ABA Forum on Affordable Housing & Community Development

Bank Regulatory Considerations for Investments in Affordable Housing

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I. INTRODUCTION

- There are several incentives—both financial and regulatory—for banking organizations and their affiliates to invest in affordable housing. For example, since 1995, the Community Reinvestment Act (“CRA”), which requires federally-insured financial institutions to meet the credit needs of the communities in which they operate, including low- and moderate-income (“LMI”) neighborhoods, has encouraged financial institutions to invest in Low Income Housing Tax Credits (“LIHTC”).1 Other federal and state programs provide additional incentives for investments in affordable housing projects.

- This outline discusses (1) the practical and strategic use of the CRA and incentive programs for financial institutions; (2) the available statutory and/or regulatory authority on which banking organizations and their affiliates may rely for participating in federal and state affordable housing incentive programs; (3) other relevant legal and regulatory considerations; and (4) current proposals to reform the CRA and how a new regulatory landscape might affect affordable housing investment in the future.

II. INCENTIVES FOR INVESTING IN AFFORDABLE HOUSING PROJECTS

A. The Community Reinvestment Act. Congress enacted the CRA as part of the Housing and Community Development Act of 19772 to encourage banks to help meet the credit needs of the communities that they serve, including LMI neighborhoods (referred to below as “Assessment Areas” or “AAs”). 12 U.S.C. § 2901(b). The federal bank regulators have promulgated substantively identical regulations to implement the CRA, which establish different frameworks by which the they will evaluate a banking institution’s record of meeting such credit needs. See, e.g., 12 CFR pt. 25.3

1. CRA Performance Tests. Regulators typically evaluate a bank’s record of helping to meet the credit needs of its AA(s) pursuant to three performance tests: (1) the lending test, (2) the investment test, and (3) the service test. Id. §§ 25.21-.4.4

   a) Lending Test. The Lending Test considers the scope of a bank’s home mortgage, small business, small farm, and community development

1 E.g., Community Reinvestment Act Regulations, 60 Fed. Reg. 22156, 22162 n.3 (May 4, 1995) (noting that “qualified investments include, but are not limited to…projects eligible for low-income housing tax credits”).


3 For the purposes of this Outline, we cite to the CRA regulations of the Office of the Comptroller of Currency (“OCC”). The Federal Reserve Board’s (“FRB”) and Federal Deposit Insurance Corporation’s (“FDIC”) CRA regulations can be found at 12 CFR parts 228 and 345, respectively.

4 Other banks, such as wholesale or limited purpose banks, are subject to a different “community development test.” 12 CFR § 25.25.
lending, including both origins and purchases of such loans. Id. § 25.22(a)(1)-(2).

b) **Investment Test.** The Investment Test evaluates the scope and extent of a bank’s “qualified investments” that benefit its AA(s) or a broader geographical area that includes its AA(s). Id. § 25.23(a). A “qualified investment” is any “lawful investment, deposit, membership share, or grant that has as its primary purpose community development.” Id. § 25.12(t). “Community development,” in turn, is defined to include (1) affordable housing (including multifamily rental housing) for LMI individuals; (2) community services targeted to LMI individuals; (3) activities that promote economic development by financing businesses or farms that meet certain eligibility requirements; and (4) activities that revitalize or stabilize: (a) LMI geographies; (b) designated disaster areas; or (c) certain other distressed or underserved non-metropolitan middle-income geographies. Id. § 25.12(g). As discussed *infra*, whether an activity would qualify as a “qualified investment” can play a key role in determining whether the bank has the authority to make such investment.

c) **Service Test.** The Service Test involves an analysis of “both the availability and effectiveness of a bank’s systems for delivering retail banking services and the extent and innovativeness of its community development services.” Id. § 25.24(a).

2. **Impact of CRA Ratings.** Banks are incentivized to engage in activities that will be reflected positively in the CRA performance tests, because a bank’s CRA performance is considered by the Regulators when evaluating a bank’s application for approval of, among other things: (1) the establishment of a domestic branch or other facility with the ability to accept deposits; (2) the relocation of the bank’s main office or a branch; and (3) under the Bank Merger Act, the merger or consolidation with, or the acquisition of assets or assumption of liabilities of an insured depository institution. Id. § 25.29(a).

