible that significant value from provision of global environmental services can be realized.

Action Items: Use CCX Offset Program for Additional Financing

- Identify offset providers and an offset aggregator in northern Israel.
- Identify financing to begin reforestation process with appropriate oversight from verifiers.
- Gain entrance to the Chicago Climate Exchange. Aggregator should become educated in CCX Registry and the Electronic Trading Platform

CONCLUSION

Regional economic security in northern Israel requires economic recovery and a turnaround from prewar conditions that neglected the country's periphery. During the 2006 conflict with Hezbollah in Lebanon, the north was made temporarily uninhabitable. The war exacerbated pre-existing conditions of economic distress. Clearly, part of the impact of the missile attacks was to discourage population growth and economic activity in the region.

But even prior to the war, the region had experienced years of negative population out-migration. Northern Israel has long been characterized by higher than national average rates of unemployment, poverty, and low income.

Israel can no longer afford, either militarily or economically, to cast the Galilee as "peripheral" in any sense of the term. Integration of northern Israel into the core growth economy must be completed, and quickly. All participants, from Los Angeles to Acre, expressed a strong sense of urgency that financing projects to strengthen Israel's northern region must be a priority.

Many existing and statutorily approved infrastructure and business finance projects remain unexecuted because of budgetary constraints. The Labs identified off-the-shelf instruments of financial innovation that could leverage scarce government and philanthropic funds through U.S. and Israeli capital markets to accelerate northern regional development.

The means to finance northern Israel's future have been identified and require the application of existing and proven financial technologies to accelerate economic development, capital formation, and job creation. The need and the motivation to address these issues was demonstrated by all participating in the Financial Innovations Lab process and subsequent discussions with Israeli officials. The next step is formalization of a Northern Israel Task Force to complete feasibility studies and commence financing and construction that will create the jobs and infrastructure for regional integration of northern Israel and the turnaround of the regional economy and the economic security of its residents.

