Financial Issues Subcommittee Recommendation to the
Federal Communications Commission's
Advisory Committee on Diversity for Communications in the Digital Age

December 10, 2004

Recommendation on the Community Reinvestment Act

BE IT RESOLVED, that the Advisory Committee on Diversity for Communications in the Digital Age urges the Federal Communications Commission to seek revisions to the Community Reinvestment Credit Act regulations to expand the definition of "qualified investments" to include private equity funds led by minority and women management teams, and private equity funds that invest in urban and rural communities.

BE IT RESOLVED FURTHER, that the Advisory Committee on Diversity for Communications in the Digital Age will convene a panel of experts to provide further expertise and counsel to the Financial Issues Subcommittee in support of this effort, and that the Subcommittee report its recommendations within FY 2005.

White Paper on
The Community Reinvestment Act
Increasing Access to Capital
Presented by the Access to Capital Subcommittee,
FCC Advisory Committee on Diversity for Communications in the Digital Age

November 4, 2004

Overview*

Since July 1, 1997, the joint rule under the Community Reinvestment Act (the "CRA")[1] has strongly encouraged large banks[2] to have a program of ongoing qualified investment activity in their communities and regions in order to meet their obligations under CRA. The CRA regulations present banks with a continuing need to make investments that qualify for CRA purposes, are permissible under the Glass-Steagall Act and related regulations, and provide a return consistent with the safe and sound operations of the bank.[3]

Investment in a fund licensed as a Small Business Investment Company ("SBIC"), administered by the Small Business Administration, gives a bank the opportunity to accomplish all three of these objectives. An investment in an SBIC operating in a bank's community or region is specifically identified in the Interagency Interpretive Questions and Answers Regarding Community Reinvestment for the joint rule[4] as a type of investment which will be presumed by the regulatory agencies to be a "qualified investment" for CRA purposes.[5] Likewise, Federal law explicitly permits banks to invest in and own SBICs.[6] Finally, the banking industry has substantial experience with both independent and affiliated SBICs.[7] The data on investment results of existing bank-affiliated SBICs demonstrate that as an industry, SBICs have provided returns on invested capital consistent with (or in many cases higher than) the return on the capital employed by their bank investors in their principal lines of business. [8]

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Background – The Community Reinvestment Act

The CRA. In 1977, Congress enacted the Community Reinvestment Act to encourage banks to help meet the credit needs of the local communities in which they operate.[9] To implement the CRA, each of the four federal bank regulatory agencies (the Office of the Comptroller of the Currency, the Federal Reserve Board, the Federal Deposit Insurance Corporation, and the Office of Thrift Supervision) promulgated regulations.[10]

The CRA Regulations. The CRA regulations establish the framework and criteria that each agency uses to evaluate a bank's performance in meeting the credit needs of its local community under the CRA. Banks are examined on a regular basis by their regulating agencies to assess how well the bank's activity has met the credit needs of its local community in the areas of lending, service and investment as measured by the regulatory standards established in the CRA regulations.[11] The agencies numerically grade each bank's performance in each of the three areas specified by the joint rule, and the combined grades for all three areas determine a bank's overall CRA performance rating.[12] The agency evaluation of a bank's CRA performance is a public document, and is required to include the agency's assessment of the bank's performance in each area and the overall CRA rating.[13]

Regulatory Compliance. The CRA does not permit the bank regulatory agencies to require banks to achieve any specified CRA performance rating.[14] Banks are strongly motivated to achieve high ratings, however, because the agencies are expressly authorized by the CRA to take a bank's CRA performance into account when reviewing an application by the bank for approval of an activity relating to deposit-taking facilities (e.g., acquisitions, new branches, and the like).[15] Historically, the bank regulatory agencies have made it clear that the quality of a bank's CRA performance can have a significant impact, both positive and negative, on obtaining regulatory approvals desired by the bank, making CRA performance important to the overall operations of the bank.[16]

Other Effects. A bank's CRA rating can also have effects beyond the CRA regulations, for example Federal Housing Finance Board regulations restrict long terms advances by Federal Home Loan Banks to a member bank unless the member bank has at least a "Satisfactory" CRA rating.[17] For many banks, an "Outstanding" CRA rating is also an important aspect of the bank's corporate image of quality, community involvement and industry leadership, and has a significance that extends beyond the bank's relationship with its regulating agency.

Background – The CRA Regulations

The Joint Rule. Beginning in 1993, all four federal regulatory agencies began a collective effort to develop new joint CRA regulations.[18] This effort culminated in the promulgation of a joint rule by all four agencies on May 4, 1995.[19] That joint rule replaced the previous CRA regulations in their entirety. The provisions of the joint rule were phased in over a two-year period, from July 1, 1995, to July 1, 1997, when all provisions of the joint rule went into effect.[20]

Ongoing Interpretation and Application of the CRA Regulations. Since the promulgation of the joint rule, the agencies have continued to develop their regulatory policy on CRA performance through the publication of "Interagency Questions and Answers Regarding Community Reinvestment" that interpret the regulations through responses to specific frequently asked questions.[21] The agencies have also provided guidance on specific questions relating to the application of the CRA regulations through issuance of Interpretive Letters.[22] In addition, the increasing number of publicly available bank CRA Performance Evaluations sheds some light on how the standards for CRA performance are being applied by examiners in the field.[23]

Scope. The joint rule applies to substantially all the banks operating in the U.S.[24] There are limited exceptions for "special purpose" banks (such as "banker's banks" and banks that provide only cash management controlled disbursement services, correspondent banking services, trust company services, or clearing agent services) and for certain types of uninsured banks.[25] There are also special provisions for "small banks."[26] The rules specifically apply, however, to limited purpose banks, wholesale banks and insured Federal or state branches of foreign banks.[27]

The Credit Needs of the Community. The joint rule generally provides that each agency will base a bank's CRA rating on an evaluation of the bank's performance record in meeting the credit needs of its community.[28] The concept of a community's credit needs used in the joint rule explicitly incorporates the concept of community development.[29] Community development under the regulations is an active concept that requires a bank to take affirmative action to address the needs of its community. This contrasts with the prior CRA regulations which listed as the first two criteria for evaluating a bank's CRA performance the activities conducted by the bank to ascertain the credit needs of the community and the bank's activities to make the community aware of the credit services that the bank had to offer.[30]

The Definition of a Bank's Community. The joint rule requires a bank to specify the geographic area that it considers to be the community in which the bank operates.[31] This defined community is referred to as the "assessment area."[32] In general, a bank's assessment area is defined in terms of the consolidated metropolitan statistical areas or other political subdivisions within which the bank's headquarters, branches and deposit-taking ATM machines are located, as well as any contiguous surrounding areas in which the bank originated or purchased a substantial portion of its loans.[33] In addition to a bank's local community (defined by its assessment area), a bank can define a larger statewide or regional area within which it operates. This larger "region" must include the bank's assessment area or areas, must be contiguous, and must be defined in terms of political units (such as states, counties or cities).[34]

Evaluating a Bank's CRA Performance. A bank's overall CRA performance is rated as "Outstanding," "Satisfactory," "Needs to Improve," or "Substantial Noncompliance."[35] To determine a bank's overall CRA rating, the agencies rate the bank on the basis of its performance in each of three performance categories: lending, service, and investment.[36] In determining the CRA rating, a bank's performance in each of the three areas is scored separately.[37] In this regard, the joint rule specifically provides that activities considered for purposes of evaluating performance under the lending and service tests may not be considered when evaluating performance under the investment test.[38] Performance in each category is rated numerically, but the three tests are not all of equal weight. The overall CRA rating is determined by a matrix, which takes both the individual test scores and the bank's combined score on all three tests into account in determining the bank's overall CRA rating.[39] Subject to some exceptions, the matrix gives the lending test a 50% weight and each of the service and investment tests a 25% weight in determining the overall CRA rating.

