

Strategic Options for Bankers in Rural Development¹

Larry Meeker and Forest Myers

Larry Meeker is a vice president and Forest Myers is an economist in the Division of Supervision and Risk Management. The views expressed are those of the authors and do not necessarily reflect those of the Federal Reserve Bank of Kansas City or the Federal Reserve System.

INTRODUCTION

While the United States has enjoyed an unprecedented economic expansion during the last decade, the picture for rural counties, especially those located in the “great plains” region, has been more varied. Metropolitan areas, counties near cities, and counties close to scenic amenities continue to grow while other counties — particularly those more dependent upon agriculture — often experience population loss (see Figure 1). This population loss has clouded the future for many rural communities.

The Great Plains — that huge tier of counties extending from Texas to Montana and North Dakota — continues its decades-long decline in population. Changes in agriculture together with a lack of economic alternatives and many amenities that drive rural population growth today are responsible. As a result, community services become more expensive to provide, the region’s population ages, and future prosperity becomes even more difficult to achieve.²

With recent strains in agriculture and with the potential for greater job and population loss looming, it is not surprising that many bankers have heightened concerns for their communities and an interest in initiatives they can undertake to promote local growth and development.³

In this paper, we address this banker interest in learning more about the role their bank organizations can play in the economic development of their communities. We begin by defining community development lending. We then identify a process, with specific steps, that can help bankers achieve success in their community development initiatives. Within the context of this process, we report on several banker-driven development initiatives, examin-

ing the management decisions behind them and lessons gleaned from their implementation.

COMMUNITY DEVELOPMENT LENDING DEFINED

Banks often can and do participate in community development through their everyday lending. For example, they make conventional mortgages and small business and commercial loans. They also purchase community development loans made by other lenders and participate in state and local government financing programs designed to meet the housing and business development needs of low-income individuals, small businesses and agricultural borrowers.

Often, it is when a deal or project falls outside these normal or conventional channels that banks seek other ways to get it completed. This frequently involves tapping different government programs for financial support and working with local community leaders to muster community and political support for projects that could not be done otherwise.

Today, much of the community development lending that involves using government programs — small business lending or lending to low- to moderate-income homebuyers — has become routine. For example, many institutions use Small Business Administration (SBA) loan guarantees and Federal Housing Administration (FHA) guarantees to help address the special needs of small businesses and lower-income homebuyers. While the necessity of government involvement makes these transactions fit the definition of community development lending — deals that cannot be done without outside assistance — the volume and routine nature of these activities result in their being normal business lines for many lenders.

However, many banks want to extend their involvement beyond the routine. For example, rural communities often have problems with aging infrastructure, a lack of technical skills to support entrepreneurial activity, a scarcity of affordable housing for lower income working families, and a need for jobs. Meeting these needs requires tailoring unique responses to the community's special circumstances

and an investment of time and resources that extend beyond the routine. Some community development initiatives, such as multifamily affordable housing lending, involve unique complexities and transaction costs that are unlikely to become routine, especially in rural communities. In addition, sometimes the need is simply for equity capital investment, something that banks can't provide in the normal course of business.

Community development lending opportunities come in many forms. A typical example is affordable housing, where the goal is to provide housing for people who cannot afford market rate housing, such as housing for the homeless, low- to moderate-income families, or the elderly.⁴ In each instance, the project's financial challenge is straightforward: the cost of creating the housing exceeds the client population's ability to pay for it. Hence, there is an important need for government or other third party resource support. Similarly, many small business development initiatives require outside support before a loan can be made. For example, new businesses, or smaller businesses strapped for working capital, may find it difficult to obtain bank credit without a government loan guarantee or a second mortgage from a government agency.

The common thread in each of these community development lending examples is the need for outside support to make a potential loan bankable or to make a deal attractive to an investor. It is these non-routine projects that receive attention in this paper. These projects usually involve a longer-term commitment of financial and managerial resources, and they are usually part of an overall strategy to achieve broad community goals.

STEPS FOR SUCCESS

Although there may be many complexities associated with community development projects, experience shows that it is important for banking organizations to treat these projects like any other business. By thoughtfully considering community needs, available resources, regulatory requirements, and appropriate development role and organizational structure, banking institutions may be able to

avoid costly missteps that limit their success in community development. These points are highlighted by results of an Office of the Comptroller of the Currency (OCC) survey of banks that participated in a study of effective community development practices. The OCC found two guiding principles in successful community development financing:

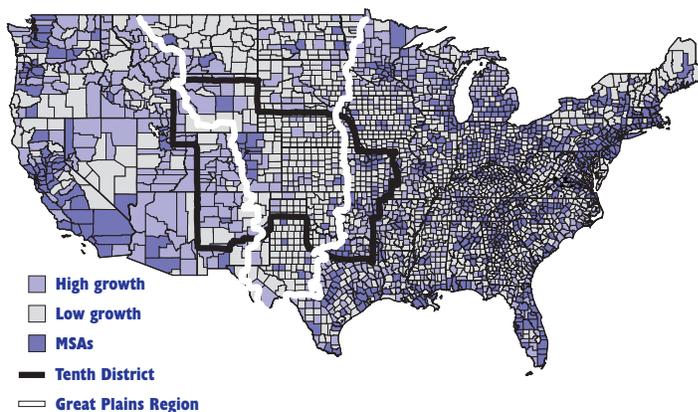
First, banks that are successful in community development financing actively investigate their communities for CD [community development] opportunities appropriate for [their] markets and take a strategic approach to partnerships with CD organizations and government agencies. Second, banks learn as much as they can from the best in the business, replicate appropriate strategies in local markets, and go back to the drawing board to develop new approaches when previous methods don't work.⁵

Table 1 identifies issues to consider before engaging in community development activities to improve chances of success.⁶ The first two steps focus on the community's needs and the resources available to address those needs. The third, determining potential roles for a bank or bank holding company, identifies ways a bank's or company's resources can help meet community needs. The last two address internal considerations for the banking organization: how to structure an activity and how to address related regulatory issues.

