

# COMMUNITY INVESTMENTS

A Community • Economic Development Publication

VOLUME FOURTEEN NUMBER 1



## SPECIAL EDITION

A GUIDE TO COMMUNITY DEVELOPMENT INVESTMENTS

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MARCH 02

## Community Investments

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# Editor's **NOTEBOOK** by Fred Mendez

As you may know, the revised Community Reinvestment Act (CRA) regulation changed the way financial institutions are evaluated from twelve fairly broad-based "assessment factors" to a more bottom-line approach. Large financial institutions (those with assets over \$250 million or a subsidiary of a holding company with combined assets over \$1 billion) are evaluated on lending, investing and service activities that relate to community development. The four federal bank regulatory agencies have defined community development to mean affordable housing for low- or moderate-income individuals, community services targeted to low- or moderate-income individuals, activities that help small businesses and activities that revitalize or stabilize low- or moderate-income geographies. Small financial institutions and wholesale/limited purpose financial institutions are evaluated in a streamlined manner that takes some of the same information into account but is tailored to their limitations and environment.

The idea behind this change was to focus on the strength of financial institutions—namely, lending in the communities they are chartered to serve. The CRA's "lending test" is the most heavily weighted of the three tests mentioned above except in those cases where an institution's charter or environment make lending difficult. The other two tests, investment and service, are designed to either compliment lending activity or to set a foundation for safe and prudent lending in the future.

The investment test was designed to allow financial institutions to meet their obligations under the CRA through methods that are "innovative, creative and flexible" – adjectives that appear several times throughout the regulation. Financial institutions vary in size and specialty, and although they are federally insured, financial institutions are private enterprises. Consequently, agencies cannot and will not dictate what specific products and services they can offer as long as they are permissible by current banking laws.

By seeking creative investment opportunities, financial institutions can act as a catalyst for other private sector investment and can make a vested interest in communities in which they are chartered to serve. This special edition of *Community Investments* is designed to help financial institutions define Community Reinvestment Act qualified investments and understand related regulatory and technical issues. In addition to the regulatory guidance provided, each of the seven articles is designed to address four areas concerning the most common CRA qualified investments:

1. What they are and how they work
2. Where and how they can be obtained, including some discussion of their availability relative to other investment vehicles
3. How they are booked; and
4. How they qualify under the CRA

This publication presumes that the reader has a working knowledge of the CRA and its implementing regulation. Information about the CRA regulation is available at [www.FFIEC.gov](http://www.FFIEC.gov). Financial institution representatives should contact their regulatory agency liaison to discuss any specific questions you may have regarding qualified investments. We hope you find this publication useful.

# Low-income Housing

## Tax Credits

by Catherine Such, Vice President of Originations and Community Development, Columbia Housing

Over the past decade, the federal Low-income Housing Tax Credit (LIHTC) has emerged as an innovative and credible financial instrument that allows banks both a profitable and safe return, and investment credit under Community Reinvestment Act (CRA) requirements. This article discusses, in part, what low income housing tax credits are, how they work, how banks can access them and how they qualify under the CRA.

### **What is a tax credit?**

The credit is a dollar for dollar reduction of the investor's federal income tax liability—if any investor owes \$100 in federal income taxes and holds \$100 in tax credits, the investor's tax liability for that year is zero. The program was created as part of the Tax Reform Act of 1986 in order to encourage the development of rental housing for low-income households (tenants housed in properties generating tax credits must earn 60% or less of median family income for their county and state housing agencies may impose lower income limits).

The program has been very successful, creating over 100,000 units annually and spawning hundreds of millions of dollars in investment. Typically used in multi-family housing development, the equity created by the sale of tax credits allows a reduction of the property's mortgage, which in turn al-

lows the property owner to lower rents, rendering the property affordable to lower-income households. For now, the credit only applies to rental properties, although the Administration has suggested expanding it to facilitate home ownership.

Tax credits are generated when a developer, either for-profit or non-profit, builds an affordable housing rental development. Most of the costs associated with development, except land and associated costs, cash reserves and certain financing costs, are accrued into what is referred to as the property's "eligible basis." The annual credit amount is calculated by multiplying the eligible basis by the applicable credit percentage (which changes monthly). Credits are earned over ten years, although the property must remain affordable for at least fifteen years (state housing agencies may impose longer affordability periods).

### **Example: Calculating the Credit**

Project Cost:	\$7,500,000
Less ineligible costs:	(1,500,000)
Eligible basis:	\$6,000,000
Credit percentage:	x 8.55%
Annual credit amount:	\$ 513,000

The investor earns credits over ten years, and the income compliance period is fifteen years. As a result, the developer has a ten-year stream of tax

credits and a fifteen-year stream of tax losses to sell to an investor. The investor is typically the limited partner of a real estate operating partnership with a general partner (who may be the developer or a separate company) who is responsible for operating the property on a daily basis. The developer sells a majority of the operating partnership (typically 99.99%) to the investor, who then contributes equity to the property in exchange for the tax credits.

### **What is the investor buying?**

The investor is buying a financial asset in the form of a stream of tax benefits (both credits and losses associated with depreciation and interest) with real estate supporting the asset. The investor's return is based on the price paid for this benefit stream. The developer will typically require payment of the capital into the property for development costs, and as a result, the investor's capital is typically paid in several installments dependent on benchmarks such as construction completion. Full payment is due by the time construction is complete, the property is stabilized and the permanent mortgage loan is closed. Returns fluctuate according to the usual economic barometers but are currently in the range of 7%–8% (after tax, assuming a 35% marginal rate taxpayer).

The equity the investor pays is calculated this way, using our previous example above:

Annual credit amount:	\$513,000
Over ten years:	\$5,130,000
Multiplied by price:	.75
<i>(varies significantly by transaction)</i>	
Multiplied by investor's share:	0.9999
<b>TOTAL EQUITY:</b>	<b>\$3,847,115</b>

Because it is a dollar-for-dollar reduction of federal tax liability, the investor's annual credit amount has a positive impact on earnings per share because it reduces tax liability without diluting earnings. In addition to the credit, the investor will earn tax losses as well; these losses do lower tax liability by lowering overall corporate earnings but typically the losses associated with depreciation and interest are much less significant to the overall investment than the credit.

### ***What are the investor's rights and responsibilities?***

As a limited partner, the investor is primarily responsible for oversight and the general partner is responsible for day-to-day operations. The relationship between the limited partner and the general partner is governed by an operating partnership agreement which is typically a complex document negotiated with the help of experienced tax counsel.

### ***How do LIHTCs qualify under the Community Reinvestment Act?***

An investment in Low-income Housing Tax Credits qualifies under the investment test of the Community Reinvestment Act. Typically, CRA credit is given in the year the investment is made although the benefits from the

investment last for the length of the operating partnership.

### ***How do you access the credit?***

This is a long-term and sophisticated financial investment. There is an active secondary market for credits, but many investors choose to keep their investment over the life of the partnership rather than trade it. The Internal Revenue Service has a number of requirements in Section 42 of the tax code including highly specific and ongoing income compliance requirements. The investor is typically a limited partner without daily operational responsibility. For all these reasons, it is important to choose your partners carefully.

Most banks invest in tax credits either directly or through investing with a tax credit syndicator. Banks that choose to invest directly typically make a significant investment in their own infrastructure, hiring relationship managers, underwriters and asset managers to watch over the investment. This may be daunting for smaller banks, particularly those not already involved in financing affordable housing through construction or permanent lending.

Banks interested in investing in tax credits, but uninterested in creating a department to do so, often choose to work with a syndicator. Syndicators are financial intermediaries that can find tax credit properties, underwrite the underlying real estate, work with the developer, general partner and development team (including the property management firm) and then manage the asset for its life. A syndicator performs these services in exchange for a load, or a percentage,

applied to the investment. Loads vary widely depending on the syndicator, services performed and whether the investor wants cash reserves. Loads typically vary between 9% and 12%. There has been consolidation in the syndicator industry over the past 18 months and as a result most syndicators who emerged from that shake-out are relatively sophisticated and in many cases have the financial backing of a significant corporate parent such as a bank.

There are two vehicles for investing with a syndicator: proprietary funds and multi-investor funds. In either scenario, the syndicator will find potential properties, perform underwriting and present the transaction to investors. The investor typically has consent rights to the transaction.

Proprietary funds are best for banks wanting a significant amount of control over the investment. Typically, a proprietary investor will exercise much more due diligence over individual transactions because they are the sole or majority investor and their risk is not mitigated by the presence of other investors. For banks that are interested primarily in maximizing their CRA credit, a proprietary fund may be the best option as the bank will have ultimate control over the geography, acquisition guidelines and pricing of the investment.

The advantage of a multi-investor fund is primarily risk diversification; for example, in a \$50M multi-investment fund, there may be between two and five investors, all of whom share risk. Usually a multi-investor fund will be fully specified, with financial and underwriting details about all the properties in the fund, prior to the fund's offering.

In syndicated transactions, the syndicator is typically responsible for primary contact with the general partner of the operating partnership. This allows the bank investor to focus on areas that are important to that investor. Because the syndicator is typically on the front line of negotiating with the general partner, it is important that the syndicator be experienced and knowledgeable, but also that the organization have competent tax counsel.

### ***How do you choose the right partner?***

Whether banks are investing directly or with syndicators, there are several things to look for in a partner. First, the partner should be generally knowledgeable about real estate. Syndicators should have depth of knowledge and experience on their management teams and in the staff working on transactions. Syndicators should also have solid underwriting processes and pro-

cedures that include checks and balances during the approval process. The syndicator should be able to provide the investor with the information necessary to approve a transaction in an organized, accurate and timely fashion. Most investors do a significant amount of due diligence on syndicators, particularly if they intend the relationship to last over a period of years, and may review the syndicator's existing portfolio, tax counsel, underwriting and asset management processes.

Over the past several years, the Low-income Housing Tax Credit has proven to be an excellent investment for banks, both from a CRA and a financial perspective. While relatively more complicated than some forms of real estate finance, with the right financial partners the tax credit is not a daunting investment and it allows banks to participate in a meaningful and financially rewarding way in their community. **CI**

### **ABOUT THE AUTHOR**



CATHERINE H. SUCH, vice president of originations and community development, is responsible for identifying and evaluating potential investment properties and for the preparation of acquisition contracts and preliminary financial analysis. Ms. Such also spearheads Columbia's community development function. In this capacity, she serves as Columbia's liaison to the political community.

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## **COMMUNITY DEVELOPMENT INVESTMENTS GUIDE AVAILABLE**

The Federal Reserve System's updated Directory: Community Development Investments is a great resource for bankers, community development groups and others interested in community development finance. It is currently available via the Federal Reserve Board of Governor's website or by mail.

The directory contains profiles of community development investments made by bank holding companies and state-chartered banks supervised by the Federal Reserve System. The profiles highlight the activities of community development corporations, limited liability companies and limited partnerships in which institutions have invested. Each profile describes the amount of initial capital invested by an institution and community development projects undertaken or planned. Also listed are contact persons who can provide additional information on community development corporation organization and operations.

The directory can be downloaded from the Federal Reserve Board of Governor's Web site:  
**[www.federalreserve.gov/community.htm](http://www.federalreserve.gov/community.htm)**

## REGULATORY OVERVIEW

### INVESTMENT TYPE: LOW-INCOME HOUSING TAX CREDITS (LIHTCs)

**Definition:** The Low-income Housing Tax Credit (LIHTC) is a credit against regular tax liability for investments in affordable housing projects acquired and rehabilitated after 1986. Generally speaking, the credit is available annually over a ten-year period beginning with the tax year in which the project is “placed in service” or, at the owner’s election, the next tax year. A tax credit project must meet one of the “minimum set-aside” requirements noted below. A qualified low-income housing project must comply continuously with these minimum set-aside requirements for a full 15-year compliance period. A failure to meet this requirement will result in a complete invalidation of a portion of the credit already taken. LIHTCs are carried as investments on the investing institution’s balance sheet in accordance with Generally Accepted Accounting Principles (GAAP).

