**Testimony of Kerwin Tesdell**
**On behalf of the**
**Community Development Venture Capital Alliance**

**Before the Federal Financial Institutions Examination Council (FFIEC)**
**Hearing on Proposed Revisions to the Community Reinvestment Act Regulations**
**Los Angeles, California**
**August 17, 2010**

I thank the members of the Federal Financial Institutions Examination Council (FFIEC) for inviting me here today to discuss proposed revisions to the regulations governing the Community Reinvestment Act (CRA). My name is Kerwin Tesdell. I am the President of the Community Development Venture Capital Alliance (CDVCA).

CDVCA is the national trade association of community development venture capital (CDVC) funds. CDVC funds provide equity capital, plus extensive entrepreneurial and managerial assistance, to businesses in low-income areas to create good jobs for entry-level employees, as well as entrepreneurial capacity and productive wealth in low income communities. They invest in communities and in types of businesses that typically do not have access to venture capital from traditional sources. About 40% of the capital invested in CDVC funds has come from banks, making them the largest group of investors. The regulations and procedures implementing CRA are therefore of great importance to our industry.

I will address in these remarks how CRA can become more effective in promoting small business finance, particularly the provision of equity capital. It is no secret that small businesses are currently struggling with access to capital, as well as with a nationwide decline in consumer demand, or that small businesses are the most likely candidate to lead a jobs recovery. Since CRA's effectiveness is directly linked to vigorous and consistent implementation, I want to address a few pressure points in the CRA regulations and in the practice of examiners at the four federal agencies that could contribute to CRA having a greater impact on small businesses in LMI communities. Given that my organization's focus is on



424 W. 33rd St., Ste. 320; New York, NY 10001 ◆ Phone: 212-594-6747 ◆ Fax: 212-594-6717 ◆ www.cdvca.org

equity investments, I will focus my remarks on implementation of the "investment test" rather than the lending and services tests.

## I. Provision of investments not routinely available from the private market, responsiveness to community needs, innovativeness, and complexity should be accorded greater weight under the investment test.

CRA implementation is too heavily focused on quantitative measures without sufficient regard to other factors that provide the context within which such quantitative factors should be evaluated and given weight. Under CRA regulations, the investment performance of large banks is supposed to be evaluated pursuant to four criteria:

(1) The dollar amount of qualified investments;
(2) The innovativeness or complexity of qualified investments;
(3) The responsiveness of qualified investments to credit and community development needs; and
(4) The degree to which the qualified investments are not routinely provided by private investors.

Conversations I have had with bank CRA officers indicate that in recent years bank examiners have increasingly focused on the first criterion at the expense of the other three. Criteria two through four relate to the appropriateness and expected impact of a particular type of investment, not just its quantity. A greater quantity of financing provided in a low-income area does not necessarily result in greater benefit; in fact, as recent problems with subprime predatory loans illustrate, greater quantity can even result in harm to a community. A more nuanced analysis of the needs of LMI communities is required.

### A. Order of Analysis and Interrelatedness

In a sense, the four factors of the investment test are listed in the reverse order from which they should be analyzed. The first factor of inquiry should be whether the type of qualified investment is routinely available from private investors. If it is, then there is no need for CRA to encourage that type of investment. The less available a type of investment is, the more important it is that the regulatory power of CRA be used to encourage its availability.

The second factor of inquiry should then be the responsiveness of the qualified investment to credit and community development needs. Predatory subprime loans are a good example of a type of financing that is not responsive to credit and community development needs. Banks should have received no or negative CRA credit for making such loans, which would have averted the

financial ruin of many low-income families and might even have lessened the scale of the financial crisis.

The third factor—innovativeness and complexity—is relevant only if the first two factors are satisfied. If an investment meets an important community need but is relatively unavailable from the private market, then and only then is CRA needed to encourage banks to provide such an investment. If making such an investment requires particular innovation and/or complexity—i.e., it is difficult to provide—then the investment should be valued highly by CRA examiners.