APPENDIX I

Financial Innovations Lab Participants

SESSION 1

*September 7
Santa Monica*

Shai Aizin

*Consul for Economic Affairs
Government of Israel Economic Mission*

Mark Chess

*Managing Director
Infinity Venture Capital Fund*

James Cummings

*Vice Chairman
The Nathan Cummings Foundation*

Debra England

*Program Officer
Koret Foundation*

Bob Feyer

*Partner
Orrick Herrington & Sutcliffe LLP*

Lorin Fife

*Chairman
Tel-Aviv/Los Angeles Partnership*

Yaacov Fisher

*Managing Director
I-BIZ*

Liana Foksheneanu

*Director, Business Development
The Merage Foundation for U.S.-Israel Trade*

Matt Fong

*Former State Treasurer
California Department of the Treasurer*

Selwyn Gerber

*CPA
Gerber & Co.*

Scott Gluck

*Vice President, General Counsel
Markstone Capital Group LLC*

Charles Grobe

*Principal
C&H Investment Company*

Morgan Hakimi

Organizational Development Consultant

Jill Holtzman Hoyt

*Director, International Programs
Jewish Federation of Greater Los Angeles*

Mitch Julis

*Managing Director
Canyon Partners*

Jeffery Kandel

*Partner
Feld Winters*

Teresa Magula

*Research Analyst
Milken Institute*

Gail Mondry

*Chief Program Officer
Koret Foundation*

Yair Orgler

*Senior Fellow
Milken Institute*

David Pollock

*Senior Managing Director
Bear Stearns*

Chairman

Milken Institute Israel Center

Orli Rinat

*Program Officer
Israel Venture Network*

Marv Schotland

*President, CEO
Jewish Community Foundation
of Greater Los Angeles*

Jacob Segal

*Director
Standard Management*

Skip Victor

*Senior Managing Director
Chanin Capital Partners*

Glenn Yago

*Director, Capital Studies
Milken Institute*

Howard Zelikow

*Managing Director
Kayne Anderson Capital Advisors LP*

SESSION 2

*September 15
New York City*

Karen Adler

*CEO
Bromor Management*

Ron Alon

*Deputy Chief Financial Officer
Ministry of Finance, Israel*

Leon Bijou

*Vice President, Assistant General Counsel
Goldman, Sachs & Co.*

Sam Bronfeld

*Chairman
Tel Aviv Stock Exchange*

Zvi Chalimisch

*Chief Finance Officer
Ministry of Finance*

Richard Chirls

*Managing Partner
Orrick, Herrington & Sutcliffe LLP*

James Cummings

*Vice Chairman
The Nathan Cummings Foundation*

Ron Dermer

*Minister, Economic Affairs
Embassy of Israel*

Tamar Drach

*Economist
Ministry of Finance*

Aaron Etra

*President
INDEVA*

Zvi Fuhrman

*Senior Executive Vice President
Bank Hapoalim*

Daniel Heimowitz

*Managing Director
Lehman Brothers Inc.*

Helena Hessel

Director
Standard & Poor's

Forsan Hussein

Graduate Student, Harvard Business School
The Abraham Fund Initiatives

Sara Itzhaki-Kaplan

Koret Israel Economic Development Funds

Carl Kaplan

Managing Director
Koret Israel Economic Development Funds

Carl Koerner

Attorney
Koerner Silberberg & Weiner LLP

Jack Leibler

Partner
Leibler & Associates LLC

Teresa Magula

Research Analyst
Milken Institute

Brant Maller

Partner
Pillsbury Winthrop Shaw Pittman LLP

Joel Mesznik

Managing Director
MESCO Ltd.

Betsy Perry

Manager, East Coast Development
and Special Projects
Milken Institute

Beth Phillips

Reporter
Bloomberg

Nat Singer

Senior Managing Director
Bear, Stearns & Company Inc.

Steven Tepper

Partner
Arnold & Porter LLP

Glenn Yago

Director, Capital Studies
Milken Institute

Mike Yampel

Director
Guggenheim Partners

SESSION 3

October 22
Acre, Israel

*Presentation of findings at
Confrontation Line Forum*

Allan Barkat

Former CEO
APAX Israel

Itsik Bechar

Manager
4D Vision

Nissim Ben-David

Economics Faculty
The Western Galilee College

Shlomo Buchbut

Mayor
Maalot-Tarschicha

Ronald Cohen

Chairman
The Portland Trust

Moshe Davidovich

CEO
Galilee Development Authority

Tal Dilian

Economic Development
Tzafona

Eival Giladi

Director General
The Portland Trust, Israel

Zev Golan

Program Director
Koret Israel Economic Development Funds/
Koret Fellows

Amos Goren

Partner
APAX

Zeev Hayut

Economic Development
Tzafona

Carl Kaplan

Managing Director
Koret Israel Economic Development Funds

Shimon Lankri

Mayor
Acre

Daniel Moshe

Deputy Director
Nahariyah Hospital

Yuval Oren

CEO
Miluot

Arza Ron

Chair of the Regional College
The Western Galilee College

Dorit Salinger

Director
Maalot

Jerry Schenier

Economic Development
Tzafona

Yehuda Shavit

Chairman
Local Authority of Mateh Asher

Mickey Shmeltzer

CEO
The Western Galilee College

Ariel Wiess

Director
Yad Hanadiv

Glenn Yago

Director, Capital Studies
Milken Institute

APPENDIX II

Potential Use of U.S. Tax-exempt Bond Financing

A coalition spearheaded by the Milken Institute is exploring alternative financing options for facilitating recovery and growth in postwar northern Israel. One of the options under consideration is the issuance of tax-exempt bonds in the U.S. market to finance infrastructure and other capital projects. This memorandum identifies key federal tax requirements for such an approach, potential federal tax issues, and a possible strategy for addressing these issues.

KEY FEDERAL TAX REQUIREMENTS

1

Under section 103(a) of the 1986 Internal Revenue Service Code, as amended (the “IRC” or “Code”), gross income does include interest on any “state or

local bond.” Under section 103(c)(1), the bond must be an obligation of a state or political subdivision thereof.

2

The interest exemption does not apply to any “private activity bond” unless it is a “qualified bond.”

A) In general, no more than 10 percent of the bond proceeds may be used for any “private business use.”¹⁷ IRC § 141(b)(1). Private business use means use (directly or indirectly) in a trade or business carried on by “any person other than a governmental unit.” IRC § 141(b)(6). Private business use includes use pursuant to a lease, a management contract that does not meet guidelines published by the Internal Revenue

Service, or other arrangements granting special legal entitlements or benefits to a private party. See Treas. Reg. § 1.141-3.

B) In addition, under section 141(c), the amount loaned to “persons other than governmental units” cannot exceed the lesser of 5% of the bond proceeds or \$5 million.