**B. Low Income Housing Tax Credits**. Created by the Tax Reform Act of 1986, the LIHTC gives authorized state and local agencies the equivalent of $8 billion in annual budget authority to issue tax credits for the acquisition, rehabilitation, or new

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5 Additionally, if consumer lending constitutes a substantial majority of a bank’s business, regulators will also evaluate the bank’s consumer lending in one or more of the following categories: motor vehicle, credit card, other secured, and other unsecured loans. Id. § 25.22(a)(1).

6 “Community development service” “means a service that: (1) has as its primary purpose community development; (2) is related to the provision of financial services; and (3) has not been considered in the evaluation of the bank’s retail banking services under § 25.24(d).” Id. § 25.12(i); see also supra Part II.A.1.b) (defining “community development”).

construction of rental housing targeted to lower-income households. 26 U.S.C. § 42; 26 CFR § 1.42 et seq.

1. **Generally** These tax credits are awarded to developers of “qualified low-income housing projects,” who typically sell them to investors to raise capital. The Congressional Research Service has said that “with lower financing costs, tax credit properties can potentially expand the supply of affordable rental housing.”

A “qualified low-income housing project” means any residential rental property project where either 20% or more of the units are rent-restricted and occupied by individuals whose income is 50% or less of the area median gross income, or 40% or more of the units are rent-restricted and occupied by individuals whose income is 60% or less of the median gross income. 26 U.S.C. § 42(g).

2. **Benefits to Investors** The primary benefit to investors is using the tax credits to offset their income tax liabilities. The amount of this return is determined in part by the market price of the tax credits, which typically ranges from the mid-$80s to low-$90s per $1.00 of tax credit. Investors may also claim other deductions on their tax returns, such as losses generated through the project’s operating costs, interest on its debt, and deductions such as depreciation. Banks and their affiliates also receive the added benefit of their investments in LIHTCs being eligible for treatment as “qualified investments” for the purposes of the CRA.

C. **Opportunity Zones.** To spur investment in lower-income communities, in 2017 Congress established special tax benefits for investments in certain qualifying property within “Opportunity Zones.”

1. **Generally.** An Opportunity Zone is a tract of land containing (generally) low-income communities that has been designated as an “Opportunity Zone” by the governor of the state in which the tract is located. Once a state-approved Opportunity Zone has been certified by the U.S. Department of Treasury (“Treasury”), the Opportunity Zone will be eligible for treatment as a “Qualified Opportunity Zone” (“QOZ”). 26 U.S.C. § 1400Z–1(b)(1)(B). As of December 14, 2018, approximately 8,764 zones have been designated and certified by Treasury as QOZs.

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9 See 26 U.S.C. § 42(g)(2) for more information regarding rent restrictions and income limitations.

10 CRS, *supra* note 8, at 4. However, investors cannot claim the credits until the project is complete and operable. *Id.* at 3.


2. **Benefits to Investors.** Until 2028, when the incentive expires, investors can invest what would otherwise be treated as “realized capital gains” in Qualified Opportunity Funds (“QOFs”) to defer realizing that gain.\(^{13}\) The longer the investment is held the more benefits one receives, including cancelling some of the capital gains and avoiding capital gains on increased gains from a QOF’s investments. *Id.* § 1400Z-2(b). Thus, the potential benefits to investors continue to diminish as 2028 approaches.

