

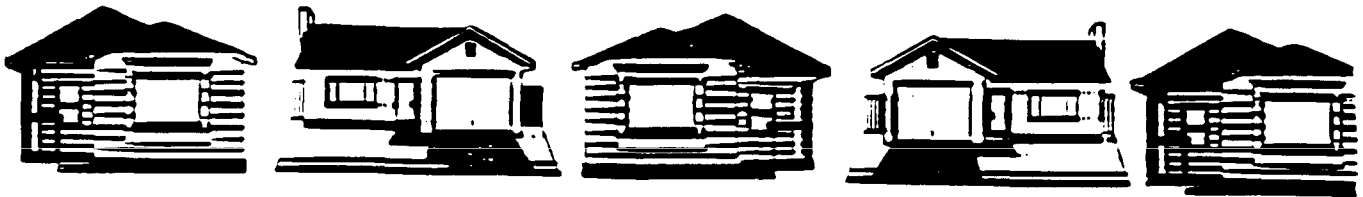


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A Guide to the Federal Laws and  
Regulations Governing Community  
Development Activities of Savings  
Associations



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## INTRODUCTION: SCOPE OF DOCUMENT

The Office of Thrift Supervision (OTS) encourages savings associations to take an active part in community development. By taking the initiative in community development, many savings associations are establishing new markets, reinforcing their identity as community institutions, and enhancing their supervisory performance.

This document provides an overview of the wide range of community development options available to federal savings associations. However, the information in this document is also relevant for state savings associations. The community development authority of state savings associations depends primarily on state law. By virtue of § 28 of the Federal Deposit Insurance Act,<sup>1</sup> state savings associations are prohibited from engaging as principal in any activity or making any equity investment that is impermissible for federal savings associations, subject to certain narrow exceptions. Thus, before engaging in any activity as principal or making any equity investment, state savings associations must first look to state law to find basic authorization, then look to federal law to confirm that the activity or investment is permissible for federal savings associations. The investments and activities of state savings associations are also subject to federal laws regulating matters such as capital, lending limits, the qualified thrift lender test, and the Community Reinvestment Act.

Part I of this document is an executive summary. Part II provides a detailed description of the authority of federal savings associations to engage in various types of community development activities and also traces the regulatory advantages and disadvantages for both state and federal savings associations regarding these various activities. Significant detail is presented in this part of the document so as to enable savings associations to make a thorough regulatory analysis of prospective community development activities without being required to invest substantial time and expense in regulatory research. Part III provides a description of useful contacts, programs, and resources.

This document has been prepared by the Chief Counsel's Office, in cooperation with Specialized Programs. The names and telephone numbers of persons to contact for further information regarding authorized community development activities are listed in Part III.<sup>2</sup>

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<sup>1</sup> 12 U.S.C.A. § 1831e (West 1989).

<sup>2</sup> This document was authored by Jeff Miner, Assistant Deputy Chief Counsel, and John Flannery, Attorney.

## I. EXECUTIVE SUMMARY: AN OVERVIEW OF AUTHORIZED ACTIVITIES

Part II of this document describes the six most significant statutory investment options available to federal savings associations that wish to engage in community development activities. This executive summary provides a brief overview of these six options, and of certain key regulatory benefits that can result from these activities.

- Housing Loans in Low- and Moderate-Income Areas. Federal savings associations are authorized to invest, consistent with safety and soundness, unlimited amounts of their assets in residential real estate loans, including loans in low- and moderate-income neighborhoods.
- Nonresidential Real Estate Loans in Low- and Moderate-Income Areas. Federal thrifts are normally allowed to invest up to 400 percent of capital in nonresidential real estate loans. Federal thrifts may also invest another 5 percent of their assets in loans secured by nonresidential real estate located in an area receiving concentrated assistance under Title I of the Housing and Community Development Act of 1974. Part II provides guidance regarding what areas will be deemed to be receiving concentrated assistance under Title I. This option can provide federal thrifts with significantly expanded nonresidential real estate lending authority.
- Equity Investments in Real Property in Low- and Moderate-Income Areas. Federal savings associations may also invest up to 2 percent of their assets in real estate, or low-income housing tax credit partnerships owning real estate, in areas receiving concentrated assistance under Title I of the Housing and Community Development Act of 1974. This option is the only way federal thrifts can acquire a direct equity interest in real estate, except when purchasing office quarters or foreclosing on a loan. Investments made under this option are aggregated with investments made under the prior option and, thus, count against the 5 percent limit noted above.
- Investments in Securities. Federal savings associations are authorized to invest in securities representing an interest in or backed by community development loans. Investments in these securities are limited to the same percentage-of-assets restrictions, if any, as would apply to the underlying loans themselves. These types of securities provide thrifts with an opportunity to invest in community development

projects without the administrative burden and concentration of risk that can occur when directly originating loans or making equity investments.

- Investments in Community Development Corporations. Federal savings associations are permitted to invest 1 to 3 percent of their assets in service corporations dedicated to community development activities. This can be an effective method for supporting community development activities because service corporations are authorized to engage in a wider range of activities than federal thrifts (e.g., direct investments in real estate without geographic restrictions). These types of subsidiaries also give thrifts an opportunity to isolate potential liability, attract outside investors, centralize community development management and expertise, and promote awareness within the community of an institution's commitment to community development.
- Holding Company Activities. Savings and loan holding companies serve as another excellent vehicle for participating in community development activities. A unitary savings and loan holding company whose subsidiary savings association meets the Qualified Thrift Lender (QTL) test is not subject to any restrictions on its community development activities beyond the general constraints of safety and soundness. Most savings and loan holding companies are restricted to community development activities that are permissible for bank holding companies. However, the scope of community development activities permissible for bank holding companies is quite broad.

Not only are the foregoing investments likely to provide a solid rate of return when originated and managed prudently, they also generally provide important regulatory benefits under both the QTL test and the Community Reinvestment Act (CRA). Under the QTL test, bonus credit is given for a variety of community development investments. See Part II for a full explanation.

In addition, in assessing an association's CRA performance, the OTS places special emphasis on the association's record of originating loans and investments in low- and moderate-income areas in its delineated community and beyond. See Part II.G. for a full explanation.

