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 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[1] 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 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

1 *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 though 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 permanent 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 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. ***CI***

About the Author

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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