3. **Recent Developments.** The IRS held a public hearing on February 14, 2019, regarding the notice of proposed rulemaking published in the Federal Register on October 29, 2018,\(^{14}\) during which many speakers commented on the need for greater flexibility with respect to exiting investments, sources of income for projects, and the structure of companies eligible to receive the tax breaks.\(^{15}\)

**D. Workforce Housing.** Workforce Housing refers to programs established by state and local governments to provide incentives for the development of affordable housing for middle-income families who would not typically qualify for other federal government subsidy programs.\(^{16}\)

1. **Target Demographic.** Today’s Workforce Housing programs usually target households earning between 60 to 120 percent of Area Median Income (“AMI”).\(^{17}\)

2. **Qualifying Projects.** Qualifying projects are directed at providing affordable housing to individuals and families in this AMI range, such as the Long Island Workforce Housing Act, which requires the housing be aimed at individuals below 130% AMI to qualify.\(^{18}\)

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\(^{13}\) According to FAQs published by the IRS, a “Qualified Opportunity Fund” is “an investment vehicle that is set up as either a partnership or corporation for investing in eligible property that is located in a Qualified Opportunity Zone.” *Opportunity Zones Frequently Asked Questions*, IRS (Apr. 17, 2019), https://www.irs.gov/newsroom/opportunity-zones-frequently-asked-questions.


\(^{18}\) *See N.Y. GEN. MUN. LAW § 699-A(1).*
3. **Benefits to Investors.** Because these programs are established at the state and local level, the incentives for participating in such projects vary based on the locality. However, such benefits could include special dispensation with respect to zoning ordinances, such as providing density bonuses and permitting nonconforming residential lots.\(^\text{19}\)

### III. **Bank Regulatory Authorities for Investments in Affordable Housing Projects**

#### A. **Generally.**

While Part II above discussed the various incentives for banking organizations to participate in investments or activities for the benefit of affordable housing, banking organizations must also be authorized to engage in such activities. Part III.B below discusses sources of authority for national banks to engage in the types of activities eligible for the incentives discussed in Part II.\(^\text{20}\) Though the activities permissible for state-chartered banks are primarily defined by their chartering state, the Federal Reserve Board (“FRB”) and the Federal Deposit Insurance Company (“FDIC”) delineate additional boundaries for state-member banks and state-nonmember banks, which are discussed in Parts III.C and III.D, respectively. Part III.E discusses sources of authority for bank holding companies (“BHCs”) and their nonbank subsidiaries, while Part III.F discusses additional sources of authority available to financial holding companies (“FHCs”) and their nonbank subsidiaries.

#### B. **National Banks**

1. **Public Welfare Investments.** National banks and their subsidiaries are expressly authorized by the OCC to make a limited amount of investments that:

   - (1) Primarily benefit LMI individuals or areas, or other areas targeted by a governmental entity for redevelopment, or
   - (2) would receive consideration under the Community Reinvestment Act as a “qualified investment.” 12 CFR § 24.3; see also id. § 25.23. See supra Part II.A.1 for discussion of the activities qualifying for treatment as a “qualified investment” under the OCC’s CRA regulation.

   a) **Limitations.** Any such investments must not exceed 5 percent of the bank’s capital and surplus, unless (1) the bank is at least adequately

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\(^{20}\) In addition to the authority discussed in Part III.B, in certain circumstances and with the prior approval of the OCC, national banks have been permitted to invoke their lending authority as the basis for making equity investments in vehicles eligible for tax credits, where the structure of the investment essentially rendered it a financing. For example, a bank was permitted to make an equity investment in an entity that owned and wished to rehabilitate several historic properties, because “in substance, the transaction was the provision of construction financing which would be repaid both from the rehabilitated properties’ operating income and through the tax credits.” OCC Int. Letter No. 1048, at 3 (Dec. 21, 2005), https://www.occ.gov/topics/licensing/interpretations-and-actions/2006/int1048.pdf (citing OCC Corp. Dec. 99-07 (May 26, 1999)). To date, the Federal Reserve Board has not provided any similar public precedents.
capitalized; and (2) the OCC determines, by written approval of a written request by the bank to exceed the 5 percent limit, that a higher amount of investments will not pose a significant risk to the deposit insurance fund. In no case may a bank’s aggregate outstanding investments under this authority exceed 15 percent of its capital and surplus. Id. § 24.4(a).