## II. Authorized Community Development Activities for Federal Savings Associations

### A. Housing Loans in Low- and Moderate-Income Areas

Perhaps the simplest, most direct way that a federal savings association can support community development is by making housing loans in low- and moderate-income neighborhoods. Under § 5(c)(1)(B) of the Home Owners' Loan Act (HOLA), federal savings associations are authorized to invest unlimited amounts of their assets in loans secured by "residential real estate" -- subject, of course, to safety and soundness considerations.<sup>3</sup> To qualify under this provision of the HOLA, a loan need not be a traditional purchase money mortgage on a single-family dwelling. It can also take the form of a loan to finance the construction or rehabilitation of a single-family dwelling or to purchase, construct, or rehabilitate multifamily dwellings (including condominiums, cooperatives, and apartment buildings), provided that in each case the loan is secured by the underlying residential real estate. Special funding is available from the Federal Home Loan Banks (FHLBanks) for savings associations that make housing loans, and certain other types of economic development loans, in low- and moderate-income areas.<sup>4</sup>

Housing loans in low- and moderate-income areas provide important regulatory advantages. In addition to CRA benefits (see Part II.G. below), housing loans in low- and moderate-income areas also receive special QTL credit. The QTL rules give a 200 percent qualified thrift investment (QTI) credit for the amount of an association's loans to fund the acquisition or improvement of residential real estate located in any credit-needy area, provided that this amount, when combined with certain other types of investments, does not exceed 20 percent of portfolio assets.<sup>5</sup> The term credit-needy area includes any area within an association's delineated community that meets at least one of several criteria listed in OTS Thrift Bulletin 20-2, June 15, 1992. These criteria include:

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<sup>3</sup> See 12 U.S.C.A. § 1464(c)(1)(B) (West Supp. 1993).

<sup>4</sup> Each FHLBank is required by law to maintain a Community Investment Program and an Affordable Housing Program to provide low-cost advances to members who help finance housing for low-income families and commercial and economic development activities in low- and moderate-income neighborhoods. 12 U.S.C.A. § 1430(i) and (j) (West Supp. 1993). Contact your regional FHLBank for further details.

<sup>5</sup> See 12 C.F.R. § 563.51(f)(1)(vi)(D).

- Any census tract, county, or area in a Metropolitan Statistical Area with median household income that is 80 percent or less of the MSA median.
- Any census tract, county, or area in a MSA that is 35 percent or more minority with a median household income that is 120 percent or less of the MSA median.
- Any census tract where (a) loans by all institutions -- as reported by the most recently available aggregate Home Mortgage Disclosure Act data -- total 50 percent or less of the average loan volume for all census tracts in the MSA, and (b) the median household income is 120 percent or less of the MSA median.

This is not an exhaustive listing. Other criteria are specified in Thrift Bulletin 20-2.

The QTL rules also give a 200 percent QTI credit (subject to the same 20 percent of portfolio assets cap noted above) for loans to fund the purchase, construction, or rehabilitation of starter homes, regardless of whether those homes are located in a credit-needy area.<sup>6</sup> Starter homes are defined as condominiums, cooperatives, and 1-to-4 family residences that are located within an association's delineated community and have purchase prices not greater than 60 percent of the median value of similar residences within the association's local community.<sup>7</sup> The term also includes housing developments within an association's delineated community where 75 percent or more of the value of the development consists of homes, condominiums, or cooperatives that meet the foregoing criteria.

Under the risk-based capital rules, qualifying mortgage loans and qualifying multifamily mortgage loans are included in the 50 percent risk-weight category.<sup>8</sup> Qualifying mortgage loans are defined as 1-to-4 family residential first mortgage loans that: (i) are prudently underwritten, (ii) are performing, (iii) are no more than 90 days past due, and (iv) have a loan-to-value (LTV) ratio not exceeding 80 percent at origination. Loans not satisfying the LTV ratio requirement may nevertheless be deemed qualifying mortgage loans provided they are insured to at least an 80 percent LTV ratio by a private mortgage insurance company

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<sup>6</sup> See 12 C.F.R. § 563.51(f)(1)(vi)(D).

<sup>7</sup> See Thrift Bulletin 20-2, June 15, 1992. This Bulletin also provides various alternative means for determining "starter home" status when no median value figures are available for an association's delineated community.

<sup>8</sup> See 12 C.F.R. § 567.6(a)(1)(iii)(B).

approved by the Federal Home Loan Mortgage Corporation or the Federal National Mortgage Association.<sup>7</sup> Qualifying multifamily mortgage loans are defined as loans secured by first liens on multifamily residential properties consisting of 5 or more dwelling units and satisfying certain criteria including that the loans: (i) have LTV ratios not exceeding 80 percent (75 percent for variable rate loans), (ii) have debt service ratios of 120 percent (115 percent for variable rate loans), (iii) are performing, (iv) are no more than 90 days past due, and (v) produced timely payments of principal and interest for the year preceding placement in the 50 percent risk-weight category.<sup>10</sup> Also, included within the 50 percent risk-weight category are qualifying residential construction loans, which are residential construction loans for 1-to-4 family homes that meet twelve criteria set forth at 12 C.F.R. § 567.1(jj).<sup>11</sup> In general, these criteria are intended to ensure that the residences under construction have been presold to buyers with sufficient means and commitment to follow through on the purchase and that the construction process is managed prudently. Mortgage loans and multifamily mortgage loans not satisfying the foregoing standards are included in the 100 percent risk-weight category.<sup>12</sup>

Housing loans in low- and moderate-income areas must also comply with other regulatory requirements typically applicable to such loans, including the loans-to-one-borrower (LTOB) limitations<sup>13</sup> and loan documentation<sup>14</sup> and appraisal requirements.<sup>15</sup>

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<sup>9</sup> See 12 C.F.R. § 567.1(u).

<sup>10</sup> See 12 C.F.R. § 567.1(v), as amended at 59 Fed. Reg. 12806 (March 18, 1994). The new multifamily rule "grandfathers" any multifamily mortgage loan that, on the effective date of the rule, qualified for the 50 percent risk-weight category under the OTS's previous rule and that continues to satisfy those criteria.