COMMUNITY DEVELOPMENT EXPERIENCES

Not every bank or bank holding company will explicitly follow the steps outlined in Table 1, nor will they give the steps the same amount of attention.⁷ However, most institutions will give some consideration to these issues once they decide to get involved in community development projects. To better understand the motivation and issues to be considered in devising and implementing community development activities, we interviewed by telephone the management of seven banks and seven bank holding companies in the Tenth Federal Reserve District⁸ that are currently engaged in rural community development.⁹ These 14 institutions constituted most of the rural-based organizations

Figure 1
County Population Change: 1990-1997



Source: USDA

identified in previous surveys as having community development activity in Tenth District states.

All of the institutions interviewed were small, ranging in size from total assets of \$12.4 million to \$712 million as of December 1999. They showed wide diversity in their approaches to community development. Some had made multiple community development investments, with one holding investments at both the bank and bank holding company levels. Several institutions held investments in a community development financial institution (CDFI), and one had an ownership stake in a multibank community development corporation.¹⁰

Affordable housing was the principal community development project for one bank and six bank holding companies. One institution owned a test farm, and two others worked on projects to entice new businesses to their communities. Another participated in an office expansion for the community's major employer. One played a role in a regional hospital expansion and a variety of other development projects to improve the community. One held an equity investment in a rural television cable company.

With the exception of those having an investment in CDFIs, none of the activities of those interviewed were conducted in more than one community. In every case, the community development activities of

the banking organizations interviewed were a relatively small part of their total business activities.

Our interview questions focused on each of the activities listed in Table 1. The comments made by bankers about their experiences with these activities and the implementation of their accompanying action steps are included in the sections below.

Conduct Community Needs Assessment

Performing a community needs assessment is an important first step in determining an institution's potential role and participation in community development services.¹¹ Information for this assessment can come from a variety of sources in a community. Neighborhood organizations are often well positioned to see unmet or inadequately met housing needs. Local government officials are on the front lines in knowing community infrastructure needs and opportunities. Bankers themselves are well positioned to be aware of community development needs as they review loan requests and decline those that don't meet the bank's credit standards. Though marginally unbankable, many of the declined requests may present development opportunities for the community.

All the institutions we interviewed did some form of needs assessments before implementing their development projects. They held discussions with local merchants, performed or reviewed studies, worked with consultants, or used their personal experiences from living in the community to identify development projects.

In most instances, these analyses were right on target, and development projects performed as expected, leading two of those interviewed to say "they couldn't have been more pleased" with their project's outcome. Two others, however, were not as satisfied and noted that, if they had done a more complete analysis, they might not have made their community development investment.

Identify Available Resources

Once development needs are identified and a project is proposed, the next step is to determine the resources required to complete that project. This helps identify gaps to be filled and aids in the search

for partners and programs that can help make projects compatible with lender or investor requirements.

Partnership arrangements invariably are made with those who have financial resources to contribute: private investors, other financial institutions, government agencies, charitable organizations, or venture capital funds. In addition, they include partners with special knowledge, skills, credibility, and contacts, such as community development organizations and community and civic groups who can help reduce the transaction costs associated with transforming an undoable deal into one that meets marketplace risk-return requirements.¹²

Government agencies are resource partners in many community development projects, simply because their programs have been created to mitigate higher risk or to compensate for below-market returns that are common to many economic development projects. These programs come in a variety of forms, including special tax incentives to attract new businesses and train their workers, government loan guarantees to lessen credit risk on small business loans, grants that make home ownership affordable for first-time or low-income homebuyers, and tax credits that provide builders or developers with incentives to construct affordable housing.

Some of those we interviewed partnered with others, while others went it alone. Those who partnered often did so with other banks and bank holding companies and with private investors. The organized community groups that are many times found in metropolitan areas did not enter the partnership picture for the simple reason that they often don't exist in many small rural communities.

Many of the banking partners and investors were located in the same town or county. Few that we interviewed could recall the exact circumstances that brought them together with their partners. Those who did mentioned referrals by a consultant or common participation on a city or county economic development council. Most said they could accomplish more, work on bigger projects, and have more of an impact on the community if they worked together. Partnership arrangements therefore became a way to leverage bank or bank holding company development resources.