b) **Examples of Permissible Investments.** This authority includes investments in the following types of affordable housing programs: (1) projects for transitional housing for the homeless; (2) special needs housing projects for disabled or elderly LMI individuals; and (3) projects that qualify for the LIHTC. Id. § 24.6(a). This authority also includes investments in an entity that finances, acquires, develops, rehabilitates, manages, sells, or rents housing primarily for LMI individuals.

c) **After-the-Fact Notice.** Certain “eligible banks” are generally required to notify the OCC of an investment under this authority within 10 working days after it makes the investment. Id. § 24.5(a)(2). If a bank does not qualify for “after-the-fact” notice, it must submit an investment proposal to the OCC prior to making such an investment, in accordance with the OCC’s regulations. Id. § 24.5(b).

d) **Recordkeeping.** Banks should document why particular investments/projects qualify as public welfare investments.23

C. **State Member Banks**

1. **Public Welfare Investments.** Subject to the limitations of the applicable chartering-state’s law, certain state member banks are authorized to make investments in entities where (1) such investment would qualify as a “community development investment” under Regulation Y, which outlines activities

21 See supra Part II.B for a discussion of the LIHTC.

22 A bank is generally eligible for “after-the-fact” notice if it (1) is well capitalized; (2) has a composite rating of 1 or 2 under the Uniform Financial Institutions Rating System; (3) has a CRA rating of at least “Satisfactory”; and (4) is not subject to a cease and desist order, consent order, formal written agreement, or Prompt Corrective Action directive, or, if subject to any such order, agreement or directive, is informed in writing by the OCC that the bank may be treated as an “eligible bank.” 12 CFR § 24.2(e).

23 *Id.* § 24.7(b) (“Each national bank shall maintain in its files information adequate to demonstrate that its investments meet the standards set out in § 24.3 of this part, including, where applicable, the criteria of 12 CFR 25.23, and that the bank is otherwise in compliance with the requirements of this part.”).

24 To utilize this authority, a state member bank must: (1) be at least adequately capitalized; (2) have received a composite CAMELS rating of at least 2 for its most recent examination and consumer compliance examination; (3) not be subject to any written agreement, cease-and-desist order, capital directive, prompt corrective action directive, or memorandum of understanding issued by the Board of a Federal Reserve Bank.” 12 CFR § 208.22(b)(5)-(7).
permissible for bank holding companies and their nonbank subsidiaries; (2) the OCC has determined such investment would qualify as a “public welfare investment”; (3) such entities are “community development financial institutions”; or (4) such entities engage solely in, or make loans solely for the purposes of, one or more enumerated “community development activities.”

12 CFR § 208.22(b)(1).

a) **Limitations.** A state member bank’s aggregate investments pursuant to this authority must not exceed the sum of 5% of its capital stock and surplus, and the investment must not expose the bank to liability beyond the amount of the investment. *Id.* § 208.22(b)(3)-(4).

b) **Notice.** Generally, state member banks must provide notice to the FRB within 30 days after making an investment. *Id.* § 208.22(c). If a state member bank wishes to make a public welfare investment that is not expressly specified in the regulation, then the bank must request prior approval from the Board. *Id.* § 208.22(d)(1).

c) **Recordkeeping.** As a matter of best practice, state member banks should maintain records evidencing how and why a particular investment meets the applicable requirements for permissibility.

**D. State Non-Member Banks**

1. **Parity with National Banks.** Subject to the limitations of the applicable chartering-state’s law, FDIC-insured state non-member banks are permitted to make equity investments to the same extent as national banks. 12 CFR § 362.3(a)(1).

2. **Qualified Housing Project Investment Companies.** State non-member banks are also authorized to take minority positions in companies, the sole purpose of which is to invest in the acquisition, rehabilitation, or new construction of a “qualified housing project.” *Id.* § 362.3(a)(2)(ii). The term “qualified housing project” is defined as “residential real estate intended to primarily benefit lower income persons throughout the period of the bank’s investment,” and expressly includes any project that has received an award of LIHTCs. Residential

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25 12 CFR § 208.22(b)(1)(i); *see also* 12 CFR part 225; *infra* Part III.E.1.

