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Introduction to Community Development Financial Institutions (CDFIs)

SOCIAL IMPACT INVESTING THROUGH CDFIs

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Rise of Socially Responsible Investing

While impact, or socially responsible investing has been around for some time,[1] it has very much gained attention in recent years as a potential answer to a range of social and environmental challenges that have not found a public policy solution.[2] Often, Community Development Financial Institutions (CDFIs) lending activity tries to fill this void. At a local level CDFIs have been and will likely continue to deliver on their impact investing-minded community development missions.

It is becoming increasingly possible for impact or other investors to participate in and help fund CDFI's missions, while also earn a financial return on their investment capital. For some investors it is also possible to receive Community Reinvestment Act (CRA) related credit by financing CDFI activity.

What is a Community Development Financial Institution?

A CDFI is a private, community-based, non-governmental entity that provides loans or others financial products and services to areas typically underserved by traditional financial institutions. There were only 196 certified CDFIs with $4 billion of assets in 1997. Twenty years later those numbers rose to 1,131 certified CDFIs with total assets of $136 billion.[3]

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The majority of CDFIs are non-profit loan funds (50%), but there are also CDFIs operating as credit unions (27%), bank or thrift institutions (13%), depository institution holding companies (9%), and there are a small number of venture capital funds (1%).[4] The focus of our commentary is on the non-profit loan funds. CDFIs operate with a dual bottom line. They are mission-based and seek to earn both a financial and social return on their investments.

A high-profile example that should resonate with municipal bond market observers can be found in Detroit. Mainstream lending fell off a cliff in Detroit, Michigan just after the 2008 Financial Crisis. CDFIs increased investment in Detroit and an Urban Institute study found:

> …CDFIs played a particularly important role. CDFIs accounted for 60 percent of direct (nonleveraged) mission lending from 2008 to 2015 and 14 percent of all lending.[5]

What Kind of Lending?

CDFIs are mission-based organizations that prioritize the community development of underserved areas. Individual CDFI loan funds concentrate on different investments but they typically focus on housing, education (often through support of charter schools), and other community development projects such as those that increase access to healthier foods.

What are the Customary Funding Sources for CDFIs?

Funding for CDFIs has evolved over time. There are various sources of capital that CDFIs have used and the utilization often depends upon the focus, expertise of management, and size of the individual CDFI. Here is a summary:

CDFIs are mission-based organizations that prioritize the community development of underserved areas.

- The U.S. Treasury Department created the CDFI Fund to promote CDFI community development. The CDFI Fund certifies CDFIs and manages access to community development capital through the New Markets Tax Credit Program and the CDFI Bond Guarantee Program.
- Federal Home Loan Bank (FHLB) system – Nondepository CDFIs became eligible for membership in the FHLB system and therefore able to acquire advances or loans from their regional FHLB.[6]
- Charitable grants and other philanthropic activity is often an important component of CDFI support.
- Socially-conscious investors, including banks.
- Capital markets taxable bond financings.

We are seeing the source(s) of funding for CDFIs evolve as an increasing number of them are beginning to access the capital markets by selling taxable debt. So far six of the nine Standard and Poor's (S&P) rated CDFIs have sold debt in this fashion.

How are CDFIs Treated by the Rating Agencies?

Standard and Poor's is the only rating agency that has rated CDFIs to date and they have issue or issuer credit ratings for nine CDFIs located in five different states and Washington, D.C. The entities that have acquired ratings range in size. The rated CDFI's asset level begins at $120 million and is as high as $660 million. Although they are private enterprises, CDFIs are rated using S&P's Housing Finance Agencies and Social Enterprise Lending Organizations criteria dated Dec 27, 2016.