Investment and CRA Performance Ratings. The requirement that activities evaluated under the lending or service tests cannot be considered when evaluating performance under the investment test requires a bank to focus specifically on its investment activity, as distinct from lending and other banking activities. This emphasis is reinforced by the scoring methodology used under the joint rule. Scoring under the joint rule is intentionally structured so that satisfactory performance in all three performance tests is important to the overall rating. The performance scoring system in the joint rule is discussed in the preface to the joint final rule in the adopting release, which describes the specific intention of the agencies to require that even if a bank had the maximum score in both lending and one of the other two areas, at least a "low satisfactory" performance rating in the third area would be necessary for the bank to receive an overall CRA rating of "Outstanding."[40] The effect of investment performance test ratings on overall bank CRA ratings can be seen by reviewing the publicly available CRA Performance Evaluations on the agency's Internet web sites.[41]

Background – The Investment Test

Effective Date for the Investment Test. Since July 1, 1997, a bank's investment activity has been one of the three types of activity that is evaluated by the regulating agencies to determine a bank's CRA rating. The joint rule requires the regulating agencies to evaluate a bank's record of helping meet the credit needs of its assessment area through qualified investments that benefit its assessment area or a broader statewide or regional area that includes the bank's assessment area(s).[42]

Criteria for Evaluating Investments. The joint rule provides four specific criteria to be used in evaluating a bank's CRA investment performance: (1) the dollar amount of qualified investments, (2) the innovativeness or complexity of the investments, (3) the responsiveness of the investments to credit and community development needs, and (4) the degree to which such investments are not routinely made by private investors.[43] While the dollar amount of an investment is a quantitative matter, the other three criteria require a qualitative evaluation of an investment. The 1999 Interagency Questions and Answers discusses how examiners should combine the quantitative and qualitative criteria, and indicate that the quantitative evaluation of the amount of a bank's investments determines a base rating, and the evaluation of the qualitative aspects of the investments determine whether there is a basis for a higher rating than would be justified solely by the amount of the bank's investments.[44]

Qualified Investments. For purposes of evaluating a bank's performance under the investment test, the joint rule defines the characteristics of investments which can be considered. These investments are referred to as "qualified investments." [45] The joint rule defines qualified investments as lawful investments that have as their primary purpose community development.

Both "primary purpose" and "community development" are used as terms of art in the definition of qualified investment.

The Definition of Community Development. The definition of "community development" in the joint rule[46] specifically identifies four activities: (1) affordable housing and community services for low- and moderate-income people (2) community services to low- and moderate income people, (3) activities that promote economic development by financing businesses or farms that meet the size eligibility standards of the Small Business Administration's Development Company or Small Business Investment Company programs[47] and (4) activities which revitalize or stabilize low- and moderate-income communities. [48] The activities listed as items (1), (2) and (4) reflect traditional concepts of community development. The explicit inclusion of "financing businesses and farms" in item (3) as a community development activity is a significant change from the much vaguer language regarding community development in the old regulations.[49]

The Definition of Primary Purpose. The term "primary purpose" is critical to determining whether an investment will be a "qualifying investment." The term, however, is not defined in the regulation and has been the subject of considerable uncertainty. The 1999 Interagency Questions and Answers adopted a new question and answer specifically to clarify the term.[50] An investment has as its primary purpose community development when it is "designed for the express purpose" of accomplishing one of the four activities in the definition of community development. An investment is viewed as being "designed for the express purpose" of accomplishing a community development activity if it meets one of two tests. The first test is whether a majority of the dollars of the investment are identifiable to one or more of the four community development activities. If the first test is not met, an investment may still qualify if (1) the express, <u>bona</u> <u>fide</u> intent of the investment is to achieve a community development purpose, (2) the investment is specifically structured to achieve the community development purpose, and (3) the investment actually accomplishes or is reasonably certain to accomplish its community development purpose.

Investments in Businesses Qualify under CRA. The joint rule expressly recognizes investments (distinct from loans) by banks in businesses and farms as a qualified CRA activity.[51] Although the language of the joint rule does not distinguish between "financing businesses and farms" and the other types of activity listed in the definition of "community development," the bank regulatory agencies have interpreted the regulation to require that even if a business meets the size standards set forth in the definition of community development, an investment in a business or farm must additionally meet one of the other criteria listed in the definition in order to be considered a "qualified investment."[52]

Background - SBICs as Qualified Investments

SBICs are Permitted Nonbank Investments for Banks. As discussed above, bank ownership of SBICs is specifically authorized by statute.[53] Equally important, securities owned by an SBIC in nonbank businesses are <u>not</u> attributed to a bank which owns an interest in the SBIC. This non-attribution is the case whether the SBIC is a wholly owned subsidiary of the bank or the bank is a minority owner of an independent SBIC. As a result, SBICs avoid a common problem for banks considering community development activity through investments in nonbank businesses.

SBICs are Qualified Investments. SBICs have a unique favorable treatment as qualified investments under the CRA regulations and agency interpretations. The adopting release for the final joint rule specifically identifies investment in an SBIC as an example of a qualified investment for CRA purposes.[54] The status of SBICs as qualified investments is clarified further in the 1999 Interagency Questions and Answers, which state that bank examiners will "presume" that an investment in an SBIC promotes economic development and meets the standard for a "qualified investment."[55] In addition, the release for the joint rule clearly contemplates that it is the investment by the bank in the SBIC itself that is considered for CRA purposes, not the underlying portfolio investments subsequently made by the SBIC.[56]

SBICs' Comparative Advantage as Qualified Investments. The presumption of economic development purpose given to SBICs creates an important distinction between an SBIC and most other types of investments (including non-SBIC investment funds) for a potential bank investor. A bank's investment in an SBIC will be presumed by examiners to be a qualified investment without further evaluation. In the case of non-SBIC investment funds, however, examiners will specifically evaluate whether the primary purpose of the fund is to engage in one or more of the community development activities specifically enumerated in the regulations.[57] In the case of a typical "blind pool" investment fund planning to invest in businesses, this determination can be difficult to make.

Independent and Bank-Affiliated SBICs. Investments in independent SBICs and affiliated SBICs are both considered qualified investments under the joint rule. The joint rule specifically permits a bank to receive credit for a qualified investment made by an affiliate (including a bank holding company parent), so long as no other bank is also claiming CRA credit for that investment.[58] The provisions of the joint rule which allow a bank to receive CRA credit for investments by affiliates allow a bank to take advantage of a broader range of investment opportunities than it could participate in directly.[59] This flexibility provides a bank that wishes to use the SBIC program as a means of addressing its CRA obligations with a wide range of alternatives in structuring and managing a qualified investment program.

Local, State, and Regional Investment. The investment test under the joint rule specifically permits consideration of qualified investments made outside the bank's assessment area in a broader surrounding region that includes the assessment area.[60] In the case of wholesale and limited purpose banks (such as credit card banks), the regulations permit a bank to consider qualified investments on a nationwide basis.[61] Permitting a regional investment focus makes it easier for a bank to determine in advance whether a prospective SBIC will be an appropriate qualified investment. As a result, allowing an SBIC that has a regional (and for some banks, national) focus to be considered a qualified investment makes SBICs much more attractive and practical investments for CRA oriented bank investors.[62]

The Importance of the Regional Investment Focus. Recognizing regionally focused SBICs as qualified investments is an important step in aligning the CRA regulations with the way SBICs actually need to operate in order to be economically viable investment operations.[63] A broad geographic territory is important for the successful operation of most SBICs, since few individual assessment areas can provide sufficient deal flow to permit an SBIC to create a diversified portfolio of private investments.[64] In addition, because many SBICs (particularly independent SBICs) are formed as "blind pools" with a limited investment period (normally 2 to 4 years) it is rarely possible to predict whether a specific locality or community will generate potential investment opportunities for a particular SBIC.

