Making Sure There Is a Future

Capitalizing Community Development Financial Institutions

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Community development financial institutions (CDFIs) exist, in the words of the CDFI Fund's 2016 strategic plan, to create "an America in which all people and communities have access to the investment capital and financial services they need to prosper" (CDFI Fund 2016, 3). CDFIs are "the innovative partners that fill critical market gaps and make it possible to unlock investment capital for underserved people and places" (CDFI Fund 2016, 4). But to succeed, CDFIs need more than just money to lend and invest. They need funding to support organizational capacity and innovation, to meet lenders' and regulators' requirements, and for the programmatic work and impact measurement essential to serving their markets well. In many disinvested communities, CDFIs also need time and support to build their capacity, community infrastructure, and partnerships so their work can be most effective.

This brief, which discusses future funding for CDFIs, is based on a 2016 Urban Institute roundtable, sponsored by JPMorgan Chase. The roundtable brought together CDFI leaders, bank and foundation funders and supporters, and CDFI Fund representatives and covered funding and measurement of impact and performance. Though the two topics are intertwined, impact and performance measurement are covered in a companion brief (Theodos and Seidman 2017). Both briefs build on an earlier look at how CDFIs can expand their impact (Theodos, Fazili, and Seidman 2016).

BOX 1

The Urban Institute's Collaboration with JPMorgan Chase

The Urban Institute is collaborating with JPMorgan Chase over five years to inform and assess JPMorgan Chase's philanthropic investments in key initiatives. One of these is Partnerships for Raising Opportunity in Neighborhoods (PRO Neighborhoods), a $125 million, five-year initiative to identify and support custom solutions for the unique challenges facing disadvantaged neighborhoods in US cities, with community development financial institutions (CDFIs) as critical partners in that effort. The goals of the collaboration include using data and evidence to inform JPMorgan Chase's philanthropic investments, assessing whether its programs are achieving desired outcomes, and informing the larger fields of policy, philanthropy, and practice. Urban Institute research is exploring the complexity of how to build CDFI capacity and impact, recognizing the diverse ways CDFIs serve their target communities.

Like all financial institutions, CDFIs have two primary financial needs: (1) debt capital to lend and invest and (2) equity to support the organization and its investment activities. As mission-oriented financial institutions, CDFIs often also need to create a market for people and businesses and in places not used to having access to capital.

Debt

Most of the money CDFIs lend to and invest in others comes from unsecured loans made to the CDFI, rather than, for example, funder participation in specific transactions. The primary sources of this debt are banks seeking to meet their regulatory obligations under the Community Reinvestment Act (CRA).[1] The CRA requires banks to help meet the credit needs of communities where they work, including low- and moderate-income neighborhoods. But the CRA's effectiveness as a driver of debt capital into CDFIs appears to be waning, according to roundtable participants.

In the past, CRA debt has been unsecured, at highly concessionary rates, and come with long maturities (and often renewed). This loan structure in turn enabled CDFIs to provide loans at reasonable rates to higher-risk borrowers and to earn a sufficient spread to support the CDFI's operations. But in recent years, the rates, terms, and duration of bank loans to CDFIs have become less favorable. As a result, CDFIs' borrowers face higher costs, and CDFIs have lost a valuable income source. In addition, bank examiners are beginning to require banks that invest in CDFIs to increase their scrutiny of those CDFI investees concerning such issues as anti–money laundering and consumer protection. Some roundtable participants said this has raised costs and decreased bank appetite for investment in CDFIs.

Though entity-level debt is becoming more challenging, new forms of debt capital are emerging as potential alternate funding sources. Federal government programs have recently expanded the scope of their lending to CDFIs. And though some CDFIs have long used such programs as the Small Business Administration's microloan program and the US Department of Agriculture's Intermediary Relending

Program, these have generally been small scale and highly targeted. During the Obama administration, however, using CDFIs to reach disinvested communities has taken off, with federal agencies using guarantees, loans, and grants to invest through CDFIs. Programs that directly support CDFIs include the Small Business Administration's Community Advantage program (a loan guarantee program) and the Department of Agriculture's Community Facilities Relending Program. Agencies like the US Departments of Energy and Education have programs that provide federal funds to states and allow them to partner with CDFIs to deploy the funds. This is also the structure of the US Treasury's State Small Business Credit Initiative.