Finally, the dollars invested should be counted only in the context of the other three factors.

### B. Need for Analysis and Research

To apply factors two through four effectively, the regulatory agencies should use their extensive research capacity to develop guidelines and provide guidance to banks regarding their CRA investment activities. The regulatory agencies have strong capacity to understand and direct the broader capital markets; this capacity should be applied to the unique capital markets serving and affecting LMI individuals and communities. The regulatory agencies should ask the question: What types of financing are necessary to promote well-functioning credit and capital markets to serve the best interests of LMI individuals? CRA should be applied in the context of this broader understanding of low-income capital markets to encourage regulated financial institutions to provide financial products appropriate to the effective functioning of these markets.

### C. Application to Community Development Venture Capital

The following is a description of how a bank's investment in a CDVC fund might be evaluated using the analysis described above.

Degree to which type of capital is provided by private investors

Traditional (non-CDVC) venture capital is extraordinarily unevenly distributed in the United States. According to the National Venture Capital Association, in the second quarter of 2010, 71.5% of venture capital dollars went to just three states: California, New York, and Massachusetts. In fact 58% went to California alone. Conversely, 11 states had no venture capital investment in the quarter, and the least-served 25 states combined—half of the states in the nation—received less than 1% of VC investment dollars.[1] Even within states such as California, New

[1] PricewaterhouseCoopers/National Venture Capital Association, MoneyTree™ Report, Data: Thomson Reuters.

York and Massachusetts, venture capital is highly concentrated in a few areas, such as Silicon Valley, New York City, and the Route 128 area near Boston, leaving little availability for other regions of these states, particularly their rural areas. A study performed several years ago by CDVCA showed that less than 1% of venture capital dollars went to all rural areas of the United States combined.

Furthermore, traditional venture capital is highly concentrated in very high-tech businesses. These businesses often provide employment primarily to a small number of very highly skilled employees with exceptional educational backgrounds.

These factors combine to make venture capital equity investments virtually unavailable for the lower-tech businesses in the LMI areas in which CDVC funds focus their activities. Furthermore, investment capital from friends and family, as well as from the organized angel capital community, is typically in short supply in the low-wealth communities where CDVC funds operate. This makes a dedicated source of venture capital equity finance a particularly powerful force for economic development and job creation in low-income, low-wealth communities.

Responsiveness to community needs

The most pressing need in low-income communities today is job creation, particularly the creation of jobs that pay a living wage and that are available to lower-skilled workers. Patient equity capital creates these jobs. CDVC funds target businesses that provide good employment opportunities to low-Income people, as compared with the very high-tech businesses that most venture capital funds target.

Most peer-reviewed studies of job creation have found that small businesses are responsible for the lion's share of net job creation. In particular, a small group of rapidly growing small businesses, commonly called "Gazelles," account for virtually all of these jobs. In fact, a recent study performed for the US Small Business Administration found that these Gazelles, or "High-Impact Firms," as this study calls them, "represent between 2 and 3 percent of all firms, and they account for almost all of the private sector job growth in the economy."[2] These firms, which the study found were in all industries and all areas of the country, are the target market for the equity investments of CDVC funds.

---

[2] Zoltan Acs, William Parsons and Spencer Tracy, "High-Impact Firms: Gazelles Revisited," prepared for Small Business Administration, June 2008.

While these High Impact Firms are vital to our economy, they typically cannot finance their growth with debt, because debt requires regular payments of interest and principal. High impact firms tend to consume cash as they grow rapidly, rather than produce cash to make loan payments. Furthermore, they often do not have sufficient collateral or profitability to attract the debt capital they need to help them grow.

That is why equity capital is so crucial to rapidly-growing High Impact Firms: it provides patient, flexible financing. Unlike debt, which typically requires immediate repayment of principal and interest, no payments are typically required on venture capital equity investments until an event occurs—such as sale of the company or a public offering of stock—that makes cash available without interrupting the growth of the business.

