Equity Equivalent[1] Investments

The Need

A strong permanent capital base is critical for community development financial institutions (CDFIs) because it increases the organization's risk tolerance and lending flexibility, lowers the cost of capital, and protects lenders by providing a cushion against losses in excess of loan loss reserves. It allows CDFIs to better meet the needs of their markets by allowing them to engage in longer-term and riskier lending. A larger permanent capital base also provides more incentive for potential investors to lend money to a CDFI. All of these results help CDFIs grow their operations and solidify their positions as permanent institutions. Unlike for-profit corporations, which can raise equity by issuing stock, nonprofits must generally rely on grants to build this base. Traditionally, nonprofit CDFIs have raised the equity capital they need to support their lending and investing activities through capital grants from philanthropic sources, or in some instances, through retained earnings. However, building a permanent capital base through grants is a time-consuming process, and one that often generates relatively little yield. It is also a strategy that is constrained by the limited availability of grant dollars.

Developing a Solution

In 1995, National Community Capital set out to create a new financial instrument that would function like equity for nonprofit CDFIs. To realize this goal, National Community Capital chose an experienced partner—Citibank—to help develop an equity equivalent that would serve as a model for replication by other nonprofit CDFIs and to make a lead investment in National Community Capital. The equity equivalent investment product, or EQ2, was developed through the Citibank/National Community Capital collaboration and provides a new source and type of capital for CDFIs.

The Equity Equivalent — What Is It?

The Equity Equivalent, or EQ2, is a capital product for community development financial institutions and their investors. It is a financial tool that allows CDFIs to strengthen their capital structures, leverage additional debt capital, and as a result, increase lending and investing in economically disadvantaged communities. Since its creation in 1996, banks and other investors have made more than $70 million in EQ2 investments and the EQ2 has become an increasingly popular investment product with significant benefits for banks, CDFIs and economically disadvantaged communities.

The EQ2 is defined by the six attributes listed below. All six characteristics must be present; without them, this financial instrument would be treated under current bank regulatory requirements as simple subordinated debt.

1. The equity equivalent is carried as an investment on the investor's balance sheet in accordance with Generally Accepted Accounting Principles (GAAP)

2. It is a general obligation of the CDFI that is not secured by any of the CDFI's assets

3. It is fully subordinated to the right of repayment of all of the CDFI's other creditors

4. It does not give the investor the right to accelerate payment unless the CDFI ceases its normal operations (i.e., changes its line of business)

5. It carries an interest rate that is not tied to any income received by the CDFI

6. It has a rolling term and therefore, an indeterminate maturity

Like permanent capital, EQ2 enhances a CDFI's lending flexibility and increases its debt capacity by protecting senior lenders from losses. Unlike permanent capital, the investment must eventually be repaid and requires interest payments during its term, although at a rate that is often well below market. The equity equivalent is very attractive because of its equity-like character, but it does not replace true equity or permanent capital as a source of financial strength and independence. In for-profit finance, a similar investment might be structured as a form of convertible preferred stock with a coupon.

1 *This article is an adaptation of a National Community Capital technical assistance memo written by Laura Sparks.*

2 *Comptroller of the Currency, Administrator of National Banks, in an opinion letter dated January 23, 1997, concerning Citibank's Equity Equivalent investment in the National Community Capital Association.*

Accounting Treatment

An investor should treat the equity equivalent as an investment on its balance sheet in accordance with GAAP and can reflect it as an "other asset." The CDFI should account for the investment as an "other liability" and include a description of the investment's unique characteristics in the notes to its financial statements. Some CDFIs have reflected it as "subordinated debt" or as "equity equivalent." For a CDFI's senior lenders, an EQ2 investment functions like equity because it is fully subordinate to their loans and does not allow for acceleration except in very limited circumstances (i.e., material change in primary business activity, bankruptcy, unapproved merger or consolidation).

CRA Treatment

On June 27, 1996, the OCC issued an opinion jointly with the Federal Deposit Insurance Corporation, Office of Thrift Supervision, and the Federal Reserve Board that Citibank would receive favorable consideration under CRA regulations for its equity equivalent investment in National Community Capital. The OCC further stated that the equity equivalents would be a qualified investment that bank examiners would consider under the investment test, or alternatively, under the lending test. In some circumstances Citibank could receive consideration for part of the investment under the lending test and part under the investment test.[3]

This ruling has significant implications for banks interested in collaborating with nonprofit CDFIs because it entitles them to receive leveraged credit under the more important CRA lending test. The investing bank is entitled to claim a pro rata share of the incremental community development loans made by the CDFI in which the bank has invested, provided these loans benefit the bank's assessment area(s) or a broader statewide or regional area that includes the assessment area(s). The bank's pro rata share of loans originated is equal to the percentage of "equity" capital (the sum of permanent capital and equity equivalent investments) provided by the bank.