<sup>11</sup> See 12 C.F.R. § 567.6(a)(1)(iii)(D).

<sup>12</sup> See 12 C.F.R. § 567.6(a)(1)(iv)(D) and (E).

<sup>13</sup> See 12 U.S.C.A. § 1464(u) (West Supp. 1993) and 12 C.F.R. § 563.90.

<sup>14</sup> See 12 C.F.R. § 563.170, as amended at 58 Fed. Reg. 28346 (May 13, 1993).

<sup>15</sup> See 12 C.F.R. § 564.3. The OTS and the other federal banking agencies have proposed modifying the appraisal rules. See 58 Fed. Reg. 31878 (June 4, 1993).



## B. Nonresidential Real Estate Loans in Low- and Moderate-Income Areas

Besides housing loans, federal savings associations can also provide support to low- and moderate-income communities by making loans to finance the purchase, construction, or rehabilitation of nonresidential real estate by businesses and nonprofit organizations located in these areas.<sup>16</sup> Investments by federal savings associations in nonresidential real estate loans are generally limited to no more than 400 percent of capital.<sup>17</sup> However, a special provision of the HOLA -- HOLA § 5(c)(3)(B) -- authorizes federal savings associations to invest an additional 5 percent of assets in nonresidential real estate loans secured by property located in any area "receiving concentrated development assistance by a local government under Title I of the Housing and Community Development Act of 1974."<sup>18</sup>

Although the programs administered by the Department of Housing and Urban Development (HUD) under Title I are quite complex, savings associations need not gain detailed familiarity with these programs to exercise their special authority under HOLA § 5(c)(3)(B). All Title I funds are disbursed through local governments. Thus, savings associations can contact city, town, county, and state governments in their region to obtain information about the extent and location of Title I funding.

Current HUD regulations employ a variety of means to identify geographic areas entitled to receive significant Title I assistance. Loans secured by real estate located in any of these areas, which are listed below, will be deemed by the OTS to qualify under HOLA § 5(c)(3)(B):<sup>19</sup>

- Any area that a community may designate on its Comprehensive Housing Affordability Strategy for targeted housing

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<sup>16</sup> Of course, federal savings associations can also make loans to support the general operations of these businesses and nonprofit organizations pursuant to HOLA § 5(c)(2)(A), subject to a 10 percent of assets investment limit. These loans need not be secured by real estate.

<sup>17</sup> See 12 U.S.C.A. § 1464(c)(2)(B) (West Supp. 1993).

<sup>18</sup> 12 U.S.C.A. § 1464(c)(3)(B) (West Supp. 1993).

<sup>19</sup> Institutions need not look behind the designations listed here to investigate the amount of Title I funds actually flowing to an area. Any area receiving one of these designations will be presumed by the OTS to be receiving concentrated Title I assistance. Thus, these designations provide safe harbors for investments under HOLA § 5(c)(3)(B).

assistance.

- Any Community Development Block Grant code enforcement area.
- Any area in which a Community Development Block Grant special subrecipient is carrying out a neighborhood revitalization project.
- Any area targeted for development assistance on a community's Community Development Block Grant final statement.
- Any Empowerment Zone.

Local government officials should be able to identify the areas within their jurisdiction that have received one or more of the foregoing designations. However, this list is not intended to be exhaustive. Federal savings associations may also make loans secured by nonresidential real estate located in low- and moderate-income areas that have not received one of the above designations, provided the association documents that the area in question is in fact receiving significant Title I assistance. Savings associations that have questions in this regard may contact regional OTS supervisory personnel for a determination whether an area in which they propose to invest qualifies under HOLA § 5(c)(3)(B). The OTS will take a practical, common sense approach to these determinations, considering factors such as the proximity of the proposed investments to projects receiving Title I assistance, the amount and timing of the assistance, and whether the area in question appears to be in need of development.

Because of the significant reduction in recent years in the number of geographic areas receiving concentrated Title I assistance, on a case-by-case basis the OTS may be willing to take a "no action" position on loans that will further the purposes of HOLA § 5(c)(3)(B) by promoting development in needy geographic areas, even though the areas have not received significant Title I assistance. No-action requests should be directed to OTS Chief Counsel's Office, Regulations and Legislation Division. These requests should contain information clearly demonstrating that the loan or loans in question will be made in geographic areas in need of significant community development.

Nonresidential real estate loans in low- and moderate-income areas can generate many of the same regulatory advantages as housing loans in those areas. In addition to CRA benefits (see Part II.G. below), the QTL rules allow a 200 percent credit to QTI for the amount of an association's investment in: (a) loans for the acquisition or improvement of schools, nursing homes, hospitals, houses of worship, or similar facilities (commonly

called community service facilities) located in credit-needy areas in an association's delineated community; and (b) loans made for any purpose to small businesses located in any credit needy area in an association's delineated community.<sup>20</sup> The definition of credit-needy area is the same for these purposes as described above for housing loans in credit-needy areas.

Under the risk-based capital rules, non-residential real estate loans, nonresidential construction loans, and land loans are generally included in the 100 percent risk-weight category.<sup>21</sup> However, the amount of land loans and nonresidential construction loans in excess of an 80 percent LTV ratio must be deducted from the association's assets and capital for purposes of determining total capital when computing an association's risk-based capital requirements.<sup>22</sup>

Nonresidential real estate loans located in low- and moderate-income areas must also comply with other regulatory requirements typically applicable to such loans, including the LTOB limitations and loan documentation and appraisal requirements.

**C. Equity Investments in Real Property in Low- and Moderate-Income Areas (LIHTC Partnerships)**

Although a federal savings association generally may not make equity investments in real estate other than for its own office quarters or in connection with foreclosure on a loan, there is an exception to this general prohibition. Under HOLA § 5(c)(3)(B), the same statutory provision discussed immediately above, federal savings associations also may invest up to 2 percent of their assets in real estate located in areas "receiving concentrated development assistance by a local government under Title I of the Housing and Community Development Act of 1974."<sup>23</sup> The standards for determining whether an area is receiving concentrated development assistance under Title I

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<sup>20</sup> See 12 C.F.R. § 563.51(f)(1)(vi)(D). Loans made to small businesses that are owned by a person living in a credit-needy area in an association's delineated community also qualify, regardless of whether the business is located within that area. Thrift Bulletin 20-2, June 15, 1992.