Furthermore, as any banker knows, equity capital makes it possible for companies to leverage their balance sheet with additional debt. Providing equity capital to small businesses in LMI communities directly increases the ability of banks to make small business loans in those communities.

Innovativeness and complexity of investing in CDVC

Venture capital equity investment is an extraordinarily complex business. The very things that make equity investments so useful to companies—flexible, patient terms tailored individually to their specific stage of growth and capital needs—makes them very difficult and complex to provide. Banks that are willing and able to develop in-house capacity to make direct equity investments in businesses, which a few have done in the past, should certainly be given substantial credit for innovativeness and complexity in making such investments. But because the venture capital business is so complex, most banks participate in this sort of financing by making investments in professionally managed funds, such as CDVC funds.

Even making equity capital available to small businesses through professionally managed funds involves an extraordinary level of innovativeness and complexity. First a bank must develop the capacity to evaluate investments in venture capital funds. This requires the ability not only to analyze complex financial terms contained in private placement memoranda but also to evaluate fund managers who will be responsible for investing a bank's capital over an extended period of time. An investing bank must choose funds that will both provide strong financial returns and create significant community development impact in low-income communities. Second, a bank must make a commitment to a fund for the ten or more years of a fund's life, without the ability to withdraw midstream. This is what allows a CDVC fund to provide long-

term patient capital to small businesses as they grow. And finally, a bank must provide capital to a traditionally-structured CDVC fund upon demand at irregular intervals, satisfying "capital calls" as required by the financing needs of the companies in a fund's investment portfolio. Banks often feel penalized for making investments in CDVC funds by requirements that make them keep high levels of reserves against such investments and by "mark to market" accounting rules that often result in large paper write-downs of CDVC investments in the early years of a CDVC fund's life, as management fees are subtracted from capital but before large investment returns are recognized. Banks should be given a high level of CRA credit for making these difficult investments to help balance out the difficulty of doing so.

## II. Reward longer-term investments.

The CRA Questions and Answers state that, all other performance criteria being equal, short-term and long-term investments should receive the same level of consideration under the investment test. However, I understand that in practice examiners often like to see new activity, and do not want banks to "rest on the laurels" of past investments. Banks therefore have the perception that they may be penalized for making long-term capital commitments, as compared with churning through a larger number of shorter term loans.

The reverse should be true. Longer-term investments should be accorded extra credit under the CRA, particularly if they result in much-needed longer-term, flexible financing to end-users in LMI communities in forms not readily available from the private market.

No regulatory change is necessary for examiners to encourage banks to make investments of patient, flexible capital. This could be accomplished by weighing the three qualitative performance factors more heavily, as suggested above. If a longer-term investment is less available from the private market, more impactful, and more innovative and complex, then it should be accorded greater CRA credit than a shorter-term investment *in each year that the investment is outstanding.* In the case of a commitment to a CDVC fund the full *capital commitment* should be given CRA credit in each year it is outstanding, not just the amount of capital that has been called thus far, because a bank must manage its cash to make its committed capital available to a CDVC fund (and therefore to the fund's portfolio companies) at any time, as needed.

## III. Revisit the definition of "qualifying investment" with an eye toward the effect on LMI communities and individuals.

Banks have been receiving credit under the investment test for activities that should be deemed lending. For instance, banks can currently receive investment test consideration for purchases of mortgage-backed securities that are backed by loans to LMI individuals (as long as the securities are not backed primarily or exclusively by loans that the same institution originated or purchased). This is an anomalous result. The substance—the product provided to residents of LMI neighborhoods or other LMI individuals—should take precedence over the form of the bank's investment. In this example, the mortgage-backed securities are credit products, not investments. Their secondary effect does not encourage investment but instead provides liquidity to encourage further lending.

A middle case might be a New Markets Tax Credit investment in a project that ultimately receives debt financing from a CDE. While the financial product provided to the end user might be debt, the Tax Credit equity plays a useful role in the capital structure of a leveraged deal by bearing the equity risk of first loss (although this risk is typically absorbed by the Tax Credit).

