The Community Reinvestment Act (CRA) requires regulated banks and thrifts to meet the credit needs of their communities. Of the three performance tests large banks are subject to—lending, service and investment—the investment test can create the most confusion as to what constitutes a qualified investment.

Under CRA, an investment qualifies that has as its primary purpose community development, which means affordable housing, community services targeted to low- and moderate-income individuals, small business finance and activities that revitalize or stabilize low- or moderate-income geographies. This flexible definition allows banks and thrifts to invest in the communities they serve through creative means rather than dictated measures.

Two instruments that such low-rate municipal securities may offer a solution. Variable Rate Demand Notes (VRDN) and Auction Rate Securities (ARS) offer investors short duration assets that have community development as their purpose.

These liquid securities have been around since the advent of money market funds in the 1970s, with ARS just recently increasing in popularity over the past five years. Currently, there are approximately $120 billion VRDNs and $120 billion ARS outstanding in the marketplace. These securities have
longer maturities—typically 30 years—but they offer variable interest rate
reset periods, usually 7 to 35 days, resulting in a shorter duration asset.

**Variable Rate Demand Note (VRDN)**
A Variable Rate Demand Note is a long-term taxable or tax-exempt bond
that bears a floating interest rate and that provides investors the option to
tender or put securities at par on seven days notice—or in some cases within
a day's notice. The bonds tendered are then resold by the remarketing agent
in the secondary market to other investors. VRDNs can be converted to a
long-term fixed-rate security upon appropriate notice by the issuer.
Also known as Variable Rate Demand Obligations (VRDOs), these securities
are designed to meet the needs of investors requiring liquidity, flexibility,
and competitive short-term rates. The interest rate resets daily or weekly,
depending upon the security. The reset rate is based on comparable
securities with similar maturities and credit ratings, as well as on supply and
demand.

The investor continually earns the market interest rate because of the reset
feature and is guarded against principal loss because of the par tender
feature. Bond holders have the right to tender their bonds for payment at
par plus accrued interest at any time with appropriate notice to the
remarketing agent. In addition, most VRDNs are highly rated due to credit
enhancements, which guarantee the principal and interest, as well as the
liquidity for bonds tendered.

Following are two examples of VRDNs whose primary purpose is community
development:

**Weekly Tax-Exempt VRDN (Westchester County, New York)**
The County of Westchester issued industrial development bonds to finance
the acquisition, construction and renovation of Levister Towers—a Section 8
and low income housing tax credit project. The bonds were structured as a
tax-exempt VRDN that will mature August 1, 2033. The security is rated Aa2/VMIG1 with a letter of credit from the Bank of New York.

**Weekly Taxable VRDN (Nevada)**
The Nevada Housing Division issued multi-unit housing revenue senior bonds to finance the acquisition, construction and furnishing of a multifamily rental housing project. Under the terms of the regulatory agreement, 100 percent of the units will remain available for persons or families with incomes at or below 60 percent of the median gross income for the area at all times during the qualified project period. The taxable security is rated Aaa with credit support from Fannie Mae. The bond's maturity is October 15, 2035.

**Auction Rate Securities (ARS)**
Similar to daily and weekly floaters, Auction Rate Securities (ARS) trade at par. ARS are sold through a Dutch Auction, which is a competitive bidding process used to determine rates on each auction date. Bids are submitted to the auction agent. The winning bid rate is the rate at which the auction "clears", meaning the lowest possible interest rate that equals the cumulative total of securities demanded (buyers) to the amount auctioned (sellers).

New buyers wishing to purchase ARS may submit a bid at a specified rate on the day of the auction. Holders of the bonds will be notified of the indicative market rate. All accepted bids receive the same interest rate.

Owners of ARS have the option to:

- **Hold**: elect to hold an existing position regardless of what the new rate might be
- **Bid**: submit a bid to hold an existing position at a specified rate
- **Sell**: request to sell an existing position regardless of the rate set at the auction
Interest rates are generally reset every 7 or 28 days for taxable issues and every 35 days for tax-exempt issues. Most ARS pay interest on the business day following the auction; however, some may have quarterly or semi-annual coupons and trade with accrued interest. ARS settle on the business day following the auction. There are no liquidations between auctions.

Following are two examples of ARS whose primary purpose is community development:

**35-day Taxable ARS (Abilene, Texas)**
The Abilene Health Facilities Development Corporation financed a loan to Hendrick Medical Center to help support a family health clinic. This clinic serves the indigent and provides educational training for nurses and residents. It is also a member of the Texas Association of Public and Nonprofit Hospitals, which provides a disproportionate share of uncompensated healthcare and has an institutional mission that includes a strong commitment to care for the indigent or needy. In fact, Medicare and Medicaid account for over 60% percent of gross patient revenues. This security is rated AAA by S&P with credit support from MBIA and matures September 22, 2025.

**28-day ARS Private Placement (San Diego, California)**
The San Diego Family Housing, LLC issued military housing revenue obligations to help provide housing for lower-pay grade enlisted personnel. Pursuant to a lease by the United States Navy, the notes finance a portion of the acquisition, construction, and renovation of housing units at 20 different properties in San Diego amounting to a total of approximately 3,200 units. Both existing and proposed housing units are targeted at personnel earning below 80 percent of median family income (for San Diego County, the 2003 HUD median family income is $59,900). This security is rated AAA by S&P
with credit support from MBIA, a municipal bond insurance company. It is a private placement, maturing July 1, 2035.

**Conclusion**

Many banks invest solely in taxable or bank-qualified municipal securities, rather than tax-exempt securities. While there are taxable variable rate demand notes, the market is considerably smaller. Given the current interest rate environment, the spread between taxable and tax-exempt floating rate securities allows taxable investors a wider array of potential community development investments with only a small sacrifice in yield. Variable Rate Demand Notes and Auction Rate Securities offer investors the opportunity to invest in short duration assets that have community development as their primary purpose. These securities are an attractive option for investors that help satisfy CRA requirements, while mitigating interest rate risk.

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**Biography**

*Barbara Rose VanScoy* is a principal at CRAFund 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 CRAFund 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
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