<sup>21</sup> See 12 C.F.R. § 567.6(a)(1)(iv).

<sup>22</sup> See 12 C.F.R. § 567.5(c)(2)(iii).

<sup>23</sup> See 12 U.S.C.A. § 1464(c)(3)(B) (West Supp. 1993). This provision also permits associations to invest in obligations secured by liens on real property located in areas receiving concentrated assistance.

are the same as described in Part II.B. above. For the same reasons as listed above, an institution may request a no-action letter from the OTS when the investment in question will further the purposes of HOLA § 5(c)(3)(B) by promoting development in needy geographic areas, even though the areas have not received significant Title I assistance. In order to ensure limited liability, it is generally advisable for savings associations to invest in real estate under HOLA § 5(c)(3)(B) via limited partnerships or separate corporations.<sup>24</sup>

Any equity investments made under HOLA § 5(c)(3)(B) must be aggregated with loans made under that provision for purposes of determining compliance with the 5 percent of assets limit described in Part II.B. above. Thus, an institution that invests a full 2 percent of its assets in equity investments in real estate may only invest another 3 percent of assets in nonresidential real estate loans under HOLA § 5(c)(3)(B).

Federal thrifts may use their real estate investment authority under HOLA § 5(c)(3)(B) to participate in low-income housing tax credit (LIHTC) programs, which were authorized by the Tax Reform Act of 1986 and are becoming increasingly popular. Most LIHTC programs are structured using a limited partnership. The general partner is usually a non-profit community organization. The partnership raises capital by selling limited partnership shares. The partnership then acquires and develops or rehabilitates an impoverished property that meets the tax code eligibility requirements. The tax credits, as well as any profits or losses from the property, get passed through to the limited partners.

Federal thrifts are allowed to acquire limited partnership shares in LIHTC partnerships, provided (i) the property owned by the partnership is located in an area receiving concentrated development assistance under Title I of the Housing and Community Development Act or the institution has obtained a no-action letter from the OTS acknowledging that the property is located in a geographic area in significant need of community development, and (ii) the thrift does not exceed the 2 percent aggregate limit on equity real estate investments under HOLA § 5(c)(3)(B). The only way a thrift can invest in a LIHTC partnership that fails to meet either of these two criteria is indirectly through a holding company or a service corporation. See discussion below regarding holding companies and service corporations.

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<sup>24</sup> T Memorandum 79a, Indirect Investments in Permissible Investments (e.g., Leasing and Commercial Loans) Through a Limited Partnership: Federal Home Loan Bank Board Requirements (June 10, 1986).

Equity investments in real estate located in low- and moderate-income areas provide CRA (see Part II.G. below) and QTL benefits to savings associations. The QTL ramifications of such investments turn on the particular type of real estate that is acquired. For these purposes, there are three relevant types of real estate: starter homes, other types of residential real estate, and nonresidential real estate. Up to 200 percent of an association's investments to purchase, construct, or rehabilitate starter homes may be counted as QTI, subject to the 20 percent of portfolio assets cap.<sup>25</sup> This treatment applies regardless of whether the investment is made directly in the starter homes or via a LIHTC partnership. As noted above, starter homes are condominiums, cooperatives, and 1-to-4 family residences that are located within an association's delineated community and have purchase prices not greater than 60 percent of the median value of similar residences within the association's local community, as well as developments within an association's delineated community where 75 percent or more of the value of the development consists of homes, condominiums, or cooperatives that meet the foregoing criteria.

The QTL treatment for investments in other types of residential real estate -- such as condominiums, cooperatives, and 1-to-4 family residences that are not low cost and apartment buildings -- is a bit different. Although the QTL rules do not allow equity investments in -- as opposed to loans for -- these types of residential real estate to be included in QTI, a savings association that wishes to make this type of investment could achieve the same result by making the investment indirectly through an operating subsidiary or service corporation. Under the QTL rules, a savings association may include in QTI 100 percent of its equity and debt investments in any subsidiary that derives at least 80 percent of its annual gross revenues from activities related to purchasing, constructing, refinancing, improving, or repairing domestic residential housing, provided again that this amount when combined with certain other types of investments does not exceed 20 percent of portfolio assets.<sup>26</sup> The term domestic residential housing includes 1-to-4 family homes regardless whether they are low cost, plus condominiums, cooperatives, apartment complexes, and manufactured homes.<sup>27</sup> Thus, a savings association that wishes to invest in these types of properties can get QTI credit for the full amount of its investment (subject to the 20 percent of portfolio assets rule noted above) by doing so through an operating subsidiary or service corporation that meets the 80 percent revenue test. This

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<sup>25</sup> See 12 C.F.R. § 563.51(f)(1)(vi)(C).

<sup>26</sup> See 12 C.F.R. § 563.51(f)(1)(vi)(B).

<sup>27</sup> See 12 C.F.R. § 563.51(d).

treatment applies regardless whether the operating subsidiary or service corporation invests directly in domestic residential housing or does so via a LIHTC partnership.<sup>28</sup>

The QTL rules do not allow equity investments in any type of nonresidential real estate to be included in QTI.

Under the capital rules, the treatment of an equity investment in real estate depends on whether the investment is made directly or through a LIHTC partnership and, if made through a LIHTC partnership, on whether the investment results in control of the partnership under generally accepted accounting principles (GAAP). Equity investments in real estate held directly rather than through a partnership generally must be deducted from total capital for purposes of computing the risk-based capital requirement.<sup>29</sup> However, such investments are not deducted from core capital or tangible capital in calculating an association's compliance with its tangible and leverage capital requirements.

The capital treatment of equity investments in real estate made via LIHTC partnerships turns on whether the partnership is viewed as a subsidiary of the investing thrift. The capital regulations require thrifts to deduct from both tangible and core capital, and thus also total capital, any investment in a subsidiary that engages in activities that are impermissible for a national bank.<sup>30</sup> National banks generally are not permitted to make direct equity investments in real estate (except when purchasing office quarters or foreclosing on a loan).<sup>31</sup> Thus, if a LIHTC partnership is deemed to be a subsidiary, a thrift's investment in that partnership would be deductible from tangible,

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<sup>28</sup> See OTS Op. Chief Counsel, June 23, 1992.