In addition to partnership arrangements, institutions can leverage their own resources by combining them with those available through federal, state, and local development programs. There are a multitude of programs to assist community development, but finding appropriate programs to meet specific development needs can be time consuming. Computerized databases, such as 1st Source (<http://www.1stsource.kc.frb.org>), established by the Federal Reserve Bank of Kansas City, can help simplify this task by matching programs with needs for specific projects.¹³

Another useful aid is the *Community Development Resource Guide* which provides information on available resources from 60 community development, banking, and governmental organizations. It may be purchased from the OCC or downloaded from the OCC's Internet site at <http://www.occ.treas.gov/cdd/resource.pdf>.

For those we interviewed, low-income housing tax credits were the most frequently used enhancement.¹⁴ To receive these credits, banks and bank holding companies invested in limited liability cor-

porations that developed and managed low-income housing units.

Resources used by those interviewed also included other business and housing programs. One bank took advantage of tax increment financ-

Table I

Checklist of Issues to Consider Before Engaging in Community Development

Activity	Action Steps
<p>Conduct Community Needs Assessment What does the community need to grow/remain viable and what obstacles are keeping the community from fulfilling these needs?</p>	<p>Identify community development needs Affordable housing, job creation, gap financing/venture capital for existing businesses or start-ups, attracting/assisting applicable new businesses to move to community, technical assistance</p>
<p>Identify Available Resources What financial and managerial resources are available to remove obstacles to the community's economic growth?</p>	<p>Identify resources needs Programs — technical assistance, financial assistance Partners — major employers, community groups, financial institutions, government agencies/programs, community leaders</p>
<p>Determine Potential Role for Bank/Bank Holding Company What gaps can our organization fill in overcoming obstacles to the community's economic development?</p>	<p>Identify potential financial and managerial resources to commit relative to the gap to be filled Evaluate consistency with the organization's strategic goals</p>
<p>Consider Structure Options What is the best way to structure our organization to fill the gaps and overcome obstacles to the community's economic development?</p>	<p>Determine scale of activity Extent — one or multiple projects/ one or more locations, relative size, short-term/long-term commitment</p>
<p>Identify Regulatory Requirements Is an application or notice required? Will loans be made to affiliates?</p>	<p>Consider who benefits Low-to-moderate income individuals or areas Decide tax status Nonprofit or for-profit Identify entity to conduct activity Limited partnerships, CDC, SBIC, etc. Consider safety and soundness issues and comply with applicable regulations</p>

ing offered by the city in which it was located to help finance an office expansion for a major employer. Another took advantage of the Department of Housing and Urban Development (HUD) Section 8 rent supplement program.¹⁵ Still another, whose projects were in the planning stages, planned to apply for Department of Commerce grants to bring new employers to town.

Determine Potential Role for Bank/Bank Holding Company

Matching community needs with available resources helps define potential roles for a financial institution in local development initiatives. Narrowing these options requires review of an institution's strengths, resources, and strategic objectives. This process helps set the course for the institution and clarifies what it seeks to accomplish. For example, a bank operating in a rural community might have a strategic objective to diversify its loan portfolio in order to lessen its reliance on agricultural borrowers. Its development objective therefore may be to attract nonagricultural businesses to the community. Consistent with this objective, the bank might make equity investments in new building construction to attract and house new companies or it might participate with a development team that actively pursues new businesses by offering tax abatements and attractive financing packages. The objective broadly defines the development role to be played by the bank or company, the degree of that involvement, and the time horizon for it (see the accompanying box summarizing the community development objectives, activities, and organizational structure of Southern Development Bancorporation as an example).

The role played by those interviewed varied, with some being passive investors and others playing an active part or taking a leadership role in community development. For those who played a more passive role, their financial investment permitted them to support community development while limiting demands on their managerial and personnel resources, leaving identification, implementation, and management of development projects to others. Examples of this approach were those who

invested in the CDFI and those who had become limited partners in affordable housing projects in order to receive tax credits.

Others took a more active role. In one case, a bank holding company purchased a test farm and designed experiments to improve management and production on area farms. In another, the banking organization did the accounting work for the affordable housing project in which it had invested. Besides helping track the project's financial progress, this also provided a way to watch over the bank's investment.

In still another case, two investing bank organizations actively participated with others in the community in the management of a community development corporation. They kept majority ownership in the organization in order to control and prevent the possible misuse of the corporation's financial resources.

Consider Structure Options

There are many ways an institution can implement its community development strategy. The structure adopted depends upon a large number of factors, and ultimately there may be more than one suitable organizational structure. Figure 2 shows four basic organizational models used by banks and bank holding companies to conduct their community development activities. These activities can be conducted directly by a bank (Panel A) or a bank holding company (Panel C), or indirectly by a bank subsidiary (Panel B) or a bank or financial holding company subsidiary (Panel D). More than one organizational structure can also be employed if the development activities of the banking organization warrant. Furthermore, these structures can be used by a single banking organization or a group of organizations acting together to assist in meeting the development needs of one or more communities.

To pare down the best choice of an organizational structure that fits the development role to be played, it is helpful to answer the following questions:

- Will the institution's involvement be confined to a single project or will the bank or company engage in multiple projects?
- Will the institution's development projects

be isolated to a single location or will they be geographically dispersed and take place wherever the institution has a banking office or other physical presence?

- Is the institution's commitment to community development of limited duration or will it be long-term?
- Will a significant amount of the institution's capital (5 percent or more of the bank or bank holding company's capital and surplus) be devoted to community development activities?
- Does the institution have the managerial resources and staff expertise to successfully carry out the development role it has chosen?
- Is the activity expected to provide competitive returns to the institution and are these returns to be made available as dividends to its shareholders?