#### Minimum Set-Aside Requirements

1. **20/50 Test:** Under this test, at least 20 percent of the residential rental units must be both rent-restricted and occupied by individuals whose income is 50 percent or less of area median gross income, adjusted for family size.
2. **40/60 Test:** Under this test, at least 40 percent of the residential rental units must be both rent-restricted and occupied by individuals whose income is 60 percent or less of area median gross income, adjusted for family size.
  - Special rules apply with respect to tenants who originally qualified under the governing income levels and whose income subsequently rises above such levels.
  - A unit is “rent-restricted” if gross rent does not exceed 30 percent of the qualifying income levels in either 1 or 2 above. Restricted rents are determined using 1.5 persons per bedroom rather than actual number of occupants. Rental assistance provided by federal, state and local agencies is not considered rent paid by the tenant; utility allowances are, however, included.
  - An election can be made to combine buildings and consider the project as a whole for purposes of meeting the minimum set-aside tests, but all of the buildings in the project must meet the minimum set-aside requirements within twelve months after the first building is placed in service.

**CRA Applicability:** Examples of qualified investments provided in the CRA regulation include lawful investments, grants, deposits or shares in projects eligible for low-income housing tax credits. If the project complies with the above restrictions, CRA applies.

# The Community Development REIT

by Judd Levy, President and Chief Executive Officer, Community Development Trust

## BACKGROUND

The Real Estate Investment Trust (REIT) was created in 1960 as a means of enabling individual investors to invest in real estate. REITs are basically mutual funds that combine funds from individual investors and then invest those funds in real estate. There are REITs that specialize in mortgage investments and there are REITs that invest solely in real estate equity. Equity REITs have shown the greatest growth in recent years. In 1990 the total market capitalization of equity REITs was approximately \$9 billion; by 2000 that figure had grown to \$140 billion. Within the equity REIT market, there is additional market segmentation with REITs that specialize in office buildings, retail, hotels, industrial and multifamily residential.

The Community Development Trust (CDT) is the only REIT created solely for the purpose of acquiring assets that benefit community development. CDT's primary goal is to preserve and increase the stock of affordable housing both through long-term equity ownership and by providing liquidity to lenders originating mortgages. CDT will also provide debt and equity capital to retail, commercial and other projects located in community development areas. CDT is a national company that makes investments throughout the country. Since it provides both equity and debt capital, it is considered a hybrid REIT.

## CRA ELIGIBILITY

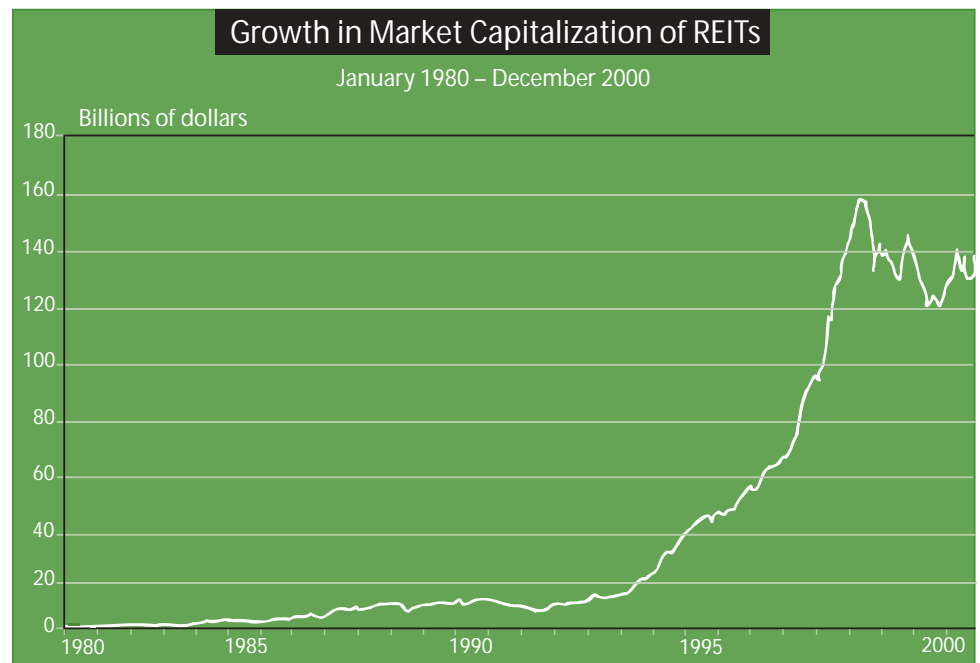
CDT's charter requires it to purchase only assets that meet the requirements of the Community Reinvestment Act (CRA). Because all of the assets CDT acquires are expected to be CRA eligible, banks may receive CRA credit by investing in CDT.

Bank investors have generally recorded the CDT stock purchase on their books as an equity investment. CDT's board of directors values the common stock on a quarterly basis by determining the net asset value (NAV) of its investments. The NAV is basically the market value of all CDT's assets less its liabilities. As a result, the

NAV changes from quarter to quarter reflecting changes in the level of interest rates as well as the individual performance of the underlying investments.

## CDT SECONDARY MARKET DEBT PROGRAM

CDT purchases multifamily mortgages from both non-profit and for-profit community development lenders. These secondary market purchases generally involve loans that are not readily acceptable to traditional secondary markets. These loans, while creditworthy, may not qualify for sale to others because of their small size (less than \$3 million), location (inner city or ru



## ABOUT THE AUTHOR



JUDD S. LEVY is the president and chief executive officer of the Community Development Trust. Mr. Levy was formerly president of LIMAC, a national nonprofit affiliated with Local Initiatives Support Corporation (LISC). Mr. Levy established CDT in July of 1998 with a background of over 25 years in affordable housing and mortgage finance.

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ral), configuration (scattered-site, urban rehabs) or type (assisted living).

The development of the commercial mortgage-backed securities (CMBS) market has benefited many real estate markets by increasing liquidity and lowering the cost of capital. Because community development loans are generally under \$3,000,000 and may have complex structures including soft second mortgages, they have not been readily packaged as investments. Also, because of the nature of the asset being financed (an affordable housing property), 5–10 year adjustable rate mortgages, popular in the CMBS market, entail too much refinancing and interest rate risk to be used to finance affordable housing.

Community development properties need long-term, fixed-rate mortgages which are often not suitable for sale into the traditional secondary markets. Banks and thrifts are equipped to originate and service these loans but do not have the capital structure to hold these assets in their portfolios. Life insurance companies, pension funds and others that are interested in investing in long-term, fixed-rate loans in community development areas do not have the expertise to underwrite these types of loans. By acting as an intermediary, CDT can use its experience in community development lending to acquire these loans from qualified originators and then securitize these specialized assets for subsequent sale to CRA-motivated and socially-responsible investors. CDT purchases loans as small as \$250,000 and aggregates these loans for subsequent syndication to institutional investors. CDT retains a subordinate interest in each loan it acquires, thus providing credit enhancement to increase the marketability of the senior securities.

## EQUITY ACQUISITION PROGRAM

In the equity area, CDT provides tax advantages to owners wishing to sell their subsidized, affordable housing properties. CDT is structured as an umbrella partnership REIT (UPREIT), which provides certain tax deferrals to owners that exchange ownership interests in their property for an interest in CDT. The tax deferral of the UPREIT structure has been used by owners of shopping centers and office buildings, for example, as a means of creating liquidity and diversification in their real estate holdings. This financial engineering is available to owners of affordable housing who want to sell their properties without incurring a taxable transaction.

When CDT acquires properties, its mission requires it to preserve the units as affordable housing. CDT works with non-profit and for-profit partners to restructure the properties to assure affordability. The UPREIT acquisition can be combined with tax-exempt financing and tax credits to provide capital for rehabilitation and to increase the financial viability of the projects while they are maintained as affordable housing.

## CONCLUSION

CDT was created to fill two gaps in the community development financial markets: secondary market financing for small loans and equity capital for housing preservation. To date there are no other REITs dedicated to community development finance. As CDT's success grows others can be expected to utilize the REIT structure as a means of increasing the flow of capital to the community development field. **CI**



## REGULATORY OVERVIEW

### INVESTMENT TYPE: COMMUNITY DEVELOPMENT REAL ESTATE INVESTMENT TRUSTS

**Definition:** A real estate investment trust (REIT) combines the capital of many investors to acquire or provide financing for real estate. A REIT also permits real estate investors to obtain the benefits of a diversified portfolio. A community development REIT (CD REIT) acquires debt and equity in projects that satisfy the definition of community development in the CRA regulation. CD REITs are carried as investments on the investing institution's balance sheet in accordance with Generally Accepted Accounting Principles (GAAP)

- CRA Applicability:**
- a. Community development, as defined in the CRA regulation, should be the investment's primary purpose.
  - b. The investment should address the needs of the institution's assessment area(s) or a broader or regional area (not nationwide) that includes the institution's assessment area(s).
  - c. The institution would receive credit for its investment only, not as a pro-rata share of the total.

### 2002 SCHEDULE OF CRA ROUNDTABLES

The Federal Reserve Bank of San Francisco sponsors quarterly roundtable meetings throughout the 12th District to assist officers of financial institutions in identifying local opportunities for improved CRA performance. If you would like to be included on a specific mailing list or update your mailing information, please contact Bruce Ito at (415) 974-2422 or contact us via e-mail at [sf.communityaffairs@sf.frb.org](mailto:sf.communityaffairs@sf.frb.org).

LOCATION	COMMUNITY AFFAIRS CONTACT	DATES
Boise, ID	Craig Nolte at (206) 343-3761	March 14, June 13, Sept. 12, Dec. 12
Las Vegas, NV	John Olson at (415) 974-2989	March 12, June 11, Sept. 10, Dec. 10
Northern California	John Olson at (415) 974-2989	Feb. 12, May 14, Aug. 13, Nov. 12
Phoenix, AZ	Adria Graham Scott at (213) 683-2785	March 21, June 20, Sept. 19, Dec. 12
Portland, OR	Craig Nolte at (206) 343-3761	Jan. 8, April 9, July 9, Oct. 8
Salt Lake City, UT	John Olson at (415) 974-2989	April 18, July 18, Oct. 17
Southern California	Adria Graham Scott at (213) 683-2785	Feb. 13, May 15, Aug. 14, Nov. 13
Seattle, WA	Craig Nolte at (206) 343-3761	Feb. 7, May 9, Aug. 8, Nov. 7

## Investments

**THE NEED**

A strong permanent capital base is critical for community development financial institutions (CDFIs) because it increases the organization's risk tolerance and lending flexibility, lowers the cost of capital, and protects lenders by providing a cushion against losses in excess of loan loss reserves. It allows CDFIs to better meet the needs of their markets by allowing them to engage in longer-term and riskier lending. A larger permanent capital base also provides more incentive for potential investors to lend money to a CDFI. All of these results help CDFIs grow their operations and solidify their positions as permanent institutions. Unlike for-profit corporations, which can raise equity by issuing stock, nonprofits must generally rely on grants to build this base. Traditionally, nonprofit CDFIs have raised the equity capital they need to support their lending and investing activities through capital grants from philanthropic sources, or in some instances, through retained earnings. However, building a permanent capital base through grants is a time-consuming process, and one that often generates relatively little yield. It is also a strategy that is constrained by the limited availability of grant dollars.

