Office of the Comptroller of the Currency
Federal Deposit Insurance Corporation
Federal Reserve Board
Office of Thrift Supervision

December 23, 1996

Interpretive Letter #763
January 1997
12 U.S.C. 2901

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Dear Messrs. [ ] and [ ]:

This letter responds to your inquiries dated July 12, 1996, September 4, 1996, November 1, 1996, and November 14, 1996, regarding the application of the Community Reinvestment Act (CRA) to a regulated financial institution's investment in a proposed umbrella partnership real estate investment trust (UPREIT) that will engage in community development activities. As more fully discussed below, it appears that an investment such as the one you describe may be considered favorably in an institution's CRA evaluation.

As you know, the four federal bank and thrift regulatory agencies promulgated substantially similar CRA regulations on May 4, 1995. In order to promote consistent interpretation of these CRA regulations, staff from all four agencies have considered your inquiry and concur in the opinions expressed in this letter. This letter discusses only whether lawful investments[1] by federally regulated financial institutions in an UPREIT such as the one you describe would receive favorable consideration under the CRA regulations. Furthermore, the federal financial institutions regulatory agencies do not endorse particular investment opportunities offered to financial institutions.

The Proposed Investment

Your client is a developer of storefront retail properties and shopping centers in low- and moderate-income neighborhoods. The developer's projects have provided residents of underserved neighborhoods with access to a variety of needed goods and services. Your July 12, 1996, letter states that the community impact of the developer's three projects, described in the attachment to your letter, has been significant. The developer estimates that these

[1] This letter assumes that such an investment is permissible under applicable laws and regulations; it does not authorize such an investment. Please be aware that 12 U.S.C. § 29 limits the authority of national banks to hold real estate. State member banks are not authorized to invest in real estate except with the prior approval of the Board of Governors of the Federal Reserve System under 12 C.F.R. part 208. In certain states, nonmember banks may invest in real estate. The CRA does not provide financial institutions with any independent authority to make investments.

projects have brought more than 200 new businesses into communities that have been ignored by the retail sector for many years. This, in turn, has led to the creation of over 1,000 new jobs in neighborhoods in need of meaningful employment opportunities. Other substantial benefits also have been achieved, including reducing crime rates, increasing real estate and sales tax revenues, attracting new residents and generally improving the quality of life in the areas served.

Over the years, the developer has financed its redevelopment activities through approximately $100 million in loans from area financial institutions. However, the pool of lending resources has not kept pace with the developer's funding needs. The developer now proposes to establish an umbrella partnership real estate investment trust (UPREIT) through which to finance its development activities.

The UPREIT Structure Generally

The following description generally outlines a "typical" UPREIT structure:

> An UPREIT typically is structured as follows: One or more existing real estate partnerships contribute all of their assets and liabilities to, or are merged into, or their interests are contributed to, an operating partnership. Contemporaneously with these transfers, the UPREIT sells its shares to the public and contributes the proceeds from the sale to the operating partnership in exchange for newly issued partnership interests. The continuing partners in the operating partnership generally receive the right to either put their partnership interests to the operating partnership or to the UPREIT for cash or shares of the UPREIT. The cash raised from the public is used to pay off debt or to make new acquisitions.[2]

An UPREIT is "a tax-driven vehicle." "An UPREIT provides a means of transferring property to a REIT without causing the transferor to recognize gain immediately, and it allows the REIT shareholders to maintain their tax advantages."[3]

The Proposed UPREIT

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[2] Ira Akselrad & Robert S. Bernstein, *Instruments, Techniques, and Transactions*, J. Corp. Tax'n, Spring 1994, at 68.

[3] Phillip S. Scherrer, *UPREITS: Their Time Has Come for the Chosen Few*, Real Est. Fin. J., Spring 1996, at 42, 43.

The proposed UPREIT is very similar to the typical UPREIT structure described above; however, one major difference exists. The proposed UPREIT will not initially sell its shares to the public. Instead, it will only offer preferred stock to institutional investors. If a public offering of common stock occurs, it will take place after the sale of preferred stock to financial institution investors and at a time when the organization has developed a successful track record.

Table 1, which you provided (attached), describes the proposed UPREIT. In telephone conversations, you have indicated that, at least initially, only the property-owning partnership located in the Washington, D.C. metropolitan area will be involved in the UPREIT rather than the three depicted in Table 1. You also explained that the operating partnership's in-kind investment of real property into the property-owning partnerships will be reflected by the operating partnership taking general partnership interests in the property-owning partnerships.