<sup>29</sup> See 12 C.F.R. § 567.1(i) and 567.5(c)(2)(ii). Thrifts must deduct from total capital equity investments that are impermissible for national banks. National banks generally are not permitted to invest directly in real estate except when purchasing office quarters or foreclosing on a loan. National banks may invest in real estate for community development purposes only if they do so indirectly via a partnership or corporation. Hence, thrifts are required to deduct direct investments in real estate (except when purchasing office quarters or foreclosing on a loan) from total capital when computing risk-based capital. See Depository Institution Disaster Relief Act of 1992, Pub. L. No. 102-485, § 6, 106 Stat. 2771, 2774 (1992) (adding a new Eleventh paragraph to § 5136 of the Revised Statutes (12 U.S.C. § 24)), and 58 Fed. Reg. 68464 (Dec. 22, 1993).

<sup>30</sup> See 12 C.F.R. § 567.1(1), 567.5(a)(2)(iv), and 567.9(c)(2).

<sup>31</sup> See footnote 28 above.

core, and total capital, because the partnership activity (*i.e.*, direct ownership of real estate) is impermissible for national banks.

Under the capital regulations, the term subsidiary is ordinarily deemed to include any company in which a thrift holds a 5 percent or greater ownership interest.<sup>32</sup> However, the regulations authorize the OTS to make exceptions to this 5 percent rule when an "investment is more appropriately treated as an equity security."<sup>33</sup> The OTS has determined that investments in LIHTC partnerships that do not exceed the threshold for GAAP control<sup>34</sup> are more appropriately treated as equity investments. When thrifts make equity investments that are permissible for national banks, such investments are not deducted from tangible, core, or total capital. The amounts of such investments are placed in the 100 percent risk-weight category when computing the risk-based capital requirement.<sup>35</sup> Thus, because national banks are permitted to invest in LIHTC partnerships,<sup>36</sup> investments by thrifts in LIHTC partnerships that do not exceed the GAAP control threshold will be included in tangible, core, and total capital and will be placed in the 100 percent risk-weight category.

Investments in LIHTC partnerships that exceed the GAAP control threshold will be reviewed by the OTS (Washington Operations) on a case-by-case basis to determine whether holding capital solely against the amount of the equity investments as opposed to deducting the investment when calculating the association's capital requirements would be consistent with safety and soundness. Factors that could be relevant to such a determination include the amount of the investment compared to the institution's capital, the level of risk posed by the investment, and how a similar investment would be treated if made by a national bank.

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<sup>32</sup> See 12 C.F.R. § 567.1(dd).

<sup>33</sup> *Id.* at footnote 28.

<sup>34</sup> As a general rule, a limited partner is deemed to be in control of a partnership under GAAP if the limited partner holds more than half of the limited partnership shares and also is able to exercise significant influence over management of the partnership. See AICPA Statement of Position 78-9, "Accounting for Investments in Real Estate Ventures."

<sup>35</sup> See 12 C.F.R. § 567.1(i)(2) and 567.6(a)(1)(iv)(T), as amended at 58 Fed. Reg. 15085 (Mar. 19, 1993).

<sup>36</sup> See footnote 28 above.

D. Securities Representing Interests In or Backed By  
Community Development Loans

The trend toward securitization of loans has also had an effect on community development lending. Increasingly, private lenders and non-profit organizations that originate or otherwise deal in community development loans are pooling, packaging, and securitizing those loans. The resulting securities may be backed by any of a variety of types of community development loans, including: (i) loans to fund the purchase, construction, or renovation of housing in low- and moderate-income areas; (ii) loans to fund the purchase, construction, or renovation of community service facilities in low- and moderate-income areas; and (iii) loans to businesses in low- and moderate-income areas.

The OTS and its predecessor, the Federal Home Loan Bank Board (FHLBB), have long taken the position that, as a result of the definition of "loan" in HOLA § 5(c)(6)(B) (which includes "interests" in loans), federal savings associations are authorized to invest not only in the various categories of loans listed in HOLA § 5(c), but also in securities representing an interest in or backed by any such loans.<sup>37</sup> Of course, investments in these securities would be subject to the same percentage-of-assets restrictions, if any, as would apply to the underlying loans themselves by virtue of HOLA § 5(c).

There are several advantages to investing in securities backed by community development loans (hereafter, CDL securities),<sup>38</sup> rather than directly originating or participating in community development loans. CDL securities give savings associations the opportunity to invest in small-denomination securities representing an interest in a diverse pool of

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<sup>37</sup> Before investing in securities representing an interest in or backed by community development loans, savings associations should confirm with the FDIC that such securities will not be considered corporate debt securities for purposes of § 28 of the Federal Deposit Insurance Act. 12 U.S.C.A. § 1831e(d) (West 1989).

<sup>38</sup> The term "CDL securities," as used herein, is intended to refer both to: (i) securities that convey an undivided interest in the underlying community development loans, and therefore, entitle their holders to a direct pass through of interest and principal payments received on those loans (minus operating expenses); and (ii) securities that are collateralized by community development loans and entitle their holders to receive the cash flow generated by such loans (minus operating expenses), even though this cash flow may be disaggregated and repackaged to create various tranches of securities with differing maturities and differing rates of return. However, the term "CDL security," as used herein, does not include any tranche of securities with residual characteristics.



community development loans. This may reduce risk exposure, as well as the administrative burden that comes with loan origination.

Moreover, investments in CDL securities provide the association with CRA (see Part II.G. below) and QTL benefits. The OTS has previously opined that CDL securities receive the same QTL treatment as the loans that underlie those securities.<sup>39</sup> Thus, for example, CDL securities backed by loans to finance the improvement or acquisition of residential real estate in credit-needy areas would be includable in QTI at a rate of 200 percent, subject to the 20 percent of portfolio assets cap. Similar treatment would be accorded to securities backed by loans to fund the acquisition or improvement of community service facilities or loans to fund the operations of small businesses located in credit-needy areas.

