



January 22, 2020

Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, NW
Washington, D.C. 20551
Docket No. R-1723
RIN 7100-AF94

Re: Docket No. R-1723, Community Reinvestment Act Regulations – Request for Public Input

Dear Sir or Madam:

I am writing in regards to the Federal Reserve Board's (FRB) recent actions to revise the Community Reinvestment Act (CRA). The FRB's Advanced Notice of Proposed Rulemaking (ANPR) outlines several potential changes to the CRA that could have important, long-term consequences for the ability of small businesses to access affordable capital and contribute to the economic growth of their local communities, as well as the opportunities for expanded credit for LMI individuals to access the mortgage market. I represent an investment adviser managing several mutual funds. One is an SEC registered mutual fund under the Securities Act of 1933 and the Investment Company Act of 1940 that primarily invests in SBA 504 loans. The other is a private fund that invests in non-QM mortgages. We believe these funds make an important contribution to the liquidity and marketability of SBA 504 loans and non-QM mortgage loans, thus helping enlarge the market for these loans, furthering the goals of the Community Reinvestment Act and the stated goals for the proposed update to the CRA legislation.

In general terms, we believe the use of a pooled investment vehicle such as a mutual fund offers significant benefits for both underserved communities and banks. There are limited secondary markets for SBA 504 loans and for non-QM mortgages. Yet these loans can provide important benefits to many communities and can further the goals of the Community Reinvestment Act. By providing an outlet for originating institutions to sell these loans, we believe our funds can significantly expand the markets for these loans, resulting in an increase in loan originations.

A secondary trading market is an important feature that can improve the attractiveness of certain loan types, including the SBA 504 loans and the non-QM residential mortgages that we deal with. While many banks that originate 504 first lien loans and non-QM mortgages do so with the intention of holding the loans to maturity, these loans carry longer maturities of 10 to 30 years. The flexibility afforded by the ability to sell such loans should a bank's circumstances change provides a needed outlet for risk mitigation. In addition, many of the smaller institutions that serve small businesses in underserved communities have limited balance sheet capacity. Though they may be the primary source of small business or mortgage funding in their community, they may be unwilling or unable to hold a loan of \$2 million to \$5 million or more or a similar-size portfolio of illiquid non-QM loans. We have been told by CDC's that a number of small banks and credit unions that currently do not participate in the 504 program would be much more likely to consider originating 504 loans if they had a ready outlet for selling these loans after origination. The same logic applies to the non-QM market. We believe we can provide such an outlet, creating a larger market for this program.

We also believe that our funds can be very beneficial to banks. We work with a large number of bank and non-bank loan originators across the U.S. and its territories. When a bank is looking for CRA-qualified loans and investments in its assessment area, we can often find loans that the bank may not normally have

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access to. In addition, the fact that the loan types we invest in are non-standard and somewhat unusual means that some banks, particularly small banks may not have the resources or expertise to handle such loans on the infrequent occasions that they might be appropriate. We can provide the resources and expertise. Meanwhile, the bank gets the benefit of a pooled investment, which spreads the risk of each individual loan among all investors in the fund. Given these benefits for the community and for banks, we would like to see the CRA rules acknowledge the role of funds as a viable way to meet CRA requirements. However, the fact that such funds are also unusual investment vehicles also means they may have been overlooked in the rulemaking efforts of the regulators. We believe pooled funds such as ours can expand the opportunities for expanded credit in LMI communities, while helping banks meet their CRA obligations.

Our comments on specific parts of the ANPR are:

Question 2. In considering how the CRA’s history and purpose relate to the nation’s current challenges, what modifications and approaches would strengthen CRA regulatory implementation in addressing ongoing systemic inequity in credit access for minority individuals and communities?

Answer 2. We believe that the current rating system provides little, if any, incentive for banks to provide more than the minimum level of compliance with CRA requirements. Any efforts to address ongoing inequities in credit access will require that banks go the extra mile. Under the current system, there is no real incentive for banks to strive for an “Outstanding” rating.

Question 3. Given the CRA’s purpose and its nexus with fair lending laws, what changes to Regulation BB would reaffirm the practice of ensuring that assessment areas do not reflect illegal discrimination and do not arbitrarily exclude LMI census tracts?

Question 4. How should the Board provide more clarity that a small bank would not be required to expand the delineation of assessment area(s) in parts of counties where it does not have a physical presence and where it either engages in a *de minimis* amount of lending or there is substantial competition from other institutions, except in limited circumstances?