Evaluating a Specific Investment for CRA Purposes. A question frequently asked by both SBIC managers and bankers is whether a bank will receive "CRA credit" for a particular investment in an SBIC. The first issue is whether the SBIC is a "qualified investment" as defined in the joint rule. For an SBIC, the answer to this question will normally be yes, because an investment in an SBIC is presumed under the joint rule to be a qualified investment.[65] The second issue is whether the SBIC is relevant to the bank's CRA performance. In the first instance, the answer to this question depends on whether the SBIC operates in the bank's region.[66] This is a factual question and the answer will depend on the SBICs business plan (does the SBIC explicitly intend to seek investments and/or invest in the bank's region) and the SBIC's actual performance.

Weighing Qualified Investments. All qualified investments do not receive equal weight (equal "CRA credit") in the evaluation of a bank's CRA performance. To the extent information is available, examiners will assess the needs and opportunities for qualified investments in a bank's performance context.[67] Examiners evaluate qualified investments using the criteria described in the joint rule: taking into account both the amount of the investment[68] and any other qualitative factors.[69] Finally, since almost all SBICs operate on a regional basis (as opposed to operating exclusively in a bank's assessment area), examiners will evaluate the degree to which the SBIC's investment activity is likely to (or does) benefit the bank's assessment area.[70] While the 1999 Interagency Questions and Answers are clear that an investment need not directly benefit a bank's assessment area, it seems equally clear that the more likely it is that the investment will produce a benefit to the assessment area, the greater the weight that investment will receive.

Impact

The investment performance required by the joint rule has caused many banks to expand their investment activities in order to maintain the CRA rating necessary for the smooth operation of their banking business. For SBICs, the uniquely favorable treatment of bank investments in SBICs under banking and CRA regulations provides an additional benefit an SBIC can offer prospective bank investors. For banks, an independent or affiliated SBIC can provide a qualified investment opportunity with distinct advantages compared with other types of qualified investments currently available to banks.

As previously mentioned Subcommittee's report of June 14, the National Association of Investment Companies ("NAIC") is a trade association of private equity funds led by minority management teams and who invest in opportunities led by women and minority entrepreneurs, and/or in opportunities in underserved markets. Currently, NAIC member funds manage over $5 billion. While this is an impressive number, it is estimated by the National Venture Capital Association that its member funds currently manage more than $65 billion. The disparity of investment capital between NAIC and NVCA member funds is stark. This is despite the fact that an independent study conducted by the Kauffman Foundation, *Minorities and Venture Capital: A New Wave of American Business*, July, 16, 2003, found that the financial returns from NAIC member funds were comparable to or exceeded majority managed funds. Clearly, private equity funds that provide investment dollars to underserved entrepreneurs and markets need greater access to capital. An amendment to, or revision of, the Community Reinvestment Act to authorize such investments by banks would provide increased funding resources for such funds.

Recommendation

The Subcommittee on Access to Capital recommends that the Advisory Committee adopt a resolution as follows:

RESOLVED, that the Advisory Committee on Diversity for Communications in the Digital Age urges the Federal Communications Commission to seek revisions to the Community Reinvestment Credit Act regulations to expand the definition of "qualified investments" to include private equity funds led by minority and women management teams, and private equity funds that invest in urban and rural communities.

RESOLVED FURTHER, that the Advisory Committee on Diversity for Communications in the Digital Age convene a panel of experts to provide further expertise and counsel to Access to Capital Subcommittee in support of this effort, and that the Subcommittee report its recommendations within FY 2005.

Appendix
CRA and SBIC Related Resources Available on the Internet

This Appendix provides directions for locating some of the resource materials relating to the Community Reinvestment Act and the Small Business Investment Company Program and a selection of Internet web sites which have a broad range of information related to the SBIC program and the CRA regulations. The lists provided in this Appendix are intended to provide an introduction and quick reference guide, and are not a comprehensive list of the wide variety of information available through the Internet.

CONGRESS

U.S. Senate

U.S. Senate Banking Committee

- www.senate.gov/banking

U.S. Senate Small Business Committee

- www.senate.gov/smbiz

U.S. House of Representatives

House Banking Committee

- www.house.gov/banking

House Small Business Committee

- www.house.gov/smbiz

Congressional Record

- www.access.gpo.gov/su_docs/aces/aces150.html

Library of Congress

- www.loc.gov

FEDERAL AGENCIES

Board of Governors of the Federal Reserve System

- www.bog.frb.fed.us

Federal Deposit Insurance Corporation

- www.fdic.gov

Federal Financial Institutions Examinations Council

- www.ffiec.gov

Federal Housing Finance Board

- www.fhfb.gov

Office of the Comptroller of the Currency

- www.occ.treas.gov

Office of Thrift Supervision

- www.ots.treas.gov

Small Business Administration

- www.sba.gov

SBA Investment Division

- www.sba.gov/INV

COMMUNITY REINVESTMENT ACT MATERIALS

Community Reinvestment Act Regulations

- www.occ.treas.gov/craindx.htm

Interagency Questions and Answers Regarding Community Reinvestment

- www.ffiec.gov/cra/info

Interpretive Letters on CRA issues

- www.ffiec.gov/cra/info

Interagency CRA Ratings data base

- www.ffiec.gov/cracf/crarating/main.cfm

CRA Performance Evaluations

- www.bog.frb.fed.us/DCCA/CRA/crarate.cfm (Banks examined by the Federal Reserve System)

- www2.fdic.gov/dcacra/cra_data.cfm (Banks examined by the FDIC)
- www.ots.treas.gov/cra.html. (Banks examined by the OTS)
- www.occ.treas.gov/electric.htm (Banks examined by the OCC)

SMALL BUSINESS INVESTMENT COMPANY PROGRAM MATERIALS

Small Business Act

- www.sba.gov/INV

Small Business Investment Company Act

- www.sba.gov/INV

Small Business Investment Company Regulations (Part 107)

- www.sba.gov/INV

Size Standard Regulations for the SBIC Program (Part 121)

- www.sba.gov/INV

SBA Forms for the SBIC Program

- www.sba.gov/INV

SBA Statistical Information on the SBIC Program

- www.sba.gov/INV

Directory of SBICs

- www.sba.gov/INV

TRADE ASSOCIATIONS

National Association of Small Business Investment Companies

- ww.nasbic.org

National Association of State Venture Funds

- www.nasvf.org

National Venture Capital Association

- www.nvca.org

NOTES

[1] The Community Reinvestment Act (12 U.S.C. §§ 2901 et seq.) was originally adopted in 1977. The Community Reinvestment Act applies to all insured depository institutions (defined as "regulated financial institutions" in the statute). Note, however, that the Community Reinvestment Act does not apply to credit unions.

The current regulations under the CRA were published as a final rule on May 4, 1995, at 60 FR 22156 - 22225. The final rule was subsequently amended to make technical corrections on December 20, 1995, at 60 FR 66048-66051, and again on May 10, 1996, at 61 FR 21362-21364.

To provide an illustration of the provisions of the joint rule, this Memorandum will focus on the version of the joint rule promulgated by the Comptroller of the Currency: 12 C.F.R. Part 25, Subparts A through D and Appendices A and B. All citations to the joint rule will be to the version promulgated by the Comptroller of the Currency, unless otherwise indicated.