Under the risk-based capital regulations, residential mortgage-related securities representing interests in, or collateralized by, loans secured by residential or mixed use real estate may be placed in the 20 percent risk-weight category provided the securities are rated in one of the two highest rating categories by at least one nationally recognized statistical rating organization and satisfy certain other criteria concerning the underlying mortgage loans.<sup>40</sup> Mortgage-related securities issued or guaranteed by Federal National Mortgage Association or the Federal Home Loan Mortgage Corporation are also placed in the 20 percent risk-weight category.<sup>41</sup> All other residential mortgage-related securities (except for those that have been stripped<sup>42</sup> or have residual characteristics) are placed in the 50 percent risk-weight category, unless the underlying loans fail to meet certain prudential standards.<sup>43</sup> Any CDL security representing an interest in or backed by mortgage loans on residences located in low- and moderate-income areas would be classified in accordance with the foregoing rules. Securities backed by residential real

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<sup>39</sup> OTS Op. by Williams, March 5, 1993.

<sup>40</sup> See 12 C.F.R. §§ 567.6(a)(1)(i)(H) and 567.1(k).

<sup>41</sup> Id.

<sup>42</sup> Effective September 30, 1994, stripped mortgage-related securities will receive the same risk-weight capital treatment as similar types of mortgage-related securities, except for collateralized mortgage obligation residual classes (which will remain in the 100 percent risk-weight category). See 58 Fed. Reg. 45799, 45813 (Aug. 31, 1993).

<sup>43</sup> See 12 C.F.R. §§ 567.6(a)(1)(iii), and 567.1(u) and (v).

estate loans not meeting the foregoing criteria, non-residential real estate loans, commercial loans, land loans, or construction loans would be assigned a 100 percent risk weight."

Investments in CDL securities must also take account of the LTOB limits. Although it is possible that under certain circumstances some types of CDL securities (such as CDL securities backed by home mortgages) may not be subject to the LTOB limits, savings associations should generally assume that their investments in CDL securities will be classified as loans, and therefore, subject to the LTOB rules. Identifying the true borrower or borrowers for these purposes requires case-by-case analysis to determine where the true investment and credit risks lie. To avoid inadvertent violations of the LTOB limits, savings associations should generally assume that both the originator of the underlying loans and the organizer of the trust that issues the securities, if different from the originator, are borrowers for purposes of the LTOB limits, absent case-specific advice from the CTS to the contrary. Accordingly, a savings association should generally not invest more than 15 percent of its unimpaired capital and surplus in securities conveying interests in or backed by loans originated by the same originator or in securities issued by trusts organized by the same organizer.

#### E. Investments in Community Development Corporations

There are many business reasons why an institution may wish to channel its community development activities through a special purpose corporation, rather than investing directly via loans, securities, or equity investments in real estate. These reasons may include the potential public relations advantages that could flow from establishment of a special-purpose community development corporation (CDC), a need to create a legal structure that will accommodate multiple investors, a desire to centralize community development management and expertise in a special-purpose corporation, or a desire to protect the institution from liabilities that may result from a community development project.

Although the term community development corporation does not appear anywhere in the statutes or regulations governing federal savings associations, federal savings associations do have

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" See 12 C.F.R. § 567.6(a)(1)(iv). Mortgage-related securities backed by qualifying mortgage loans at the time of origination are transferred to the 100 percent risk-weight category if the underlying loans fail to continue to satisfy the criteria for a qualifying mortgage loan. Mortgage-related securities backed by qualifying multifamily loans at the time of securitization remain in the 50 percent risk-weight category unless the securities fail to receive timely payments in accordance with the securities' terms.

authority to invest in CDCs. This authority is subsumed within the statutory and regulatory provisions governing service corporations.

Under those provisions, federal associations may invest up to 3 percent of their assets in service corporations, but any investment exceeding 2 percent of assets must serve "primarily community, inner-city, or community development purposes."<sup>45</sup> Thus, a federal savings association that invests the legal maximum of 2 percent of its assets in service corporations engaged in activities unrelated to community development still has the authority to invest another 1 percent of its assets in service corporations engaged in community development activities. These activities need not be limited to an institution's local community.<sup>46</sup>

Service corporations are authorized to engage in a wide variety of pre-approved activities that have community development potential, including maintaining and managing real estate; acquiring real estate for prompt development, construction or improvement; acquiring improved real estate for remodeling, renovating or rebuilding; acquiring improved real estate for resale or rental; making all types of loans; providing home ownership counseling; and providing financial counseling for individuals.<sup>47</sup> A service corporation that wishes to provide technical or consulting services or other forms of support services for community development projects or businesses located in low- and moderate-income areas must obtain regulatory approval to do so since this is not a pre-approved activity. In a community development context, such activities are likely to be deemed reasonably related to the business of a federal savings association and, therefore, approved.

Investments by savings associations in CDCs also provide CRA (see Part II.G. below) and QTL benefits. The QTL rules give 100 percent QTI credit (subject to the same 20 percent of portfolio assets cap noted above) for investments in service corporations that derive at least 80 percent of their annual gross revenues from purchasing, refinancing, constructing, improving, or

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<sup>45</sup> 12 C.F.R. § 545.74(d)(1).

<sup>46</sup> See 45 Fed. Reg. 56029, 56030 (August 22, 1980).

<sup>47</sup> See 12 C.F.R. § 545.74(c). Unlike under HOLA § 5(c)(3)(B) (discussed above), no geographic limits are placed on the real estate activities of service corporations. Thus, there is no need to establish that a property is located in an area receiving concentrated assistance from the HUD.

repairing domestic residential housing or manufactured housing.<sup>48</sup>

The capital treatment of investments in CDCs is basically the same as that described above for investments in LIHTC partnerships.<sup>49</sup> Investments in CDCs that exceed the threshold for GAAP control<sup>50</sup> are treated as investments in a subsidiary.

