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

**Interpretive Letter #727
July 1996
12 U.S.C. 2901**

June 27, 1996

[]

Dear []:

This letter responds to your correspondence dated May 1, 1996, and May 10, 1996, concerning the treatment under the revised Community Reinvestment Act (CRA) regulations of the proposed purchase by [] ("the Bank") of certain "equity equivalent" instruments to be offered by a non-profit community development lender.* As you know, the four bank and thrift regulatory agencies have promulgated substantively identical CRA regulations. 12 C.F.R. parts 25, 228, 345, and 563e. Therefore, staff from all of the agencies have considered the issues you raised, and they concur in the opinions expressed in this letter.

You have asked whether the Bank would receive favorable consideration under the CRA regulations for its purchase of the equity equivalents. As explained more fully below, the purchase of the equity equivalents would be a qualified investment that examiners would consider under the investment test provided that the investment benefits the Bank's assessment area(s) or a broader statewide or regional area that includes the assessment area(s). Alternatively, the Bank could ask examiners to consider in its lending test evaluation its pro rata share of the community development loans made by the community development lender, again provided the loans benefit the Bank's assessment area(s) or a broader statewide or regional area that includes the assessment area(s). Finally, in some circumstances, the Bank could receive consideration for part of the investment under the lending test and part under the investment test.

*The scope of this letter is limited to whether investments by the Bank in the equity equivalents would receive favorable consideration under the CRA regulations. This letter does not address whether the Bank may lawfully make this investment. Furthermore, the agencies do not endorse particular investment opportunities offered to banks and thrifts.

Background

The [] is a non-profit organization and therefore cannot issue equity stock. However, you state that [] intends to issue equity equivalents that will be identical to stock in key respects. As explained in your letter, the equity equivalents will be booked by the Bank as investments following generally accepted accounting principles; will constitute general obligations of [] that will not be secured by any [] assets; will be fully subordinated to the right of repayment of all other creditors of []; generally will not permit the Bank to accelerate payment of the instrument; will carry an interest rate that is not tied to any income received by []; and will have an initial ten-year “tenor” that annually will be rolled back to a new ten-year tenor.

You state that [] will use the funds provided by the equity equivalents to garner other investments and grants and to make loans to its community development financial institution (“CDFI”) members. The CDFIs, in turn, will use the funds to support their community development programs, which involve providing credit for affordable housing and small businesses to revitalize low-income areas throughout the United States.

Discussion

The new CRA regulations set out a number of different tests for examiners to use in evaluating CRA performance, depending on the size and business strategy of the institution. The CRA performance of a large institution, such as the Bank, is typically evaluated under the lending, investment, and service tests.

The investment test evaluates an institution's number and amount of qualified investments, the innovativeness or complexity of its qualified investments, the responsiveness of the qualified investments to credit and community development needs, and the degree to which the qualified investments are not routinely provided by private investors. See 12 C.F.R. §§ 25.23(e), 228.23(e), 345.23(e), and 563e.23(e). Qualified investments include lawful investments, deposits, membership shares or grants that have as their primary purpose community development. 12 C.F.R. §§ 25.12(s), 228.12(s), 345.12(s), and 563e.12(r). Community development means: affordable housing for low- or moderate-income persons; community services targeted to low- or moderate-income persons; activities that promote economic development by financing small businesses or farms; and activities that revitalize or stabilize low- or moderate-income geographies. 12 C.F.R. §§ 25.12(h), 228.12(h), 345.12(h), and 563e.12(g).

A lawful investment in a security issued by a non-profit, like [], that uses the funds to promote community development by making loans to CDFIs that finance affordable housing for low- or moderate-income persons and promote economic development by financing small businesses, as you state [] will do, is a qualified investment. To be considered in the Bank's evaluation under the investment test, the investment must benefit the Bank's assessment area(s)

or a broader statewide or regional area that includes the Bank's assessment area(s). See 12 C.F.R. §§ 25.23(a), 228.23(a), 345.23(a), and 563e.23(a).