1 *This article is an adaptation of a National Community Capital technical assistance memo written by Laura Sparks.*

2 *Comptroller of the Currency, Administrator of National Banks, in an opinion letter dated January 23, 1997, concerning Citibank's Equity Equivalent investment in the National Community Capital Association.*

**DEVELOPING A SOLUTION**

In 1995, National Community Capital set out to create a new financial instrument that would function like equity for nonprofit CDFIs. To realize this goal, National Community Capital chose an experienced partner—Citibank—to help develop an equity equivalent that would serve as a model for replication by other nonprofit CDFIs and to make a lead investment in National Community Capital. The equity equivalent investment product, or EQ2, was developed through the Citibank/National Community Capital collaboration and provides a new source and type of capital for CDFIs.

**THE EQUITY EQUIVALENT — WHAT IS IT?**

The Equity Equivalent, or EQ2, is a capital product for community development financial institutions and their investors. It is a financial tool that allows CDFIs to strengthen their capital structures, leverage additional debt capital, and as a result, increase lending and investing in economically disadvantaged communities. Since its creation in 1996, banks and other investors have made more than \$70 million in EQ2 investments and the EQ2 has become an increasingly popular investment product with significant benefits for banks, CDFIs and economically disadvantaged communities.

The EQ2 is defined by the six attributes listed below. All six characteristics must be present; without them, this financial instrument would be treated under current bank regulatory requirements as simple subordinated debt.

1. The equity equivalent is carried as an investment on the investor's balance sheet in accordance with Generally Accepted Accounting Principles (GAAP)
2. It is a general obligation of the CDFI that is not secured by any of the CDFI's assets
3. It is fully subordinated to the right of repayment of all of the CDFI's other creditors
4. It does not give the investor the right to accelerate payment unless the CDFI ceases its normal operations (i.e., changes its line of business)
5. It carries an interest rate that is not tied to any income received by the CDFI
6. It has a rolling term and therefore, an indeterminate maturity

Like permanent capital, EQ2 enhances a CDFI's lending flexibility and increases its debt capacity by protecting senior lenders from losses. Unlike permanent capital, the investment must eventually be repaid and requires interest payments during its term, although at a rate that is often well below market. The equity equivalent is very attractive because of its equity-like character, but it does not replace true equity or permanent capital as a source of financial strength and independence. In for-profit finance, a similar investment might be structured as a form of convertible preferred stock with a coupon.

## ACCOUNTING TREATMENT

An investor should treat the equity equivalent as an investment on its balance sheet in accordance with GAAP and can reflect it as an “other asset.” The CDFI should account for the investment as an “other liability” and include a description of the investment’s unique characteristics in the notes to its financial statements. Some CDFIs have reflected it as “subordinated debt” or as “equity equivalent.” For a CDFI’s senior lenders, an EQ2 investment functions like equity because it is fully subordinate to their loans and does not allow for acceleration except in very limited circumstances (i.e., material change in primary business activity, bankruptcy, unapproved merger or consolidation).

## CRA TREATMENT

On June 27, 1996, the OCC issued an opinion jointly with the Federal Deposit Insurance Corporation, Office of Thrift Supervision, and the Federal Reserve Board that Citibank would receive favorable consideration under CRA regulations for its equity equivalent investment in National Community Capital. The OCC further stated that the equity equivalents would be a qualified investment that bank examiners would consider under the investment test, or alternatively, under the lending test. In some circumstances Citibank could receive consideration for part of the investment under the lending test and part under the investment test.<sup>3</sup>

This ruling has significant implications for banks interested in collaborating with nonprofit CDFIs because it entitles them to receive leveraged credit under the more important CRA lending test. The investing bank is entitled to claim a pro rata share of the incremental community development loans made by the CDFI in which the bank has invested, provided these loans benefit the bank’s assessment

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*This special debt investment is a precedent-setting community development debenture that will permit ‘equity-like’ investments in not-for-profit corporations.*

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area(s) or a broader statewide or regional area that includes the assessment area(s). The bank’s pro rata share of loans originated is equal to the percentage of “equity” capital (the sum of permanent capital and equity equivalent investments) provided by the bank.

For example, assuming a nonprofit CDFI has “equity” of \$2 million—\$1 million in the form of permanent capital and \$1 million in equity equivalents provided by a commercial bank—the bank’s portion of the CDFI’s “equity” is 50 percent. Now assume that the CDFI uses this \$2 million to borrow \$8 million in senior debt. With its \$10 million in capital under management, the CDFI makes \$7 million in community development loans over a two-year period. In this example, the bank is entitled to claim its pro rata share of loans originated—50 percent or \$3.5 million. Its \$1 million investment results in \$3.5 million in lending credit over two years. This favorable CRA treatment provides another form of “return on investment” for a bank

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<sup>3</sup> See the Resources section of National Community Capital’s website [www.communitycapital.org](http://www.communitycapital.org) for a copy of the opinion letter.

in addition to the financial return. The favorable CRA treatment is a motivating factor for many banks to make an EQ2 investment.

## OUTCOMES AND BENEFITS

National Community Capital estimates that approximately \$70 million in EQ2 investments have been made by at least twenty banks, including national, regional and local banks. These transactions have resulted in the following benefits:

*EQ2 capital has made it easier for CDFIs to offer more responsive financing products.*

With longer-term capital in the mix, CDFIs are finding they can offer new, more responsive products. Chicago Community Loan Fund, one of the first CDFIs to utilize EQ2, once had difficulty making the ten-year mini-permanent loans its borrowers needed. Instead, Chicago had to finance these borrowers with seven-year loans. With over 15% of its capital in the form of EQ2, Chicago can now routinely make ten-year loans and has even started to offer ten-year financing with automatic rollover clauses that effectively provide for a twenty-year term. Cascadia Revolving Fund, a CDFI based in Seattle, finds EQ2 a good source of capital for its quasi-equity financing and long-term, real estate-based lending, and Boston Community Capital has used the EQ2 to help capitalize its venture fund.

*Very favorable cost of capital.* When National Community Capital first developed the equity equivalent with Citibank, National Community Capital was uncertain about where the market would price this kind of capital. The market rate for EQ2 capital seems to be between two to four percent.

*Standardized documentation for EQ2 investments.* As EQ2 transactions become more common, CDFI’s and banks

## ABOUT THE AUTHOR



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have worked to standardize the documentation, thereby lowering transaction costs, reducing complexity and expediting closing procedures. There are good examples of both short, concise EQ2 agreements and longer, more detailed agreements. Of particular note are the loan agreements crafted by Boston Community Capital and US Bank. US Bank's three-page agreement, which succinctly lays out the investment terms and conditions, is a user-friendly document that has been used with approximately 25 CDFIs.

The Boston Community Capital documents, with a 23-page loan agreement and a three-page promissory

note, are substantially longer and more detailed, but include several statements and provisions that may make a hesitant bank more likely to simply use the CDFI's standard documents. For example, the agreement specifically references the OCC opinion letter recognizing an EQ2 investment as a qualified investment and includes a formal commitment from Boston Community Capital to assist a bank investor with a Bank Enterprise Award application.<sup>4</sup>

*Non-bank investors are beginning to utilize EQ2 investments.* Although banks have a unique incentive under the CRA to invest in equity equivalents, other investors can and are beginning to use the tool as well. Chicago Community Loan Fund has secured an EQ2 from a foundation, and Boston Community Capital has secured an EQ2 from a university. While the university and foundation do not have the same CRA incentives, they are able to demonstrate leveraged impact in their communities by making an EQ2 investment—rather than a loan—similar to how banks claim leveraged lending test credit under CRA.

### BANK ENTERPRISE AWARD (BEA) CREDIT FOR EQ2 INVESTMENTS

The CDFI Fund's BEA program gives banks the opportunity to apply for a cash award for investing in CDFIs. Banks typically receive a higher cash award (up to 15% of their investment) for equity-like loans in CDFIs than for typical loans (up to 11% of investment). To classify as an equity-like investment for the BEA program, EQ2 investments must meet certain characteristics, including having a minimum initial term of ten years, with a

five year automatic rolling feature (for an effective term of 15 years). The EQ2 must also meet other criteria, which are described in the Fund's Equity-Like Loan Guidance (available through the BEA page of the Fund's website: [www.treas.gov/cdfi](http://www.treas.gov/cdfi)). For more information on qualifying for equity-like loans under the BEA program, visit the Fund's website or contact the CDFI Fund at 202.622.8662.

### CONCLUSION

For CDFIs to grow and prosper, they will need to create more sophisticated financial products that recognize the different needs and motivations of their investors. The EQ2 is one step in this direction. Unlike investors in conventional financial markets, CDFI investors (and particularly investors in non-profit CDFIs) have few investment products to choose from. The form of investment is typically a grant or a below-market senior loan. This new investment vehicle, the EQ2, is one step in developing the financial markets infrastructure for CDFIs by creating a new innovative product which is particularly responsive to one class of investors—banks. Further development and innovation in CDFI financial markets will help increase access to and availability of capital for the industry. **CI**

### ADDITIONAL RESOURCES

Please visit National Community Capital's website [www.communitycapital.org](http://www.communitycapital.org) for the following free documents:

- Sample Equity Equivalent Agreements
- Regulatory Opinions Letters regarding EQ2

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<sup>4</sup> *The Bank Enterprise Award Program is a program of the CDFI Fund that provides incentives for banks to make investments in CDFIs.*

## REGULATORY OVERVIEW

### INVESTMENT TYPE: LOW-INCOME HOUSING TAX CREDITS (LIHTCs)

**Definition:** The equity equivalent investment product (EQ2) is a long-term deeply subordinated loan with features that make it function like equity. These features include the six attributes listed below which are characteristics that must be present under current bank regulatory restrictions. Without them, this financial instrument would be treated as simple subordinated debt. Like permanent capital, the equity equivalent investment enhances the non-profit's lending flexibility and increases the organization's debt capacity by protecting senior lenders from losses. Unlike permanent capital, investments must eventually be repaid and they require interest payments be made during their terms, although at rates that are usually below market. In for-profit finance, a similar investment might be structured as a form of "convertible preferred stock with a coupon."

**Attributes:**

1. The equity equivalent is carried as an investment on the investing institution's balance sheet in accordance with Generally Accepted Accounting Principles (GAAP),
2. It is a general obligation of the non-profit organization that is not secured by any of the non-profit organization's assets,
3. It is fully subordinated to the right of repayment of all of the other non-profit organization's creditors,
4. It does not give the investing institution the right to accelerate payment unless the non-profit organization ceases its normal operations (i.e., changes its line of business),
5. It carries an interest rate that is not tied to any income received by the non-profit organization, and
6. It has a rolling term and therefore, an indeterminate maturity.

**CRA Applicability:** On June 27, 1996, and March 28, 1997, the four federal bank regulatory agencies issued joint interpretive letters that financial institutions would receive favorable consideration under the CRA regulation for investments in equity equivalents. The June 27 letter stated that equity equivalents would be qualified investments under the investment test, or alternatively, under the lending test (the pro rata share of loans originated equal to the percentage of "equity" capital provided by the institution). In some circumstances a financial institution could receive consideration for part of the investment under the lending test and part under the investment test. (See the FFIEC interpretive letter issued June 14, 1996.)

# Small Business Investment Companies

by Lawrence S. Mondschein, Managing Director, CRA Funding LLC

Investing in Small Business Investment Companies (SBICs) is a CRA qualified activity that offers banks potential profits competitive with other lines of business. SBICs enjoy a special status within the CRA because they are recognized as specifically CRA-eligible. And, as will be mentioned in more detail a bit later in this article, SBICs may also enjoy a favored position in the emerging Gramm-Leach-Bliley regulatory framework relative to other permissible merchant banking activities. Nevertheless, SBICs pose certain challenges to those institutions seeking to participate in them. Participation in SBICs through a diversified special purpose investment vehicle may be an attractive alternative for many institutions and may help address these challenges.