The highest level of CRA credit under the investment test should be accorded to true "equity investments," such as CDVC equity investments, where both the form of the bank capital invested and the resulting financial product supplied to the end user in the community is in the form of equity that bears an equity level of risk.

## IV. Minimize the impact of mismatch between assessment areas and private fund investment areas.

Currently, banks are reluctant to make an investment in a blind pool investment fund if the fund's market area extends beyond a bank's assessment area. This makes it challenging for funds, such as CDVC funds, to raise capital from CRA-motivated banks. CDVC funds will sometimes try to ameliorate this problem by signing side letters with banks agreeing to invest the bank's funds within its assessment area, but such side letters can hamstring the efficient operation of the fund and also make it more difficult for a fund to raise capital from other investors who see such agreements as potentially damaging the ability of the fund to operate effectively.

This regulatory system severely handicaps blind pool funds, which are often the best way to provide certain types of financing in a way that is most responsive to community needs. To avoid the onerous system of side letters and allocation,

the FFIEC should adopt a policy that, wherever there is substantial overlap between a blind poll fund's investment area (as stated in its Private Placement Memorandum or other offering documents), and a bank's assessment area, the bank be allowed to count 100% of its investment in the fund as a qualifying investment.

## V. Assessment areas should reflect real markets, rather than deposit locations, which are increasingly artificial.

A bank's assessment area is currently the geography where the bank takes deposits. But this is fast becoming an artificial concept, as deposits are collected through the internet and banks lend and invest in broad national markets.

To cite an extreme example, in 2008 American Express, Goldman Sachs, and Morgan Stanley each converted to a bank holding company model, becoming regulated by the Federal Reserve and subject to CRA. Yet each took deposits only in Salt Lake City (although this year, Morgan moved its deposit-taking and assessment area to Purchase, NY), resulting in some of the largest financial institutions in the world being assessed primarily according to their activities in Utah.

CRA should cover all broad geographies in which a bank does significant banking business. In particular, banks that operate primarily over the internet should not have local assessment areas.

## VII. Certified CDFIs should be on equal footing with minority- and women-owned banks and thrifts and low-income credit unions.

Current interagency guidance states that investments and deposits in minority- and women-owned banks and thrifts and low-income credit unions as eligible CRA activities without regard to the geographies these institutions serve. Certified Community Development Financial Institutions should receive the same treatment. CRA consideration should be afforded to bank investments in CDFIs even if the CDFI's target market does not overlap with the bank's assessment area.

The current system has counter-productive implications. Because banks receive minimal consideration for investments in CDFIs outside their assessment areas, they are less likely to make these investments. This implies that underbanked areas are less likely to be served by well-capitalized CDFIs. This unwanted result could be mitigated by awarding banks CRA credit for investments in any certified CDFI, regardless of its target market.

## VIII. Intermediate small institutions should receive extra credit for innovative and complex solutions as part of the community development test.

"Innovativeness" and "complexity" are currently not factors in the community development test applicable to intermediate small institutions. Certainly regulators should not require banks to make investments that are beyond their capacity to understand and evaluate. However, if an intermediate small bank chooses to make an investment that is particularly complex or innovative, it should be accorded extra credit for such an investment.

## IX. CRA should be updated to reflect thirty turbulent years in the financial services industry.

To this point, I have commented only on the CRA regulations and the examiners' implementation of the Act. But in closing I would like to echo a large part of the community development finance field in calling for the expansion of community reinvestment responsibilities to non-bank financial institutions. The financial services industry has changed dramatically in the 33 years since CRA was enacted, and it should be updated so that all corners of the industry (e.g., insurance companies, investment banks, mortgage companies) share the obligation to ensure that LMI areas and individuals are not excluded. While this sort of expansion is primarily a question for Congress, the bank regulatory agencies should, where possible, apply CRA expansively.