C) A “qualified bond” includes, among others, an exempt facility bond, a qualified redevelopment bond or a qualified 501(c)(3) bond. IRC § 141(e).

3

Under Code section 142(a), exempt facility bonds include bonds used to finance airports, docks, and wharves; mass-commuting facilities; facilities for the furnishing of water; sewage facilities; solid-waste disposal facilities; qualified residential rental projects; facilities for the local furnishing of electric energy or gas; local district heating or cooling facilities; qualified hazardous-waste facilities; high-speed intercity rail facilities; environmental enhancements of hydroelectric generating facilities; qualified public educational facilities; qualified green building and sustainable-design projects; and qualified highway or surface freight transfer facilities.

A) A “governmental unit” must own all of the bond-financed property in the case of airports, docks, and wharves; mass-commuting facilities and environmental enhancements of hydroelectric generating facilities. IRC § 142(b)(1)(A). The governmental unit may lease the facilities to a private party or enter into a management contract if the agreement meets certain requirements designed to limit the availability of federal tax benefits to the lessee or manager. IRC § 142(b)(1)(B).

3

Cont.

B) In other respects, each type of exempt bond facility bond has particular definitions and requirements, many of which do not appear to contemplate tax-exempt bond financing for facilities located outside the United States. For example:

- A facility for the furnishing of water must be operated by a governmental unit or have its rates regulated by a state or local governmental body, or a federal agency or instrumentality. IRC § 142(e).
- A facility for the local furnishing of electric energy or gas must serve an area limited to a city and one contiguous county or two contiguous counties. IRC § 142(f).

- Similarly, a local district heating or cooling facility can serve only a city and one contiguous county. IRC § 142(g).
- Qualified hazardous waste facilities must be subject to final permit requirements under the federal Solid Waste Disposal Act. IRC § 142(h).
- Environmental enhancements of hydroelectric generating facilities must be related to a federally licensed hydroelectric generating facility owned and operated by a governmental unit. IRC § 142(j).
- Qualified highway and surface freight transfer facilities must receive assistance under specified federal programs. IRC § 142(m).

4

If the user of bond proceeds is a section 501(c)(3) organization, no more than 5 percent of the proceeds may be used for private business use, loaned to any person other than a governmental unit, or used by the organization in unrelated trade or business

activities. IRC § 145(a)(2). In addition, all property to be financed by the net proceeds of the bond issue must be owned by a section 501(c)(3) organization or a “governmental unit.” IRC 145(a)(1).

5

The use of tax-exempt bonds by a section 501(c)(3) organization to finance recovery projects in Northern Israel must qualify as a “charitable” purpose under Code section 501(c)(3) and regulations issued thereunder. Charitable purposes include, among

others, relief of the poor and distressed or the underprivileged; erection or maintenance of public buildings, monuments or works; lessening of the burdens of government; and combating community deterioration.

APPENDIX II

CONTINUED

Potential Use of U.S. Tax-exempt Bond Financing

POTENTIAL FEDERAL TAX ISSUES

1

The bond issuer must be a state or political subdivision thereof, but the bond laws in most states do not authorize the issuance of bonds for projects located outside the state. While there are a few

exceptions, even those states may not be able to issue bonds for projects outside the United States without amendments to their applicable laws.

2

Under Code section 150(a)(2), the term “governmental unit” is defined to exclude the United States or any agency or instrumentality thereof.” The statutory definition does not expressly exclude or include foreign governmental units. However, the private activity bond regulations define “governmental person” to mean a state or local governmental unit, or any agency or instrumentality thereof, and define “nongovernmental person” to mean a person other

than a governmental person. Treas. Reg. § 1.141-1(b). Thus, bonds used to finance facilities that are owned by or leased to an Israeli governmental unit will constitute taxable private activity bonds unless they are qualified bonds used for exempt facilities. Similarly, bonds used to make or finance loans to Israeli entities will constitute private activity bonds. See Treas. Reg. § 1.141-5(a).

3

While undertaking the recovery projects would lessen the burdens of Israeli governmental entities, it is not clear whether lessening the burdens of a foreign government is a charitable activity under section 501(c)(3) of the code. It is clear, however, that U.S.

charities may conduct their charitable activities outside the United States. If necessary, therefore, the contemplated activities of a U.S. nonprofit corporation could qualify as charitable on grounds other than lessening the burdens of government.