26 12 CFR § 208.22(b)(1)(ii); *see also supra* Part III.B.1.

27 12 CFR § 208.22(b)(1)(iii); *see also* 12 U.S.C. § 4702(5) (defining “community development financial institution”).

28 12 CFR § 208.22(b)(1)(iv). This includes the authority to invest in, develop, rehabilitate, manage, sell, or rent residential property where a majority of the units will be occupied by low- and moderate-income persons, or the property would otherwise qualify as a “qualified low-income building” as defined for the purposes of the LIHTC. *Id.* § 208.22(b)(1)(iv)(A); *see also supra* Part II.B.
real estate projects that do not qualify for LIHTCs may still qualify under this exception if 50 percent or more of the housing units are to be occupied by lower income persons. *Id.* § 362.3(a)(2)(ii).*

a) **Limitations.** The bank’s aggregate investment must not exceed 2% of the bank’s total assets as of the date of the bank’s most recent consolidated report of condition. *Id.* § 362.3(a)(2)(ii).

b) **Notice Requirements.** There are no notice requirements with respect to the FDIC, though there may be notice requirements pursuant to applicable state law.

c) **Recordkeeping.** As a matter of best practice, state nonmember banks should maintain records evidencing how and why a particular investment meets the applicable requirements for permissibility.

### E. Bank Holding Companies

1. **Community Welfare.** BHCs and their subsidiaries are authorized to make equity and debt investments in “corporations or projects designed primarily to promote community welfare, such as the economic rehabilitation and development of low-income areas by providing housing, services, or jobs for residents.” 12 CFR § 225.28(b)(12)(i). This also includes approval to engage in certain other activities, up to 5 percent of the BHC’s total consolidated capital stock and surplus, without additional Board or Reserve Bank approval. *Id.* § 225.127(f).

   a) **Limitations.** Certain of the activities authorized under this authority are limited to 5 percent of the BHC’s total consolidated capital stock and surplus, absent prior approval from the FRB. *Id.* § 225.127(f).

   b) **Recordkeeping.** BHCs and their subsidiaries should maintain records evidencing how and why a particular investment meets the applicable requirements for permissibility.

2. **De Minimis Investments.** Unless otherwise prohibited by applicable law, BHCs are generally permitted to invest in any company provided that the BHC’s position does not exceed 5% of any class of the company’s voting securities. 12 U.S.C. § 1843(b)(6); 12 CFR § 225.22(b)(5); *see also id.* § 225.137.

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29 “Lower income” has the same meaning as “low income” and “moderate income” as defined for the purposes of 12 CFR § 345.12(n)(1) and (2). *Id.* § 362.3(a)(2)(ii).

30 The notice requirements of 12 CFR §§ 225.22-.23 apply to these investments as they do to other investments made under Regulation Y.
a) **Limitations.** Such investments must be made on a “passive” basis, and the BHC must not otherwise control the company. 12 CFR §225.137.

b) **Notice.** The Board’s prior approval is not required for these acquisitions. *Id.* §225.22(d)(5)-(6).

c) **Recordkeeping.** The BHC should ensure that is keeps track of its aggregate investments in the particular company to ensure that it does not exceed the 5% ownership threshold.

**F. Financial Holding Companies.** BHCs that have successfully elected FHC status may avail themselves of additional sources of authority for investing in affordable housing projects.