This means the assets of the subsidiary will be consolidated with the parent association's assets in calculating its tangible, core, and total capital, provided the subsidiary holds only assets that a national bank is permitted to hold. If the subsidiary holds any assets that a national bank cannot hold, the association's investment in that subsidiary will be deducted, subject to any applicable transition schedule, from the association's tangible, core, and total capital. For example, a GAAP-controlling investment in a CDC that develops real estate would be deducted from capital (since national banks cannot directly develop real estate) in accordance with any applicable transition schedule, whereas a GAAP-controlling investment in a CDC that originates community development loans would not be deducted (since national banks may directly originate such loans). In the latter situation, the assets of the CDC would be consolidated with the assets of the thrift on a pro rata basis for purposes of computing capital.<sup>51</sup>

Investments in CDCs that do not exceed the threshold for GAAP control are treated as equity investments that are includable in tangible, core, and total capital, provided the investment is of a type permissible for national banks. National banks have broad CDC investment authority. Thus, virtually any thrift investment in a CDC that does not exceed the GAAP control threshold will not be required to be deducted from tangible, core, and total capital. However, the amount of the association's investment in the subsidiary will be placed in the

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<sup>48</sup> See 12 U.S.C.A § 1467a(m)(4)(C)(iii)(II) (West Supp. 1993) and 12 C.F.R. § 563.51(f)(1)(vi)(B).

<sup>49</sup> For appropriate citations to the capital rules, see the discussion of LIHTC partnerships in Part II.C. above.

<sup>50</sup> The general test for GAAP control of a corporation is ownership of a majority voting interest. However, control is also deemed to exist when one company exercises significant influence over the management of another, even if the company does not hold a majority voting interest. See Statement of Financial Accounting Standards No. 94 and Accounting Principles Board Opinion No. 18 and AICPA Statement of Position 78-9.

<sup>51</sup> See 12 C.F.R. § 567.1(a), 567.1(ff), 567.5, and 567.9.

100 percent risk-weight category when computing the risk-based capital requirement.<sup>52</sup>

Loans to CDCs that are not controlled subsidiaries are subject to the LTOB limitations, whereas loans to controlled subsidiaries are exempt from the LTOB limitations, but subject to the service corporation investment limits.<sup>53</sup> The definition of "control" that is applicable for these purposes is set forth at 12 C.F.R. § 563.41(b)(4):

Finally, there are certain structural restrictions that apply to service corporations that must be considered when investing in a CDC. A first-tier service corporation must be chartered in the same state as the thrift's home office is located.<sup>54</sup> Moreover, a first-tier service corporation must be owned exclusively by thrifts.<sup>55</sup> These structural restrictions do not apply below the first-tier, however. Thus, a federal savings association that wishes to invest in a CDC that is chartered in another state or that has multiple investors, some of whom are not thrifts, may do so by transferring funds to a first-tier service corporation subsidiary, which, in turn, invests in the CDC. Generally, this two-tiered structure would not have any adverse CRA, QTL, capital, or LTOB consequences.

#### F. Holding Company Activities

Unitary savings and loan holding companies<sup>56</sup> are subject to fewer community development restrictions than savings associations. In fact, so long as its subsidiary savings association satisfies the QTL test, a unitary holding company is not subject to any restrictions on its community development activities, provided such activities do not threaten the safety and soundness of its subsidiary savings association.<sup>57</sup> Thus, a unitary savings and loan holding company serves as an excellent vehicle for engaging in community development activities.

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<sup>52</sup> See 12 C.F.R. § 567.1(i)(2) and 567.6(a)(1)(iv)(T), as amended at 58 Fed. Reg. 15085 (Mar. 19, 1993).

<sup>53</sup> See 12 C.F.R. §§ 563.93(a), 563.41(b)(4), 567.1(dd), and 545.74(d)(i).

<sup>54</sup> See 12 C.F.R. § 545.74(b).

<sup>55</sup> See 12 U.S.C.A. § 1464(c)(4)(B) (West Supp. 1993).

<sup>56</sup> A "unitary savings and loan holding company" is a company that controls only one savings association.

<sup>57</sup> See 12 C.F.R. § 584.2a(a)(1)(i).

Although multiple savings and loan holding companies<sup>58</sup> and unitary savings and loan holding companies with subsidiary thrifts not in compliance with the QTL test are subject to certain activities restrictions,<sup>59</sup> these holding companies are authorized to engage in any activities permissible for bank holding companies.<sup>60</sup> Bank holding companies are expressly authorized to engage in projects "designed primarily to promote community welfare, such as the economic rehabilitation and development of low-income areas by providing housing, services, or jobs for residents."<sup>61</sup> Thus, even multiple savings and loan holding companies and unitary savings and loan holding companies with subsidiary thrifts not in compliance with the QTL requirements are able to engage in virtually any type of community development activity free from the investment limits and other regulatory restrictions that would apply if conducted at the savings association level or through a subsidiary of a savings association.

#### G. CRA Benefits

Each of the community development investment options described in Part II, except for those engaged in by savings and loan holding companies, provide savings associations with CRA benefits. Currently, OTS examiners evaluate a savings association's CRA performance based on a twelve-factor test which takes into account the association's "record of meeting the credit needs of its entire community, including low- and moderate-income neighborhoods."<sup>62</sup> OTS regulations specify that a savings association will receive CRA credit for making loans and investments in its delineated community. This is true regardless whether the loans or investments are made directly or indirectly through a subsidiary.

Moreover, as a matter of practice, OTS examiners give favorable consideration to loans and investments made outside an

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<sup>58</sup> A "multiple savings and loan holding company" is a company that directly or indirectly controls two or more savings associations. See 12 C.F.R. § 583.12.

<sup>59</sup> See 12 C.F.R. § 584.2(b). However, such restrictions do not apply to multiple savings and loan holding companies if all or all but one of the subsidiary thrifts were acquired pursuant to an assisted acquisition and such thrifts satisfy the QTL test. See 12 C.F.R. § 584.2a(a)(1)(ii).

<sup>60</sup> See 12 C.F.R. § 842.2-2(a).

<sup>61</sup> 12 C.F.R. § 225.25(b)(6).

<sup>62</sup> 12 U.S.C.A. § 2903 (West 1989), and 12 C.F.R. § 563e.7.

association's delineated community, provided: (i) the association would otherwise receive CRA credit for making the loan or investment but for its geographic location; and (ii) the association's loans and investments in its delineated community are at a "satisfactory" level. Thus, investments made in areas located outside an association's delineated community, including investments in CDL securities representing a geographically diverse pool of loans, could enhance a CRA rating that is already at least "satisfactory."