POSSIBLE STRATEGIES

The first issue discussed above can be addressed by seeking state legislation in New York or California to authorize the issuance of bonds by a state entity to finance the northern Israel recovery projects in particular or, more broadly, to finance projects outside the United States.

The second issue discussed above could be addressed by having a U.S. charity retain ownership and operational control of facilities, with the possible operation of the facilities by a private party pursuant to a management contract that satisfied IRS guidelines. Such an approach, however, may raise significant non-tax concerns, both for Israel and the U.S. charity.

The federal tax issues also could be addressed by seeking a legislative solution. The legislation might include the following elements:

- It would establish a new federally chartered corporation (e.g., “the Northern Israel Reconstruction Finance Corporation”) for the specific purpose of assisting in the financing of northern Israel recovery and development projects.
- It would define the purposes of the corporation to include the relief of poor and distressed persons in northern Israel (including those affected by the war); the erection or maintenance of public buildings, monuments or works in northern Israel; lessening of the burdens of Israeli governmental entities; and combating deterioration in northern Israel communities. The legislation would declare these purposes to be “charitable” within the meaning of section 501(c)(3) of the Code.
- It would authorize the corporation to use the proceeds of tax-exempt bonds issued by a state or local governmental unit in the United States in order to finance the projects in northern Israel. The corporation would be authorized to build the projects, retain ownership, and lease them to Israeli governmental entities; to build the projects and transfer ownership to Israeli governmental entities; and/or to lend the bond proceeds to Israeli governmental entities that would undertake the projects themselves.¹⁸
- The legislation would provide that, notwithstanding existing law, the Israeli governmental entities shall be treated as “governmental units” for purposes of code sections 141 and 145.
- The legislation would prescribe a governance structure for the corporation, which might provide that initial appointments to the board of directors be made by one or more specified U.S. charities that support Israel financially. Following the initial appointments, the board could be “self-perpetuating,” with vacancies filled by the remaining board members.

Because the proposed legislation would expand existing federal tax law on tax-exempt bond financing, particularly with respect to the definition of “governmental unit,” it likely would be scored as having a negative impact on federal revenues. The legislation therefore would have to limit the total amount of tax-exempt bond financing authorized for projects that otherwise would not qualify for such financing under existing law.