Your letter of September 4, 1996, indicated that the articles of incorporation of the corporate REIT will specifically state that the purpose of the company is to provide financing for "community development," as that term is defined in the CRA regulations, and to promote the public welfare consistent with 12 U.S.C. § 24 (Eleventh) and 12 C.F.R. part 24. The articles of incorporation also will provide that the activities of the company will be limited to those consistent with 12 C.F.R. part 24 and otherwise permissible to national banks. The relevant corporate documents related to the REIT will further specify the locations and types of properties that would be permissible investments for the REIT. In addition, designated representatives of the financial institutions investing in the REIT will serve on a "Community Development Evaluation Committee" that will review proposed REIT projects to assure that they comply with the stated purpose of the REIT.

Discussion

Accounting Issues

You asked how a financial institution would account for its preferred stock purchase -- as an investment or a loan. Under generally accepted accounting principles, an institution that purchases preferred stock typically books the purchase as an equity investment.

Assuming a financial institution exercises significant influence over the activities of the UPREIT, according to the Call Report instructions, the institution would list these assets as "Investments in unconsolidated subsidiaries and associated companies" on Schedule RC-M, line 8(b)(1), under "direct and indirect investments in real estate ventures." Such investments shall be reported using the equity method of accounting. If the financial institution does not exercise significant influence over the activities of the UPREIT, the institution would list these assets as "Other real estate owned" on Schedule RC-M, line 8(a)(1), also under the heading "direct and indirect investments in real estate ventures."

CRA Issues

> *Would a financial institution's investment in an UPREIT such as the one you describe be considered positively during the institution's CRA evaluation?*

Under the new CRA regulations, regardless of the assessment method used by examiners, financial institutions can receive positive consideration for making "qualified investments."[4] "Qualified investment" is defined in the new regulations as:

> [A] lawful investment, deposit, membership share or grant that has as its primary purpose community development.[5]

"Community development" is defined, *inter alia*, as:

> (4) Activities that revitalize or stabilize low- or moderate-income geographies.[6]

A qualified investment must benefit the institution's assessment area(s) or a broader statewide or regional area that includes the assessment area(s).[7] A wholesale or limited purpose institution can also receive consideration for qualified investments that benefit areas outside the institution's assessment area(s) (or a broader statewide or regional area that includes that institution's assessment area(s)), if the institution has adequately addressed the needs of its assessment area(s).[8]

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[4] Large institutions' CRA performance is typically evaluated under the lending, investment and service tests. Examiners consider large institutions' qualified investments under the investment test. 12 C.F.R. §§ 25.23(a), 228.23(a), 345.23(a), and 563e.23(a). In a small institution examination, examiners may adjust an institution's loan-to-deposit ratio, if appropriate, based on qualified investments. 12 C.F.R. §§ 25.26(a)(1), 228.26(a)(1), 345.26(a)(1), and 563e.26(a)(1). Qualified investments may also be considered to determine if a small institution merits an outstanding CRA rating. 12 C.F.R. pt. 25 app. A(d)(2), pt. 228 app. A(d)(2), pt. 345 app. A(d)(2), and pt. 563e app. A(d)(2). The community development test, which is appropriate for institutions designated as wholesale and limited purpose institutions, evaluates, *inter alia*, the number and amount of qualified investments. 12 C.F.R. §§ 25.25(c)(1), 228.25(c)(1), 345.25(c)(1), and 563e.25(c)(1). And, finally, institutions evaluated on the basis of a strategic plan must include in their plan how they intend to meet the credit needs of their assessment area(s). They may meet credit needs through lending, *investment*, and/or services, as appropriate. 12 C.F.R. §§ 25.27(f)(1), 228.27(f)(1), 345.27(f)(1), and 563e.27(f)(1) (emphasis added).

[5] 12 C.F.R. §§ 25.12(s), 228.12(s), 345.12(s), and 563e.12(r).

[6] 12 C.F.R. §§ 25.12(h), 228.12(h), 345.12(h), and 563e.12(g).

[7] 12 C.F.R. §§ 25.23(a), 228.23(a), 345.23(a), and 563e.23(a).

[8] 12 C.F.R. §§ 25.25(e), 228.25(e), 345.25(e), and 563e.25(e).