[2] The discussion in this Memorandum focuses primarily on the application of the joint rule to larger banks and savings associations, those institutions that do not fall under the definition of a "small bank" (see 12 C.F.R. § 25.12(t)) or a "small savings association" (see 12 C.F.R. § 563e.11(s)) in the joint rule. In this paper, these larger banks and savings associations are collectively referred to as "banks."

[3] The joint rule requires that all CRA related activity must be consistent with the "safe and sound operation of the institution," a standard which normally refers to the financial quality of a bank's activities. See 12 C.F.R. §§ 25.11(b) and 25.21(b)(4).

As a matter of practice, however, banks generally do not subject CRA related loans and investments to the same standards for profit and loss as their other lines of business. CRA investments tend to be viewed as de facto grants or as "soft" money with significantly higher risk and lower return expectations than other lines of business activity.

[4] The purpose of the Interagency Questions and Answers Regarding Community Reinvestment, as described in the issuing release for the 1999 Interagency Questions and Answers (see below), is to "answer the most frequently asked questions about community reinvestment" and are described as "informal staff guidance for agency personnel, financial institutions, and the public." See 64 FR 23618.

The regulatory agencies promulgated an initial set of "Interagency Questions and Answers Regarding Community Reinvestment," published October 21, 1996, at 61 FR 54647-54667. The initial Interagency Questions and Answers were replaced a year later by a supplemented and amended set of "Interagency Questions and Answers Regarding Community Reinvestment," published October 6, 1997, at 62 FR 52105-52128. The 1997 Interagency Questions and Answers were superceded by a new restatement of the "Interagency Questions and Answers Regarding Community Reinvestment," published May 3, 1999, at 64 FR 23618-23648 (referred to further below as the "1999 Interagency Questions and Answers").

[5] This position is clearly stated in the 1999 Interagency Questions and Answers, in the Answer to Question 1 with regard to 12 CFR 25.12(h)(3), at 64 FR 23628:

> "To be considered as 'community development' under __.12(h)(3) and 563e.12(g)(3), a loan, investment or service, whether made directly or through an intermediary must meet both a size test and a purpose test. An activity meets the size requirement if it finances entities that either meet the size eligibility standards of the Small Business Administration's Development Company (SBDC) or Small Business Investment Company (SBIC) programs, or have gross annual revenues of $1 million of less. To meet the purpose test, the activity must promote economic development. . . . The agencies will presume that any loan or investment in or to a SBDC or SBIC promotes economic development. [emphasis added]"

[6] Bank ownership of SBICs is specifically authorized by Section 302(b) of the Small Business Investment Company Act (15 U.S.C. § 682(b)).

The effect of this authorization under the Bank Holding Company Act is discussed in detail at 12 C.F.R. § 225.107, which provides that:

> "Since the shares of a small business investment company are of a kind and amount expressly made eligible for investment by a national bank under the Small Business Investment Act of 1958, it follows, therefore, that the ownership or control of such shares by a bank holding company would be exempt from the prohibitions of section 4 of the Bank Holding Company Act by virtue of the provisions of section 4(c)(4) of that Act. Accordingly, the ownership or control of such shares by the bank holding company would be exempt from the prohibitions of section 4 of the Bank Holding Company Act [emphasis added]."

See 12 C.F.R. 225.107(c).

Until recently there was a question as to whether a national bank had authority to invest in an applicant for an SBIC license prior to the time that the applicant was formally licensed as an SBIC (see OCC Interpretive Letter #617, March 4, 1993). This issue was recently clarified by the OCC in a letter reconsidering this issue (unpublished letter dated June 18, 1998, from Raymond Natter, Acting Chief Counsel, Office of the Comptroller of the Currency to Christopher Lane Davis), which concluded *inter alia* that " . . . it is my opinion that a national bank may invest in an SBIC that is in the process of being organized, as well as one that has already obtained a license from the SBA."

Unlike banks, savings and loan associations do not have explicit statutory authority to own SBICs, although a holding company for a savings and loan association may own an SBIC (just as a bank holding company may). This inconsistency in authority between banks and savings and loan associations is apparently unintended, and the Director of OTS has called attention to this issue and advocated corrective legislation in testimony before the House Banking Committee. See "Statement of Eileen Seidman, Director, Office of Thrift Supervision, Concerning the Financial Regulatory Relief and Economic Efficiency Act," before the Committee on Banking, Housing and Urban Affairs of the United States Senate, March 10**,** 1998. More recently, at the SBA's New Markets Workshop conference in New York City on April 12, 1999, Director Seidman stated in her speech to the conference that OTS has granted requesting savings associations permission to invest directly in SBICs and that OTS expects to continue to grant such permission to requesting savings associations in the future.

[7] Banks are significant participants in the SBIC program. The number of bank-owned SBICs has climbed from 64 at the end of fiscal 1992 to 84 at the end of 1998. As of the end of fiscal 1998 there were 84 bank-owned SBICs. (Data is not available with respect to bank participation as investors in independent SBICs.)

The table below indicates the size of bank participation in relation to the whole SBIC program as of the end of fiscal 1998:

Licenses Outstanding and SBIC Program Capital Resources
Fiscal Year 1998 ($ in millions)

Fiscal Year 1998	#	Private Capital	Leverage from SBA	Capital Resources
Bank-Owned Regular SBICs	84	4,005.4	23.5	4,028.9
Debenture-Type Regular	92	897.2	704.8	1,602.0
Participating Security	69	1,226.9	889.4	2,116.3
Specialized SBICs	73	165.9	178.2	344.1
TOTAL	318	$6,295.4	$1,795.9	$8,091.4

See SBIC Program Statistical Package, January 1999, Table 36.

[8] The SBA statistics on weighted realized rate of return on invested capital for the ten year period from fiscal 1989 - 1998 are as follows:

Weighted Realized Rate of Return on Invested Capital for SBIC Program Licensees
Fiscal Years 1977 to 1998

Fiscal Year	**Bank Owned Reg SBICs**	Debent-ure Regular SBICs	Part. Sec. Regular SBICs	All Regular SBICs	All SSBICs	All SBIC Program Licensees
1989	**8.42**	8.00	--	8.32	7.96	8.28
1990	**14.77**	6.39	--	12.95	3.23	12.19
1991	**5.31**	(4.38)	--	3.54	(1.38)	3.18
1992	**11.89**	1.50	--	10.46	4.34	10.04
1993	**17.01**	14.09	--	16.66	0.58	15.70
1994	**16.03**	0.63	--	14.32	4.37	13.80
1995	**8.54**	5.41	(15.59)	7.96	4.50	7.80
1996	**14.51**	11.59	(6.70)	13.58	0.83	3.46
1997	**19.78**	10.02	7.32	18.05	8.11	17.59
1998	**21.42**	10.33	7.85	19.36	5.54	18.89

Realized Rate of Return on Invested Capital was calculated by dividing "Net Income" by the average of the beginning and ending balances of "Paid-in Capital Stock & Surplus" plus "Partners' Permanent Capital Contributed" plus "Undistributed Realized Earnings".

See SBIC Program Statistical Package, January 1999, Table 23.

[9] The statement of purpose of Community Reinvestment Act states, in part:

> "Section 2901. Congressional Findings and Statement of Purpose.
> (a) The Congress finds that –
> . . . . .
> (3) regulated financial institutions have continuing and affirmative obligation to help meet the credit needs of the local communities in which they are chartered.
> (b) It is the purpose of this chapter to require each appropriate Federal financial supervisory agency to use its authority when examining financial institutions, to encourage such institutions to help meet the credit needs of the local communities in which they are chartered consistent with the safe and sound operation of such institutions."

See 12 U.S.C. §§ 2901(a)(3), and discussion in Note 1.