ENDNOTES

1. In an extensive interview with Al-Jazeera's Beirut Bureau Chief Ghassan Ben-Jiddu on July 20, 2006, Secretary General Hasan Nasrallah explained his vision of the economic objective of military action: "When time drags—the north is brought to a halt, northern Israel, excuse me, I apologize, I mean northern occupied Palestine—there are two million Israelis who are either in shelters or outside the area, displaced outside the area. The entire economy in the north is brought to a halt. The factories, trade, tourism, and economic movement are all brought to a halt." See also: Patrick Devenny, "Hezbollah's Strategic Threat to Israel," *Middle East Quarterly*, Winter 2006.
2. Israeli Ministry of Foreign Affairs. "Hizbullah Attacks Northern Israel and Israel's Response." July 12, 2006.
3. Israeli Ministry of Foreign Affairs. "Hizbullah Attacks Northern Israel and Israel's Response." July 12, 2006; *Interactive Tool*. "Major Attacks in Lebanon, Israel and the Gaza Strip." *New York Times*, August 14, 2006.
4. Kraft, Dina. "Dry Forests in Northern Israel Are Damaged as Hezbollah's Rocket Attacks Ignite Fires." *New York Times*, August 8, 2006.
5. Central Bureau of Statistics, Statistical Release, February 22, 2007, reflects a fourth quarter revision of second half GDP growth at an annual rate 3.1 percent and fixed investment at 8.9 percent.
6. For detailed data comparing Israel's Northern District on each component of regional economic performance and regional income inequality see Nissim Ben-David, presentation at Koret Knesset Fellows Conference, October 22, 2006, Western Galilee College, Acre, Israel, and "Economic Growth and its Effect on Income Distribution," *Journal of Economic Studies*, 2007 (Forthcoming).
7. Israel Business Information Services, "The Galilee Region: Before and After the War," August 2006.
8. For a historical perspective, see Tessa Rajak, Josephus: *The Historian and His Society*, London: Duckworth, 2002. Jonathan J. Price, *Jerusalem Under Siege: The Collapse of the Jewish State, 66-70 CE*. Leiden: Brill, 1992. From the spring of 68 A. D., Vespasian began his systematic, military reduction and occupation of Judaea in the Galilee and it was there that the longest resistance before that of Jerusalem occurred. Jerusalem elders appointed Josephus Flavius commander of the Galilee to lead the defense against Rome's Tenth Legion. The military and strategic importance of northern Israel was understood as determining the fate of Jerusalem and the country as a whole. Josephus explained the Galilee's strategic position and character in *Jewish Wars*, iii. 3.2: "The Galileans are inured to war from their infancy, and have been always very numerous; nor hath the country been ever destitute of men of courage or wanted a numerous set of them; for their soil is universally rich and fruitful, and full of plantations of trees of all sorts, insomuch that it invites the most slothful to take pains in its cultivation. ... Moreover, the cities lie here very thick, and the very many villages there are here are everywhere full of people."
9. PPP/PFI Projects in Israel, Public Private Partnership Division, Ministry of Finance, Inbal, January 18, 2007.
10. Estimate provided by Murali Kanakasabai, economist, Chicago Climate Exchange. The estimation uses conservative annual sequestration rates for the U.S. Corn Belt and CCX carbon price of \$4.5 per metric ton. Actual revenue will depend on specific forest sequestration rates in Israel and CCX market prices at the time of sale.
11. Lab participants noted that one should be wary of initial government estimates as they may be low or inaccurate. Calculations of projected revenue for Highway 6, for example, were much lower than actual revenue.
12. Glenn Yago and Betsy Zeidman, *Building Israel's Small Business and Microenterprise Sector: Israel Entrepreneurial Finance Initiative*, Milken Institute, January 2005. On postwar credit-crunch issues, see Tani Goldstein, "Northern Business Owners: Banks Aren't Giving Credit," *Yediot Aharanot*, September 21, 2006. KIEDF has facilitated over \$100 million of financing to nearly 3,500 small and micro-businesses in Israel. In August and September of 2006 alone, KIEDF facilitated nearly NIS 25million (more than \$4.4 million) of primarily working capital loans on attractive terms to more than 300 small businesses—85 percent of which are in northern Israel—and continues to respond to the more than 1,00 applications for assistance since the start of the Lebanon conflict.
13. The Israeli banking system requires most small-business borrowers to be fully secured and to pay high interest rates. KIEDF uses its assets as guarantees to provide a portion of the securities needed to facilitate loans to small business and uses the investment proceeds to subsidize interest rates to cover loan losses. In 2002, KIEDF established the first leveraged micro-enterprise lending program in cooperation with Bank Hapoalim. Since its inception, the program has provided 650 micro loans representing approximately \$2.5 million. In June 2006, KIEDF launched the Israel Microenterprise Initiative to develop sustainable micro-enterprise programs throughout Israel and increase employment and socioeconomic advancement opportunities for low-income entrepreneurs. More than twenty-five program modules will be implemented in 2007. The Israeli Arab Loan Fund, in partnership with Center for Jewish-Arab Economic Development (CJAED) and Mercantile Discount Bank, was launched in November 2004. The demand for credit on reasonable terms in the Israeli Arab sector is acute. There more than 70,000 small family-owned businesses in this sector with limited access to bank financing. Since inception, the fund has approved more than 100 loans totaling \$2.25 million.
14. The definition of restricted account appears in *The Law of Uncovered Checks*, 1981 (Hebrew), relating to accounts where ten or more not covered checks during twelve months passes with more than fifteen days between the first and tenth check. *Severely restricted accounts* are those whose successor account was also restricted within three years of the first restriction period. Restricted accounts are for one year and severely restricted accounts for two years.
15. Given the absence of securitization legislation in Israel currently, the option to have a synthetic structure is possible. This form of credit derivative enables the originating bank to retain the loans on its balance sheet but merely securitizes the inherent credit risk. This repackaging of the underlying loans into cash flows that suit the needs of the investors are not dependant on the repayment structure of the underlying loans.
16. The estimation uses conservative annual sequestration rates for U.S. Corn Belt and CCX carbon price of \$4.5 per metric ton. Actual revenue will depend on specific forest sequestration rates in Israel and CCX market prices at the time of sale.
17. This threshold can be exceeded if no more than 10 percent of the proceeds is (a) secured by any interest in property used or to be used for a private business use or by payments in respect of such property, or (b) to be derived from payments in respect of property, or borrowed money, used or to be used for a private business use. IRC § 141(b)(2).
18. The corporation also would be authorized to purchase bonds issued by Israeli entities to finance the recovery efforts.

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