An investment in an UPREIT such as the one your client proposes would be a "qualified investment" if the UPREIT primarily promotes community development. It appears that the articles of incorporation of the UPREIT and past activities of your client support the inference that the UPREIT will provide financing for development projects that revitalize or stabilize low- or moderate-income geographies.[9]

> *Could an investing financial institution receive consideration under the lending test for loans made by the UPREIT?*

Among the performance criteria considered in the lending test is an institution's community development lending, including the number and amount of community development loans and their complexity and innovativeness.[10] A "community development loan" must have community development as its primary purpose and must benefit the institution's assessment area(s) or a broader statewide or regional area that includes the institution's assessment area(s).[11] (Examiners will also consider community development loans that benefit areas outside a wholesale or limited purpose institution's assessment area(s) (or a broader statewide or regional area that includes the assessment area(s)) if the institution has adequately addressed the needs of its assessment area(s).)[12] The CRA regulations allow an institution that invests in a third party entity that uses the institution's investment to originate or purchase loans to receive consideration under the lending test for its pro rata share of community development loans made by the entity.[13] The institution's pro rata share is based on its percentage of equity ownership in the third party entity.[14]

Whether an institution that invests in an entity that invests in a second entity that makes community development loans may receive consideration under the lending test for its pro rata share of the community development loans has not yet been addressed by the agencies.

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[9] Further guidance regarding activities that promote community development may be found in the "Interagency Questions and Answers Regarding Community Reinvestment" (Qs and As), 61 Fed. Reg. 54,647 (Oct. 21, 1996). Although Q/A 4 addressing § __.12(i), 61 Fed. Reg. at 54,651, refers to community development loans, it is especially relevant to community development based on revitalizing and stabilizing low- or moderate-income geographies.

[10] *See* 12 C.F.R. §§ 25.22(b)(4), 228.22(b)(4), 345.22(b)(4), and 563e.22(b)(4).

[11] *See* 12 C.F.R. §§ 25.12(i)(1) & (2)(ii), 228.12(i)(1) & (2)(ii), 345.12(i)(1) & (2)(ii), and 563e.12(h)(1) & (2)(ii).

[12] *See* 12 C.F.R. §§ 25.25(e), 228.25(e), 345.25(e), and 563e.25(e).

[13] 12 C.F.R. §§ 25.22(d), 228.22(d), 345.22(d), and 563e.22(d). The institution must report data concerning these loans pursuant to 12 C.F.R. §§ 25.42(b)(2), 228.42(b)(2), 345.42(b)(2), or 563e.42(b)(2) before its supervisory agency will consider them.

[14] Qs and As, 61 Fed. Reg. at 54,657 (Q/A 1 addressing § __.22(d)).

The CRA regulations state:

> (d) *Lending by a consortium or a third party.* Community development loans originated or purchased by . . . a third party in which the bank has invested:
> (1) Will be considered, at the bank's option, if the bank reports the data pertaining to these loans . . .; and
> (2) May be allocated among . . . investors, as they choose, for purposes of the lending test, except that no . . . investor:
> (i) May claim a loan origination or loan purchase if another participant or investor claims the same loan origination or purchase; or
> (ii) May claim loans accounting for more than its percentage share (based on the level of its . . . investment) of the total loans originated by the . . . third party.[15]

Generally speaking, this section provides that the community development loans for which an investing institution may receive consideration under the lending test must be originated or purchased by the third party in which the institution has invested. The agencies, therefore, are limited in their ability to expand their interpretation of this section. However, for the following reasons, the staff of the agencies believe an UPREIT structure such as the one you describe should be looked at as a whole when considering what constitutes the "third party."

First, as discussed earlier, the UPREIT structure is a tax-driven vehicle. Prior to the development of the UPREIT structure, developers often structured their projects as real estate investment trusts (REITs). The standard REIT structure omits the operating partnership level of the UPREIT. Property-owning partnerships transferred their property directly to the corporate REIT in exchange for REIT stock. Because this transfer is a taxable event for the property-owning partnerships, the UPREIT structure was developed.[16]

If the project being proposed were a REIT structure, the REIT would directly lend to the property-owning partnerships. Therefore, a REIT structure would meet the literal wording of the regulatory provision. Although the form of the UPREIT differs somewhat from that of a REIT, it is functionally equivalent to the REIT. Both are entities that enable financing of real estate projects through securitization.