## THE SBIC PROGRAM

The SBIC program was established with passage of the Small Business Investment Act of 1958, which aimed to foster economic development by facilitating the flow of equity capital and long-term loans into small businesses. Pursuant to the Act, the SBA, through the use of public markets and a government guarantee, provides capital to SBICs at rates which are pegged to the cost of funds to the United States Government. These low-cost funds expand the financing capacity of SBICs and can substantially increase the financial return to their private investors.

There are presently almost 500 licensed SBICs with over \$15 billion in private capital. SBICs that are wholly owned by banks represent about half the industry and receive no capital from SBA. These SBICs were particularly prevalent in the Glass-Steagall era when

they represented the primary vehicle through which banks could invest in the equity securities of private companies. Passage of Gramm-Leach-Bliley has removed this incentive for their formation.

The types of SBICs of most interest to investors are Debenture SBICs and Participating Security SBICs. Debenture SBICs, which date back to the establishment of the SBIC program, borrow money from SBA and in turn provide it to small businesses, typically in the form of fixed-income securities. The Participating Security program was established in 1994 to better accommodate the needs of the many small businesses that are not yet generating sufficient cash flow to service debt. Participating Security SBICs, which typically make equity investments in small businesses, receive funding from SBA on terms similar to those of Debenture SBICs, but instead of paying interest on a current basis to SBA, they remit to the SBA a portion of the profits they earn on their investment portfolio.

SBICs enjoy a mandate to invest in a broad range of companies. As long as SBIC managers comply with SBA regulatory guidelines, they need consider only the financial merits of prospective investments. With a few industry exceptions, SBICs may invest in companies that have as much as \$6 million in average net income for the two preceding fiscal years and \$18 million in net worth.

SBICs have been quite profitable in recent years. In FY2000, for example, SBICs overall had a 39% return on invested capital (ROI) and Participating Security SBICs had an ROI

of 99.4%. CRA Funding's analysis of data reported by SBA suggests that Participating Security SBICs have realized returns of three times their cost basis with nearly \$4 billion of realized assets. As impressive as this performance has been, those returns were not evenly distributed among SBICs and occurred in a historically favorable investment climate.

## CRA QUALIFICATION OF SBICs

SBICs enjoy unusual clarity with respect to their qualification for consideration under the CRA. SBICs were specifically identified as an example of a qualified investment in the preamble to the CRA regulation published in 1995. In 1997, SBICs were granted a special status with the initial publication of the Federal Financial Institutions Examination Council's (FFIEC) Questions and Answer document on the CRA which serve as guidance by regulators to their field examiners and the CRA community. In this guidance, regulators established a "purpose test" to determine whether an investment by a bank constitutes "community development." Despite their broader investment mandate, SBICs were effectively exempted from the purpose test by the regulators who created a presumption "that any loan to or investment in a . . . Small Business Investment Company promotes economic development" and is potentially a qualified CRA investment.

The CRA regulation requires that community development activities benefit an institution's assessment area "or a broader statewide or regional area that includes the bank's assess

ment area(s).” Pursuant to guidance issued earlier this year, banks that have already met the needs of their assessment area need not consider the inclusion of their assessment area in the broader geographic investment activity. Regulators may also evaluate the prospective impact an investment has on communities within an assessment area.

SBICs are particularly well suited to operate in a broad geography while, at the same time, benefiting a specific area within the region. This is because for every dollar invested by a CRA-oriented institution, the SBA matches that investment exponentially. As a result, even though the investing activity may be over a relatively broad geography, this multiplier increases the likelihood of a dollar-for-dollar, *bona fide* impact on a bank’s assessment area.

Investing in SBICs can be a challenge for many institutions. Since SBICs provide equity, they have a higher risk profile than most other banking industry lines of business. Moreover, SBICs offer limited current return and as ten-year private partnerships are generally not liquid. Banking regulations recognize these risks and typically limit financial institution SBIC investments to five percent of net capital.

Largely because of the CRA, SBICs seek out bank investors operating in their geographies. Some banks have chosen to operate collectively in forming regionally focused SBICs or by participating with banks from other regions in professionally managed partnerships that purchase diversified portfolios of SBICs.

While SBICs no longer enjoy a near-monopoly on bank private equity investment activity, they may retain an important advantage under the Gramm-Leach-Bliley Act. Regulators impose a special, higher reserve requirement on merchant banking

activities authorized by Gramm-Leach-Bliley. It is likely these requirements will not be imposed on SBIC investments. So, while the amount of capital a bank may deploy in an SBIC remains limited, the associated “regulatory cost of capital” may ultimately be less than the cost of non-SBIC investments.

### FINANCIAL REPORTING AND ACCOUNTING

Accounting and financial reporting of SBICs is similar to that for other assets held for investment. When an institution makes a commitment to an SBIC, it makes a small capital contribution that is recorded on the balance sheet as an asset. The balance of the commitment shows up as a contingent liability in the institution’s call report. Once recorded in the bank’s financial reporting system, the full amount of the commitment is eligible for CRA consideration. Fees and expenses of the SBIC that typically result in operating losses in the early years are generally capitalized on the balance sheet and not offset against operating earnings of the bank. They may, however, be deducted for tax purposes. The most common practice is to continue recording the investment on a cost basis until distributions are received or a demonstrable event occurs with respect to the SBIC’s portfolio to justify a change in valuation.

### SUMMARY AND CONCLUSIONS

In summary, SBICs enjoy a unique position within the CRA framework that makes them ideally suited to that portion of a CRA portfolio where profit generation is the paramount goal. Institutions that understand and can tolerate the risks of private equity investing can enjoy enhanced financial and regulatory benefits by investing in SBICs. *CI*

LAWRENCE MONDSCHN is the managing director of CRA Funding, LLC which is the Manager and General Partner of the CRA Fund of SBICs. The Fund, all of whose limited partners are banks, invests in a diversified portfolio of Small Business Investment Companies (SBICs) throughout the United States.

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## REGULATORY OVERVIEW

### INVESTMENT TYPE: SMALL BUSINESS INVESTMENT COMPANIES (SBICs)

**Definition:** SBICs are privately-owned venture capital funds licensed by the Small Business Administration (SBA) to invest in the long-term debt and equity securities of small businesses. These businesses possess generally less than \$18 million in net assets or \$6 million in annual net income and are represented in a variety of industries such as manufacturing, services and wholesale trade. Almost 75 percent of the small businesses funded by SBICs are non-technology businesses. The SBA provides “financial assistance” to SBICs by purchasing securities from them on terms which are related to the cost of funds to the U.S. Government. These low-cost funds, or “leverage,” augment the private capital invested in the SBIC and may represent up to 66 percent of the capitalization of an SBIC. The amount and attractive terms of this leverage have the potential to substantially increase the financial returns to private investors. As of March 1999, there were a total of 332 SBICs licensed to operate with a total of almost \$10 billion in capital committed both from private sources and the SBA.

**CRA Applicability:** The CRA regulation defines the term “community development” to include activities that promote economic development by financing small businesses or farms that meet the size eligibility standards of the Small Business Administration’s Development Company or Small Business Investment Company programs (13 CFR 121.301) or have gross annual revenues of \$1 million or less. According to the Federal Financial Institutions Examination Council (FFIEC), examiners “will now presume that any loan to or investment in an SBIC promotes economic development.”

## ANNOUNCING . . .

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The State of Oregon	The State of Utah	Seattle, WA
Spokane, WA		

A pdf version can be downloaded from [www.frbsf.org/community/index.html](http://www.frbsf.org/community/index.html), or call Bruce Ito at (415) 974-2422 to receive a hard copy.



# Investing in CRA-Qualified Municipal Securities

By Barbara Rose VanScoy, Principal, CRA Fund Advisors

## BACKGROUND

The Community Reinvestment Act (CRA) requires regulated banks and thrifts to meet the credit needs of their communities. Large institutions—those with assets greater than \$250 million—are subject to three performance tests: lending, service and investment. Small institutions—those with total assets under \$250 million or an affiliate with total banking and thrift assets of less than \$1 billion at the end of the previous two years—can opt to have examiners review their performance under the investment test. For small institutions, investment test performance may be used to enhance a satisfactory rating, but may not be used to lower a rating.

While financial institutions are experienced with the lending and service aspects of the performance tests, some banks are still grappling with what constitutes a qualified investment. Under CRA, a qualified investment has as its primary purpose community development when it is designed for the express purpose of revitalizing or stabilizing low- or moderate-income areas, or providing affordable housing for or community services to low- to moderate-income persons. This allows banks and thrifts the latitude to invest in the communities that they serve through creative means rather than dic-

tated measures. Performance under the investment test is based on:

- the dollar amount of qualified investments
- the innovativeness or complexity of qualified investments
- the responsiveness of qualified investments to credit and community development need, and
- the degree to which qualified investments are not routinely provided by private investors

Finally, qualified investments must benefit the financial institution's assessment area(s) or a broader statewide or regional area that includes the assessment area(s).

The Interagency CRA Q&A<sup>1</sup> provides some examples of qualified investments. These include: state and municipal obligations, such as revenue bonds, that specifically support affordable housing or other community development; projects eligible for low-income housing tax credits; and organizations supporting the capacity of low- and moderate-income people or geographies to sustain economic development. The regulations also state that "as a general rule, mortgage-backed securities and municipal bonds are not qualified investments because they do not have as their primary pur-

pose community development, as defined in the CRA regulations." Thus, the key to investing in municipal securities is in determining the primary purpose of the bond issue.

## HOUSING BONDS

In order to qualify as a community development investment, housing-related securities must primarily address affordable housing. Housing bond issues are generally either single-family or multi-family and can be local or statewide issues.

**Single Family Issues:** Single-family bond deals are usually targeted to geographic areas, such as cities and counties, or to a broader statewide area, and are often aimed at first-time borrowers. In analyzing single-family issues, financial institutions should look closely at the eligible participants for the bond program. Because housing authorities frequently define low- to moderate-income under a broader definition than the CRA regulations allow, the bank should research who ultimately benefits from the programs.

For example, the Idaho Housing and Finance Association permits participants in their residential lending program to have annual gross incomes up to certain limits, depending on which county the borrower lives in and the number

<sup>1</sup> <http://www.ffiec.gov/cra/qnadoc.htm>

of people in the household. In 1999, some targeted counties allowed borrowers to have incomes in excess of 140 percent of median family income. (To qualify as moderate-income under CRA, borrowers' incomes cannot exceed 80 percent of median family income.) Further research revealed that the average borrower in the Idaho Housing Program had an income of \$32,681 in 2000. The statewide median income for Idaho for fiscal year 2000 was \$43,700. Therefore, on average, the borrowers participating in the Idaho Housing and Finance Association residential lending program were moderate income.

Because of this confusion, some finance agencies have taken further steps to accommodate financial institution qualified investing. The Washington State Housing Finance Commission issues CRA Taxable Single-Family Program Bonds and imposes an annual income limitation of 80 percent or below of the Metropolitan Statistical Area's median income, which is in line with the regulators' definition. Programs such as these help facilitate community development investing by CRA-mandated institutions. Banks interested in investing in these types of issues should ensure that the housing authority's residential lending program guidelines coincide with those cited in the CRA regulations.

