SOLOMON HESS Capital Management | CRA news

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Update on CRA Modernization Efforts

The OCC, led by Joseph Otting, is spearheading the effort to modernize CRA. At an appearance before the Senate Banking Committee on June 14, Otting reiterated his hopes that the regulators can propose amendments to the CRA in 2019. Above, the Capitol Building in Washington, DC.

On June 15, the Office of the Comptroller of the Currency (OCC) issued a bulletin that clarifies how banks are examined for lending under the Community Reinvestment Act (CRA). While reiterating the OCC's full commitment to its effort to modernize CRA, the bulletin stopped short of announcing the much anticipated release of an Advanced Notice of Proposed Rulemaking (ANPR) on more extensive CRA changes. Comptroller of the Currency Joseph Otting has repeatedly said that the OCC is hopeful that the Federal Deposit Insurance Corp (FDIC) and the Federal Reserve Board (FRB) will join in the modernization efforts and that the delay in the ANPR release *(continued on page 2)*

Inside

Impact of Change in Equity Investments Accounting on Solomon Hess SBA Loan Fund

A new accounting standard came into effect for public business entities on January 1st that requires equity investments to be measured at fair value with changes in fair value recognized in net income. This change means that the available-for-sale category is no longer an option for equity investments, possibly resulting in income statement volatility. Non public business entities will begin to comply in 2019.

The rule at issue is the Financial Accounting Standards Board (FASB) Standard known as ASU 2016-01, *Recognition and Measurement of Financial Assets and Liabilities* and the magnitude of its effects can be significant based on the kinds of investments a company makes. As an extreme example of this, most notably, Warren Buffet, Chairman of Berkshire Hathaway, called the rule a "nightmare" that would produce "wild and capricious swings" in bottom line results.

The good news for investors in the CRA-eligible Solomon Hess *(continued on page 2)*

SBA Loan Fund Profile: Wilson Pediatric Dentistry in Wilson, NC

Wilson Pediatric Dentistry is owned and operated by Dr. Jasmine R. Elmore. Elmore focuses on creating a warm and welcoming environment for her young patients, having been specially trained to work with children with previous negative experiences with dentists. Proceeds of the SBA 7(a) loan were used to finance equipment for business operations. The borrower is located in a CDFI Fund Qualified Investment census tract and reported that this loan supported the creation and/or retention of 16 jobs. Left, a boy having his teeth examined by a dentist.

An example of the type of loans in the SBA Loan Fund portfolio is the loan to Wilson Pediatric Dentistry, a full-service dental practice owned and operated by a minority woman located in Wilson, North Carolina. Wilson Pediatric Dentistry offers services ranging from general exams and cleaning to early orthodontic treatment to emergency care. The staff includes 2 full-time pediatric dentists and 1 part-time general dentist. Dr. Jasmine R. Elmore owns and operates the practice, which she purchased from the previous owner in 2016.

In 2013, Elmore earned her Doctor of Dental Surgery from Virginia Commonwealth's School of Dentistry in Richmond. In appreciation for a scholarship that she received while in dental school, Elmore established the Dr. Jasmine R. Elmore Scholarship in 2016 as a way to "pay it forward" for students from disadvantaged socio-economic backgrounds and to encourage good patient rapport. Criteria for scholarship recipients include: member of the Student National Dental Association, from a disadvantaged socio- *(continued on page 3)*

CRA Modernization Update *(from page 1)* would be worth it if it could be released as an inter-agency proposal. In the meantime, Senate Democrats raised concerns about the potential weakening of the CRA.

June 15: OCC Bulletin Published

The bulletin released by the OCC clarifies the exam cycle for when a bank is evaluated for CRA compliance, mainly based on asset size and how examiners look at assessment areas where banks get CRA credit for community lending. The objective of this bulletin is to promote consistency and effectiveness of CRA performance evaluations.

Highlights of the bulletin include:

- **Lending to low or moderate income (LMI) persons and small businesses outside a bank's assessment areas (AAs) does not compensate for poor lending performance within AAs**
- **Loans, investments and services that help create, retain, and/or improve jobs for LMI individuals, in LMI geographies or areas targeted for redevelopment by federal, state, local or tribal governments are among activities listed as meeting the purpose test of community development**

June 14: Senate Banking Committee and The Congressional Black Caucus Raise Concern Over Otting Comment

On June 13, Otting told the House Financial Services Committee that he has "never personally observed" discrimination in banking "but many of my friends from the inner city across America will tell me that it is relevant today." These comments prompted criticism that dominated Otting's appearance before the Senate Banking Committee the next day. Otting clarified that he believed discrimination existed but that he had "personally never experienced it." Elizabeth Warren, D-Mass, expressed concern that this effort to modernize CRA and Otting's remarks on discrimination indicate that the OCC will be too lenient on banks.