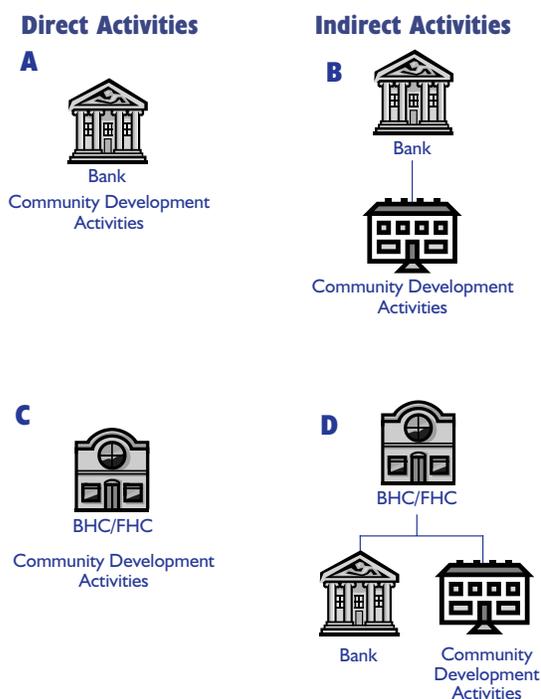
Answers to these questions further define the scale and time horizon for the banking organization's community development activities, the beneficiaries of its activities, and the organization's own needs — shareholder return and community service recognition — and help define the most effective structure to adopt.

Scale

The number, size, duration, and locations of the development projects in which an institution becomes involved are important issues in organizational structure. If a single, small (relative to the size of the banking organization) project or only a few small projects of short duration, limited to a few locations, are envisioned, then conducting development activities directly from the bank or bank holding company may be a low-cost and quick way to implement these activities. On the other hand, if larger development projects are going to be undertaken over long periods of time and at many locations, then housing the development activities in a separate subsidiary may be more appropriate.

From a shareholder and regulatory perspective, corporate separateness helps shield the insured depository institution from any added risk exposure that larger scale community development projects may pose. From a business perspective, a separate

Figure 2
Alternative Organizational Structures for Community Development Activities



Notes:

The federal banking agencies' list of pre-approved community development activities include:

- building or refinancing the construction of low- to moderate-income residential housing;
- financing or participating in the rehabilitation and redevelopment of commercial property located in low- to moderate-income neighborhoods or other areas needing revitalization;
- investing in or providing financing for small businesses in economically depressed areas;
- job training and placement for low- to moderate-income persons;
- investment in entities which will provide long-term employment opportunities for low- to moderate-income persons;
- credit counseling, and research and development services to low- to moderate-income individuals and other firms engaged in community development activities; and
- other activities approved by state and federal bank supervisory agencies.

Box

**Southern Development Bancorporation:
A Comprehensive Approach to Community Development¹**

Most bank-initiated community development activities are incidental to a bank's broader business activities. In a few cases, however, just the opposite is true. Southern Development Bancorporation is such an organization. With charitable foundations as principal shareholders and a mission of "...transforming rural economies in Arkansas by creating new trends of investment in people, jobs, businesses and real property," its primary objective is to provide returns to the community, rather than profits to its shareholders.

While most banking organizations may not subordinate shareholder return to engage in community development activities to the extent Southern Development Bancorporation does, the organization's structure and activities are illustrative of the breadth of opportunities in which rural community banks can become involved to better their communities. The accompanying abbreviated organizational chart depicts the various pieces of Southern Development Bancorporation and their relationship to one another.

The banks in Southern Development Bancorporation are run like most banks, with a focus on serving financially strong customers and employing good underwriting criteria. Unlike many banks, however, these banks are willing to accommodate borrowers who are slightly more risky than traditional bank borrowers. Accommodating such borrowers frequently requires using various government programs to help mitigate that risk. They are willing to expend the time and resources it takes to utilize these programs to reach a broader customer base, even though it may mean lower profit expectations. One of the banks, Elk Horn Bank and Trust Company, also has a mortgage company subsidiary to facilitate mortgage lending, including lending to lower-income borrowers.

Opportunity Lands Corporation and Southern Community Development Corporation are, respectively, for-profit and not-for-profit real estate development subsidiaries. Working individually or together, they are able to develop both commercial and residential real estate, depending upon a community's needs. Many of their projects involve affordable housing for low-income residents. Thus, the non-profit entity, Southern Community Development Corporation, is often used to access government and other money to help subsidize these projects.

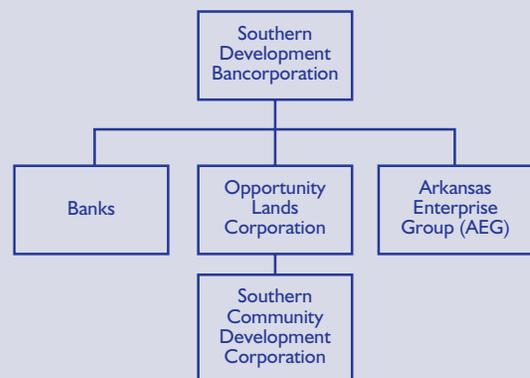
The Arkansas Enterprise Group's (AEG) focus is on assisting smaller businesses without the operating and credit histories necessary to access bank funding. Its subsidiaries provide

subsidiary may also allow concentrating the banking organization's community development resources and permit taking advantage of any available scale economies in conducting these activities. In this regard, it takes time and money to search out partners and resources to help get a project from the drawing board to completion. Once found, it takes additional resources to manage the many aspects of the project as it is implemented. All of these efforts increase transaction costs.