**Multi-family Issues:** Multi-family bond issues typically finance the construction and rehabilitation of apartment complexes. To be considered affordable, there must be a low- to moderate-income set-aside or some other income restriction. Not all multi-family housing deals address affordable housing. As with single-family issues, the bank should closely examine how the housing authority or issuer defines 'qualifying' or 'eligible tenants.'

## HEALTHCARE ISSUES

Some bond proceeds are used to support healthcare facilities that serve a community development purpose. Community development includes health or social services targeted to low- or moderate-income persons. Hospitals, nursing homes, assisted living facilities and homes for the developmentally disadvantaged may qualify under CRA regulation if the patients at these facilities are low- to moderate-income. Usually these facilities serve a large share of Medicaid patients, whose incomes fall within the guidelines of CRA.

## TAX ALLOCATION BONDS

Tax Allocation Bonds are bonds issued in conjunction with a specific redevelopment project—typically affordable housing. The taxes pledged to their repayment come from the increased assessed value over and above a pre-established base. The redevelopment creates this added value, known as the tax increment. Many states use tax increment financing (TIF), which provides for the financing of redevelopment projects through the use of tax increment revenues. Obviously, since not all community development activities occur in low- or moderate-income areas, it is important to explore beyond the project description and establish the income composition of the community.

## ECONOMIC DEVELOPMENT

Many bond deals state their purpose as economic development. For regulatory purposes, there must be some determination of how the primary purpose is community development. Under CRA, an activity promotes economic development if it, "supports permanent job creation, retention, and/or improvement for persons who are currently low- or moderate-income; or supports perma-

nent job creation, retention, and/or improvement either in low- or moderate-income geographies or in areas targeted for redevelopment by federal, state, local or tribal governments." Ultimately, the community development purpose should be quantifiable in jobs created or retained, affordable housing units or other economic development activities.

## ELIGIBLE INVESTMENTS

Aside from looking at the primary purpose of the issue, financial institutions must also analyze certain attributes associated with the bonds. Investment policies may restrict purchases of eligible investments because of rating or maturity constraints. Smaller deals may be non-rated or below investment grade because of the costs associated with insuring the bonds and thus ineligible investments for banks that can only invest in grade BBB or higher securities. Some investment policies limit the purchase of securities to maturities inside of ten years, although it is not uncommon for multi-family securities to have maturities of 30 to 40 years. Other banks are limited to taxable or bank qualified municipal securities (i.e. issues under \$10 million). Furthermore, bank qualified issues are generally limited to revenue bonds, which is only a fraction of the municipal market. This significantly reduces the universe of available opportunities. Taxable municipal securities offer a greater opportunity for investment than bank qualified issues, as issuance is considerably larger, both in the frequency of issues and the overall dollar volume generated.

## PURCHASING QUALIFIED INVESTMENTS

Purchasing qualified investments usually requires a concerted effort by different divisions within the banking organization. Bank investment officers

often have a negative perception of qualified investments and choose to purchase only under duress from other areas of the financial institution. It is very important that the person responsible for monitoring CRA compliance establishes a strong working relationship with the person responsible for investing on the bank's behalf.

Unlike other investments, securities with a primary purpose of community development are not common in the market place. Because community development investments trade rapidly, especially in areas with a strong investor demand, financial institutions should be poised to respond quickly to qualified investment opportunities. This often requires establishing a network of investment professionals who are familiar with qualified investments. This network is a valuable resource for identifying projects currently trading in the market place, as well as sources for new origination. Given the limited expertise in CRA qualified investments, financial institutions should look for investment professionals with a proven track record, who are committed to researching and providing ample docu-

mentation to support the investment's community development purpose. While a bank or thrift should not depend solely on an outside source for supporting documentation, the financial institution should request verification of the qualified investment before undertaking any transaction.

### CONCLUSION

Analyzing municipal securities as community development investments requires banks to explore the purpose, the structure and the credit risk of the issue. Financial institutions should establish a framework for examining qualified investments. A plan of action should also be developed so that community development and investment officers know what to look for and how much to invest. Examiners are often willing to suggest firms that specialize in qualified investment transactions if the institution is having difficulty finding or investing on their own. Ultimately, it is up to the financial institution to clearly understand the primary purpose of the issue and be able to relate that to their examiner. **CI**

### ABOUT THE AUTHOR



BARBARA ROSE VANSCOY is a principal at CRAFT Fund Advisors, the registered investment advisor for the CRA Qualified Investment Fund. Ms. VanScoy is responsible for researching and documenting qualified investments on behalf of the CRA Qualified Investment Fund's shareholders. Prior to joining CRAFT Fund Advisors, Ms. VanScoy was the director of research at SunCoast Capital Group. While there, she also headed SunCoast's Community Development Initiative, in which she assisted their depository clients with community development investing. Ms. VanScoy was previously employed with Raymond James Tax Credit Funds as the director of debt placement, and as a vice president in fixed income research. She is a graduate of the University of Florida with a BSBA in finance, and a specialization in Latin American studies. She can be reached through CRAFT Fund Advisors at 877/272-1977 or directly at 800/519-7065.

## A BANKER'S QUICK REFERENCE GUIDE TO COMMUNITY DEVELOPMENT MUNICIPAL BONDS

**Definition:** *Municipal bond* is a general term referring to securities issued by states, cities, towns, counties and special districts. A primary feature of these securities is that interest on them is generally exempt from federal income taxation and, in some cases, state income taxation. Because of this feature, the interest rates on municipal bonds are lower than interest rates on other types of bonds, but when taking into account one's income taxes, often provide a comparable, or better rate of return. Revenue bonds are municipal bonds secured and repaid only from a specified stream of non-tax revenues. Examples of revenues include tolls, utility charges, or charges and use fees from a facility being constructed with the proceeds of a bond issue, such as a sports facility or a housing project.

At one time, banks were permitted to deduct all the interest expense incurred to purchase or carry municipal securities. Tax legislation subsequently limited the deduction first to 85 percent of the interest expense and then to 80 percent. The 1986 tax law eliminated the deductibility of interest expense for bonds acquired after August 6, 1986. The exception to this non-deductibility of interest expense rule is for bank-qualified issues. An issue is bank-qualified if:

1. It is a tax-exempt issue (other than private activity bond) including any bonds issued by 501(c)(3) organizations, and
2. It is designated by the issuer as bank qualified and the issuer or its subordinate entities do not intend to issue more than \$10 million a year of such bonds

# Mortgage-backed Securities & Collateralized Mortgage Obligations: Prudent **CRA INVESTMENT** Opportunities

*by Andrew Kelman, Director, National Business Development Securities Sales and Trading Group, Freddie Mac*

Mortgage-backed securities (MBS) have become a popular vehicle for financial institutions looking for investment opportunities in their communities. CRA officers and bank investment officers appreciate the return and safety that MBSs provide and they are widely available compared to other qualified investments.

Mortgage securities play a crucial role in housing finance in the U.S., making financing available to home buyers at lower costs and ensuring that funds are available throughout the country. The MBS market is enormous with the volume of outstanding MBSs exceeding \$3.8 trillion. Investors include corporations, banks and thrifts, insurance companies and pension funds. MBSs are popular because they provide a number of benefits to investors including liquidity, yield and capital management flexibility. CRA officers should understand these benefits to enable them to work with bank investment officers.

## UNDERSTANDING MBSs

An MBS is similar to a loan. When a bank purchases an MBS, it effectively lends money to the borrower/homeowner who promises to pay interest and to repay the principal. The purchase effectively enables the lender to make more mortgage loans. MBSs are known as “fixed-income” investments and represent an ownership interest in mortgage loans. Other types of bonds include U.S. government securities, municipal bonds, corporate bonds and federal agency (debt) securities.

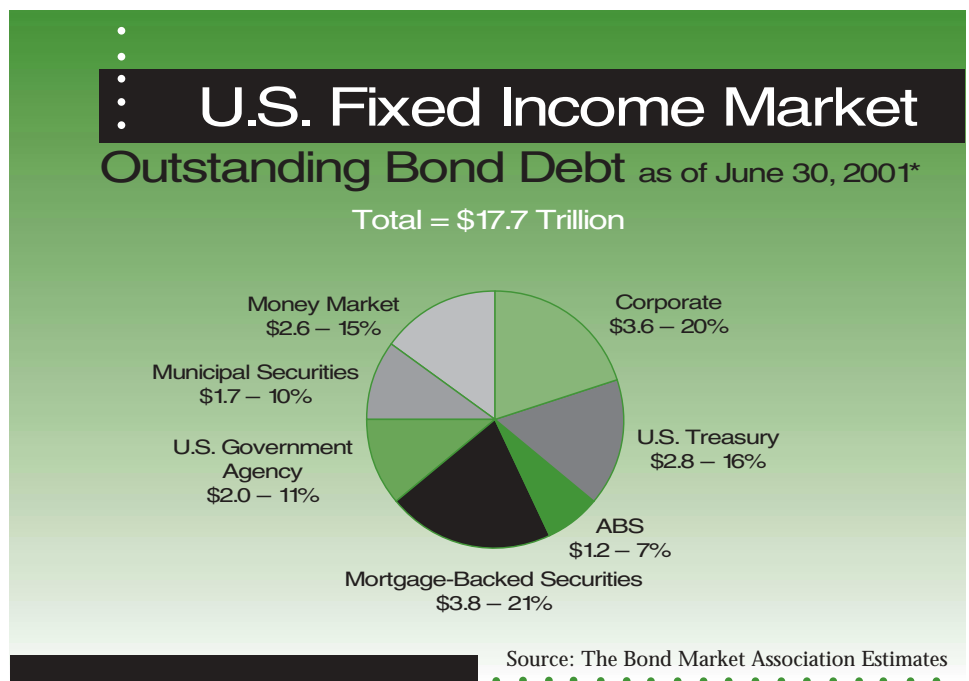
Here is how MBSs work. Lenders originate mortgages and provide groups of similar mortgage loans to organizations like Freddie Mac and Fannie Mae, which then securitize them. Originators use the cash they receive to provide additional mortgages in their communities. The resulting MBSs carry a guarantee of timely payment of principal and interest to the investor and are further backed by the mortgaged properties themselves. Ginnie Mae securities are backed by the full faith and credit of the U.S. Government. Some private institutions issue MBSs, known as “private-label” mortgage securities in contrast to “agency” mortgage securities issued and/or guaranteed by Ginnie Mae, Freddie Mac or Fannie Mae. Investors tend to favor agency MBSs

because of their stronger guarantees, better liquidity and more favorable capital treatment. Accordingly, this article will focus on agency MBSs.

The agency MBS issuer or servicer collects monthly payments from homeowners and “passes through” the principal and interest to investors. Thus, these pools are known as mortgage pass-throughs or participation certificates (PCs). Most MBSs are backed by 30-year fixed-rate mortgages, but they can also be backed by shorter-term fixed-rate mortgages or adjustable rate mortgages.

## LIQUIDITY

Agency MBSs are extremely liquid. Because there is a large amount of outstanding mortgage securities and investors, there is a sizable and active sec



ondary market. Investors can easily buy, sell or borrow against MBSs. The liquidity of MBSs is enhanced by the relative homogeneity of the underlying assets, compared with corporate bonds (different issuers, industries and credit) or municipal bonds (state issued, authority issued, revenue bond, etc.).

## YIELD

Mortgage-backed securities offer attractive risk/return profiles. There are higher yielding fixed-income investments in the marketplace, but they have greater credit risk. MBSs have traditionally provided returns that exceed those of most other fixed-income securities of comparable quality.<sup>1</sup> MBSs are often priced at higher yields than Treasury and corporate bonds of comparable maturity and credit quality.