In response to the same comment, the Congressional Black Caucus (CBC) requested a meeting with Otting and relevant personnel involved in drafting the proposed rules.

Otting, left, released a statement to say that he looked forward to meeting with members of the Congressional Black Caucus. He said, "Members of the CBC provide critical insight and perspective necessary to find the best ways to improve our approach to the CRA and I welcome their important voice in this process."

May 25: Senate Democrats Raise Concern Over CRA Modernization

16 Democratic senators led by Mark Warner, D-VA, sent a letter to the heads of the OCC, FRB and the FDIC that called for strengthening of CRA by expanding its applicability to regions and institutions not currently covered under the law and cautioned against proposals that could undermine its long-standing effectiveness. The Senators cited the decline in minority home ownership rates, challenges minority-owned businesses face in getting approved for credit and changes in technology in arguing for a strong CRA. ■

"We are concerned that permitting expansions for banks with 'less than satisfactory' ratings undermines the only formal compliance mechanism that exists under the CRA," wrote the Senators to agency heads on May 25.

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Accounting Rules *(from page 1)* SBA Loan Fund, into which banks invest for CRA, is that the new accounting rules do not change the way this investment is reported in financial statements. The reason for this is twofold: first the nature of the fund's primary asset lends itself to relatively narrow fluctuations in value, and second, the fund is structured with an operating reserve that absorbs changes in asset values before income is affected.

The primary asset held by the SBA Loan Fund (over 95%) is the federally guaranteed portion of SBA7(a) loans which adjust quarterly or monthly and are indexed to the Prime Rate. The floating rate nature of the asset result in relatively narrow fluctuations in its valuations.

The SBA Loan Fund is a joint venture using a private investment vehicle, a limited liability company, into which banks invest for CRA. No one investor has any control or influence over the fund's operating and financial policies. The fund maintains individual capital accounts for each investor, which reflect each's share of the Net Asset Value (NAV). The fund follows the accounting rules related to Investment Companies and marks all its assets to market and flows any changes through income. The fund is structured with an operating reserve into which changes in market value flow before impacting income, with the goal of maintaining a stable NAV for investors. As of March 31, 2018, the fund's operating reserve was $10.7 million on assets of $558 million. Liquidity is offered monthly and investors are redeemed at the par value of their capital accounts.

Equity investments in the SBA Loan Fund do not have readily determinable Fair Market Value (FMV) and the fund meets the requirements for the use of NAV as a practical expedient for reporting FMV. Thus, investments in the fund are reported at NAV which is equal to the par value of capital accounts. The structure of the fund and its primary asset class contribute to keeping the fund's NAV stable. ■

SBA Loan Fund Profile: Joyful Adult Daycare Center in Baltimore, MD

Proceeds of this SBA 7(a) loan to Joyful Adult Daycare Center were used to finance the property on which the business is established. The borrower is located in a moderate income census tract in Baltimore City. The center further supports community development by focusing on care for seniors and meeting healthcare needs for the community. The borrower self-reported to the SBA that this loan supported the creation and/or retention of 12 jobs. Left, senior patient with nurse.

Another example of the type of loan in the SBA Loan Fund portfolio is the loan to Joyful Adult Daycare Center, a provider of affordable daytime services for the elderly and persons with disabilities. Located in Baltimore City, the center provides services to adults who do not have the ability to live independently or carry out activities of daily living such as preparing meals. The center also provides services to functionally impaired adults, including those with Alzheimer's Disease and other neurological diseases that limit their capacity for independence and daily activities. Along with clinical care, the center makes available a variety of entertaining daily activities to provide ways for patients to be able to enjoy their time and have needed social interaction. The center's goal is to allow the patients to remain in the community, stay with their family members longer and to avoid unsuitable or premature nursing home or institutional admission for as long as possible. ■

Profile: Wilson Pediatric Dentistry *(from page 1)* economic background, excellent patient skills and rapport and exhibits dedication to patients.