Vesting community development knowledge in a single unit or group of individuals may help reduce transaction costs. Depending upon geographic distribution and volume of development activity, a banking organization may be able to hire people who concentrate their attention on community development activities.¹⁶ These people may have a background in real estate and small business lending and have practical knowledge of local, state, and federal government programs that can be used to leverage the organization's resources. Furthermore, they may be familiar with the community development organizations and intermediaries in local communities and be aware of how partnerships with these organizations can help a bank or bank holding company meet community needs.

A similar argument can be made for banking organizations joining with one another to engage in community development activities. For example, 18

**Abbreviated Organization Chart
for Southern Development Bancorporation***



*The abbreviated organization chart shown is based on a more detailed chart taken from Southern Development Bancorporation's 1999 Annual Report.

banks, a bankers' bank, and a government agency invested in Oklahoma Metafund Community Development Corporation (Metafund). The purpose of this fund is to "finance and invest in community economic development and workforce development to promote job creation and self-employment opportunities, housing, and property development/rehabilitation, and maintenance primarily for low and moderate income individuals in under served populations in Oklahoma."¹⁷ With this in mind, it is the goal of the Metafund to work with existing partners in communities, including banks, and to fill whatever gaps other partners are not able to fill. Hence, in one community Metafund might buy a run-down house to be rehabilitated by others to rent to a low-income resident, while in another, it may extend a second mortgage to a local, expanding business.

Interviews with several bank investors indicated a variety of reasons for joining this statewide venture. Among these were the ability to promote economic development in individual communities and the state of Oklahoma; to receive an acceptable return on investment; to work around the inability to join with other local banks on community development projects; to obtain benefits such as capturing scale economies and sharing risks and expenses in community development projects; and to obtain Community Reinvestment Act (CRA) investment credit.¹⁸

Beneficiaries

It is important to identify beneficiaries of community development projects because banks and bank holding companies have been given added flexibility to make investments in projects that primarily benefit low- to moderate-income individuals and areas. These include affordable housing, community services, small business and farm finance, and neighborhood revitalization and stabilization activities. In such cases, banking organizations, which are subject to safe and sound operation requirements and the regulatory limitations discussed below, can make investments and conduct activities that might otherwise be prohibited.

All of those interviewed were located in low- to moderate-income areas or their development proj-

Box (continued)

"non-traditional financial services, technical support, and human resource development." A lending officer representing AEG sits on the loan committee of the banks to determine if credits that are unacceptable to the banks might be workable for AEG. Technical assistance is made available for AEG customers both to improve business operations and to help manage AEG's credit risk. This support is provided via a third party so as to avoid lender liability risks to AEG. Finally, another AEG subsidiary provides job training to improve the skills of local residents, thereby helping them obtain meaningful employment. Many of these clients are exiting welfare rolls.

Throughout the years, Southern Development Bancorporation has adjusted its operations and operating philosophy to better serve its communities. Some operations, such as Southern Ventures, a venture capital company providing equity funding, have been de-emphasized, because they lost money and didn't accomplish their purpose or a better way was found to accomplish the same purpose. Others, such as the company's job training programs, received greater attention because of their success. For example, Careers in Health Care, which provides certified nurses training and career development opportunities, has graduated 142 certified nursing assistants since its inception in 1997 and is being looked at as a model for similar programs offered by others.

Additionally, Southern Development Bancorporation has moved from a philanthropic to a business-like operating philosophy to help maximize resources flowing to its community development activities. Although profits are still not the primary motivating force behind the company's community development activities, it does attempt to provide its development services at no less than a breakeven level. Without such fiscal responsibility, the company's ability to provide continuing, long-term financial support for its activities would disappear.

For more information about Southern Development Bancorporation and its operation and the lessons learned from those operations, contact Mr. Phillip Baldwin, Executive Vice President and Chief Financial Officer, at (870) 246-3945. His e-mail address is pbaldwin@ehbt.com.

¹ Southern Development Bancorporation is headquartered in Arkadelphia, Arkansas.

ects primarily benefited low- to moderate-income individuals. Without provisions in banking laws and regulations designed to benefit low- to moderate-income individuals and communities, many of their activities may not have been allowed or would have been reduced in magnitude.

Needs of the bank or bank holding company

The needs of the bank or bank holding company should be balanced with community economic development needs. Banks and bank holding companies have the option of organizing their development activities in for-profit or non-profit entities, making the need for earnings an important consideration in structuring their activities.

Private foundations and government agencies often have grant money or other funding that can be used by non-profit organizations for community development. As a consequence, banks and bank holding companies hoping to take advantage of those funds often elect non-profit status under the Federal Internal Revenue Code for their community development activities.