## CAPITAL MANAGEMENT

For banks and thrifts, agency MBSs are considered bank-qualified assets. They can be held in higher concentration than other assets. In addition, the risk-based capital treatment of agency MBSs is superior to that for corporate and many municipal bonds. For example, depositories holding Ginnie Maes do not have to hold risk-based capital (RBC) against the assets and they have to hold just 20% of the RBC requirement for Freddie and Fannie MBSs. This contrasts with a 100% RBC requirement for corporate bonds and up to 50% for municipal bonds. Finally, there is an active repurchase (“repo”) market for MBSs that enables institutions to earn increased income from their investments by lending in the repo market.

## SUPPORTING CRA OBJECTIVES WITH MBSs

The affordable housing goals that the U.S. Department of Housing and Ur-

ban Development (HUD) set for Freddie and Fannie (e.g., 50% of their business must be to low-and-moderate income (LMI) borrowers) help depository institutions to achieve their LMI objectives through MBS investments.

Usually, MBSs are comprised of loans scattered throughout the country to borrowers with varying incomes. To support CRA objectives, affordable housing MBSs are created with loans to LMI borrowers in specified geographies. As a “qualified investment,” the MBS should include loans in an institution’s assessment area or in a “statewide or regional area that includes the assessment area.” At least 51% of the dollars in the MBS should be in loans to LMI borrowers, although most total 100%. In addition, a financial institution that, considering its performance context, has adequately addressed the community development needs of its assessment area(s) will receive consideration for MBSs with loans located within a broader statewide or regional area. “Examiners will consider these activities even if they will not benefit the institution’s assessment area(s).”<sup>2</sup>

The Federal Financial Institutions Examination Council (FFIEC) issued an opinion letter (#794) indicating that targeted MBSs may receive positive CRA consideration. This has been reinforced by scores of CRA examinations. Moreover, as lending-related qualified investments, CRA-qualified MBSs assist “small banks” with their CRA performance by enabling an upward adjustment of their loan-to-deposit ratio.

CRA-qualified MBSs increase the supply of affordable housing. Freddie Mac’s Securities Sales & Trading Group (SS&TG) pays a premium to originators for the LMI loans that they provide, giving originators an incentive

to create additional LMI lending opportunities in communities, which is the essence of the CRA. Bank purchases of MBS pools from Freddie Mac support this affordable housing initiative. Since more than 2/3 of mortgages are originated by companies whose loan officers work on commission and have an incentive to originate mortgages on expensive homes, SS&TG creates an incentive to originate LMI loans.

Here are reasons to consider MBSs as part of a CRA strategy:

- Payment of principal and interest is guaranteed
- Market rate return
- No management fees
- Favorable capital treatment
- Liquid investment – can be sold or borrowed against
- Flexible – can be tailored to bank’s assessment area and sold in varying amounts
- Low transaction costs
- Available everywhere—even in rural areas

## EVALUATING AND PURCHASING MBSs

Banks and other investors buy MBSs from securities dealers such as SS&TG, Freddie Mac’s in-house mortgage securities dealer operation. New MBSs usually sell at or close to their face value. However, MBSs traded in the secondary market fluctuate in price as interest rates change. When the price of an MBS is above or below its face value, it is said to be selling at a pre-

1 Source: *The Bond Market Association*

2 *FFIEC Question and Answer Document on CRA*

mium or a discount, respectively. The price paid for an MBS is based on variables including interest rates, the coupon rate, type of mortgage backing the security, prepayment rates and supply and demand.

MBSs issued in book-entry<sup>3</sup> form initially represent the unpaid principal amount of the mortgage loans. Freddie Mac and Fannie Mae MBSs issued in book-entry form are paid by wire transfer through the central paying agent, the Federal Reserve Bank of New York, which wires monthly payments to depository institutions. Depositories put the MBS in “held to maturity” or “available for sale” accounts, depending on their investment strategy. Some investors hold bonds until they mature, while others sell them prior to maturity. Buy-and-hold investors worry about inflation, which makes today’s dollars worth less in the future.

Bank investment officers analyze the economic value of MBSs using a number of terms, including “weighted-average coupon” (WAC), which is the weighted average of the mortgage note rates, and “weighted-average life” (WAL), which is the average amount of time a dollar of principal is invested in an MBS pool. The most important measure used by investment officers to value investments is yield.

**Yield** is the return expressed as an annual percentage rate. Unlike other fixed-income investments, MBS principal payments are made monthly and may vary due to unscheduled prepayments (e.g., refinancing or sale of the mortgaged home), which may also affect the amount and timing of MBS interest payments and MBS yields. Prepayment assumptions are factored into price and yield to compare the value of a mortgage security with other fixed-income investments.

As fixed-income securities, MBS prices fluctuate with changing interest rates: when interest rates fall, prices rise, and vice versa. Interest rate movements also affect prepayment rates of MBSs. When interest rates fall, homeowners refinance mortgages, and prepayment speeds accelerate. Conversely, rising rates tend to decrease the prepayment speed. An earlier-than-expected return of principal increases the yield on securities purchased at a discount. However, when an MBS is purchased at a premium, an earlier-than-expected return of principal reduces yield.

Each MBS has a coupon, which is the interest rate passed on to the investor. The coupon is equal to the interest rate on the underlying mortgages in the pool minus the guarantee fee paid to the agency and the fee paid to the servicer. The WAC is the weighted average of the mortgage note rates and it is often used by investment officers to compare MBSs. In analyzing a potential MBS investment, the length of time until principal is returned is important and the concept of a weighted-average life (WAL) is used. Average life is the average amount of time a dollar of principal is invested in an MBS pool. The WAL is influenced by several factors, including the actual rate of principal payments on the loans backing the MBS. When mortgage rates decline, homeowners often prepay mortgages, which may result in an earlier-than-expected return of principal to an investor, reducing the average life of the investment. This can be thought of as an implied call risk. Investors are then forced to reinvest the returned principal at lower interest rates. Conversely, if mortgage rates rise, homeowners may prepay slower and investors may

find their principal committed longer than expected, which prevents them from reinvesting at the higher prevailing rates. This scenario can be thought of as extension risk.

### COLLATERALIZED MORTGAGE OBLIGATION (CMO)

The prepayment uncertainty of MBSs led to Freddie Mac’s development of the collateralized mortgage obligation (CMO) in 1983. This more complex type of mortgage security helps compartmentalize prepayment risk and better addresses investment time frames and cash-flow needs. Since 1986, most CMOs have been issued in real estate mortgage investment conduit (REMIC) form for tax purposes. The terms are now used interchangeably.

MBSs are pooled to create CMOs. In structuring a CMO, an issuer distributes cash flow from the underlying collateral over a series of classes called tranches, each having average lives designed to meet specific investment objectives. As the payments on the underlying mortgage loans are collected, the CMO issuer usually first pays the coupon rate of interest to the bondholders in each tranche. All scheduled and unscheduled principal payments go first to investors in the first tranches. Investors in later tranches do not start receiving principal payments until the prior tranches are paid off. This basic type of CMO is known as a *sequential* CMO.

Almost all CRA MBSs are comprised of 30-year fixed-rate mortgages. Some bank investment officers find the average life of 30-year MBSs too long (since bank funding sources tend to be shorter). These investors can support affordable housing by purchasing a **CRA CMO** tranche, which is structured with CRA MBS pools to provide

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3 An electronic issuance and transfer system for securities transactions

shorter cash flows than the CRA MBS pools would normally provide. This enables many banks to invest more in CRA CMOs than they would be able to in CRA MBSs. Additionally, the innovative and complex CMO structure enables banks to leverage investment in affordable housing from non-CRA regulated institutions, since the long cash flows are sold to pension funds and insurance companies. This approach is not routinely provided by private investors. Additionally, CRA CMOs provide all the previously mentioned compliance and investment benefits of CRA MBSs. While the economics of developing complex securities like CMOs generally require development of tranches usually exceed-

ing \$20 million, pieces of tranches may be sold. Nevertheless, CRA CMOs are not as readily available as CRA MBSs.

### SUMMARY AND CONCLUSION

Both CRA MBSs and CRA CMOs meet the investment objectives of CRA officers while providing a safe and sound strategy with market rate returns. Investors increase the supply of financing for affordable housing through these products by leveraging investment in affordable housing from non-depositories and by incenting loan originators. As with all CRA products, institutions should discuss their unique circumstances with their regulator to determine suitability. **CI**

### ABOUT THE AUTHOR



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## REGULATORY OVERVIEW

### INVESTMENT TYPE: MORTGAGE-BACKED SECURITIES

**Definition:** Mortgage originators can either (1) hold a new mortgage in their portfolio, (2) sell the mortgage to an investor or conduit, or (3) use the mortgage as collateral for the issuance of a security. A mortgage-backed security (MBS) is a pool of mortgages that represent the collateral for a security. The cash flow pattern associated with an MBS is based on the payment of the individual mortgage loans underlying the security. The ability of borrowers/homeowners to prepay part or all of the mortgage at any time creates uncertainty regarding cash flow (above and beyond possible delinquencies), so investors usually wish to be compensated for accepting the risk of unscheduled payments. A targeted MBS is a security collateralized by a pool of mortgages originated to borrowers/homeowners whose incomes are 80 percent or below area median income.

**CRA Applicability:** As a general rule, mortgage-backed securities are not qualified investments under the CRA because they do not have as their primary purpose community development as defined in the CRA regulation. Nonetheless, mortgage-backed securities designed primarily to finance community development are qualified investments. These housing-related securities must primarily address affordable housing needs (including multifamily rental housing needs) in order to qualify. In addition, an institution may receive investment test consideration for purchases of these targeted mortgage-backed securities as long as they are not backed primarily or exclusively by loans that the same institution originated or purchased.

# Venture Capital for Communities

by Kerwin Tesdell, President, Community Development Venture Capital Alliance

Community development venture capital (CDVC) is one of the fastest growing sectors in the field of community development finance. From a handful of funds in 1990, the industry has grown to more than sixty funds in the United States, and at least another twenty funds operating or in formation in other parts of the world. In the last year alone, CDVC under management in the U.S. has grown to \$400 million, up \$100 million dollars from the end of 2000. Almost \$40 million of this increase was raised by three established managers that have successfully closed on second funds.<sup>1</sup>

## THE DOUBLE BOTTOM LINE

CDVC funds use the tools of venture capital to create jobs, wealth and entrepreneurial capacity to benefit low-income people and distressed communities. They are mission-driven funds that invest in businesses that promise rapid growth. This growth creates not only financial returns for the fund and its investors but also social returns in the form of good jobs for low-income people—a double bottom line.

CDVC funds apply disciplined equity investment practices in places where other venture capitalists do not go: inner cities and distressed rural communities. They offer financing to minority- and women-owned firms and

those that are environmentally focused. They invest in such businesses as new-economy manufacturing companies and promising new service-sector firms, which can offer good employment to large numbers of low-income people. They seek to apply principles that have helped create unprecedented economic growth in places from Silicon Valley to areas often left behind such as rural Appalachia, inner-city Baltimore and Nizhny Novgorod, Russia.

## THE IMPORTANCE OF EQUITY CAPITAL

Equity capital is vital to all businesses. It provides a cushion against slow business climates and is relatively patient and flexible. As any banker analyzing debt/equity ratios can tell you, without sufficient equity, companies cannot borrow additional funds. Most important for economic development, equity provides the seed funding to start new companies and allows established companies to develop new products or build new plants—activities that create significant new employment and economic opportunity.

Equity capital is difficult for any company to raise. Most entrepreneurs raise initial equity capital from their own savings and those of family and friends, but this is particularly hard to come by in low-wealth communities. A ready source of equity capital can thus be an extraordinarily effective tool for fueling the creation of new wealth in economically distressed areas and also new job opportunities for people who need them.