These new lending programs are positive for CDFIs. Even when the statutory language does not quite fit the needs of CDFI borrowers or the CDFIs themselves, government officials and CDFIs have worked together to make difficult programs work. Moreover, the programs have leveraged financial support from banks. However, the regulations and practices that match statutory language to practical reality can often make the programs even more complex and expensive to use, which makes accessing them difficult, especially for smaller CDFIs and for smaller or riskier loans.

New public sources of long-term debt have also been established, including the CDFI Bond Guarantee Program and CDFI membership in (and ability to borrow from) the Federal Home Loan Banks. But both sources remain fraught with challenges. These vehicles can provide CDFIs low-cost, long-term funds for relending that can help CDFIs meet the needs of affordable housing and community facilities that are best financed over a long period. But the funds take the form of secured lending, with general recourse to the CDFI's entire balance sheet. Highly encumbered balance sheets can reduce CDFIs' ability to take on risky projects. CDFIs and their potential funders need to know whether these large facilities, designed to be low risk to the provider, produce scale at the cost of impact. And to what extent do they limit CDFIs' ability to obtain or retain traditional unsecured capital from banks?

Equity

Debt capital must be supported with *equity*—funds with no (or only the most tenuous) obligation to repay. This is true whether the CDFI is a for-profit entity, such as a bank (in which case, the term is *shareholder's equity*), a nonprofit credit union (*capital*), or a nonprofit loan fund (*unrestricted net assets*). Sufficient equity[2] is critical to provide a cushion for operating expenses and loan repayment in hard times, support debt, fund research and innovation, and satisfy regulators and funders.[3] Without equity, CDFIs cannot operate, even if large volumes of low-cost debt become available to the sector. And equity, as roundtable participants pointed out, is the most difficult money to raise.

Early in the CDFI movement, religious orders and philanthropic foundations provided the bulk of the equity for what were then very small institutions. Following passage of the Riegle-Neal Act in 1994, the CDFI Fund became the industry's major equity source, which makes the fund's strategic goal of "adhering to the principle of flexible organization-level funding" critical to the industry's survival and increased service to communities (CDFI Fund 2016, 4).

But continuing equity funding at current levels will not be sufficient for five primary reasons. First, the absolute number of CDFIs is increasing and is likely to continue to do so, especially as the CDFI Fund emphasizes consumer financial services. Second, the proliferation and expansion of government lending programs requires that CDFIs using those programs hold additional equity in loan-loss reserves or otherwise. Third, CDFIs are getting larger. Fourth, CDFIs are encouraged to go even deeper to reach people and places traditional financial institutions do not serve. Finally, CDFIs are being asked to get more borrowers and deals ready for financing, jobs for which they are often uncompensated if the deal falls through or not fully or timely compensated if the transaction comes to fruition. As federal and state governments ask more of CDFIs, additional appropriations for the CDFI Fund will be needed.

But the time has long passed when CDFIs could rely solely on grants, including CDFI Fund awards, for equity. No matter the form of the CDFI (e.g., for-profit or nonprofit), retained earnings from operations are essential to building a CDFI's equity. Net interest margin (i.e., the difference between the cost of funds and the rate the funds are lent out) has traditionally been CDFIs' major source of retained earnings. But the margin has become compressed by the rising cost of debt capital and the low interest rate environment.[4] Fee income and new sources of low-cost debt could strengthen CDFIs' ability to fund their operations.

Roundtable participants discussed the strategies they employ for generating fee income. Many underscored the importance of earnings from the New Markets Tax Credit program. New Markets Tax Credit origination fees, servicing fees, and fees earned when the transaction unwinds or refinances after the seven-year tax credit period have been important to building CDFIs' balance sheets, especially for entities that win multiple allocations. Other earnings sources include finder, servicing, licensing, and brokerage fees, as well as investment returns for the few CDFIs that have made equity investments themselves, directly or through venture funds. In addition, while selling or participating out loans may be primarily designed to reduce the call on an institution's capital, enhance liquidity, or increase the size of transactions the entity can originate, such activities are also an earnings source.

Can the private sector become a source of equity capital for the industry, augmenting retained earnings and government and philanthropic grants? Although CDFI banks and credit unions can raise equity capital from investors, this is difficult because of the challenges investors face trying to exit their equity investments in a CDFI. For nonprofit loan funds, which cannot offer investors an equity stake, structuring appropriate upside opportunities is difficult. Nonetheless, the industry needs to ask whether innovative techniques or structures can be developed to draw in private-sector equity investments.