The lending test evaluates an institution's lending activities. 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. See 12 C.F.R. §§ 25.22(b)(4), 228.22(b)(4), 345.22(b)(4), and 563e.22(b)(4). A "community development loan" is a loan that has "community development" as its primary purpose and, except in the case of a wholesale or limited purpose institution, benefits the institution's assessment area(s) or a broader statewide or regional area that includes the assessment area(s) and has not been considered as part of the institution's assessment as a home mortgage, small business, small farm, or consumer loan. 12 C.F.R. §§ 25.12(i), 228.12(i), 345.12(i), and 563e.12(h).

Under the lending test, community development loans originated by a third party in which an institution has invested will be considered, at the institution's option, subject to certain limitations. 12 C.F.R. §§ 25.22(d), 228.22(d), 345.22(d), and 563e.22(d). Generally, the agencies consider an institution to have "invested" in a third party within the meaning of this provision when the institution has made an equity or equity-like investment in the third party -- not when the institution has made a loan to, or purchased an ordinary debt obligation of, the third party.

For example, an institution might purchase stock in a community development corporation (CDC) that lends in low- and moderate-income areas or to low- and moderate-income individuals in order to promote community development. The institution may claim a pro rata share of the CDC's loans as community development loans. By contrast, securities backed by loans, such as mortgage-backed securities, are not equity or equity-like investments in the third party that originated the loans. An institution that purchases these securities cannot receive consideration under the lending test for the loans underlying them, although the institution can receive consideration for the securities themselves under the investment test provided they meet the definition of qualified investment and are appropriately geographically targeted.

As noted above, no one can legally hold a true equity interest in a non-profit like []. However, the purchase of the equity equivalents described above, while not a true equity investment, is sufficiently comparable to qualify as an investment within the meaning of the regulation. Like a true equity interest, the equity equivalents are fully subordinated to the claims of all debtors, are designed to raise revenue for the issuer, and have, in effect, an indeterminate term (because of the rolling tenor). The equity equivalents more closely resemble preferred, rather than common, stock because they have a fixed rate of return and do not confer voting rights. See 11 WILLIAM MEADE FLETCHER, FLETCHER CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS § 5283 (1995). Based on this analysis, if the Bank purchased these equity equivalents, examiners would consider in the Bank's lending test evaluation, at the Bank's request, the Bank's pro rata share of any community development loans made by []

that benefit the Bank's assessment area(s) or a broader statewide or regional area that includes its assessment area(s).

An investing institution's pro rata share of community development loans made by a *for-profit* third party is determined by the percentage of the capital of the third party contributed by the investing institution. The institution's pro rata share of community development loans by a *non-profit* third party is determined in a comparable manner, taking into account the fact that non-profit institutions do not have "capital" and are subject to different accounting rules than for-profit institutions.

The following example illustrates how a purchase of equity equivalents may be considered under the lending test: Assume a community development lender has \$4 million in funds comparable to "capital" -- \$2 million from an investing institution's purchase of equity equivalents and \$2 million from grants. Thus, the investing institution has supplied 50% of this \$4 million. Assume further that the community development lender, after borrowing another \$6 million, makes \$10 million in community development loans during the period under review in the investing institution's CRA evaluation. Under the lending test, the investing institution may receive consideration for \$5 million in community development loans, its pro rata share of the community development lender's community development loans, provided these loans benefit the investing institution's assessment area(s) or broader statewide or regional area that includes the assessment area(s).

To the extent an institution's investment is considered under the lending test, it will not also receive consideration under the investment test. 12 C.F.R. §§ 25.23(b), 228.25(b), 345.25(b), and 563e.25(b). In some circumstances an institution may receive consideration for part of an investment under the lending test and also receive consideration under the investment test for part of the investment that was not considered under the lending test. See OCC Interpretive Letter 673 (June 26, 1995) and the attached interagency interpretive letter.

I trust that this letter has been responsive to your inquiry. The financial supervisory agencies will consider incorporating this guidance into the formal written guidance on the new CRA regulation that is being developed by the staffs of the agencies. If you have any further questions, please feel free to contact me or Michael Bylsma of my staff at (202) 874-5750.

Sincerely,

/s/

Matthew Roberts
Director
Community and Consumer Law Division
Office of the Comptroller of the Currency