[10] The CRA separately authorizes each of the Comptroller of the Currency, the Federal Reserve Board, the Federal Deposit Insurance Corporation, and the Office of Thrift Supervision to promulgate regulations under the statutes applicable to that agency. See 12 U.S.C. §§ 2901(b), 2902(1), and 2905. The parallel provisions of the joint rule relating to each agency are found in separate Parts of 12 C.F.R. The Comptroller of the Currency's regulations are in Part 25, the Federal Reserve Board's regulations are in Part 228, the Federal Deposit Insurance Corporation's regulations are in Part 345, and the Office of Thrift Supervision's regulations are in Part 563e.

To avoid confusion the agencies have cooperated in promulgating separate regulations which are identical except for those specific areas which relate to the different types of banks or savings institutions regulated. See the Federal Reserve System regulation 12 C.F.R. § 228.11(c)(2) *Foreign Bank Acquisitions*, the Federal Deposit Insurance Corporation regulation 12 C.F.R. § 345.11(c)(2) *Insured State Branches*, and the Office of Thrift Supervision regulation 12 C.F.R. § 563e.11(c) *Scope.*

[11] Banks are subject to CRA examinations by the bank regulatory agencies which produce a written evaluation of the bank's performance under the CRA regulations and the bank's CRA rating. See 12 U.S.C. §§ 2903(a) and 2906.

CRA examinations take place approximately every 24 months. CRA examinations are scheduled one or more quarters in advance, and lists of scheduled CRA examinations are available at the agency web sites. All CRA Performance Evaluations are available to the public, both from the examining agency and from the examined bank. See 12 C.F.R. § 25.43(a)(3), (c) and (d).

[12] This is a very substantial change from the process under the prior CRA regulations. Under the prior regulators were directed generally to:

> "assess the record of performance of the bank in helping to meet the credit needs of its entire community, including low- and moderate-income neighborhoods, consistent with safe and sound operation of the bank."

See 12 C.F.R. § 25.7, superseded by the current joint rule.

[13] See 12 U.S.C. § 2906(b)(1)(A), and 12 C.F.R. § 25.43(a)(2).

[14] The Community Reinvestment Act requires the regulatory agencies to evaluate and publicly report on bank performance, but it does not authorize the regulating agencies to require banks to comply with performance standards or to impose sanctions on a bank which fails to meet performance standards. See 12 U.S.C. §§ 2901(b) and 2903(2), and 12 C.F.R. § 25.29.

As indicated in the May 4, 1995, release, the prior proposed versions of the rule provided that the regulatory agencies would have enforcement authority with respect to banks found to be in "Substantial Noncompliance," however those provisions were deleted from the final version of the joint rule. See the discussion of this issue at 60 FR 22158 under "Enforcement Authority."

[15] Although failure to meet CRA performance standards does not expose a bank to regulatory sanctions, the Community Reinvestment Act expressly authorizes the agencies to make decisions on granting regulatory approval for certain important bank activities based on the CRA performance record of the bank. See 12 U.S.C. § 2903(a)(2).

This statutory authority is reflected in the regulations, which provide that a bank's record of CRA performance may be the basis for denying or conditioning approval of an application to establish a domestic branch, relocate a main office or a branch, participate in a merger or acquisition with another insured depository institution, or convert to a national bank. See 12 C.F.R. § 25.29.

[16] The weight agencies give to a bank's CRA performance when reviewing an application is discussed in the 1999 Interagency Questions and Answers, in Question and Answer 1 to Sec. ___.29(a), at 64 FR 23641. See discussion at 60 FR 22170.

A "Satisfactory" CRA rating may be sufficient to avoid having a bank's CRA performance becomes a block to obtaining a requested regulatory approval. However, an "Outstanding" rating is still regarded as preferable. While an "Outstanding" rating is not a "safe harbor," it reduces the possibility that CRA performance will delay regulatory approval.

[17] Federal Housing Finance Board regulations restrict long term advances by Federal Home Loan Banks to a member bank unless the member bank has a "Satisfactory" CRA rating. See 12 C.F.R. § 936.5, effective June 1, 1997, promulgated on May 29, 1997, at 62 FR 28983 - 28991.

While the Federal Housing Finance Board regulation only requires an overall CRA rating of "Satisfactory," the impact of this regulation is quite broad. As of September 30, 1998, the twelve Federal Home Loan Banks comprising the Federal Home Loan Banking System had more than 6800 members, and had approximately $388,394 million in total assets, of which $245,659 million were outstanding advances to members. (Information from the Internet web site for Federal Home Loan Bank Office of Finance at www.fhfb-of.com.)

[18] Proposed rules were published for comment on December 21, 1993 (see 58 FR 67466), and again on October 7, 1994 (see 59 FR 51232).

[19] See Notes 1 and 10.

[20] See 12 C.F.R. § 25.51, which sets out the transition rules for the version of the joint rule promulgated by the Comptroller of the Currency. Note that certain provisions of the joint rule became effective on January 1, 1996, and additional sections became effective January 1, 1997. All sections of the rule became effective July 1, 1997.

[21] See Note 4.

[22] Interpretive letters regarding CRA questions can be issued by each of the regulatory agencies, although in practice most of the interpretive letters on CRA issues made publicly available have been issued by the Office of the Comptroller of the Currency. These interpretive letters are available from the issuing agencies, and copies of all the publicly available interpretive letters are posted on the Internet at the web sites for the Office of the Comptroller of the Currency (www.occ.treas.gov) and the Federal Financial Institutions Examination Council (www.ffiec.gov). In general, however, since the publication of the first set of Interagency Questions and Answers Regarding Community Reinvestment in 1996, the agencies have tried to avoid issuing interpretive letters in favor of addressing issues through revisions and expansions of the Interagency Questions and Answers.

[23] The CRA Performance Evaluation describes the examined institution, states its overall CRA rating, and contains an analysis of the bank's performance under each of the lending, service and investment tests. See 12 C.F.R. § 25.43(a)(3), (c) and (d).

A searchable database of examined banks showing their CRA Performance rating and the date of their last examination is available over the Internet at the web site Federal Financial Institutions Examination Council (www.ffiec.gov/cracf/crarating/main.cfm.) For more detailed information, the full text of many CRA Performance Evaluations is available over the Internet at the web sites for each regulatory agency. Web sites for other relevant regulatory agencies are listed in the Appendix to this paper.

[24] See 12 C.F.R. § 25.11(c).

[25] See 12 C.F.R. § 25.11(c)(3) that discusses the exception for special purpose banks. The definition of the term "banker's bank" used in the rule can be found at 12 C.F.R. § 24 (Seventh).

See 12 C.F.R. § 25.11(c)(2) that discusses the application of the regulations to uninsured banks. See also the Federal Reserve System regulation 12 C.F.R. § 228.11(c)(2) *Foreign Bank Acquisitions*, the Federal Deposit Insurance Corporation regulation 12 C.F.R. § 345.11(c)(2) *Insured State Branches*, and the Office of Thrift Supervision regulation 12 C.F.R. § 563e.11(c) *Scope*

The application of the CRA regulations to foreign banks in the United States is a source of frequent confusion. As a general matter, foreign banks operating in the United States are subject to the CRA regulations if they are insured by the FDIC. Some uninsured foreign banks are also covered, however, as described in 12 C.F.R. § 228.11(c)(2). Foreign banks that qualify as special purpose are exempted from the CRA regulations under the exemption for special purpose banks referred to above.

[26] There are more limited performance requirements for institutions defined as "small banks" under the joint rule: independent banks with under $250 million in total assets or banks with under $250 million in total assets that are affiliated with a bank holding company with less than $1 billion in total assets. Small bank performance requirements focus on lending, and do not include the investment and service tests. See 12 C.F.R. § 25.11(t) for the definition of "small bank" and 12 C.F.R. § 25.26 for small bank performance standards. Also see Note 39.