Elmore went to complete her residency at St. Christopher's Hospital for Children in Philadelphia, PA. While there, she volunteered two days a week to provide free dental care to uninsured children on the Ronald McDonald Care Mobile. Elmore continues her commitment to providing dental care to the less fortunate by participating in "Give Kids a Smile Day" in North Carolina, where she provides free dental care to local children. ■

The SBA Loan Fund has invested in over 3,000 US-based small businesses since inception in 2004, which have supported the resultant creation and/or retention of over 40,000 jobs. "When we review small business loans for investment, we look for businesses that embody the spirit of the regulations and go beyond CRA requirements," said Bill Einstein, Chief Financial Officer of Solomon Hess.

SBA 7(a) Loans in a Rising Interest Rate Environment

Small Business Administration 7(a) loans can form a core component of a bank's CRA strategy in small business lending, community development lending and investing. Understanding how a rising interest rate environment impacts SBA 7(a) loans is increasingly important as the Federal Reserve continues to raise rates.

The 7(a) program of the SBA is designed to encourage licensed bank and non-bank lenders to make loans to small business borrowers who otherwise would not qualify for conventional financing. Roughly $24 billion of SBA 7(a) loans were authorized in 2016. There is an established secondary market for this asset with over $7 billion of volume transacted in 2016.

Approximately 90% of SBA 7(a) loans adjust monthly or quarterly and are indexed to the Prime Rate, which in turn is tied to the Federal Funds Target Rate (FTTR). The recent June 13 raise in the FTTR was the second raise this year and the seventh raise since the end of December, 2015. The Federal Reserve has indicated that it expects to raise the FTTR 2 more times this year.

The obvious good news for banks is the higher coupons associated with the loans. The less obvious bad news is that more sophisticated small business borrowers faced with rising capital costs may look to refinance their loans under fixed or fixed to float terms and prepay loans if possible. Monitoring prepayment speeds and managing prepayment risk are critical to balancing the benefits and risks of SBA 7(a) loans in a bank's CRA portfolio.

For banks who are looking for SBA 7(a) loans to form a part of their CRA strategy to take advantage of rising interest rates but also want to outsource the management of prepayment speeds and associated risks, the Solomon Hess SBA Loan Fund is an attractive option to consider. The fund is acquires the guaranteed portion of CRA-eligible SBA 7(a) loans in the targeted AAs of bank investors. Investment in the fund qualifies for CRA under community development lending or investment test credit. The fund pays a Preferred Return that is re-set quarterly and is NET OF ALL fees and expenses. Solomon Hess has raised the Preferred Return 8 times since December 2015, tracking the rise in the FTTR over the same time period. For Q3 2018, the Preferred Return is set at 2.65% (annualized) for targeted CRA. The economic benefit of investing in the fund is that investors are pro-rata shareholders of the fund's "mega pool" of over 1000 SBA 7(a) loans and the prepayment risk is diversified across all these loans, which span 47 states and over 250 industry codes. The fund received the highest credit quality rating (Aaa-bf) from Moody's Investor Services in January. ■

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SBA Loan Fund Raises Preferred Return Again for Q3 2018

The SBA Loan Fund raised its Preferred Return for Q3 2018, marking the eighth increase since Q1 2016. The Preferred Return is re-set each quarter and is annualized and NET of all expenses and fees (including management fee). For Q3 2018, the Preferred Return is set at 2.65% for targeted CRA investments and 2.75% for non-targeted CRA investments. This increase in the Preferred Return demonstrates the continued strong performance of the SBA Loan Fund's assets in a rising interest rate environment. The SBA Loan Fund has over $500 million in assets and over 100 bank investors.

Managing Good Capital Well

Solomon Hess Capital Management ("Solomon Hess") is an alternative asset manager specializing in fixed income. Our mission is to provide investors with community and economic development-focused investment funds that generate both competitive risk-adjusted returns and positive quantifiable community impact. Founded in 2004 and located in Falls Church, Virginia, Solomon Hess has over $700 million of assets under management. Solomon Hess is Fund Manager to the SBA Loan Fund and investors include banking institutions of all sizes that are seeking Community Development Investment or Lending test credit within the Community Reinvestment Act (CRA) rules via exposure to SBA 7 (a) loans and related assets. Other investment opportunities with Solomon Hess include investing in our Absolute Return strategy. We offer our strategies as funds or separate accounts.

2018 Conference Calendar

CRA & Fair Lending Colloquium

November 4-7, Hollywood, FL

www.cracolloquium.com

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