Typically, this is done under Section 501(c)(3) of the code — the exemption from federal income tax for “corporations ... organized and operated exclusively for ... charitable ... purposes”¹⁹ The trade-off in making this election is that “no part of the net earnings [can] inure to the benefit of any private shareholder or individual.”²⁰ Because of this stipulation in the Internal Revenue Code, an investment in a 501(c)(3) corporation is a non-earning asset. Therefore, if some form of shareholder return is expected, placing housing development activities in a for-profit entity may be a more appropriate structure.

However, investing in a 501(c)(3) corporation doesn't necessarily preclude receiving investment returns. For example, investments in Metafund, a 501(c)(3) corporation, are structured to meet the definition of an equity investment used by the Department of Treasury's CDFI fund but not that of the Internal Revenue Code.²¹ Thus, Metafund shareholders can receive a return on their investment without violating tax law. Another way for obtaining a return on an investment in a 501(c)(3)

corporation is through lending to it. The rate on the loans can include an investor return plus any amount parties to the loans agree is an appropriate interest rate.

Four banking organizations interviewed made community development investments through 501(c)(3) corporations. Three of the non-profit investments were in Metafund, and the fourth placed its community development activities in a 501(c)(3) corporation because it planned to apply for grant money.

Alternative organizational structures

After addressing the above issues and questions, alternative organizational structures can readily be identified. The most frequently used structure by those interviewed was the for-profit, limited liability corporation. Limited liability corporations are separate legal entities that can be viewed as a cross between a general corporation and a partnership. Like general corporations, limited liability corporations offer their owners the advantage of limited liability.²² Like partnerships, these corporations permit pass-through taxation, which means the earnings of limited liability corporations are treated like those of sole proprietorships, partnerships, and S corporations,²³ thereby avoiding double taxation. For those interviewed, this advantage translated into pass-through of low-income housing tax credits.

Bank-owned community development corporations (CDCs) were another structural option chosen by two of those interviewed. CDCs are separately incorporated entities whose primary corporate purpose is to make equity and debt investments in projects designed to promote community welfare, development, and revitalization (see note to Figure 2). One CDC was organized as a for-profit corporation. The other was organized as a non-profit corporation to take advantage of possible grant money. One was owned by a bank, the other by a bank and a bank holding company. No reason was given for the difference in ownership structure adopted except individual preference for the federal banking supervisor with whom the organizations worked.

Forming a Small Business Investment Company (SBIC) was an option chosen by one of the banks

interviewed, making it somewhat unusual among those surveyed. SBICs are for-profit corporations or limited partnerships licensed by the Small Business Administration under the Small Business Investment Act of 1958 to provide venture capital to small, independent businesses. They can buy equity securities and convertible debt securities issued by small businesses and also make loans to them. Banks and bank holding companies are restricted from being general partners in a small unincorporated business and from becoming liable for its general obligations. SBICs owned by banks and bank holding companies often serve as venture capital units.

As far as banking involvement is concerned, SBICs are typically owned by larger banks and companies, because a minimum of \$5 million capital is required to start one. It is this relatively large capital commitment that makes the small rural bank interviewed unusual.²⁴

Although not yet used by Tenth District organizations, new regulations regarding merchant banking activities of financial holding companies may play a role in community economic development in the future.²⁵ Merchant banking activities are broadly defined as “investments in any amount of the shares, assets, or ownership interest of any type of non-financial company.” Subject to limitations on the investment holding period, capital exposure, and management control, merchant banking may provide smaller banks another tool for community development.

Identify Potential Regulatory Issues

Banks and bank holding companies operate under a host of laws and regulations to promote safe and sound operations and to ensure fair dealings with consumers. Among other things, these laws and regulations place restrictions on the products, services, and investments of banks and are important considerations in structuring community development activities. Of particular relevance for community development activities are investment and lending restrictions placed on banking organizations and matters pertaining to safe and sound operations.

Investment restrictions

Subject to provisions of state law, state chartered banks face the same limitations and conditions on their equity investments as nationally chartered banks. Bank holding companies do not face restrictions on their stock ownership as severe as those of banks, but their ownership is limited to entities that engage in financial activities, nonbank financial activities that complement financial activities, or activities that are closely related to owning and controlling banks.

National banks cannot own shares of stock in a corporation, except as specifically permitted by law (for example ownership in a bankers' bank).²⁶ However, they are authorized to make investments designed to promote public welfare, including the welfare of low- to moderate-income areas or individuals, such as providing housing, services, or jobs.²⁷ By federal regulation, state chartered banks can also make these types of investments as long as they are permissible under state law. Bank holding companies can do so as well, as long as they abide by the restrictions of the Federal Reserve Board of Governors' Regulation Y.²⁸

Although banks and bank holding companies have greater ownership latitude when making community development and public welfare investments, there are limits and conditions on this ownership. In no case can the aggregate of welfare and development investments exceed 10 percent of a bank's or company's capital and surplus. Furthermore, in the case of banks, the investments they make cannot expose them to unlimited liability. These limitations and conditions help explain why the investments made by those interviewed were relatively small in relation to their capital, and why these investments were in corporations and limited partnerships.²⁹

The passage of the Gramm-Leach-Bliley Act of 1999 (GLB), which created financial holding companies, provides a new means to promote public welfare by permitting equity investments above the previously described limitations. Financial holding companies can commit as much as \$6 billion or 30 percent of their capital in equity investments as part

of an authorized merchant banking activity. These expanded limits could permit greater commitment of a banking organization's resources to community development activities, provided the investments are consistent with the restrictions for merchant banking activities.³⁰

In some instances, these restrictions may limit the use of merchant banking activities in promoting public welfare. For example, they put limits on the holding period for merchant banking investments, specify capital support, and restrict taking part in managing companies in which equity investments are held. While each of these restrictions could limit the use of merchant banking activities as a community development tool, the restrictions on control may be of particular concern. Some of the institutions interviewed wanted to exercise control over the organizations in which they invested. Their reasons ranged from having a voice in how funds were used to making sure funds were fully accounted for. Thus, for these banking organizations, existing community development tools may still represent their best option.