Second, the ownership interest (equity interest) of the investing financial institutions flows downward from the corporate REIT to the operating partnership as a general partnership interest in the partnership. There is, thus, continuity of ownership by the financial institutions

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[15] 12 C.F.R. § 25.22(d). *See also* 12 C.F.R. §§ 228.22(d), 345.22(d), and 563e.22(d).

[16] *See, e.g.,* Akselrad & Bernstein, *supra*, at 69.

in both the corporate REIT and the operating partnership that makes the loans.

Finally, the funds that the financial institutions invest in the corporate REIT are the same monies that the operating partnership lends to the property-owning partnership. The addition of the operating partnership into the UPREIT structure does not diminish the amount of funds being lent to the property-owning partnerships. The amount of funds flowing to the property-owning partnerships would be the same whether the structure were a REIT or an UPREIT.

A financial institution, therefore, may receive positive consideration under the lending test for community development loans made through an UPREIT of the type described in this letter in which it has made a qualified investment pursuant to 12 C.F.R. §§ 25.22(d), 228.22(d), 345.22(d) and 563e.22(d).[17]

> *How would a financial institution's pro-rata share of community development loans be calculated?*

In your letter of November 1, 1996, you point out that the UPREIT will have a lot of equity in addition to preferred stock, which will be purchased by financial institutions. Equity will also be built in cash, by purchases by the public of common shares in the corporate REIT, and in property, by transfer of property to the operating partnership in return for partnership interests. By basing a financial institution's "level of investment" on its percentage share of the total equity of the UPREIT, an institution would receive consideration under the lending test for community development loans made by the UPREIT of less than the amount that would be considered if the institution's share of the total preferred stock investment were the benchmark. You submit that, rather than basing the institution's "level of investment" on its percentage of total equity in the UPREIT, the institution's "level of investment" should be based upon its percentage share of a particular class of equity (i.e., preferred stock only). Thus, under the interpretation that you advocate, an institution that contributed 100 percent of the preferred stock equity would receive a 100 percent pro rata share of all community development loans made by the UPREIT (even though preferred stock represents less than 100 percent of the UPREIT's total equity).

The regulation states that no financial institution:

> (ii) May claim loans accounting for more than its percentage share (based on the level of its . . . investment) of the total loans

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[17] This statement assumes the community development loans were made during the period under review in an examination and benefit a retail institution's assessment area(s) or a broader statewide or regional area that includes the institution's assessment area(s). The same holds true if the institution is a wholesale or limited purpose institution; however, if the wholesale or limited purpose institution has adequately addressed the needs of its assessment area(s), examiners will also consider community development loans that benefit areas outside the institution's assessment area(s) (or a broader statewide or regional area that includes the institution's assessment area(s)).

originated by the . . . third party.[18]

The agencies have interpreted this provision to mean that the institution's pro rata share is based on its percentage of equity[19] ownership in the third party entity.[20]

The agencies have considered the points raised in your letters. However, we maintain that an institution's pro rata share is to be based on its percentage of equity ownership in the third party and the overall activities of the third party.

Basing an institution's "level of investment" only on an investment in a particular class of equity rather than total equity could lead to anomalous results in some cases. In your client's proposal, basing the level of investment on only preferred stock would permit the financial institutions that purchased preferred stock to claim 100 percent of the community development loans made by the UPREIT. However, in other situations such an interpretation would not have similarly favorable results. For example, financial institutions could contribute to the total equity of an UPREIT by purchasing preferred or common stock of the corporate REIT or by transferring real estate to the operating partnership in return for a partnership interest in the operating partnership.[21] In each of these cases, financial institutions have made equity investments of different types. And, each institution would wish to have its pro rata share (based on its share of total equity) of the UPREIT's community development loans considered under its lending test. If all of the equity invested in the UPREIT is considered when determining the institutions' level of investment, that result is possible. On the other hand, if only certain classes of equity are considered for purposes of determining an investing financial institution's pro rata share of community development loans, institutions investing in other types of UPREIT equity would not be able to have a share of the UPREIT's community development loans considered during their CRA evaluations.