The four federal banking agencies, including the OTS, have recently proposed to replace the existing CRA regulations in their entirety with new regulations in an attempt to improve the effectiveness and fairness of the CRA.<sup>63</sup> The proposed regulations would replace the current twelve-factor test with a three-part performance-based test. Under the proposed regulations, most banks and thrifts would be examined on the degree to which they provide: (i) loans in low- and moderate-income areas, (ii) investments in low- and moderate-income areas, and (iii) branches and other services to low- and moderate-income areas. Small institutions, although required to comply with the CRA, would be subject to a more streamlined examination.<sup>64</sup> This examination would include a review of certain lending criteria with respect to the institution's service area such as loan-to-deposit ratio, the number of loans made, and loan mix.

Under the proposed regulations, savings associations would be evaluated primarily under the lending test, but could boost their CRA ratings by engaging in equity investment activities and by providing branches and other services in low- and moderate-income areas. Under the lending test, savings associations would receive CRA benefits for making direct loans in low- and moderate-income neighborhoods in their service area or indirect loans through lending consortia or community lending organization that lend in low- and moderate-income areas regardless of whether located in the institution's service area. In addition, equity investments by savings associations and branch locations and other services that benefit low- and moderate-income areas or persons in the thrift's service area would be considered during the CRA examination. Moreover, the proposed regulations expressly provide that community development loans and investments made in areas outside the thrift's service

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<sup>63</sup> 58 Fed. Reg. 67,466 (Dec. 21, 1993), to be codified at 12 C.F.R. Part 563e).

<sup>64</sup> Small institutions are defined as independent institutions with assets of less than \$250 million or institutions, with less than \$250 million in assets, that are members of holding companies with total banking and thrift assets of less than \$250 million.

area may be considered by OTS examiners in determining the association's CRA rating.

Thus, under both the current and proposed CRA regulations, any of the community development option discussed in this document (except activities conducted through a holding company) could have a significant positive impact on an institution's CRA rating.

#### H. Recent Developments

This document provides an overview of the principle community development investment options currently available to federal savings associations. This overview is not intended to be exhaustive. Although we have attempted to describe the most significant community development investment options, there are other specialized provisions in the HOLA that are not discussed here that may prove helpful under some circumstances.<sup>65</sup>

In addition, at the time of publication of this document, numerous bills have been introduced in Congress to encourage additional community development activity by financial institutions. One of these bills, the Administration's proposal,<sup>66</sup> would create the Community Development Banking and Financial Institutions Fund (the Fund) to provide technical and financial assistance to community development financial institutions.<sup>67</sup> The term community development financial institutions (CDFI) refers to community development banks, revolving loan funds, minority-owned depository institutions, and (most important for savings associations) community development corporations whose primary mission is lending to and developing an underserved target area or population that is low-income or disadvantaged. In addition to providing government funds and technical assistance to assist CDFIs, the Administration's proposal would authorize the Fund to incorporate private entities that could receive private contributions and investments from the private sector, including savings associations.

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<sup>65</sup> See, e.g., 12 U.S.C.A. §§ 1464(c)(1)(K) (loans insured under the National Housing Act), 1464(c)(1)(N) (investments in stock or partnership interests under Title IX of the Housing and Urban Development Act of 1968), 1464(c)(1)(O) (additional loans insured under the National Housing Act), 1464(c)(1)(P) (investments in state housing corporations), 1464(c)(4)(A) (investments in business development credit corporations), and 1464(c)(4)(D) (investments in small business investment companies).

<sup>66</sup> H.R. 2666, 103rd Cong., 1st Sess. (1993).

<sup>67</sup> Financial assistance could be in the form of loans, equity investments, deposits, membership shares, or grants.



Thus, the potential significance of the Administration's bill for savings associations is twofold: (i) it may provide a means by which CDC subsidiaries of savings associations can receive technical or financial assistance; and (ii) it may result in the creation of new community development investment opportunities for savings associations if the Fund incorporates private entities to serve as conduits of private investments in CDFIs. Savings associations should continue monitoring developments in this area.

### III. COMMUNITY DEVELOPMENT RESOURCES

As savings associations explore the most effective methods to expand their involvement in the communities they serve, they can turn both to traditional resources and to a growing array of new community initiatives by public and private organizations.

City or county governments are a good place to seek assistance in identifying unmet community needs as well as potential partners. Since most communities have recently developed a new Comprehensive Housing Affordability Strategy to qualify for federal housing and community development funds from HUD, local governments should be able to provide an excellent current overview of community needs.

All FHLBank members can tap the technical expertise of their Bank's Community Investment Office. Also, each FHLBank has two community development programs, the Affordable Housing Program and the Community Investment Program, to provide special funding for the community development investments by savings associations and others. See footnote 3 above.

Often a community needs investments or improvements that are too large, complex or difficult for one savings association to tackle as part of its normal business operations. Consequently, thrifts have found it beneficial to participate in cooperative efforts involving state and local housing development agencies, other federal agencies, FHLBanks, churches, nonprofit organizations, for-profit developers, and other financial institutions. There are many success stories where financial institutions have joined together with non-profit organizations and local and state agencies to turn communities around. Local governments often provide subsidies and guarantees that permit leveraging of private credit granted by financial institutions and allow the institution to earn a secure market rate of interest.

If you have any questions concerning the information contained in this document or would like additional information on authorized community development activities for federal savings associations, you may contact the community affairs liaison in the OTS office located in your region:

Northeast Region:	Ada Melendez Moran	(201) 413-7501
Southeast Region:	Lynn Bedard	(404) 888-8443
Central Region:	Helen Mirza	(312) 540-5963
Midwest Region:	T. Aaron Satterthwaite, Jr.	(214) 281-2114
West Region:	Jim Woods	(415) 616-1551

In Washington, you may contact John Flannery, Chief Counsel's Office, (202) 906-7293, or Gilda Morse, Policy-Consumer Affairs Division, (202) 906-6238.