Lending restrictions

Besides investments, banking organizations can make loans to finance community development projects. In some situations, they may be faced with making loans to corporations in which they have an investment. This was the case for two of those interviewed. Another interviewee said that it was likely they would extend a line of credit in the future.

In cases such as these, care must be taken to ensure compliance with Sections 23 A & B of the Federal Reserve Act. Sections 23 A & B place limits and collateral requirements on loans and certain other transactions with affiliates and require terms on these transactions to be similar to those with nonaffiliated entities. The purpose of these sections of law is to prevent banks from sacrificing their own profitability to favor their affiliates.

An affiliate is defined as any company that controls a bank and any other company that is under common control with a bank. "Control" includes instances where one company, directly or indirectly, owns, controls, or has power to vote 25 percent or

more of any class of voting securities of another company. It also includes cases in which a company can elect the majority of directors of another or where a company has a majority of its owners/directors in common with another company.

When a company is an affiliate of a bank, then limitations and conditions apply to transactions covered by Sections 23 A & B. Covered transactions include, among other things, loans or extensions of credit by a bank to an affiliate, and a bank's purchase of or investment in securities issued by an affiliate. In the case of a single affiliate, the combined amount of covered transactions with the bank cannot exceed 10 percent of the bank's capital stock and surplus.³¹ For all affiliates in aggregate, covered transactions with the bank cannot exceed 20 percent of capital stock and surplus. The effect therefore is to limit the total commitment of a bank's resources to affiliates to 20 percent of its capital and surplus. This commitment can be in the form of loans, equity investments, or any combination of loans and investments.

Issues pertaining to safe and sound operations

Banks and bank holding companies have limited resources, and it is important to treat development activities as other business is treated. Resources devoted to development activities need to be used effectively, efficiently, and with due regard for safe and sound operations. This means establishing policies and internal controls commensurate with the size and complexity of these activities and having a management team and staff with the capabilities to lessen the operational, liquidity, market, and credit risks they may pose. Where community development activities consist of a single project, little more may be required than a written statement that sets out the objectives to be accomplished, an assessment of the project's appropriateness for the organization, plans to supervise the project, board guidance and approval of the project, and time frames for periodic reporting to the board on progress.

On the other hand, if large or multiple projects are planned, then more detailed policies and internal controls may be needed to guide the organiza-

tion's staff in seeking out community development projects, making decisions about them, and committing the organization's resources. Formal budget and profit objectives may be needed to assess the financial implications of the project. In addition, since many development projects tend to be long-term, consideration needs to be given to issues of liquidity and market risk. Also, if lending is to be done as part of the development activities, then appropriate additions must be made to loan policies to mitigate the additional credit risk these activities may pose and to ensure compliance with Sections 23 A & B.³²

All of those interviewed had briefed their boards of directors on proposed community development investments and received approval for those investments. None of those interviewed had written policies pertaining to their community development activities. Many had a single investment and didn't have immediate plans to make others, lessening their need for written policies regarding these investments.

SUMMARY AND CONCLUSION

Many rural Midwest communities have experienced prolonged job loss and population decline associated with technological and structural changes in agriculture. A small number of Tenth District banks and bank holding companies have taken advantage of special provisions in banking law to make loans and investments to promote the welfare of and arrest adverse trends in their communities. For the most part, they joined with private investors, other banks, and government agencies and took advantage of government programs to leverage financial and managerial resources devoted to community development.

Their development projects often focused on funding construction of better quality housing for low-income individuals, enticing new business, and helping existing businesses in their communities expand. With only two exceptions, they viewed their community development projects as successful. Their activities have provided good housing for low-income elderly residents, changed farm produc-

tion techniques, and provided increased job opportunities for workers. The lesson learned from those who were less satisfied with their community development projects' outcome was the importance of performing a good needs analysis at the outset.

Although promoting community good was a primary motivation for investments made by those interviewed, altruism was not the only motivation. Most development activities were organized as for-profit corporations, and many interviewees received some return, if not a market return, on their investment.

Banking organizations have many options available to them in structuring their community development investment activities and the structure chosen depends heavily upon the organization's and the community's needs. Recent passage of GLB provides an additional option for banking organizations to promote economic development through merchant banking activities. However, existing development tools appear to offer banking organizations more flexibility and control over their investments in low- to moderate-income areas.

In conclusion, all those interviewed thought their investments, regardless of outcome or return, helped improve their communities. Some, in fact, took special pride that their investments helped move their communities from stagnation and decline to renewed growth.

