Community Development Financial Institutions

A Unique Partnership for Banks

The Federal Reserve Bank of Richmond

Community Development Financial Institutions, or CDFIs, are specialized financial institutions that operate in markets underserved by traditional financial institutions. Their goals include promoting economic development, supplying affordable housing, and offering banking services to low-income communities. They provide an array of financial products and services to their customers, who include individuals as well as nonprofit and for-profit organizations. They also provide technical assistance and training for their customers in areas such as financial education, housing counseling and development. Most CDFIs serve local markets, but some serve state, regional and even national markets.

The term CDFI covers several different types of institutions. **Community Development Banks** and **Community Development Credit Unions** are depository institutions that function in much the same way as other commercial banks and credit unions. Community Development Banks, for example, are for-profit institutions that provide products and services such as checking and savings accounts, and personal and business loans. They are also regulated and insured by the same agencies that regulate and insure other banks and credit unions.

Community Development Loan Funds, **Microenterprise Development Loan Funds**, **Community Development Venture Capital Funds** and **Community Development Corporations (CDCs)** are types of non-depository, non-regulated CDFIs. CDCs are nonprofit institutions focused on revitalizing neighborhoods. Although they may offer financial products, this is usually not a primary focus.

The Community Development Financial Institution Fund was created for the purpose of promoting economic revitalization and community development through investment in and assistance to CDFIs. The CDFI Fund was established by the Riegle Community Development and Regulatory Improvement Act of 1994, as a bipartisan initiative. Since its creation, the CDFI Fund has awarded $1.11 billion to community development organizations and financial institutions. It has also allocated$26 billion in New Market Tax Credits.

The CDFI Fund manages the following programs:

- Bank Enterprise Award Program
- Capital Magnet Fund Program
- Community Development Financial Institutions Program
- Financial Education and Counseling Program
- New Markets Tax Credit Program and its Native Initiatives including the Native American CDFI Assistance Program
- Certification: Community Development Entity
- Certification: Community Development Financial Institution

Source: www.cdfifund.gov/

There are over 800 certified CDFIs in the United States.[1] Formal certification as a CDFI is conferred by the U.S. Department of the Treasury's CDFI Fund, which was established in 1994. Most, but not all, CDFIs choose to be certified. Certification is a requirement to receive funding from the CDFI Fund, which is the largest source of funding for the CDFI sector. Banks also provide significant funding for CDFIs, although for many banks these institutions are still largely unknown. The purpose of this brief report is to provide bankers with a better understanding of the types of partnership opportunities that exist with CDFIs.

Some of the larger financial institutions that invest in CDFIs include: Bank of America, Citi, Wachovia/Wells Fargo, JP Morgan Chase and Morgan Stanley.

Partnership Opportunities

A partnership with a CDFI allows banks to participate in new markets and cultivate additional business opportunities. In many instances, a CDFI provides the initial acquisition or pre-development capital to get a project underway, enabling the bank to provide additional construction or permanent financing. A CDFI's initial capital in a project allows banks to participate in deals that they might otherwise overlook. A CDFI may also provide micro-financing as start-up capital for a small business, while the bank investor provides complementary financial support by offering loans and depository services to the small business.

CDFI financing complements community development lending opportunities and does not generally compete with bank products and services. CDFIs provide critical gap-financing, technical assistance, and training to borrowers, which help minimize default risk. CDFIs can also provide banks with experience and expertise in underwriting and servicing community development loans.

"CDFIs have a thorough understanding of underserved markets, and they provide high quality technical assistance to their borrowers. Banks recognize and value the risk mitigating expertise that CDFIs bring to their borrowers. Providing capital to CDFIs is an effective and efficient way for banks to participate in these niche markets," says Eileen Stenerson of Wells Fargo Bank.

An investment in a CDFI meets the investment test for credit under the Community Reinvestment Act, or CRA. Under the 1994 CRA Amendments, investments in CDFIs were made a qualifying factor on which banks are assessed. Examiners consider qualitative and quantitative factors in their assessment. They assess several variables, including the following:

- the size of the investment;
- the need that the investment addresses;
- the beneficiaries, including the population and geographic area that benefits from the investment; and
- the effect on the local community.

For CRA purposes, an investment in a CDFI is either a grant or an equity investment of some type. A loan to a CDFI is defined by CRA as a community development loan. For example, Carolina First Bank, a state-chartered bank, was awarded $300,000 through the CDFI Fund's Bank Enterprise Award Program in 2010. The funds were used to support Business Carolina, Inc., a certified CDFI devoted to promoting economic growth by providing loans to small businesses in the Carolinas and Georgia. Tammy Wilson, of Wilson Consulting Associates, facilitated the transaction: "CRA is insufficient as an incentive to drive bank investments in CDFIs. Ultimately, banks are looking for investments that provide a reasonable rate of return and facilitate sustainable community impact within distressed communities. Since CDFIs have proven to be a key part of our country's journey towards economic recovery, supporting their work is imperative."