Beyond the Balance Sheet: Using Other People's Capital

In addition to attracting new investors, CDFIs can expand their impact by going beyond their balance sheets. Instead of holding loans on the balance sheet, a CDFI can sell loans or parts of loans (participations). Opportunity Fund uses this strategy for its small-business investments. For larger loans, some participation sales are being facilitated by CapNexus, a platform established by the CDFI

Partners for the Common Good. The growing financial-technology sector may offer new opportunities for CDFIs to sell loans or shift their business models to use technology to drive additional affordable capital to underserved communities, but doing so requires careful attention to mission alignment with partners, especially if the partner (or a third party) will service the loan for the CDFI. As the country discovered during the mortgage crisis, loan servicing that is not borrower-centric can lead to delinquency, default, and outcomes that are not good for the borrower, lender, or community. This is especially true when the borrower requires additional attention or is having difficulty.

BOX 2

Is It Time to Rethink CDFIs' Corporate Form?

Might another corporate form help CDFIs raise additional equity capital from private investors, including impact investors?[a] In 2007, the nonprofit B Lab started certifying companies "using business as a source for good" for workers, community, customers, and the environment as *B Corps*.[b] Some CDFI banks are certified B Corps, and they hope the certification will increase investor interest. The B Corp label does not convey legal status to a CDFI to, for example, enable a nonprofit CDFI to raise private investment capital or a for-profit CDFI to emphasize mission over profit with its investors.

To respond to that legal need, 31 states now recognize a corporate form called a *benefit corporation*.[c] Unlike B Corp certification, benefit corporation status changes the legal rules surrounding the corporation's obligations toward shareholders, enabling the corporation to serve other stakeholders, such as employees, customers, the community, and the environment, even at the sacrifice of some profit. Though this would seem well suited to CDFI banks, several technical issues reduce banks' ability to use the status. For nonprofit CDFIs, the questions are more difficult: Would moving to benefit corporation status attract enough new equity investment to overcome the loss of tax-free status? What would be the effect of such a change on the ability to access grants and investments from foundations and those seeking a charitable tax deduction? How would benefit corporation CDFIs be treated under federal programs, such as the Small Business Administration's Community Advantage program? Whether the benefit corporation or similar successor structures could have a positive impact on CDFI capitalization is unclear, but is worth exploring.

[a] Some nonprofit CDFIs have wholly owned for-profit subsidiaries, usually devoted to managing funds or New Markets Tax Credit allocations. Though these can bring private investment capital into the CDFIs' work and generate returns that benefit the CDFI's balance sheet, they do not constitute a vehicle for direct equity investment in the nonprofit CDFI.

[b] "Our History," BCorporation.net, accessed January 6, 2017, https://www.bcorporation.net/what-are-b-corps/the-non-profit-behind-b-corps/our-history.

[c] "State by State Status of Legislation," BenefitCorporation.net, accessed January 6, 2017, http://benefitcorp.net/policymakers/state-by-state-status.

CDFIs can also use off-balance sheet funds or coinvestments to do substantially larger projects or more business with smaller amounts of capital. Affordable housing transactions have long relied on a *capital stack*, in which the bulk of the funds are provided at market rates by traditional debt investors, with government, philanthropy, or CDFIs providing the level of credit enhancement that satisfies the debt investors and their regulators. This strategy is now being used for transit-oriented development, federally qualified health care centers, and even small business lending. Leveraged New Markets Tax

Credit transactions use a similar strategy. These transactions result in expanded reach for a somewhat smaller return. CDFIs can also coinvest with such entities as port authorities, utilities, and economic development agencies that may have land and capital that can be matched with a CDFI's ability to structure a mission-rich transaction. These transactions may also help CDFIs invest in larger transactions than they could do on their own.

New Capital Sources: The Role of Impact Investors

Impact investors invest for social, environmental, and financial returns and may be willing to take a lower financial return than available on other similar investments. They are not a new phenomenon; philanthropic and private investors in CDFIs have been impact investors from the start.[5] But the term today usually focuses on investments made by "nontraditional" investors—that is, sources other than banks motivated by the CRA, insurance companies motivated by similar statutes, or program-related investments from traditional CDFI foundation supporters.[6] These new investors include individuals, family offices, and small foundations and could include endowments from universities, hospitals, and other large nonprofits and the capital of large private and quasi-public entities (e.g., port authorities). Mission-related investments from the endowments of traditional foundation CDFI supporters can also be impact investments.[7] With their experience, track record, longevity, and structure for capital absorption, CDFIs are strong investment candidates for impact investors interested in community revitalization and similar strategies.