CDVC funds seek to create good

jobs that pay a living wage. To produce the financial portion of the double bottom line, CDVC funds must seek out companies that hold the promise of rapid growth. Companies that are growing and successful can afford to pay higher wages than companies that are just scraping by. Successful companies tend to offer better benefits to their employees, as well as job training and opportunities for advancement, and to attract and retain the workforce they need for expansion.

By providing equity and near-equity investments to businesses that otherwise would not have access to them, CDVC funds create a powerful engine of economic growth. Equity investments are made through the purchase of common or preferred stock, while near-equity investments might be made through a subordinated loan that carries an “equity kicker,” such as royalties or warrants to purchase stock. These investments each carry significant risk of loss but are structured so that the fund will share the “upside” of the business if the business does well.

## MORE THAN MONEY: ENTREPRENEURIAL AND MANAGERIAL ASSISTANCE

CDVC funds become part-owners of the companies in which they invest, tying their own success directly to the success of their portfolio businesses. As a result, CDVC funds invest not just money but a great deal of time and effort in helping the companies in which they invest succeed. They typically take seats or observer rights on the boards of their portfolio compa

<sup>1</sup> This includes Silicon Valley Community Ventures of San Francisco, California, which closed its second fund with a \$10 million commitment from the California Public Employees' Retirement System—the first capital ever committed to a CDVC fund by a retirement fund.



nies. Fund staff may help with such activities as raising additional capital or marketing a new product. Fund staff may even fill the chief financial officer function for a company for a period of time, then help recruit a new head of finance. Extensive entrepreneurial and managerial assistance is central to the economic development function of CDVC funds and often proves as important to the success of portfolio companies as the financing itself.

Taking this assistance a step further, several funds have learned to act as intermediaries between local workforce development programs and the businesses in which they invest. Adding value to portfolio companies by helping to recruit trained employees from distressed areas and disadvantaged populations augments a fund's social and financial bottom lines. Likewise, some funds have learned how to help their portfolio companies use government tax incentives and other programs in empowerment zones and other economically distressed communities. In this way, the funds make it not only financially possible but also attractive for a business to locate in a low-income area and hire area workers.

## FACTS AND FIGURES

While CDVC funds share a common mission, they take a number of legal forms, including: limited liability companies; limited partnerships; regular "C" corporations; and not-for-profit tax-exempt corporations. Their capital comes from sources that share their interest in a double bottom line return, including foundations, banks fulfilling their Community Reinvestment Act obligations, other corporations, government and wealthy individuals.

Although foundations and other socially motivated investors led the way in the development of the industry, banks have now supplanted these investors as the leading source of capital for the industry. While they pro-

vided a little over a third of the equity capital to CDVC funds started before 1998, banks provided about two-thirds of the equity capital raised by funds formed after that year. And the range of legal structures used by CDVC funds offer banks a variety of investment options including the purchase of interests in a limited partnership or limited liability company, the purchase of stock in a corporation, straight debt, equity equivalent investments<sup>2</sup> and capital grants.

Based on a survey of 25 CDVC funds, the average capitalization per fund was \$12.7 million at the end of 2000 and the median for these funds was \$6.2 million. However, newer CDVC funds are starting out larger. The three funds that raised capital in 2001 each began life in the \$12 to \$13 million range.

Because most CDVC funds are relatively young, it is impossible to quantify precise financial or social returns. However, a sample of the older funds indicates that they have created approximately one job for every \$10,000 invested. These job creation numbers are particularly impressive in light of the fact that the funds surveyed were all operating in very depressed rural areas. And, of course, the money invested is not spent, but returned to investors or recycled to invest in other companies to create more jobs in the future.

## OPPORTUNITIES AND CHALLENGES AHEAD

The environment in which CDVC funds and their investors operate has changed significantly during the past year. New funds are forming at a rapid pace, mature funds are successfully

raising money to start second funds and two new federal programs have been introduced that will further boost the field: the New Markets Venture Capital (NMVC) and New Markets Tax Credit (NMTC) programs, both enacted in December of 2000.

In July of 2001, the Small Business Administration conditionally designated seven new NMVC companies. The NMVC program provides capital in the form of zero coupon debentures<sup>3</sup> and operating assistance grants to NMVC funds that invest in small businesses in low-income areas. NMVC companies must raise matching funds from the private sector for both the capital and the technical assistance grant. The seven funds aim to raise between \$5 million and \$12.5 million in private capital and an additional \$1.5 to \$3 million in private operating assistance grants. The target date for a second round of NMVC selection is the fall of 2002.

The New Markets Tax Credit provides a dollar-for-dollar credit of 39% of the amount invested in a community development venture capital fund, spread out over a period of seven years. A community development venture capital fund that wishes to participate in the program would apply to the Community Development Financial Institutions (CDFI) Fund for an allocation of tax credits. If such an allocation is awarded, the fund can go to the market to raise capital with the tax credit as a strong inducement to investors. The NMTC program will pump \$15 billion into community development venture capital funds and other investments in low-income urban and rural areas of the country with \$2.5 billion available in 2002.

These two programs together offer unprecedented opportunities to the

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2 For more information on equity-equivalents (or EQ2s), please refer to Mark Pinsky's article on page 10.

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3 Unsecured debt backed only by the integrity of the borrower, not by collateral, and documented by an agreement called an indenture. One example is an unsecured bond.

## ABOUT THE AUTHOR



KERWIN TESDELL is president of the Community Development Venture Capital Alliance ([www.cdvca.org](http://www.cdvca.org)), the trade association of community development venture capital (CDVC) funds. It provides training, technical assistance and consulting services to the field; operates a Central Fund that invests in and co-invests with CDVC funds; performs and publishes research; and advocates for the field.

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community development venture capital industry. At the same time, they offer some challenges. The industry must be careful that the regulatory definition of New Markets investing—based on geography—does not replace the more nuanced and powerful methods that mission-driven CDVC funds use to produce their social returns. These methods take into account not only the area in which a business is located but also a complex mix of factors including the types of jobs the business is likely to create and the types of people who are likely to take those jobs.

Perhaps more important than any legislation is the fact that community development venture capital is becoming an established and recognized industry. Someone raising a CDVC fund six or seven years ago faced a

difficult task of trying to define for investors this unusual activity with few points of reference; now those raising funds have an entire industry to point to. Investing in CDVC funds is an established activity and a number of larger institutional investors have staffs of people with expertise and budgets dedicated to that purpose. People are building careers in CDVC funds, developing a unique set of skills that combine those of venture capital finance and economic development. At the same time, the CDVC field is changing rapidly, with an unusual spirit of experimentation and learning that will serve it well in the search for innovative ways to produce double bottom line results. *CI*

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## REGULATORY OVERVIEW

### INVESTMENT TYPE: COMMUNITY DEVELOPMENT VENTURE CAPITAL

**Definition:** Community development venture capital organizations (CDVC) use the tools of venture capital to conduct community and economic development activities as defined in the CRA regulation. CDVC funds make equity and equity-like investments in small businesses that hold the promise of rapid growth and a “double bottom line” of not only financial returns, but also community and economic development benefits. CDVC funds come in many different forms, including not-for-profit, for-profit, and quasi-public organizations. Their structures encompass for-profit “C” corporations, limited partnerships, limited liability companies, community development corporations (CDCs) and Small Business Investment Companies (SBICs). CDVCs fund investments ranging from the purchase of preferred and common stock to the provision of subordinated debt with equity “kickers” such as warrants or royalties. Investments in CDVCs should be carried as investments on the investing institution’s balance sheet in accordance with Generally Accepted Accounting Principles (GAAP).

**CRA Applicability:** A lawful investment, deposit, membership share or grant to a community development venture capital fund that has as its primary purpose community development will be considered a qualified investment/community development investment under the CRA regulation.

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**QUALIFIED INVESTMENT** means a lawful investment, deposit, membership share or grant that has as its primary purpose community development

**COMMUNITY DEVELOPMENT** means:

1. Affordable housing (including multifamily rental housing) for low- or moderate- income individuals
2. Community services targeted to low- or moderate-income individuals
3. Activities that promote economic development by financing businesses or farms that meet the size eligibility standards of 13CFR121.301 or have gross annual revenues of \$1 million or less
4. Activities that revitalize or stabilize low- or moderate-income geographies

## QUESTIONS AND ANSWERS FOR QUALIFIED INVESTMENTS

§§ \_\_.12(i) & 563e.12(h) – 5:

*Must there be some immediate or direct benefit to the institution's assessment area(s) to satisfy the regulation's requirement that qualified investments and community development loans or services benefit an institution's assessment area(s) or a broader statewide or regional area that includes the institution's assessment area(s)?*

**A5.** No. The regulation recognizes that community development organizations and programs are efficient and effective ways for institutions to promote community development. These organizations and programs often operate on a statewide or even multi-state basis. Therefore, an institution's activity is considered a community development loan or service or a qualified investment if it supports an organization or activity that covers an area that is larger than, but includes, the institution's assessment area(s). The institution's assessment area(s) need not receive an immediate or direct benefit from the institution's specific participation in the broader organization or activity, provided that the purpose, mandate, or function of the organization or activity includes serving geographies or individuals located within the institution's assessment area(s).

In addition, a retail institution that, considering its performance context,

has adequately addressed the community development needs of its assessment area(s) will receive consideration for certain other community development activities. These community development activities must benefit geographies or individuals located somewhere within a broader statewide or regional area that includes the institution's assessment area(s). Examiners will consider these activities even if they will not benefit the institution's assessment area(s).

§§ \_\_.12(i) & 563e.12(h) – 6:

*What is meant by the term "regional area"?*

**A6.** A "regional area" may be as small as a city or county or as large as a multi state area. For example, the "mid-Atlantic states" may comprise a regional area. Community development loans and services and qualified investments to statewide or regional organizations that have a bona fide purpose, mandate or function that includes serving the geographies or individuals within the institution's assessment area(s) will be considered as addressing assessment area needs. When examiners evaluate community development loans and services and qualified investments that benefit a regional area that includes the institution's assessment area(s), they will

consider the institution's performance context as well as the size of the regional area and the actual or potential benefit to the institution's assessment area(s). With larger regional areas, benefit to the institution's assessment area(s) may be diffused and, thus less responsive to assessment area needs.

In addition, as long as an institution has adequately addressed the community development needs of its assessment area(s), it will also receive consideration for community development activities that benefit geographies or individuals located somewhere within the broader statewide or regional area that includes the institution's assessment area(s), even if those activities do not benefit its assessment area(s).

§§ \_\_.12(i) & 563e.12(h) – 7:

*What is meant by the term "primary purpose" as that term is used to define what constitutes a community development loan, a qualified investment or a community development service?*

**A7.** A loan, investment or service has as its primary purpose community development when it is designed for the express purpose of revitalizing or stabilizing low- or moderate-income areas, providing affordable housing for, or community services targeted to, low- or moderate-income persons, or promoting economic development by fi

nancing small businesses and farms that meet the requirements set forth in §§ \_\_.12(h) or 563e.12(g). To determine whether an activity is designed for an express community development purpose, the agencies apply one of two approaches. First, if a majority of the dollars or beneficiaries of the activity are identifiable to one or more of the enumerated community development purposes, then the activity will be considered to possess the requisite primary purpose. Alternatively, where the measurable portion of any benefit bestowed or dollars applied to the community development purpose is less than a majority of the entire activity's benefits or dollar value, then the activity may still be considered to possess the requisite primary purpose if (1) the express, bona fide intent of the activity, as stated, for example, in a prospectus, loan proposal, or community action plan, is primarily one or more of the enumerated community development purposes; (2) the activity is specifically structured (given any relevant market or legal constraints or performance context factors) to achieve the expressed community development purpose; and (3) the activity accomplishes, or is reasonably certain to accomplish, the community development purpose involved. The fact that an activity provides indirect or short-term benefits to low- or moderate-income persons does not make the activity community development, nor does the mere presence of such indirect or short-term benefits constitute a primary purpose of community development. Financial institutions that want examiners to consider certain activities under either approach should be prepared to demonstrate the activities' qualifications.