Question 5. Should facility-based assessment area delineation requirements be tailored based on bank size, with large banks being required to delineate facility-based assessment areas as, at least, one or more contiguous counties and smaller banks being able to delineate smaller political subdivisions, such as portions of cities or townships, as long as they consist of whole census tracts?

Answer 3. This answer touches on Questions 3,4, & 5. We have some concern that some small, underserved communities in rural areas could be entirely left out of any bank’s assessment areas. If small banks only serve a portion of a County and large banks are entirely absent from the same County, a community in a remote corner of the County might fall outside of any bank’s assessment area. In order to prevent such communities from being left out, we believe that banks both small and large should be given full CRA examination credit for providing credit in such communities, even though the community lies outside of their assessment area.

Question 11. Is it preferable to make the default approach for small banks the current framework, with the ability to opt in to the metrics-based approach, as proposed, or instead the metrics-based approach, with the ability to opt out and remain in the current framework?

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Answer 11. While we recognize some of the reasons for limiting the scope of examinations for small banks, such as data collection burdens and costs, there are some consequential shortcomings to this Answer 11. We believe that there are considerable shortcomings under the current framework. We feel that this approach may, in fact, discourage small banks from participating in some activities that would benefit LMI communities in their assessment areas. Many small banks have little experience with some types of loans, including SBA 504 loans to small businesses and non-QM loans. The infrequency with which these types of loans occur in some markets means that small banks, lacking experience with them, will simply choose not to pursue them. In addition, the lack of a secondary market for such loans means that these banks could be forced to hold onto them, even when it might be more advantageous for the bank to sell these loans. Pooled investment vehicles are an ideal way to overcome these obstacles, but the current framework effectively rules this out as an option for small banks. Mutual funds are classified as equity investments, but a small bank only gets credit for small business loans listed as such on its Call Report or for mortgage loans listed as loans. Consequently, mutual funds would only be considered under the Community Development section of a CRA exam, something which is not part of the regular exam for small banks. Small banks have the option of requesting that an examiner look at their community development activities, but there are several reasons why most small banks would be reluctant to do this. First, there is little incentive to doing this, since the inclusion of community development activities can only be used to raise a bank's rating from "Satisfactory" to "Outstanding", an upgrade that has little practical benefit. At the same time, many bankers feel that asking an examiner to widen the exam could open up a whole new can of worms, creating significant additional uncertainty about the exam. Hardly a good trade-off. While SBA 504 loans and non-QM mortgage loans can be of great benefit to LMI communities, under the current framework, these loans may not even be considered in communities served mainly by small banks. Even under the proposed framework, it remains unclear if such loans would fare any better.

Question 14. Is the retail lending screen an appropriate metric for assessing the level of a bank's lending?

Answer 14. Consideration for inclusion in the retail lending screen should be given to small business and residential mortgage loans (within the bank's assessment area) included in pooled investment vehicles, such as mutual funds, even though such loans would not be included on a bank's HMDA data, its Call Report, or on its balance sheet as a loan. Mutual funds and other pooled investment vehicles will often provide side letters to banks assigning specific loans to a bank investor for CRA purposes. These loans should be treated no differently than purchased loans, since this is effectively what they are. This change would greatly contribute to achieving the goal of evaluating how well a bank serves LMI census tracts, LMI borrowers, small businesses, and small farms. As practice now stands, loans to LMI borrowers or to small businesses that are contained in a pooled investment vehicle do not contribute to a bank's retail lending metrics, even in cases where the pooled investment vehicle facilitates such loans specifically to provide CRA credits for a specific bank. In other words, these loans might only be made to satisfy CRA needs and without such credit for the bank, the loans will not have funding from the pooled investment vehicle and will therefore not be made in the first place.

Allowing banks to have loans in a pooled investment vehicle counted toward their retail lending screen should not increase costs or record-keeping requirements noticeably. While this information would not be included on Call Reports or HMDA data, it could easily be provided to the bank (and examiners) by the mutual fund or pooled investment manager.

Question 33. Should the Board establish a major product line approach with a 15 percent

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threshold in individual assessment areas for home mortgage, small business, and small farm loans?

Answer 33. Establishing a 15 percent threshold in individual assessment areas could have the perverse effect of discouraging banks from making desirable small business or LMI mortgage loans if these loans would be in assessment areas where they would not fall under the 15 percent threshold. This could have a particularly significant impact in credit deserts.

Question 38. Should the Board provide CRA credit only for non-securitized home mortgage loans purchased directly from an originating lender (or affiliate) in CRA examinations? Alternatively, should the Board continue to value home mortgage loan purchases on par with loan originations but impose an additional level of review to discourage loan churning?