1. **Merchant Banking Authority.** FHCs and their subsidiaries may utilize their “merchant banking authority” to invest in companies that engage in non-financial activities, subject to certain conditions. 12 CFR §225.170. This authority may be available for investments in companies or funds that invest in affordable housing projects. Generally, an investment relying on merchant banking authority may not be held for longer than 10 years (with a longer holding period potentially available depending on the facts and circumstances). In addition, subject to certain exceptions, an FHC may not exercise routine management or operation of a merchant banking portfolio company, including by appointing a director, officer, or employee of the bank as an officer of the merchant banking portfolio company. *Id.* §225.171.

   a) **Recordkeeping.** To engage in merchant banking activity, an FHC would need to establish and maintain policies, procedures, records, and systems reasonably designed to conduct, monitor, and manage such investments and the risks associated with such investments in a safe and sound manner. *Id.* §225.175(a)(1). The FRB has issued a supervisory letter describing in detail the internal controls and risk management policies, procedures, and systems that are expected for FHCs engaging in merchant banking activity.31

**IV. VOLCKER RULE CONSIDERATIONS**

**A. Generally.** The Volcker Rule generally prohibits banking entities from engaging in proprietary trading and from investing in, sponsoring or having certain relationships with “covered funds.” This part of the outline addresses the three main questions relevant to a Volcker Rule analysis that may be required when a banking entity invests in a company or other entity that invests in affordable housing projects: (1) Does the investment raise Volcker Rule covered fund issues and (2) is the entity in which the bank

31 Supervisory Guidance on Equity Investment and Merchant Banking Activities, SR Letter No. 00-9 (SPE) (June 22, 2000).
is investing (including as a result of the contemplated investment) a banking entity that itself is subject to the Volcker Rule’s proprietary trading and covered fund prohibitions?

B. Covered Fund Issues. Under the Volcker Rule, a banking entity generally may not acquire or hold an ownership interest in, sponsor or have certain relationships with a “covered fund,” which includes an investment company relying on Section 3(c)(1) or 3(c)(7) of the Investment Company Act to avoid registration as an investment company. However, funds that are “[d]esigned primarily to promote the public welfare, of the type permitted [for national banks], including the welfare of [LMI] communities or families (such as providing housing, services, or jobs),” are exempt from the definition of “covered fund.” E.g., 12 CFR § 44.10(c)(11). Thus, provided that the fund is designed primarily to make investments that would be permissible for a national bank to make directly, pursuant to its “Public Welfare Investment” authority, such fund would not be treated as a “covered fund” under the Volcker Rule.

C. “Banking Entity” Issues. The Volcker Rule applies to all “banking entities,” a term which includes insured depository institutions, foreign banks with a U.S. banking presence, and all of their affiliates. Id. § 44.2(c). However, covered funds (that are not themselves insured depository institutions or bank holding companies) are excluded from the definition of the term “banking entity.” Id. § 44.2(c)(2)(i). Thus, if a banking organization invests in a non-covered fund—such as a fund that is exempt from the covered fund definition based on the public welfare exclusion noted above—it is important to analyze whether the investment, or other relationships with the fund, could lead to the fund being a banking entity, which would result in the fund itself being subject to the Volcker Rule. See id. § 225.144.

V. OUTLOOK & CONCLUDING THOUGHTS

A. OCC’s Advance Notice of Proposed Rulemaking. The OCC recently published an Advance Notice of Proposed Rulemaking (“ANPR”) requesting comments on the current CRA regulatory framework in light of changes to the regulatory landscape since the CRA was first enacted, particularly with respect to the removal of interstate branching restrictions and the expanded role of technology. Topics addressed in the ANPR included questions relating to: (1) the transparency, consistency, and fairness of the regulation; (2) the potential use of a metric-based framework to evaluate performance; and (3) whether bank communities should be redefined, particularly in light of the role of the internet.

32 Certain commodity pools and foreign funds also may be covered funds under the Volcker Rule. See 12 CFR § 44.10(b).

33 See supra Part III.B.1 for discussion of national banks’ Public Welfare Investment authority.

B. **Tax Reform.** Recent changes to the Internal Revenue Code substantially changed the federal income tax framework. The revision did not directly alter the LIHTC program; however, the reduction in corporate taxes, along with the limits on deducting net operating losses that were part of the changes, led affordable housing advocates at the time to voice concern about a reduction in the demand of LIHTCs.\(^{35}\) It remains to be seen whether these changes will in fact impact the demand for LIHTCs, and thus the resources available for affordable housing development.

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\(^{35}\) CRS, *supra* note 8, at 5.