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 dictated 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 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 purpose 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 multifamily and can be local or statewide.

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

Because of this confusion, some fi-
nance agencies have taken further steps 
to accommodate financial institution 
qualified investing. The Washington 
State Housing Finance Commission is-
sues CRA Taxable Single-Family Pro-
gram Bonds and imposes an annual 
income limitation of 80 percent or be-
low of the Metropolitan Statistical 
Area’s median income, which is in line 
with the regulators’ definition. Pro-
grams such as these help facilitate com-
munity 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 construc-
tion and rehabilitation of apartment 
complexes. To be considered afford-
able, there must be a low- to moder-
ate-income set-aside or some other 
income restriction. Not all multi-fam-
ily 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 sup-
port 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 liv-
ing facilities and homes for the devel-
opmentally disadvantaged may qualify 
under CRA regulation if the patients 
at these facilities are low- to moder-
ate-income. Usually these facilities 
serve a large share of Medicaid pa-
ients, whose incomes fall within the 
guidelines of CRA.

Tax Allocation Bonds
Tax Allocation Bonds are bonds issued 
in conjunction with a specific rede-
velopment project—typically afford-
able housing. The taxes pledged to 
their repayment come from the in-
creased assessed value over and above 
a pre-established base. The redevel-
opment creates this added value, 
known as the tax increment. Many 
states use tax increment financing 
(TIF), which provides for the financ-
ing of redevelopment projects though 
the use of tax increment revenues. Ob-
viously, since not all community de-
velopment activities occur in low- or 
moderate-income areas, it is impor-
tant 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 deter-
mination of how the primary purpose 
is community development. Under CRA, 
an activity promotes economic devel-
opment if it, “supports permanent job 
creation, retention, and/or improve-
ment either in low- or moderate-income 
geographies or in areas targeted 
for redevelopment by federal, state, lo-
cal 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 pur-
pose of the issue, financial institutions 
must also analyze certain attributes 
associated with the bonds. Investment 
policies may restrict purchases of eli-
gible 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 in-
eligible investments for banks that can 
only invest in grade BBB or higher 
securities. Some investment policies 
limit the purchase of securities to ma-
turities inside of ten years, although it 
is not uncommon for multi-family se-
curities to have maturities of 30 to 40 
years. Other banks are limited to tax-
able or bank qualified municipal se-
curities (i.e. issues under $10 million). 
Furthermore, bank qualified issues are 
generally limited to revenue bonds, 
which is only a fraction of the munici-
pal market. This significantly reduces 
the universe of available opportuni-
ties. Taxable municipal securities of-
fer a greater opportunity for investment 
than bank qualified issues, as issuance 
is considerably larger, both in the fre-
quency of issues and the overall dol-
lar volume generated.

Purchasing Qualified Investments
Purchasing qualified investments usu-
ally requires a concerted effort by dif-
ferent divisions within the banking or-
ganization. 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 documentation 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.

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 elimination 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.