ENDNOTES

- ¹ This paper is based on an economic development presentation given by the authors earlier this year.
- ² USDA Economic Research Service, *Rural Development Perspectives, Great Plains Issue*, vol. 13, no.1, June 1998, p. 2.
- ³ Bankers attending the Federal Reserve Bank of Kansas City's 1999 Regulatory Update Seminar expressed interest in learning more about community development banking and requested this topic be covered in the 2000 Seminar.
- ⁴ Low- to moderate- income means individual or family income less than 80 percent of area median income or median family income.
- ⁵ Office of the Comptroller of the Currency, *Effective Strategies for Community Development Finance*, Washington, D.C., p. 4. This publication can be purchased from the OCC or downloaded from the agency's Internet site (<http://www.occ.treas.gov/strategy.pdf>)
- ⁶ The information presented in Table 1 includes a synthesis of information taken from *Community Development Investments: A Guide for State Member Banks and Bank Holding Companies*, Board of Governors of the Federal Reserve System Washington, D.C., pp. 11-31.
- ⁷ References to bank holding companies include financial holding companies that were created by the Gramm-Leach-Bliley Act of 1999.
- ⁸ The Tenth Federal Reserve District encompasses all or parts of Colorado, Kansas, Missouri, Nebraska, New Mexico, Oklahoma, and Wyoming.
- ⁹ We interviewed only bank and bank holding companies whose home offices were located outside of Metropolitan Statistical Areas.
- ¹⁰ CDFIs were created as part of the Riegle Community Development and Regulatory Improvement Act of 1994 in an effort to promote community revitalization and community development in areas under served by financial institutions.
- ¹¹ Sandra L. Jacobsen, *Federal Home Loan Bank Des Moines CICA Research Project, April-May 1999*, (Jacobsen Associates, Inc. 1999), pp 43-45, 49.
- ¹² Transaction costs refer to expenses incurred by a lender or investor to evaluate a project for its suitability, to search out development partners and enter into agreements with them, and to find appropriate development programs and comply with their requirements.
- ¹³ 1st Source is an interactive, Internet database through which the inquirer, by checking boxes that describe a project, receives a tailored list of potentially applicable programs with summary descriptions. Additionally, 1st Source provides web links to more detailed program information from the sponsoring agencies.
- ¹⁴ Under this program, investors in eligible housing projects are granted credit against taxes they would have otherwise paid. These credits, administered by state government, can be used for up to 10 years. To avoid recapture of these credits, eligible housing projects must be set aside for a minimum of 15 years.
- ¹⁵ Section 8 — Rental Certificate and Rental Voucher Program and Contract Renewals — is one of the largest HUD programs. It provides funding to state and local public housing agencies so they may provide rental certificates or rental vouchers to qualified low-income households.
- ¹⁶ When functions are specialized, capturing scale economies may be elusive. For example, there is evidence to suggest that a separate department making single family residential mortgage loans that are eligible for CRA credit may incur higher origination costs than if this lending were kept with other loan activities. See Larry Meeker and Forest Myers, *Financial Industry Perspectives*, "Community Reinvestment Act lending: Is it Profitable," December 1996, pp. 30-31.
- ¹⁷ Metafund is a CDFI.
- ¹⁸ An institution may receive investment credit under the CRA regulations if it invests in a fund whose purpose is community development, "provided the investment benefits one or more of the institution's assessment area(s) or a broader statewide or regional area(s) that includes one or more of the institution's assessment area(s)." Examiners take these investments into account in assessing a bank's performance under the CRA.
- ¹⁹ 26 USC § 501(c)(3)
- ²⁰ Ibid.
- ²¹ The investment is structured as an equity note, a form of debt capital, that qualifies as "equity-like investments" under the definition used by the Department of Treasury's CDFI fund.
- ²² Unlike limited partnerships that limit the liability of their limited partners but not their general partners, limited liability corporations limit the liability of all their owners. Also, unlike limited partners, limited liability corporation owners can fully participate in governing and managing the corporation.
- ²³ S corporations are corporations that have elected under the Federal Internal Revenue Code to pass their income through to their shareholders, thus avoiding federal corporate income taxes.
- ²⁴ For more information on venture capital investments in rural markets see *Equity for Rural America: Community Development Venture Capital, Community Reinvestment*, Fall 1999, Federal Reserve Bank of Kansas City.
- ²⁵ Financial holding companies are bank holding companies that have certified they are eligible to be treated as financial holding companies as authorized by the Gramm-Leach-Bliley Act of 1999.
- ²⁶ 12 USC 24(Seventh)
- ²⁷ 12 USC 24(Eleventh)

²⁸ 12 CFR 225.127

²⁹ Banks may self-certify or provide post notice of a community development or welfare investment if the aggregate of all these investments remains below 5 percent of their capital and surplus and meets other tests set out by their primary federal banking supervisor. This allows banks to respond quickly to community development opportunities, and the certification/notification process is relatively inexpensive and hassle-free, providing extra incentive to keep aggregate community development investments at 5 percent or below.

³⁰ 12 CFR 225.171

³¹ Capital and surplus is defined as the sum of Tier 1 and Tier 2 capital under the federal banking agencies' risk-based capital guideline plus the balance of allowance for loan and lease losses not included in Tier 2 capital under these guidelines. See 12 CFR 240.242.

³² Office of the Comptroller of the Currency, *Effective Strategies for Community Development Finance*, p 18.