[27] The definition of "limited purpose bank" is found at 12 C.F.R. § 25(o), of "wholesale bank" at 12 C.F.R. § 25.11(w), and of "foreign bank" at 12 C.F.R. § 228.11(c)(2). See also the discussion in the release under "Scope" at 60 FR 22158–22159.

[28] See 12 C.F.R. § 25.11(b)(1).

[29] See 12 C.F.R. § 25.12(h) for the definition of "community development."

[30] The prior regulation listed twelve factors to be considered in assessing a bank's record of performance under the CRA, of which the first two are:

> "(a) Activities conducted by the bank to ascertain the credit needs of its community, including the extent of the bank's efforts to communicate with members of its community regarding the credit services being provided by the bank;
>
> "(b) The extent of the bank's marketing and special credit-related programs to make members of the community aware of the credit services offered by the bank;"

See 12 C.F.R. §§ 25.7(a) and (b) of the prior CRA regulation.

[31] The regulating agency does not evaluate the assessment area chosen by the bank, as long as the area complies with the criteria in 12 C.F.R. § 25.41.

[32] See 12 C.F.R. § 25.41(a).

[33] See 12 C.F.R. § 25.41(c), (d) and (e).

[34] Both the investment test and the service test evaluate the bank's activities in both the bank's assessment area and "a broader statewide or regional area that includes the bank's assessment area(s)." See 12 C.F.R. §§ 25.23(a) and 25.24(b). See Note 60 for a more detailed discussion of the concept of a "region.")

[35] See 12 U.S.C. § 2906(b)(2) and 12 C.F.R. § 25.28.

[36] Banks have the option of being evaluated under goals set out in a "strategic plan" developed by a bank for meeting the credit needs of its community. This alternative is intended to provide additional flexibility to banks; however, the plan must be framed in terms of annual measurable goals for performance in lending, investment and service over a period of up to five years. Strategic plans must include public participation and are subject to advance approval by the regulating agency. A bank operating under an approved strategic plan will be evaluated based on the bank's performance relative to the specific annual goals set forth in the approved plan. See 12 C.F.R. § 25.27.

[37] The Community Reinvestment Act prescribes <u>four</u> ratings for overall CRA performance: outstanding, satisfactory (both "high satisfactory" and "low satisfactory" are combined for overall performance scoring), needs to improve, and substantial noncompliance. See 12 U.S.C. § 2906(b)(2). Note, however, that the CRA regulations provide separately for <u>five</u> scoring levels for each individual performance category: outstanding, high satisfactory, low satisfactory, needs to improve, and substantial noncompliance. See 12 C.F.R. § 25.28 and Appendix A to Part 25 for scoring.

[38] See 12 C.F.R. § 25.23(b).

[39] See 12 C.F.R. § 25.28, which addresses the principles to be used in determining CRA ratings. The basic principles are set forth in 12 C.F.R. § 25.28(b)(1)-(3):

> "(1) A bank that receives an 'outstanding' rating on the lending test receives an assigned rating of at least 'satisfactory';
>
> "(2) A bank that receives an 'outstanding' rating on both the service test and the investment test and a rating of at least 'high satisfactory' on the lending test receives an assigned rating of 'outstanding'; and
>
> "(3) No bank my receive an assigned rating of 'satisfactory' or higher unless it receives a rating of at least 'low satisfactory' on the lending test."

See 60 FR 22183.

The issuing release for the joint rule discusses the rationale and methodology for determining CRA ratings and sets out the matrix and other considerations used to relate scores to performance ratings (see 60 FR 22169-22170). The scoring matrix is also set out in the 1999 Interagency Questions and Answers in Question and Answer 3 to Sec. ___.28(a), at 64 FR 23641.

The scoring matrices are as follows:

Individual Performance Tests

Component Test Ratings	Lending	Service	Investment
Outstanding	12	6	6
High Satisfactory	9	4	4
Low Satisfactory	6	3	3
Needs to Improve	3	1	1
Substantial Noncompliance	0	0	0

Overall CRA Rating

Points	Composite Assigned Rating
20 or over	Outstanding
11 through 19	Satisfactory
5 through 10	Needs to Improve
0 through 4	Substantial Noncompliance

See the issuing release for the joint rule at 60 FR 22170 and the 1999 Interagency Questions and Answers at 64 FR 23641.

In addition to the matrix, the issuing release and the Answer to Question 3 notes that there is one exception to the matrix. An institution may not receive an overall CRA rating of "Satisfactory" unless it has at least a rating of "low satisfactory" on the lending test. To achieve this result, an institution's combined score is capped at three times its score on the lending test. See the issuing release for the joint rule at 60 FR 22170 and the 1999 Interagency Questions and Answers, Question and Answer 3 to Sec. ___.28(a), at 64 FR 23641.

Note that there are modifications to the relevant performance tests in the case of banks that fall in the definitions of "small banks" (see 12 C.F.R. § 25.12(t)) or "small savings associations" (see 12 C.F.R. § 563e.11(s)). "Small banks" and "small savings associations" have separate performance standards that do not require performance under the investment and service tests in order for a "small bank" or a "small savings association" to obtain a "satisfactory" CRA rating (for "small banks" see 12 C.F.R. § 25.26 and 12 C.F.R. Part 25 Appendix A paragraph (d), and for "small savings associations" see 12 C.F.R. § 563e.26 and 12 C.F.R. Part 563e Appendix A paragraph (d)).

There are separate modifications to the criteria for both a bank's assessment area and the relevant performance tests in the case of banks which fall in the definitions of "wholesale or limited purpose banks" (see 12 C.F.R. § 25.12(o) and (w)). "Wholesale" or "limited purpose" banks have separately defined performance standards (see 12 C.F.R. § 25.25 and 12 C.F.R. Part 25 Appendix A paragraph (c)).

Both "small banks" and "wholesale or limited purpose banks," may also elect to be evaluated based on goals set forth in an approved strategic plan, as described in Note 36.

[40] See 60 FR 22169-22170. A performance score of at least "low satisfactory" is necessary in order for a bank to obtain an "Outstanding" CRA rating.

While at least “low satisfactory” performance on the investment test is necessary for an “Outstanding” CRA rating, the effect of poor performance on the investment test is more variable for a “Satisfactory” rating. If performance scores on the lending and service tests are “low satisfactory,” a “needs to improve” score on the investment test may cause the overall CRA rating to be “Needs to Improve.” See for example, the Community Reinvestment Act Performance Evaluation for Fidelity National Bank, in Norcross, Georgia, dated September 9, 1998.

A bank can, however, achieve a "Satisfactory" CRA rating with “high satisfactory” score in lending test and a “low satisfactory” score on the service test, even if it receives the lowest performance rating (“substantial noncompliance”) under the investment test. As a result, even if a bank fails to make any qualified investments it may still receive an overall CRA rating of “Satisfactory.” See for example, the Community Reinvestment Act Performance Evaluation for Community First National Bank, in Alliance, Nebraska, dated August 3, 1998.

[41] See the Appendix to this paper for a list of Internet web sites at which CRA Performance Evaluations are available.

[42] See 12 C.F.R. § 25.23(a).

