

## 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.

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.*

**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.

## 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.<sup>3</sup>

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

---

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

---

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

---

<sup>3</sup> See the Resources section of National Community Capital’s website [www.communitycapital.org](http://www.communitycapital.org) for a copy of the opinion letter.

in addition to the financial return. The favorable CRA treatment is a motivating factor for many banks to make an EQ2 investment.

## 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

## ABOUT THE AUTHOR



BETH LIPSON is the manager of special projects in the financial services division at National Community Capital. National Community Capital provides financing, training, consulting and advocacy services to a national network of private-sector Community Development Financial Institutions (CDFIs). Beth manages National Community Capital's collection and publication of CDFI industry data and New Markets Tax Credit efforts. She also underwrites loans and investments to CDFIs. Beth has a BA from the University of Pennsylvania and an MBA from the Wharton School. For more information about National Community Capital, visit [www.communitycapital.org](http://www.communitycapital.org).

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.<sup>4</sup>

*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](http://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.

### 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 non-profit 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.communitycapital.org](http://www.communitycapital.org) for the following free documents:

- Sample Equity Equivalent Agreements
- Regulatory Opinions Letters regarding EQ2

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

## 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.)