§§ \_\_.12(s) & 563e.12(r) – 2:

*Are mortgage-backed securities or municipal bonds “qualified investments”?*

**A2.** As a general rule, mortgage-backed securities and municipal bonds are not

qualified investments because they do not have as their primary purpose community development, as defined in the CRA regulations. Nonetheless, mortgage-backed securities or municipal bonds designed primarily to finance community development generally are qualified investments.

Municipal bonds or other securities with a primary purpose of community development need not be housing-related. For example, a bond to fund a community facility or park or to provide sewage services as part of a plan to redevelop a low-income neighborhood is a qualified investment. Housing-related bonds or securities must primarily address affordable housing (including multifamily rental housing) needs in order to qualify. See also § \_\_.23(b) – 2.

§§ \_\_.12(s) & 563e.12(r) – 3:

*Are Federal Home Loan Bank stocks and membership reserves with the Federal Reserve Banks “qualified investments”?*

**A3.** No. Federal Home Loan Bank (FHLB) stock and membership reserves with the Federal Reserve Banks do not have a sufficient connection to community development to be qualified investments. However, FHLB member institutions may receive CRA consideration for technical assistance they provide on behalf of applicants and recipients of funding from the FHLB's Affordable Housing Program. See §§ \_\_.12(j) & 563e.12(i) – 3.

§§ \_\_.12(s) & 563e.12(r) – 4:

*What are examples of qualified investments?*

**A4.** Examples of qualified investments include, but are not limited to, investments, grants, deposits or shares in or to:

- Financial intermediaries (including, Community Development Financial Institutions (CDFIs), Community Development Corporations (CDCs),

minority- and women-owned financial institutions, community loan funds, and low-income or community development credit unions) that primarily lend or facilitate lending in low- and moderate-income areas or to low- and moderate-income individuals in order to promote community development, such as a CDFI that promotes economic development on an Indian reservation

- Organizations engaged in affordable housing rehabilitation and construction, including multifamily rental housing

- Organizations, including, for example, Small Business Investment Companies (SBICs) and specialized SBICs, that promote economic development by financing small businesses

- Facilities that promote community development in low- and moderate-income areas for low- and moderate-income individuals, such as youth programs, homeless centers, soup kitchens, health care facilities, battered women's centers, and alcohol and drug recovery centers

- Projects eligible for low-income housing tax credits

- State and municipal obligations, such as revenue bonds, that specifically support affordable housing or other community development

- Not-for-profit organizations serving low- and moderate-income housing or other community development needs, such as counseling for credit, homeownership, home maintenance, and other financial services education

- Organizations supporting activities essential to the capacity of low- and moderate-income individuals or geographies to utilize credit or to sustain economic development, such as, for example, day care operations and job training programs that enable people to work

§§ \_\_.12(s) & 563e.12(r) – 5:

*Will an institution receive consideration for charitable contributions as “qualified investments”?*

**A5.** Yes, provided they have as their primary purpose community development as defined in the regulations. A charitable contribution, whether in cash or an in-kind contribution of property, is included in the term “grant.” A qualified investment is not disqualified because an institution receives favorable treatment for it (for example, as a tax deduction or credit) under the Internal Revenue Code.

§§ \_\_.12(s) & 563e.12(r) – 6:

*An institution makes or participates in a community development loan. The institution provided the loan at below-market interest rates or “bought down” the interest rate to the borrower. Is the lost income resulting from the lower interest rate or buy-down a qualified investment?*

**A6.** No. The agencies will however, consider the innovativeness and complexity of the community development loan within the bounds of safe and sound banking practices.

§§ \_\_.12(s) & 563e.12(r) – 7:

*Will the agencies consider as a qualified investment the wages or other compensation of an employee or director who provides assistance to a community development organization on behalf of the institution?*

**A7.** No. However, the agencies will consider donated labor of employees or directors of a financial institution in the service test if the activity is a community development service.

§ \_\_.23(b) Exclusion

§ \_\_.23(b) – 1:

*Even though the regulations state that an activity that is considered under the lending or service tests cannot also be considered under the investment test, may parts of an activity be considered under one test and other parts be considered under another test?*

**A1.** Yes, in some instances the nature of an activity may make it eligible for consideration under more than one of the performance tests. For example, certain investments and related support provided by a large retail institution to a CDC may be evaluated under the lending, investment, and service tests. Under the service test, the institution may receive consideration for any community development services that it provides to the CDC, such as service by an executive of the institution on the CDC’s board of directors. If the institution makes an investment in the CDC that the CDC uses to make community development loans, the institution may receive consideration under the lending test for its pro-rata share of community development loans made by the CDC. Alternatively, the institution’s investment may be considered under the investment test, assuming it is a qualified investment. In addition, an institution may elect to have a part of its investment considered under the lending test and the remaining part considered under the investment test. If the investing institution opts to have a portion of its investment evaluated under the lending test by claiming a share of the CDC’s community development loans, the amount of investment considered under the investment test will be offset by that portion. Thus, the institution would only receive consideration under the investment test for the amount of its investment multiplied by the percentage of the CDC’s assets that meet the definition of a qualified investment.

§ \_\_.23(b) – 2:

*If home mortgage loans to low- and moderate-income borrowers have been considered under an institution’s lending test, may the institution that originated or purchased them also receive consideration under the investment test if it subsequently purchases mortgage-backed securities that are*

*primarily or exclusively backed by such loans?*

**A2.** No. Because the institution received lending test consideration for the loans that underlie the securities, the institution may not also receive consideration under the investment test for its purchase of the securities. Of course, an institution may receive investment test consideration for purchases of mortgage-backed securities that are backed by loans to low- and moderate-income individuals as long as the securities are not backed primarily or exclusively by loans that the same institution originated or purchased.

§ \_\_.23(e) Performance criteria

§ \_\_.23(e) – 1:

*When applying the performance criteria of § \_\_.23(e), may an examiner distinguish among qualified investments based on how much of the investment actually supports the underlying community development purpose?*

**A1.** Yes. Although § \_\_.23(e)(1) speaks in terms of the dollar amount of qualified investments, the criterion permits an examiner to weight certain investments differently or to make other appropriate distinctions when evaluating an institution’s record of making qualified investments. For instance, an examiner should take into account that a targeted mortgage-backed security that qualifies as an affordable housing issue that has only 60 percent of its face value supported by loans to low- or moderate-income borrowers would not provide as much affordable housing for low- and moderate-income individuals as a targeted mortgage-backed security with 100 percent of its face value supported by affordable housing loans to low- and moderate-income borrowers. The examiner should describe any differential weighting (or other adjustment), and its basis in the Public Evaluation. However, no matter how a qualified investment is handled for purposes

of § \_\_.23(e)(1), it will also be evaluated with respect to the qualitative performance criteria set forth in § \_\_.23(e)(2), (3) and (4). By applying all criteria, a qualified investment of a lower dollar amount may be weighed more heavily under the Investment Test than a qualified investment with a higher dollar amount, but with fewer qualitative enhancements.

§ \_\_.23(e) – 2:

*How do examiners evaluate an institution's qualified investment in a fund, the primary purpose of which is community development, as that is defined in the CRA regulations?*

**A2.** When evaluating qualified investments that benefit an institution's assessment area(s) or a broader statewide or regional area that includes its assessment area(s), examiners will look at the following four performance criteria:

1. The dollar amount of qualified investments;
2. The innovativeness or complexity of qualified investments;
3. The responsiveness of qualified investments to credit and community development needs; and
4. The degree to which the qualified investments are not routinely provided by private investors.

With respect to the first criterion, examiners will determine the dollar amount of qualified investments by relying on the figures recorded by the institution according to generally accepted accounting principles (GAAP). Although institutions may exercise a range of investment strategies, including short-term investments, long-term investments, investments that are immediately funded, and investments with a binding, up-front commitment that are funded over a period of time, institutions making the same dollar amount of investments over the same number of years, all other performance criteria being equal, would receive the

same level of consideration. Examiners will include both new and outstanding investments in this determination. The dollar amount of qualified investments also will include the dollar amount of legally binding commitments recorded by the institution according to GAAP.

The extent to which qualified investments receive consideration, however, depends on how examiners evaluate the investments under the remaining three performance criteria—innovativeness and complexity, responsiveness, and degree to which the investment is not routinely provided by private investors. Examiners also will consider factors relevant to the institution's CRA performance context, such as the effect of outstanding long-term qualified investments, the pay-in schedule, and the amount of any cash call, on the capacity of the institution to make new investments.

§ \_\_.25(d) Indirect activities

§ \_\_.25(d) – 1:

*How are investments in third party community development organizations considered under the community development test?*

**A1.** Similar to the lending test for retail institutions, investments in third party community development organizations may be considered as qualified investments or as community development loans or both (provided there is no double counting), at the institution's option, as described above in the discussion regarding §§ \_\_.22(d) and \_\_.23(b).

§ \_\_.26(a) Performance criteria

§ \_\_.26(a) – 1:

*May examiners consider, under one or more of the performance criteria of the small institution performance standards, lending-related activities, such as community development loans and lending-related qualified investments, when evaluating a small institution?*

**A1.** Yes. Examiners can consider "lending-related activities," including community development loans and lending-related qualified investments, when evaluating the first four performance criteria of the small institution performance test. Although lending-related activities are specifically mentioned in the regulation in connection with only the first three criteria (i.e., loan-to-deposit ratio, percentage of loans in the institution's assessment area, and lending to borrowers of different incomes and businesses of different sizes), examiners can also consider these activities when they evaluate the fourth criteria—geographic distribution of the institution's loans.

§ \_\_.26(a) – 5:

*Under the small institution performance standards, how will qualified investments be considered for purposes of determining whether a small institution receives a satisfactory CRA rating?*

**A5.** The small institution performance standards focus on lending and other lending-related activities. Therefore, examiners will consider only lending-related qualified investments for the purposes of determining whether the small institution receives a satisfactory CRA rating.

§ \_\_.26(b) – 2:

*Will a small institution's qualified investments, community development loans, and community development services be considered if they do not directly benefit its assessment area(s)?*

**A2.** Yes. These activities are eligible for consideration if they benefit a broader statewide or regional area that includes a small institution's assessment area(s), as discussed more fully in §§ \_\_.12(i) & 563e.12(h) – 6. **CI**

# DISTRICT BULLETIN

## NATIONAL COMMUNITY CAPITAL'S 18TH ANNUAL TRAINING CONFERENCE

October 30 through November 2, 2002, in Oakland, California. Community Development Financial Institution staff and board members, groups interested in starting a CDFI, funders, investors and policymakers should attend. More information can be found at [www.communitycapital.org](http://www.communitycapital.org).

## CALIFORNIA REINVESTMENT COMMITTEE STUDY ON SUB-PRIME LENDING

On November 29, 2001, the California Reinvestment Committee (CRC) released a statewide study, "Stolen Wealth: Inequities in California's Subprime Mortgage Market." The study indicates that one-third of subprime mortgage borrowers in the state could be victims of predatory lending and represents the first effort to statistically reflect California's subprime mortgage lending market. *For a copy of the study, contact Kevin Stein, CRC Associate Director, at (415) 864-3980 or visit the CRC website at [www.calreinvest.org](http://www.calreinvest.org).*

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