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Creative Partnerships Fund CDFIs

The Communities at Work Fund™ was established in May 2010 to provide unique financing to CDFIs through a collaborative partnership. The Fund has been initially capitalized with $200 million, and is structured as a limited partnership—with Citi as the Limited Partner. The Calvert Foundation and the Opportunity Finance Network are General Partners. The Calvert Foundation and Opportunity Finance Network will jointly manage the Fund, with the Calvert Foundation responsible for managing lending and fund administration and the Opportunity Finance Network responsible for marketing and compliance.

The Fund provides affordable loans on a timely basis to CDFI loan funds that finance small businesses, nonprofits, charter schools and other community service organizations in low-income and low-wealth communities. The Fund offers unsecured, interest-only loans with terms up to five years to loan funds and affiliates participating in the New Markets Tax Credit Program.

For more information, visit www.communitiesatworkfund.com.

CDFI Safety and Soundness

Like banks, CDFIs make loans using sound underwriting policies and procedures and credit risk analysis. A well-established CDFI should also possess a strong corporate structure with solid operating procedures. To gain certification, the CDFI Fund reviews the CDFI's organizational capacity, financial health and viability. It analyzes historic lending information, management teams, systems, and policies and procedures for managing loans. The Fund also evaluates the organization's financial statements, capital cost, earnings self-sufficiency ratio and operating liquidity. CDFIs are required to maintain conservative self -sufficiency, deployment and liquidity ratios.

Although the CDFI Fund does not perform audits, CDFIs are required to report to the CDFI Fund if they have received a funding award. The reporting may vary depending on the program under which they were funded.

Many leading CDFIs also voluntarily participate in a rating process known as CARS™, or the CDFI Assessment and Ratings System. CARS™ subscribers include national and regional banks; foundations that make program-related investments; investment advisors; and, various socially responsible investors. CARS ™ is both a rating system and an in-depth analytical tool for investors. CARS™ is the only rating system to provide a comprehensive third-party assessment of both impact performance (how well a CDFI achieves its social mission) and financial strength and performance (overall creditworthiness based on CAMELS analysis.)[2]

Examiners see CDFIs and banks as unique partners who encourage and enhance community investment opportunities in underserved markets.

State member banks of the Federal Reserve can make community development investments as long as the investment meets the following criteria:

- is allowed by state law;
- does not expose the bank to liability beyond the investment;
- does not exceed five percent of tier 1 and tier 2 capital;
- is rated CAMELS 1 or 2 and adequately capitalized; and
- is not subject to any regulatory action.

Banks may provide investment notification to the Federal Reserve within 30 days after the fact by Form FR H-6 or letter. The maximum statutory limit is 15 percent of tier 1 and tier 2 capital, so any additional investment in the range of 5 to 15 percent requires an application to be filed with the Federal Reserve. An application is also needed if the above criteria are not met.

Bank holding companies need authority only once to engage in community development investment activities under Section 4(c)(8) of the Bank Holding Company Act, as long as these investments meet the following criteria:

- do not represent more than 5 percent of the bank holding company's capital and excess reserves;
- are permissible activities by law; and,
- meet statutory and regulatory requirements.

Bank Enterprise Award Program

"The CDFI Fund's Bank Enterprise Award (BEA) Program provides financial incentives to FDIC-insured banks and thrifts to expand investments in CDFIs and to increase lending, investment, and service activities within economically distressed communities.

Qualifying activities for the BEA Program awards must occur in census tracts where at least 30 percent of the population lives at or below the national poverty level and where the unemployment rate is 1.5 times the national average.

Awards are based on activities within three categories:

1. **CDFI Related Activites**: Equity Investments, Equity-like Loans, Grants, Loans, Deposit/Shares and Technical Assistance to Qualified CDFI Partners.
2. **Distressed Community Financing Activities**: Affordable Home Mortgage Loans, Affordable Housing Development Loans, Small Business Loans, Home Improvement Loans, Education Loans and Commercial Real Estate Loans.
3. **Service Actitives**: Deposits, Community Services and Financial Services.

In September 2010, the CDFI Fund announced awards of $25 million to 69 depository institutions for serving economically distressed communities across the nation. Collectively, these 69 depository institutions increased their loans and investments in distressed communities by over $276 million; increased their loan, deposits and technical assistance to CDFIs by over $53 million; and increased the provision of financial services in distressed communities by over $13 million."

Source: CDFI Fund, www.cdfifund.gov/what_we_do/programs_id.asp?programID=1

Prior approval is needed if the bank holding company (and/or subsidiary bank) investment exceeds five percent. Banks should check with their specific regulators for additional requirements.

Banks should seek CDFIs that have quality risk management systems and processes that guide their lending policies, procedures and underwriting. Banks also should identify CDFIs that serve diverse populations and underserved geographic locations and provide services and products that meet community development needs. Banks can obtain additional guidance about CDFI investments from their primary regulator.

Investment and Lending Tools at Work

"Virginia Community Capital is a community development bank that provides innovative loan, deposit and investment solutions for affordable housing and economic development projects in Virginia. Through a Program-Related Investment, Bank of America has committed $3.5 million in a subsidized loan to help fund VCC's lending activity.