Answer 38. The Board should consider providing CRA credit to home mortgage loans included in mutual funds. Mutual funds are different than MBS in that they cannot be bought and sold as easily or as quickly as MBS. In addition, churning activity would greatly increase the expenses incurred by the mutual fund. Consequently, concerns about churning should be much lower for mutual funds, particularly funds that follow a buy-and-hold strategy. Such funds typically would be first-time purchasers of these mortgage loans and would facilitate lending for banks that rely on other lenders to directly provide liquidity in order to originate new loans without engaging in loan churning.

Question 39. Are there other alternatives that would promote liquidity by freeing up capital so that banks and other lenders, such as CDFIs, can make additional home mortgage loans to LMI individuals?

Answer 39. Providing CRA credit to mutual funds holding home mortgage loans would help free up capital to banks and CDFIs to make additional home loans to LMI individuals, while helping these same banks and CDFIs reduce risks due to geographic concentrations.

Question 42. Should the Board combine community development loans and investments under one subtest? Would the proposed approach provide incentives for stronger and more effective community development financing?

Answer 42. Investors in our mutual fund that holds SBA 504 loans have received CRA credit on numerous occasions from their examiners. However, the treatment has not been consistent, with some banks getting credit under the community development lending test and others getting credit under the community development investment test. In cases where lending test credit was received, the bank investor received a one-time credit for a single year. For bank investors that received investment test credit, the CRA credits have lasted through multiple exam cycles. We believe that combining these into one subtest and providing ongoing credit for both loans and investments would encourage banks to provide more long-term, patient capital.

Question 71. Would an illustrative, but non-exhaustive, list of CRA eligible activities provide greater clarity on activities that count for CRA purposes? How should such a list be developed and published, and how frequently should it be amended?

Answer 71. We believe that an illustrative, non-exhaustive list of CRA eligible activities would be very helpful in providing clarity on what activities count for CRA purposes.

Question 72. Should a pre-approval process for community development activities focus on specific proposed transactions, or on more general categories of eligible activities? If more specific, what information should be provided about the transactions?

Answer 72. We believe a pre-approval process that focuses on general categories of eligible activities would be more useful, though a process that focuses on specific transactions could also be helpful. In either case, we would hope any pre-approvals coming out of the process would provide some form of

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precedent that banks could look at for guidance and would remove the uncertainty that comes from operating in a different region or having a different examiner.

Question 93. Are there other approaches to data collection that would benefit small banks and should be considered?

Answer 93. The current method for data collection for small banks is very good at reducing the cost and burdens of data collection. By focusing on data that is already required for the Call Report or for HMDA compliance, small banks do not have to increase their staffing or costs in order to document their CRA activities. However, this approach also limits any creating or unusual efforts to provide activities that might further CRA goals.

When a large bank invests in our mutual fund that holds SBA 504 loans, we provide the bank a side letter assigning CRA credits to the bank for any of the SBA 504 loans held in the fund that are within the bank's assessment area. The CRA credits for each loan can only be assigned to one bank. Examiners will typically accept these side letters and include credit for the assigned loan in the fund to the bank investor in the bank's CRA exam. In some cases, the bank will get community development lending test credit and in others it will get community development investment test credit.

This option is not available to small banks in the normal course of an examination. Only loans that are considered in the exam. A small bank can ask that an examiner consider its community development financing activities, but many banks seem to be reluctant to open up a whole new front in the CRA exam for fear that it could open up new avenues for criticism.

We propose that examiners can use the side letters provided to a bank, whether small or large, to simply add onto the subject bank's lending totals and the totals for CRA eligible loans. This would recognize the substance of the loans held in a mutual fund rather than their accounting treatment as an equity investment. The reality is that the mutual fund purchases loans that might otherwise not be made in order to provide CRA benefits to specific banks in specific assessment areas. Without the bank's investment in the fund, the fund would not purchase the loan, and without the fund's purchase of the loan, the original lender (whether it is a bank or non-bank lender) might not make the loan in the first place. In substance, the bank investing in the fund is responsible, though indirectly, for the origination of the loan. If an examiner can accept a side letter for a large bank, we believe it should also be able to accept these letters for a small bank in order to consider such investments in a mutual fund, and the loans contained therein, as part of the small bank's lending activities.

There are many underserved communities, both urban and rural, that are not well served by large banks. Such communities are already at a disadvantage due to the reduced financing options that are available to small banks versus the wider range that could be provided by large banks. The exclusion of the mutual fund option for smaller banks exacerbates this problem.

Sincerely,
Joe Gladue
President
Bluestone Capital Partners