COMMUNITY DEVELOPMENT

Community Investments

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Qualified Investments
How to Make Investing in Your Communities Really Count!

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Editor's Note: Since the implementation of the new Community Reivestment Act (CRA) regulation, bankers have expressed concern about their ability to find qualified investments. Beyond finding them, bankers worry that examiners won't recognize their investment as qualified under the new CRA. For some banks, the issue of defining qualified investments remains elusive and has too many gray areas. For others who have a firm grasp on the regulatory definition, many still face the problem of finding deals in which their banks want to invest. Several savvy bankers have resorted to creating their own investment initiatives which address the unique needs of their communities and ensure strong performance under the investment test (some of which will be highlighted in future issues in Community Investments). Community Affairs staff often recommend that banks read CRA public evaluations of similarly situated financial institutions to understand what other banks are doing to comply with the CRA. Specifically for qualified investments, the public evaluations provide insight into what banks are investing in and what level of CRA consideration they are receiving. Recently, Community Affairs staff reviewed a total of 45 public evaluations and strategic plans from the 12th District from the four regulatory agencies and compiled a list of the types of investments banks are making. To keep things in context, the list also includes asset size, investment test rating and overall CRA rating. The document was first distributed at the American Bankers Association's National Compliance Conference in San Diego in May 1998. Since then, many bankers and community groups who reviewed the document have called with technical questions about what qualifies as an investment under the CRA. The following article sets out to answer these questions by reiterating the regulatory definition of qualified investments and highlighting the process that examiners use to determine whether an investment will receive CRA consideration.

Investing in disenfranchised communities can infuse life back into decaying neighborhoods. Through redevelopment bonds, loan pool certificates, equity investments in local community banks, and grants to local nonprofits, bank investors can reap social benefits, earn returns on their investments, and meet their CRA goals. But meeting CRA goals implies an understanding of what qualifies as an investment. To gain that understanding, consider the background information examiners use to identify and rate qualified investments.

Identifying Qualified Investments

When determining investments, examiners look at four broad categories of investments including lawful investments, membership shares, deposits, and grants. Within these categories, investments are evaluated by considering their *purpose* and *geography*.

Purpose

Qualified investments must have *community development* as their primary purpose, which means invested funds must be used for any one of the following:

- Affordable housing for low- and moderate-income (LMI) persons;
- Community services targeted to LMI persons;
- Promoting economic development[1] by financing small businesses or farms;[2] or,
- Revitalizing or stabilizing LMI areas.[3]

If a majority of the dollars or beneficiaries of an investment falls into one of the above categories, then the "express purpose" of an investment is considered to be community development. If there is no clear majority, examiners determine if an investment meets any one of the following criteria:

- The express "bona fide" intent of the investment is for community development;
- The investment is specifically structured to achieve the express community development purpose; or,
- It is reasonably certain that the investment will accomplish the stated community development purpose.

Keep in mind that it is each institution's responsibility to demonstrate that an investment is a lawful investment, deposit, membership share, or grant that has community development as its primary purpose.

Once the primary purpose is established, examiners assess the degree of innovation and complexity of investments. To do this, examiners rely on qualitative information, such as comparing qualified investments to typical investments in an institution's portfolio and to types of investments made by an institution's peers. Most importantly, examiners look at what types of investments are most common in a bank's assessment area.

Geography

When evaluating potential qualified investments, examiners also determine if an institution's assessment area benefits from these investments. A qualified investment must benefit an institution's assessment area(s) or a broader statewide or regional area inclusive of the assessment area. According to the CRA, "the fundamental determination that an examiner must make in regard to an investment is the extent to which it contributes to a bank's overall record of helping to meet the credit needs in its assessment area."[4]

To ensure that an investment meets the geographic criterion, examiners consider the following:

- Who benefits from the investment;
- Whether the investment responds to credit and community development needs; and,
- Whether private investors routinely provide this type of investment, and if there are any other unmet investment needs in an assessment area.

Rating Qualified Investments

Examiners assess total qualified investment level in comparison to an institution's total investment portfolio; percentage ratios of previous examinations are often compared to ratios for current examinations to assess percentage increases or decreases over time.

Banks must receive at least a "low satisfactory" on the lending test to achieve a "satisfactory" or better composite rating. Institutions with "high satisfactory" ratings in the lending test can effectively raise their assigned composite CRA rating to "outstanding" with a "high satisfactory" or "outstanding" rating in the investment test, depending on the service test score.

Institutions may receive favorable CRA credit under both the lending and investment test for a single qualified investment. For example, institutions that make qualified investments in third party community development organizations that, in turn, use the investments to make community development loans can receive favorable consideration under both the investment and lending tests for their pro-rata share of the loans made by the third party.

Conclusion

This article offers some basic information on identifying and developing qualified investments. A successful strategy should address the credit needs in an institution's assessment area in a manner that is integrated with and integral to the institution's overarching investment plan. CI

TEN MOST COMMON QUALIFIED INVESTMENTS

JULY '97oMARCH '98

This list of qualified investments is presented in the order of frequency from the most (1)to the least (10)frequently reported investments for which institutions have received CRA consideration.

1. Grants to nonprofit organizations providing services to low-and moderate- income people and communities
2. Grants to nonprofit affordable housing developers
3. Donations to charitable organizations,specifically involved in education, health care,nutrition,and welfare-to-work programs for low-and moderate- income people and communities
4. Purchases of housing finance bonds targeted to low-and moderate-income communities
5. Purchases of low-income housing tax credits
6. Purchases of certificates of deposit and equity investments in community development banks and community development credit unions
7. Investments in community development corporations
8. Purchases of municipal redevelopment bonds targeted to low-and moderate- income communities
9. Investments in other community development financial institutions
10. Purchases of multifamily affordable housing revenue bonds

Community Affairs staff prepared a list of all qualified investments that had received CRA consideration from July 1,1997 through March 15,1998. Data was gathered from completed performance valuations from all four regulatory agencies.These performance valuations were based on data from large financial institutions, small financial institutions that had opted to have investments reviewed, and limited purpose and wholesale banks, all located within the Federal Reserve's Twelfth District. All strategic plans were also included.

1 Economic development is promoted if the activity supports permanent job creation, retention, and/or improvement for persons who are currently LMI, or in LMI geographies targeted for redevelopment by the federal, state, local, or tribal government.

2 The CRA regulation defines small businesses and farms as those with gross annual revenues of $1 million or less. The regulation also recognizes the Small Business Administration's and Small Business Investment Company program's definition of small businesses as legitimate, although different, for the purpose of determining CRA credit. See publication, Federal Register/Vol. 62, No. 193/October 6, 1997.

3 Community development activities that revitalize or stabilize LMI areas include community or tribal-based child care, educational, health, or social services targeted to LMI persons.

4 Interagency Interpretation Letter dated June 26, 1995.

About the Author

Cynthia Burnett is a community affairs specialist at the Federal Reserve Bank of San Francisco, which she joined in 1997. Her work focuses on issues of welfare reform, specifically, welfare-to-work and regional job creation initiatives related to the Community Reinvestment Act. She is currently researching local and national asset accumulation models for low-income families. Prior to joining the Bank, Ms. Burnett served ten years in the management of nonprofit affordable housing, and health and human service organizations in Sacramento and the San Francisco Bay Area. She holds a bachel