S&P Rated Community Development Financial Institutions

Organization	State	Rating	Outlook	Date	Notes
Capital Impact Partners	DC	A+	Negative	Aug-23-19	Housing, health care, community develop.
Century Housing Corp.	CA	AA-	Stable	Nov-27-18	Affordable housing specialty
Clearinghouse CDFI	CA	A-	Stable	Oct-18-18	Affordable housing, community develop.
Enterprise Loan Fund	MD	AA-	Stable	Sep-07-18	74% of loans for housing
Housing Trust Silicon Valley	CA	AA-	Stable	Feb-11-19	Multi-family lending, homebuyer asst.
Local Inititatives Support Corporation	NY	AA	Negative	Feb-11-19	Community development specialty
Low Income Investment Fund	CA	A-	Positive	Jul-02-19	Education, housing 75% of loans
Raza Development Fund	AZ	AA-	Stable	Oct-08-18	Education, housing 74% of loans
Reinvestment Fund Inc.	PA	AA-	Stable	Aug-30-18	Education, real estate, healthy food retail

Source: S&P Global and HilltopSecurities.

Other CDFI related publications from the Rating Agencies

- CDFI Partnerships Benefit HFAs Without Materially Increasingly HFA Risk Profiles; Moody's Investor Service; May 3, 2018. Highlights State HFA partnerships in: CO, CT, MN and WI.
- How Issuer Credit Ratings are Determined For Community Development Financial Institutions; S&P; September 20, 2017.
- Community Development Financial Institutions Look To Build Fiscal Sustainability; page 12 in S&P's U.S. Municipal Housing 2019 Sector Outlook: Stable For Now; Jan 23, 2019.

Should a CDFI acquire a rating?

We are increasingly seeing that CDFIs are considering applying for a rating from one of the major rating agencies.[7] An underlying rating would typically be considered by the buy-side, so should at least be contemplated if a CDFI is planning on selling debt in the capital markets.

There are also situations where it might make sense for a CDFI to acquire an underlying rating even if they are not planning a capital markets debt issuance.

There are also situations where it might make sense for a CDFI to acquire an underlying rating even if they are not planning a capital markets debt issuance. There could be situations where investors or companies would like to work with or invest in a CDFI outside of a bond issuance, and one way to quickly introduce the credit framework of the CDFI would be with an underlying issuer credit rating.

Qualify for Community Reinvestment Act Consideration?

Even though banks have generally decreased their investment in municipal bonds since the 2017 Tax Cuts and Jobs Act, an incentive that remains valuable for banks is whether an investment qualifies for CRA consideration. There are different factors to deliberate for different types and sizes of banks, but generally a bank's investment in a CDFI can be considered an investment in community development activities. The Office of the Comptroller of the currency published the following guidance on the topic.

> The "Interagency Questions and Answers on Community Reinvestment" (Q&As) explicitly recognize community development loans, community development services, and qualified investments in CDFIs as community development activities. For loans and investments in a CDFI to receive CRA consideration, the CDFI must primarily lend or facilitate lending to promote community development.[8]

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Other Sources:

CDFIs & Impact Investing: An Industry Review; Elise Balboni and Christina Travers; Local Initiatives Support Corporation; Dec 2017.

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[1] *Brian Trelstad wrote about the first screened investment fund that was created in Boston in 1928 called the Pioneer Fund in Impact Investing: A Brief History; Capitalism & Society, Vol. 11, Issue 2 Article 4 2016.*

[2] *See for example this article describing Blackrock's entrance into impact investing: A pair of 20-somethings set out to answer a fundamental question about investing – the team they heled create now manages $200 billion; Portia Crowe; Business Insider; June 19, 2016.*

[3] *Keynote Address by Director Annie Donovan at the 2017 Opportunity Finance Network Conference, Sept. 28, 2017 accessed at www.cdfifund.gov.*

[4] *See the link "View the list of certified CDFIs" at the U.S Treasury's CDFI Fund website. The most recent data was as of August 13, 2019.*

[5] *Mission Finance in the Motor City, Brett Theodos, Eric Hangen, and Sierra Latham; Urban Institute; September 2017; see page 7.*

[6] *Breakthrough in CDFI Capital Access; Keith Rolland, Federal Reserve Bank of Philadelphia, Fall 2015, page 3.*

[7] *Natalie Nickens Gunn, The CFO and CAO of Capital Impact Partners wrote a primer on topics CDFIs should be considering as it relates to ratings and accessing the capital markets. Please see: How Nonprofits Can Tap Into the Impact Investment Market; Stanford Social Innovation Review; March 13, 2018.*

[8] *Community Development Loan Funds: Partnership Opportunities for Banks; Office of the Comptroller of the Currency; October 2014, page 13.*