CDFIs have, however, found it difficult to reach these newer impact investors in any volume and in a sustainable way because of three major barriers:

- **Communication.** Impact investors appear to be attracted by problem-solving and a focus on issues (e.g., environmental sustainability, race and gender equity) rather than outputs (e.g., affordable housing units or charter school seats produced). CDFIs do much of what impact investors are interested in, but they do not always talk about it in language that resonates with the potential investors.
- **Size and structure of offerings.** Many new impact investors use wealth managers to guide their investments. For legal and business reasons, these managers are most attracted to investments that share the same technical characteristics as other investments they are looking for, such as frequent and transparent financial (and often impact) reporting, liquidity, Committee on Uniform Securities Identification Procedures (CUSIP) numbers that identify most financial instruments, and ease of use (finding, making, and liquidating the investment). In addition, larger potential impact investors (including investment funds) may look for hundred-million-dollar transactions, a size few CDFIs can support individually. The financial return on the investment also needs to be structured so the investor can meet their portfolio needs and the CDFI can deploy the funds effectively.

- **Impact measurement.** There is uncertainty about what impact investors look for in impact measurement, and different investors and types of investors have different needs. The rigorous program evaluations that foundation investors look for may be too expensive or not required for individuals, family offices, and small foundations. "New" impact investors are likely to invest in organizations attempting to solve a problem in which they are interested, who are going about it intentionally, have well-crafted anecdotes and stories, and have output metrics that indicate positive results, even if those do not meet academic standards for measuring programmatic impact.

To access these new investors at scale, CDFIs need additional platforms and intermediaries. ImpactUS, a recently launched online broker-dealer developed by Enterprise and City First Enterprises, intends to become a platform through which both retail and accredited investors can invest in CDFI fixed-income products, along with other mission-oriented offerings and funds. CapNexus brokers loan participations among CDFIs and other investors. The National Association for Latino Community Asset Builders aggregates capital for its members. But these are limited and relatively new facilities. Roundtable participants called for additional syndicators and aggregators of CDFI investments, notwithstanding the concern sometimes raised about intermediary fees in related fields, such as low-income housing tax credit investments.

Underlying It All: Policy

Policy has unlocked new capital sources. Through legislation, regulation, and practice, local and national policymakers have attracted more public, private, and philanthropic funding to CDFIs. What more can all levels of government do to improve funding for CDFIs through equity, debt, programmatic, or liquidity supports?

Regarding equity, roundtable participants emphasized the important role the CDFI Fund plays providing flexible, equity-like institutional funding for the industry. They encouraged policymakers to consider increasing funding to enable CDFIs to expand to more underserved communities. But appropriations are not the only policy innovation to consider. Banking regulations, accounting rules, and tax treatment can also strongly affect private investors' willingness and ability to make equity investments. For example, in the early 2000s, the CDFI industry worked with bank investors and banking regulators to develop a new equity instrument—the equity equivalent investment, or EQ2—which subsequently fell into disuse but seems to be undergoing something of a renaissance.[8]

On debt, participants saw unrealized potential in the Bond Guarantee program if the program could be more user friendly and move away from a requirement that it not "score" for federal budget purposes as having no cost ("zero subsidy"). Such a scoring change would allow a more reasonable level of credit support from CDFIs, unlocking long-term, low-cost debt for more entities and uses. Participants also suggested allocating new markets tax credits more deliberately to mission-based entities to maximize community benefits after the seven-year term, including prioritizing smaller CDFIs and those serving areas of persistent poverty. This could enhance the credit's direct impact and grow CDFI capacity to increase other activities' impact.

Regulatory policy also influences CDFIs. For years, the community development field has asked for regulatory changes to the CRA to make the statute more effective in the face of changes in the banking industry's structure since the last major CRA regulatory changes in 1995.[9] The banking industry was far less concentrated then, banks with a national footprint were unknown, Internet and mobile banking had barely begun, and banks were still dominant in mortgage lending.[10] The changes over the intervening 20 years have created "CRA hot spots," where deposits are so concentrated that banks compete bitterly for CRA investments, and "CRA deserts," where few or no banks can garner CRA credit for making investments. Waxing and waning of CRA enforcement with changing administrations and differences in interpretation among agencies (and parts of agencies) demonstrate the power of regulatory policy to affect CDFIs. But the CRA is not the only source of regulatory influence over CDFI growth. Federal Home Loan Banks' collateral requirements and bank regulators' capital demands are other areas where regulatory policy constrains CDFI impact.