Note that the provisions of the joint rule relating to investment are less relevant for institutions defined as "small banks" under the joint rule (see Notes 26 and 39). Qualified investments in the form of loans can have some positive effects, however, as examiners may adjust a small bank's loan-to-deposit ratio, if appropriate, based on lending-related qualified investments (see 12 C.F.R. § 25.26(a)(1), and the discussion in footnote 4 in OCC Interpretive Letter 763, December 26, 1996). The regulating agencies will also evaluate investment activity in the case of a small bank or thrift which wishes to obtain an "Outstanding" rating (see 12 C.F.R. § 25 Appendix A paragraph (d)(2) for "small banks," and 12 C.F.R. § 563e Appendix A paragraph (d)(2) for "small savings associations"). The importance of investment activity for a small bank or small savings association that wishes to obtain an "Outstanding" rating is also discussed in footnotes in two interagency CRA interpretive letters (see CRA Interpretations -- footnote 2 in OCC Interpretive Letter 750, September 23, 1996, and footnote 4 in OCC Interpretive Letter 763, December 26, 1996).

[43] See 12 C.F.R. § 25.23(e). The application of these criteria to the CRA ratings is discussed in more detail in 12 C.F.R. Part 25 Appendix A paragraph (b)(2).

[44] The interaction between the examiners’ evaluation under the quantitative criteria and the evaluation under the qualitative criteria is not clearly articulated, and the guidance in the 1999 Interagency Questions and Answers is difficult to interpret.

See the 1999 Interagency Questions and Answers, Question and Answer 2 to Sec. ___.28, at 64 FR 23640, which states, in relevant part:

> "... Some of these performance criteria are quantitative, such as number and amount, and others, such as the use of innovative or flexible lending practices, the innovativeness or complexity of qualified investments, and the innovativeness or responsiveness of community development services, are qualitative. The performance criteria that deal with these qualitative aspects of performance recognize that these loans, qualified investments, and community development services sometimes require special expertise and effort on the part of the institution and provide a benefit to the community that would not otherwise be possible. As such, the agencies consider the qualitative aspects of an institution's activities when measuring the benefit received by a community. <u>An institution's performance under these qualitative criteria may augment the consideration given to an institution's performance under the quantitative criteria of the regulations, resulting in a higher level of performance and rating</u> [emphasis added]."

But also see the apparently contrasting guidance on the qualitative criteria in the Answer to Question 2 to Sec. ___23(e), at 64 FR 23638:

> "The extent to which qualified investments receive consideration, however, depends on how examiners evaluate the investment under the remaining three criteria [the qualitative criteria]—innovativeness and complexity, responsiveness, and degree to which the investment is not routinely provided by private investors."

[45] See 12 C.F.R. § 25.12(s) for the definition of "qualified Investment." The issuing release elaborates this definition, by providing specific examples of financial activities that will be considered qualified investments under the rule. See 60 FR 22162, footnote 3.

[46] See 12 C.F.R. § 25.12(h) for the definition of "community development."

[47] See 12 C.F.R. § 25.12(h)(3).

The SBA size eligibility standards referred to are set out in 13 C.F.R. § 121.301(b) and (c), the definition of "business concern" is set out at 13 C.F.R. § 121.105, and the standards for determining a business concern's "affiliates" for purposes of the size eligibility standards are set out in 13 C.F.R. § 121.103.

The size eligibility standard for the SBIC program set out at 13 C.F.R. § 121.301(c)(1) requires a small business (together with its affiliates) to have: ". . . tangible net worth not in excess of $18 million, and average net income after Federal income taxes (excluding carry-over losses) for the preceding 2 completed fiscal years not in excess of $6 million. . . ."

Note also that in addition to the SBA size standards, Section 25.12(h) (3) also includes businesses or farms that have gross annual revenues of $1 million or less.

[48] The word "communities" has been used here colloquially. The technical term used in the joint rule here is "geographies" rather than "communities." Thus this provision reads: "activities that revitalize or stabilize low- or moderate-income <u>geographies</u> [emphasis added]." See 12 C.F.R. § 25.12(h)(4).

The term "geographies" is specifically defined in the joint rule as "a census tract or block numbering area delineated by the United States Bureau of the Census in the most recent decennial census." See 12 C.F.R. § 25.1(l).

[49] By contrast, the prior rule provided a list of twelve factors that the regulating agency was directed to take into account in assessing a bank's performance. Bank investment activity is referred to in only one of the twelve factors:

> "(h) The bank's participation, including investments, in local community development and redevelopment projects or programs;"

See 12 C.F.R. § 25.7(a) through (l), superseded by the joint rule.

Investment activity is referred to under the old rule simply as one way that a bank can participate in "community development and redevelopment projects and programs." The old rule contemplated bank investment in nonprofit community development organizations and low- and moderate-income housing projects. It provided little, if any, guidance as to what types of commercial investments would be considered appropriate community reinvestment activity.

[50] See 1999 Interagency Questions and Answers, Question and Answer 7 under Sec. __-.12(i) and 563e.12(h). This new Question and Answer is discussed in the issuing release for the 1999 Interagency Questions and Answers at 64 FR 23619.

[51] It is necessary to keep in mind, however, that neither the CRA nor the joint rule change the existing statutory restrictions on the types of lawful investments which a bank, bank holding company or other affiliate may make in nonbank businesses. Any investment by a bank or bank holding company must comply with applicable banking statutes and regulations regarding ownership of securities in nonbanking businesses.

[52] The interpretation by the regulatory agencies that in order to be considered a "qualified investment," an investment in business must both meet the size standard in the definition of "community development" and also meet one (or more) of the other criteria listed in the definition of community development is articulated in the 1999 Interagency Questions and Answers in Question and Answer 1 under Secs. ___.12(h)(3) and 563e.12(g)(3):

> "*Q1. 'Community development' includes activities that promote economic development by financing businesses or farms that meet certain size eligibility standards. Are all activities that finance businesses and farms that meet these size eligibility standards considered to be community development?*
>
> "A1. No. To be considered as 'community development' under Secs. ___.12(h)(3) and 563e.12(g)(3), a loan, investment or service whether made directly or through an intermediary, must meet both a size test and a purpose test [emphasis added]. An activity meets the size requirement if it finances entities that either meet the size eligibility stands of the Small Business Administration's Development Company (SBDC) or Small Business Investment Company (SBIC) programs . . . . To meet the purpose test, the activity must promote economic development. An activity is considered to promote economic development if it supports permanent job creation, retention, and/or improvement either in low- or moderate-income geographies or in areas targeted for redevelopment by Federal, state, local or tribal governments. The agencies will presume that any loan to or investment in an SBDC or SBIC promotes economic development [emphasis added]. . . ."

[53] See Note 6.

[54] See 60 FR 22162, footnote 3.

[55] See the emphasized language in the Answer to Question and Answer 1 to Secs. ___.12(h)(3) and 563e.12(g)(3) in the 1999 Interagency Interpretive Questions and Answers, discussed in Note 52.

[56] As a general matter, there is no "look through" to an SBIC's underlying portfolio in connection with determining the amount of an investment in an SBIC when it is evaluated in connection with the investment test. Examiners may look at an SBIC's portfolio investments, however, in their qualitative evaluation of the investment. See the discussion of quantitative and qualitative criteria in Note 44.

Note, however, that in the case of an SBIC engaged in lending, a bank would have the alternative of electing to have the lending activities of the SBIC evaluated in connection with the bank's performance under the lending test. Where a bank has elected to have an SBIC's activities evaluated under the lending test, the agencies will look through the SBIC and evaluate its underlying portfolio. See, for example, the discussion in OCC Interpretive Letter 727, June 27, 1996.