Wells Fargo has provided a total of $4 million of investments through various programs to VCC. Through a recent EQ2, Wells Fargo invested $500,000 to be utilized for lending for affordable rental housing preservation acquisition loans. The investment is a low-interest rate, 10-year loan. At the end of 10 years, VCC has the option (subject to certain conditions) to extend the investment for another two years, at which time principal begins curtailment in eight equal installments. Wells Fargo has also invested $1 million through Program-Related Investments."

Jane Henderson, Virginia Community Capital

From a safety and soundness perspective, no clear best practices for the examination of CDFI investments have yet been developed. Examiners typically work a line of 2 percent of capital; therefore, they rarely look at community development investments for credit quality due to low balances relative to other investments/loans. They would likely focus more on the controls around this type of lending.

Examiners will want to understand the quality of a CDFI's loan portfolio, risk assessment and loan loss evaluation and its ability to provide quality reporting. Prior to investing, banks should review the CDFI's risk profile to obtain a full understanding of its risk selection and pricing process. Credit underwriting and approval processes, controls over draws for projects funded, strong management oversight and portfolio risk management systems (MIS), stress-testing procedures, problem loan resolution, allowance for loan and lease losses analysis, underwriting policies and procedures and servicing capacity (staff and leadership).

From a CRA credit perspective, examiners want banks to receive credit for all community development activities in which they participate. To receive credit, the examiner has to be given enough information about the activity to fully understand it. Examiners will not give credit for activities they do not understand, so it is essential banks understand the organizations in which they are investing. Banks must also fully understand the investment tools they use and have an established process for underwriting those investments.[3]

Investment and Lending Tools

Banks can make financial investments in CDFI loan pools using a variety of tools. The following is a brief description of the most common investment vehicles.

EQ2: Equity Equivalent

EQ2s are financial investments that allow CDFIs to strengthen capital and leverage debt. An EQ2 is a long-term, low-interest loan made by a financial institution that is typically structured with a rolling maturity and an automatic annual extension of the loan, as long as the borrower carries out its community development purposes.

While CDFIs recognize the EQ2 as permanent capital, bank regulators consider it as a qualified investment under the investment test, lending test, or in some circumstances both.[4]

PRI: Program-Related Investments

Program-Related Investments (PRIs) are low-interest loans that foundations and/or financial institutions use to finance charitable activities. As with EQ2s, they are typically non-secured investments.

Certificates of Deposits

Deposits are investments to community development banks or CDFIs that support loans to local communities. Many CDFIs are FDIC-insured for deposits up to $250,000. Certificate of Deposit Account Registry Service is a service provided by Promontory Interfinancial Network that allows deposits of up to $20 million in community development banks to receive FDIC insurance.[5]

Guarantees

Guarantee options include guarantees or letters of credit and are used to enhance the creditworthiness of a borrower receiving a loan from a third-party lender. Guarantees are considered a loan to the CDFI.[6]

Donations

A financial donation provides additional equity for a CDFI or can be used for operating purposes, depending on the terms and conditions of the contribution or donation. It is considered an investment in the CDFI.

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Resources

Find a CDFI in your area by visiting the following websites:

U.S. Department of Treasury, CDFI Fund
www.cdfifund.gov/docs/certification/cdfi/CDFI%20List%20-%20By%20State-%202-28-11.pdf

Opportunity Finance Network (OFN)
www.opportunityfinance.net

The Coalition of Community Development Financial Institutions (CDFI Coalition)
www.cdfi.org

The Federal Reserve Bank of Richmond *Community Scope* publication
www.richmondfed.org/publications/community_development/community_scope/2010/vol01_issue01/pdf/full_issue.pdf

Endnotes:

[1] Hearl, Lisa, Neelakantan, Urvi, and Zeuli, Kimberly. "CDFIs in the Southeast." Federal Reserve Bank of Richmond, *Community Scope*, Vol. 1, Issue 1, 2010. www.richmondfed.org/publications/community_development/community_scope/2010/vol01_issue01/pdf/full_issue.pdf

[2] CARS Rating System for CDFI Investment. Opportunity Finance Network. 2009, www.CARSratingsystem.net. CAMELS is a comprehensive rating system that regulators use to help evaluate a financial institution's safety and soundness and to minimize the degree of risk exposure to the banking system. The six components of the CAMELS Rating System address the adequacy of **C**apital, the quality of **A**ssets, the capability of **M**anagement, the quality and level of **E**arnings, the adequacy of **L**iquidity and the **S**ensitivity to market risk. A rating of 1 through 5 is given, with 1 having the least regulatory concern, and 5 having the greatest concern. www.fdic.gov

[3] Moss, Barbara and Nurney, William. Opportunity Finance Southeast Regional Meeting Presentation, Federal Reserve Bank of Richmond, July 19, 2010.

[4] Lipson, Beth. "Equity Equivalent Investments." Community Investments, National Community Capital. March 2002.

[5] For more information on CDARS, visit www.cdars.com.

[6] Community Investing Products. Community Investing Center. www.communityinvest.org/overview/Products.cfm