Roundtable participants also expressed hope that policy changes could encourage impact investing. In the past two years, spurred by an international coalition of foundations, investors, and others interested in impact investing, regulations on program-related investments have been clarified to reduce concerns about making impact investments, and rules regarding pension investments under the Employee Retirement Income Security Act of 1974 have been made friendlier to investments that have a social, as well as a financial, return. Foundations are beginning to take advantage of these changes; expanding that work and encouraging pension managers to take advantage of the changes are the next steps.

Conclusion

Capital, whether debt or equity, plays an essential role in CDFIs' scope, reach, and impact. The industry has had a decade of strong growth and demonstrated success in weathering the Great Recession. CDFIs have increased their service to a customer base particularly affected by the housing boom and bust and subsequent recession. CDFIs are increasingly in demand to reach people and communities that traditional financial services have not effectively served. Participants at our roundtable are devoted to increasing their impact and being a recognized part of the US financial sector. But to do so, they will need more capital.

Notes

1. The Community Reinvestment Act was enacted in 1977 to help ensure that bank deposits were reinvested in the communities from which those deposits were collected. But CRA regulation and examinations have not kept up with the changing banking environment, in particular the rise of regional and national banks and online and mobile banking (Braunstein 2008). Thus, the geographic restrictions of the CRA limit how bank investments in CDFIs garner CRA credit.

2. The equity CDFIs carry depends on regulators, funders, and industry conventions. It ranges from an average of 8 percent of assets for CDFI banks to an average of 11 percent for CDFI credit unions to about 31 percent for CDFI loan funds. These figures come from a CDFI Fund presentation (see “Annual CIIS Public Data Release on CDFI Program Recipient Reporting,” news release, July 20, 2016, https://www.cdfifund.gov/news-events/news/Pages/news-detail.aspx?NewsID=221&Category=Updates). Formal regulatory requirements for banks require less equity for a bank to be considered “well capitalized,” but in practice, bank examiners require far more of smaller banks, especially those whose assets are geographically concentrated.

3. Most CDFIs (by number) are not depository institutions and are not subject to entity-level capital regulation. But as of March 31, 2017, of 1,094 certified CDFIs, 224 were banks or bank holding companies, and 297 were credit unions (see “CDFI Certification,” US Treasury, CDFI Fund, accessed April 29, 2017, https://www.cdfifund.gov/programs-training/certification/cdfi/Pages/default.aspx). In addition to regulatory requirements of the CDFI Fund and of programs in which they participate, these depository institution CDFIs are subject to the same prudential (e.g., capital) regulation as their non-CDFI colleagues.

4. Spreads are also challenged by some CDFIs’ business models, especially in poor or overbanked areas, under which they keep interest rates relatively low for “mission purposes.” Without earnings, the CDFI’s financial future and its ability to serve its community may be compromised.

5. Here, *investor* is a person or entity who expects a return of principal, usually with some interest. It does not include those making grants or government investors, even if they expect a return.

6. *Program-related investments* are investments, including loans and guarantees, made by a private foundation on concessionary terms for purposes consistent with the foundation’s exempt purpose. They are treated the same as grants for the Internal Revenue Service requirement that private foundations distribute 5 percent of their endowments annually, are typically provided at below-market rates, and are usually administered by foundation program officers rather than investment personnel.

7. *Mission-related investments* are investments from a private foundation that seek to accomplish social good. Unlike program-related investments, they are typically provided at market-rate terms and do not count toward the Internal Revenue Service’s 5 percent endowment distribution requirement.

8. An *equity equivalent investment* is a long-term, subordinated debt instrument that banking regulators, through guidance, treat like equity for CRA examinations.

9. CDFIs may be reluctant to press for legislative reconsideration of the CRA to broaden its reach given the political risks that come with renegotiation. Some states, notably New York and Massachusetts, also have state CRA laws, and California and Massachusetts have established CRA-like obligations for insurance companies.

10. In 2015, for the first time since records have been kept, financial institutions not affiliated with any depository originated 50 percent of home mortgage purchase loans.

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