For example, assuming a nonprofit CDFI has "equity" of $2 million—$1 million in the form of permanent capital and $1 million in equity equivalents provided by a commercial bank—the bank's portion of the CDFI's "equity" is 50 percent. Now assume that the CDFI uses this $2 million to borrow $8 million in senior debt. With its $10 million in capital under management, the CDFI makes $7 million in community development loans over a two-year period. In this example, the bank is entitled to claim its pro rata share of loans originated—50 percent or $3.5 million. Its $1 million investment results in $3.5 million in lending credit over two years. This favorable CRA treatment provides another form of "return on investment" for a bank in addition to the financial return. The favorable CRA treatment is a motivating factor for many banks to make an EQ2 investment.

> *This special debt investment is a precedent-setting community development debenture that will permit 'equity-like' investments in not-for-profit corporations.*

Outcomes And Benefits

National Community Capital estimates that approximately $70 million in EQ2 investments have been made by at least twenty banks, including national, regional and local banks. These transactions have resulted in the following benefits:

EQ2 capital has made it easier for CDFIs to offer more responsive financing products.
With longer-term capital in the mix, CDFIs are finding they can offer new, more responsive products. Chicago Community Loan Fund, one of the first CDFIs to utilize EQ2, once had difficulty making the ten-year mini-permanent loans its borrowers needed. Instead, Chicago had to finance these borrowers with seven-year loans. With over 15% of its capital in the form of EQ2, Chicago can now routinely make ten-year loans and has even started to offer ten-year financing with automatic rollover clauses that effectively provide for a twenty-year term. Cascadia Revolving Fund, a CDFI based in Seattle, finds EQ2 a good source of capital for its quasi-equity financing and long-term, real estate-based lending, and Boston Community Capital has used the EQ2 to help capitalize its venture fund.

Very favorable cost of capital. When National Community Capital first developed the equity equivalent with Citibank, National Community Capital was uncertain about where the market would price this kind of capital. The market rate for EQ2 capital seems to be between two to four percent.

Standardized documentation for EQ2 investments. As EQ2 transactions become more common, CDFI's and banks

3 *See the Resources section of National Community Capital's website* **www.communitycapital.org** *for a copy of the opinion letter.*

About the Author

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have worked to standardize the documentation, thereby lowering transaction costs, reducing complexity and expediting closing procedures. There are good examples of both short, concise EQ2 agreements and longer, more detailed agreements. Of particular note are the loan agreements crafted by Boston Community Capital and US Bank. US Bank's three-page agreement, which succinctly lays out the investment terms and conditions, is a user-friendly document that has been used with approximately 25 CDFIs.

The Boston Community Capital documents, with a 23-page loan agreement and a three-page promissory note, are substantially longer and more detailed, but include several statements and provisions that may make a hesitant bank more likely to simply use the CDFI's standard documents. For example, the agreement specifically references the OCC opinion letter recognizing an EQ2 investment as a qualified investment and includes a formal commitment from Boston Community Capital to assist a bank investor with a Bank Enterprise Award application.[4]

Non-bank investors are beginning to utilize EQ2 investments. Although banks have a unique incentive under the CRA to invest in equity equivalents, other investors can and are beginning to use the tool as well. Chicago Community Loan Fund has secured an EQ2 from a foundation, and Boston Community Capital has secured an EQ2 from a university. While the university and foundation do not have the same CRA incentives, they are able to demonstrate leveraged impact in their communities by making an EQ2 investment—rather than a loan—similar to how banks claim leveraged lending test credit under CRA.

Bank Enterprise Award (BEA) Credit for EQ2 Investments

The CDFI Fund's BEA program gives banks the opportunity to apply for a cash award for investing in CDFIs. Banks typically receive a higher cash award (up to 15% of their investment) for equity-like loans in CDFIs than for typical loans (up to 11% of investment). To classify as an equity-like investment for the BEA program, EQ2 investments must meet certain characteristics, including having a minimum initial term of ten years, with a five year automatic rolling feature (for an effective term of 15 years). The EQ2 must also meet other criteria, which are described in the Fund's Equity-Like Loan Guidance (available through the BEA page of the Fund's website: **www.treas.gov/cdfi**). For more information on qualifying for equity-like loans under the BEA program, visit the Fund's website or contact the CDFI Fund at 202.622.8662.

4 *The Bank Enterprise Award Program is a program of the CDFI Fund that provides incentives for banks to make investments in CDFIs.*

Conclusion

For CDFIs to grow and prosper, they will need to create more sophisticated financial products that recognize the different needs and motivations of their investors. The EQ2 is one step in this direction. Unlike investors in conventional financial markets, CDFI investors (and particularly investors in nonprofit CDFIs) have few investment products to choose from. The form of investment is typically a grant or a below-market senior loan. This new investment vehicle, the EQ2, is one step in developing the financial markets infrastructure for CDFIs by creating a new innovative product which is particularly responsive to one class of investors—banks. Further development and innovation in CDFI financial markets will help increase access to and availability of capital for the industry. ***CI***

Additional Resources

Please visit National Community Capital's website **www.community capital.org** for the following free documents:

- Sample Equity Equivalent Agreements
- Regulatory Opinions Letters regarding EQ2

REGULATORY OVERVIEW

Investment Type: Low-income Housing Tax Credits (LIHTCs)

Definition: The equity equivalent investment product (EQ2) is a long-term deeply subordinated loan with features that make it function like equity. These features include the six attributes listed below which are characteristics that must be present under current bank regulatory restrictions. Without them, this financial instrument would be treated as simple subordinated debt. Like permanent capital, the equity equivalent investment enhances the non-profit's lending flexibility and increases the organization's debt capacity by protecting senior lenders from losses. Unlike permanent capital, investments must eventually be repaid and they require interest payments be made during their terms, although at rates that are usually below market. In for-profit finance, a similar investment might be structured as a form of "convertible preferred stock with a coupon."

Attributes:

1. The equity equivalent is carried as an investment on the investing institution's balance sheet in accordance with Generally Accepted Accounting Principles (GAAP),

2. It is a general obligation of the non-profit organization that is not secured by any of the non-profit organization's assets,

3. It is fully subordinated to the right of repayment of all of the other non-profit organization's creditors,

4. It does not give the investing institution the right to accelerate payment unless the non-profit organization ceases its normal operations (i.e., changes its line of business),

5. It carries an interest rate that is not tied to any income received by the non-profit organization, and

6. It has a rolling term and therefore, an indeterminate maturity.

CRA Applicability: On June 27, 1996, and March 28, 1997, the four federal bank regulatory agencies issued joint interpretive letters that financial institutions would receive favorable consideration under the CRA regulation for investments in equity equivalents. The June 27 letter stated that equity equivalents would be qualified investments under the investment test, or alternatively, under the lending test (the pro rata share of loans originated equal to the percentage of "equity" capital provided by the institution). In some circumstances a financial institution could receive consideration for part of the investment under the lending test and part under the investment test. (See the FFIEC interpretive letter issued June 14, 1996.)

Community Reinvestment Act

Correspondence Date: June 27, 1996

Dear [ ]:

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

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

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Background

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

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

Discussion

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

The investment test evaluates an institution's number and amount of qualified investments, the innovativeness or complexity of its qualified investments, the responsiveness of the qualified investments to credit and community development needs, and the degree to which the qualified investments are not routinely provided by private investors. *See* 12 C.F.R. 25.23(e), 228.23(e), 345.23(e), and 563e.23(e). Qualified investments include lawful

investments, deposits, membership shares or grants that have as their primary purpose community development. 12 C.F.R. 25.12(s), 228.12(s), 345.12(s), and 563e.12(r). Community development means: affordable housing for low- or moderate-income persons; community services targeted to low- or moderate-income persons; activities that promote economic development by financing small businesses or farms; and activities that revitalize or stabilize low- or moderate-income geographies. 12 C.F.R. 25.12(h), 228.12(h), 345.12 (h), and 563e.12(g).

A lawful investment in a security issued by a non-profit, like [ ], that uses the funds to promote community development by making loans to CDFIs that finance affordable housing for low- or moderate-income persons and promote economic development by financing small businesses, as you state [ ] will do, is a qualified investment. To be considered in the Bank's evaluation under the investment test, the investment must benefit the Bank's assessment area(s) or a broader statewide or regional area that includes the Bank's assessment area(s). *See* 12 C.F.R. 25.23(a), 228.23(a), 345.23(a), and 563e.23(a).

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

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

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

As noted above, no one can legally hold a true equity interest in a non-profit like [ ]. However, the purchase of the equity equivalents described above, while not a true equity investment, is sufficiently comparable to qualify as an investment within the meaning of the regulation. Like a true equity interest, the equity equivalents are fully subordinated to the claims of all debtors, are designed to raise revenue for the issuer, and have, in effect, an indeterminate term (because of the rolling tenor). The equity equivalents more closely resemble preferred, rather than common, stock because they have a fixed rate of return and do not confer voting rights. *See* 11 William Meade Fletcher, Fletcher Cyclopedia of the Law of Private Corporations 5283 (1995). Based on this analysis, if the Bank purchased these equity equivalents, examiners would consider in the Bank's lending test evaluation, at the Bank's request, the Bank's pro rata share of any community development loans made by [ ] that benefit the Bank's assessment area(s) or a broader statewide or regional area that includes its assessment area(s).

An investing institution's pro rata share of community development loans made by a *for-profit* third party is determined by the percentage of the capital of the third party contributed

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

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

To the extent an institution's investment is considered under the lending test, it will not also receive consideration under the investment test. 12 C.F.R. 25.23(b), 228.25(b), 345.25(b), and 563e.25(b). In some circumstances an institution may receive consideration for part of an investment under the lending test and also receive consideration under the investment test for part of the investment that was not considered under the lending test.

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

Sincerely,
/s/
Matthew Roberts
Director
Community and Consumer Law Division
Office of the Comptroller of the Currency

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Footnotes

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