In addition, it may be possible for an UPREIT to leverage its equity through borrowing. The UPREIT, in turn, may lend these borrowed funds to the property-owning partnerships. Your September 4, 1996, and November 1, 1996, letters discussed the possibility of a "dollar-for-dollar" consideration under the lending test based on an investing institution's amount of investment. Under the agencies' current interpretation, however, if an UPREIT is able to leverage its equity and make loans in excess of the amount of cash-contributed equity, the

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[18] 12 C.F.R. §§ 25.22(d)(2)(ii), 228.22(d)(2)(ii), 345.22(d)(2)(ii), and 563e.22(d)(2)(ii).

[19] Under generally acceptable accounting principles, both cash-contributed equity and property-contributed equity are included in an entity's total equity without differentiation.

[20] Qs and As, 61 Fed. Reg. at 54,657 (Q/A 1 addressing § __.22(d)). *See also* Interagency Staff CRA Opinion Letters from Matthew Roberts dated June 27, 1996, June 14, 1996, and June 26, 1995 (designated as OCC Interpretive Letters Nos. 727, 709, and 673, respectively).

[21] The legality of the investments described in this example has not been determined.

investing financial institutions may have their pro rata shares of the total community development loans made by the UPREIT considered in their CRA evaluations.[22] Thus, under the agencies' interpretation, an investing institution in some circumstances may have community development loans considered in its CRA evaluation in excess of its dollar investment, an interpretation that would be more advantageous to investing institutions than a "dollar-for-dollar" approach.

Finally, at the time of the interagency rulemaking, concerns were raised by a number of commenters, most of whom represented consumer and community groups, that institutions would use third-party lending to avoid their direct lending obligations and, in effect, "buy out" of their CRA obligations. "Under the final rule, direct lending performance is an essential element of an institution's CRA performance."[23] Although the final CRA rule permits consideration under the lending test for loans made by a third party in which a financial institution invested, the agencies were mindful of the concerns expressed during the rulemaking process. Consequently, agency staff believes the regulation reflects the notion that permitting a financial institution to claim a majority of the community development loans made by a third party in which the institution has invested only a minority of the equity would not further the goals of the CRA.

Could an investing financial institution receive favorable consideration under both the lending test and the investment test for its purchase of preferred stock?

Yes. A financial institution that invests in a third party also has the option of consideration under both the lending and investment tests if the third party, in turn, makes both community development loans and qualified investments. If the investing institution chooses to have a portion of its investment evaluated under the lending test by claiming its pro rata share of the third party'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 third party's assets that meet the definition of a qualified investment.[24]

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[22] See Interagency Staff CRA Opinion Letter from Matthew Roberts (June 14, 1996) (designated as OCC Interpretive Letter No. 709) (attached) for an analogous description of a leveraged investment in a community development bank (CDB). The pro rata share of community development loans resulting from leveraged investments in an UPREIT would be calculated in the same manner as was the permissible share of community development loans made by the CDB described in that letter. Your November 14, 1996, letter indicates that the proposed UPREIT may leverage its equity through borrowing.

[23] Supplementary information, Community Reinvestment Act Regulations, Final Rule, 60 Fed. Reg. 22,156, 22,166 (May 4, 1995).

[24] *See* Qs and As, 61 Fed. Reg. at 54,657-58 (Q/A 1 addressing § __.23(b)). For more information about and an example of consideration under both the lending and investment tests, please refer to the interagency letter from Matthew Roberts dated June 14, 1996 (designated as OCC Interpretive Letter No. 709) (attached).

Qualified investments may be in-kind investments.[25] In an UPREIT such as the one you described, in addition to lending funds to the property-owning partnerships, the UPREIT also invests in the property-owning partnerships. The form of the investments is real property; and, in return for the property, the operating partnership receives general partnership interests in the property-owning partnerships. As long as the primary purpose of these in-kind investments is community development, as defined in the CRA regulations, the qualified investment assets of the UPREIT may also be considered when the investing financial institution is evaluated under the regulations' investment test.

I trust this letter responds to the issues you have raised. If you have further questions, feel free to contact me or Margaret Hesse, an attorney on my staff, at (202) 874-5750.

Sincerely,

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Michael S. Bylsma
Acting Director
Community and Consumer Law Division
Office of the Comptroller of the Currency

Attachments: Table 1 - *unavailable in electronic format*
Letter from Matthew Roberts (June 14, 1996)
(*http://www.occ.treas.gov/interp/july/cra709re.htm*)

[25] *See, e.g.,* Qs and As, 61 Fed. Reg. at 54,653 (Q/A5 addressing § __.12(s) and 563e.12(r)).