[57] The nature of the bank examiners' evaluation of an investment in a non-SBIC fund is discussed in an interpretive letter dated September 3, 1997, designated as OCC Interpretive Letter 799:

> "Examiners may determine that the Fund [a non-SBIC fund] engages in activities primarily intended to revitalize or stabilize low- or moderate-income geographies. They will make this determination based on information provided to them by the investor financial institutions. In evaluating that information, examiners may consider the following factors:
>
> > - Whether the express, bona fide intent of the Fund is to promote the community development purpose of revitalizing or stabilizing a low- or moderate-income geography;
> >
> > - Whether the Fund is specifically structured to achieve the expressed community development purpose(s); and
> >
> > - Whether the Fund is reasonably certain to accomplish the expressed community development purpose(s)."

[58] The term "affiliate" is defined in terms of common control, see 12 C.F.R. § 25.12(a), and investments by affiliates is discussed at 12 C.F.R. § 25.23(c).

[59] For example, a bank can claim CRA credit for an equity investment in a nonbank business made by an affiliated bank holding company which meets the requirements for a qualified investment, even though the bank would not be permitted to make such an equity investment directly.

[60] Any such broader regional area must include the bank's assessment area (see 12 C.F.R. § 25.23(a)). The status of regionally focused investments is discussed specifically in the 1999 Interagency Questions and Answers, in the Answers to Questions 5 and 6 under Sec. ___.25.12(i) at 64 FR 23629:

> "*Q5. Must there be some immediate or direct benefit to the institution's assessment area(s) to satisfy the regulations' requirement that qualified investments and community development loans or services benefit an institution's assessment area(s) or a broader statewide or regional area that includes the institution's assessment area(s)?*
>
> "A5. No, the regulations, for example, recognize that community development organizations and programs are frequently efficient and effective ways for institutions to promote community development. These organizations and programs often operate on a statewide or even multi-state basis. Therefore, an institution's activity is considered a community development loan or service or a qualified investment if it supports an organization or activity that covers an area that is larger than, but includes, the institution's assessment area(s). The institution's assessment area need not receive an immediate or direct benefit from the institution's specific participation in the broader organization or activity, provided the purpose, mandate, or function of the organization or activity includes serving geographies or individuals located within the institution's assessment area [emphasis added]. . . .
>
> "*Q6. What is meant by a 'regional area' in the requirement that a community development loan must benefit the institution's assessment area(s) or a broader statewide or regional area that includes the institution's assessment area(s)?*
>
> "A6. A 'regional area' may be as small as a city or county or as large as a multistate area. For example, the 'mid-Atlantic states' may comprise a regional area. When examiners evaluate community development loans that benefit a regional area that includes the institution's assessment area(s), however, the examiners will consider the institution's assessment area(s). In most cases, the larger the regional area, the more diffuse the benefit will be to the institution's assessment area(s). Examiners may view loans with more direct benefits to an institution's assessment area(s) as more responsive to the credit needs of the area(s) than loans for which the actual benefit to the assessment area(s) is uncertain or for which the benefit is diffused throughout a larger area that includes the assessment area(s)."

[61] See 12 C.F.R. §§ 25.12(o) and (w) for the definitions of "limited purpose bank" and "wholesale bank."

If a wholesale or limited purpose bank has "adequately addressed the needs of its assessment area(s)," then examiners are directed to consider qualified investments "that benefit areas outside the bank's assessment areas(s)." See 12 C.F.R. §§ 25.25(e)(2). The 1999 Interagency Questions and Answers make clear that this means that a wholesale or limited purpose bank may make investments on a national (as opposed to a more limited regional) basis, in the Answer to Question 1 to Sec. ___.25(e), at 64 FR 23638:

> "*Q1. How do examiners evaluate a wholesale or limited purpose institution's qualified investment in a fund that invests in projects nationwide and which has a primary purpose of community development, as that is defined in the regulations?*
>
> "A1. If examiners find that a wholesale or limited purpose institution has adequately addressed the needs of its assessment areas(s), they will give consideration to qualified investments, as well as community development loans and community development services, by that institution nationwide. In determining whether an institution has adequately addressed the needs of its assessment area(s), examiners will consider qualified investments that benefit a broader statewide or regional area that includes the institution's assessment area(s)."

[62] Although an SBIC with a regional investment focus (assuming the region includes the bank's assessment area) will be presumed a qualified investment, how the investment is evaluated under the investment test depends on how directly the investment benefits the bank's assessment area.

The issue of how benefit to the assessment area should be taken into account is discussed in the context of community development loans in the 1999 Interagency Questions and Answers, however, the degree to which the same analysis is applicable to investments in SBICs is not clear. An investment in an SBIC is significantly different than a loan to a specific entity. In addition, it is hard to integrate the approach described in the 1999 Interagency Questions and Answers, at Question and Answer 6 to Sec. ___.25.12(i) with the description of how quantitative and qualitative criteria should be applied in evaluating qualified investments set out in Question and Answer 2 to Sec. ___.28. See Notes 60 and 44.

[63] For example, in many rural areas, the small size of a community's economy makes it necessary to give an SBIC a statewide or regional territory to assure that the SBIC will have a territory which can provide the volume of investment opportunities necessary for financially successful operations. The most likely effect of requiring a local, as opposed to a regional, investment focus in this situation will be to hinder or prevent the banks in smaller communities (or with limited assessment areas) from using the SBIC program as a means to increase the amount of equity capital available in their region.

This is illustrated by the case of an SBIC formed in a Midwestern state and funded by investments from more than two dozen rural community banks throughout the state. Because of the generally small size of the communities which the bank investors served, it was not possible for the SBIC to provide any bank investor with any reasonable assurance that the SBIC would be able to make an investment in that bank's assessment area. This is accentuated by the comparatively small number of portfolio investments (normally 15 – 25) that an SBIC makes during its investment life.

[64] The generally accepted view in the venture capital industry is that the ratio of business plans reviewed to investments made is on the order of 100:1. Thus, a typical SBIC planning a portfolio of investments in 15 to 20 businesses over a two to three year period will need a market area which can provide a deal flow of approximately 1500 to 2000 investment opportunities (which are sufficiently developed to support a business plan) over that period. If an SBIC's market territory is not large enough to provide an adequate deal flow, the economic viability of the SBIC will be adversely affected, since it will have to either lower its quality standards for investments or slow its rate of investment and limit the number of the investments in its portfolio.

[65] See Note 55.

[66] See Note 60.

[67] The impact and importance of the information that is available (and not available) about the "performance context" for a locality is often overlooked. This is particularly true for qualifying investment activity, since there is relatively little data available assessing the capital needs of small businesses on a national, regional or local basis. This absence of specific data limits the ability of both banks and agencies to evaluate a community's needs and opportunities for investment, design programs to address those needs and opportunities, and appropriately evaluate performance in relation to the needs and opportunities.

A recent study by the California Research Bureau is a good example of a systematic effort to collect data and evaluate the capital needs of small businesses in several specific localities. The study illustrates the kind of information which both banks and agencies need in order to accurately evaluate the performance context for qualifying investment activity. See "Business Capital Needs in California: Designing a Program," by Gus Koehler, Ph.D. and Rosa Maria Moller, Ph.D (CRB-98-005, April 1998), available at the California Library Internet web site (www.library.ca.gov/html/statseg2a.cfm).

[68] The 1999 Interagency Questions and Answers discuss how the amount of a qualified investment is determined in the Answer to Question 2 to Sec. ___.25(e), at 64 FR 23638-23639:

> ". . . examiners will determine the dollar amount of qualified investments by relying on the figures recorded by the institution according to generally accepted accounting principles (GAAP). Although institutions may exercise a range of investment strategies, including short-term investments, long-term investments, investments that are immediately funded, and investments with a binding, up front commitment that are funded over a period of time, institutions making the same dollar amount of investments over the same number of years, all other performance criteria being equal, would receive the same level of consideration."

[69] See 12 C.F.R. § 25.21(b) and Notes 39 and 62.

[70] See Note 62.