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Another crisis, another opportunity for CDFIs

Big in '08, community development financial institutions have a revival

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Cynthia Muller sees CDFIs as a way to close the gap on the harsher effect the virus has on minority communities.

Foundations and other institutional investors are targeting capital to help hardest-hit communities recover from the coronavirus pandemic, reviving a structure that helped during the Great Recession: community development financial institutions.

"COVID has really shone a light on some of the inequities," such as disproportionately higher infection rates and job losses in minority communities, said Cynthia Muller, director of mission investment at the $7.8 billion W.K. Kellogg Foundation, Battle Creek, Mich. "It has been heartening to hear from people we haven't heard from in this space," said Ms. Muller, who added she recently has seen "a huge swath of investors" checking out and investing in CDFI-backed funds that offer market-rate and below-market-rate loans. The funds typically fall within an investor's impact investment portfolio and may have lower return assumptions.

Unlike traditional banks, CDFIs deploy federal funds that they then leverage four to six times with private debt from banks, foundations, corporations and individuals to lend to disadvantaged business owners, affordable housing developers and community projects that would not otherwise qualify for traditional loans.

The capital structure depends on whether the CDFI fund involves a loan fund, banks, credit unions or venture capital funds, or some combination. There are now more than 1,100 CDFIs in the U.S. with more than $222 billion in assets certified by the Department of Treasury's Community Development Financial Institutions Fund program.

As the economic crisis caused by the pandemic has a disproportionate impact on small businesses and minority communities, "CDFI's are springing into action, reprising the role of 'economic first responders' that they have played during past crises," said Paige Chapel, president and CEO of Aeris Insight Inc., a rating and information service for impact investments based in Philadelphia.

Debra Schwartz, managing director of impact investments for the John D. and Catherine T. MacArthur Foundation, Chicago, which represents $500 million of the foundation's $6 billion in assets, said she thinks CDFIs "will be on the front lines of the recovery and rebuilding, just as they were in the last crisis. It is all about filling the gap."

MacArthur investments

The MacArthur Foundation has invested in CDFIs since the mid-1980s and provided more than $300 million in investments and grants to them. "It has been terrific to see the important role they are playing at this critical time," said Ms. Schwartz, who noted that the earliest institutional investors in CDFIs were faith-based pension funds that continue to invest today.

The MacArthur Foundation charges 1% to 3% for its loans made to CDFIs, and "it has worked out great. The loans have really paid off and the evidence is the institutions that have been built," said Ms. Schwartz, who calls CDFIs "an overnight sensation that have been 30 years in the making."

CDFI advocates point out that the infrastructure for making these smaller, targeted loans is already built, and success rates can be impressive because loans can be restructured. "Lenders at this level can be much more flexible. The losses are lower than a bank because we are working with folks in the communities," said Ms. Muller of the Kellogg Foundation.

"CDFIs are great fixed-income products. If you want to get in on the ground floor (with impact investing) that is a great way to do it," she said.

More investors seem to agree. The Opportunity Finance Network, a national network of community development financial institutions working to ensure that underserved communities have access to affordable and responsible financial products and services, has seen a 336% jump in visitors to its locator website in recent months.

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That is on top of strong growth even before the COVID-19 crisis. As OFN President and CEO Lisa Mensah testified at a June 3 congressional hearing, loans and investments through the federal government's CDFI Fund program jumped 93% in fiscal year 2019. That represented more than 772,000 loans and $21.5 billion in investments financing more than 51,300 units of affordable housing and nearly 19,200 businesses in distressed and underserved communities lacking access to traditional lending institutions. Their cumulative net charge-off rates were less than 1%. The average size of each individual loan or investment was $39,821, according to the CDFI Coalition in Washington.

PPP funds

The value of CDFIs was underscored in May, when at the urging of Congress, the Small Business Administration and the Treasury Department announced that $10 billion of remaining Paycheck Protection Program funds would be reserved exclusively for them. There is even more money in the House's latest stimulus package passed May 15, the Heroes Act, which includes a $1 billion emergency appropriation to the Treasury's CDFI Fund and up to $10 billion of any remaining PPP funds. There has been no movement on the bill in the Senate.

Ms. Chapel's organization, Aeris, helps prospective investors get comfortable with CDFIs through a rating system that evaluates both risk and impact management. "Do they have the capacity to do what they said, are there processes in place to measure it? We rate their capital strength, the quality of assets, management overall, the board, their earnings history, and liquidity for lending and operating," she said.

The uptick in institutional investor interest in CDFIs to help communities hardest hit is something she has seen before, most recently during the Great Recession and New Orleans' recovery from Hurricane Katrina in 2005.

While there were more loan delinquencies, there were fewer defaults because the CDFI lenders "could keep the loans alive," Ms. Chapel said. "We are seeing the exact same thing now. CDFIs are doing a ton of things to keep small businesses alive right now."

Foundations in particular want to get involved because "COVID has disrupted what they are trying to accomplish. Every foundation that I have talked to has a COVID response. (With CDFIs) they are able to take their foundation dollars and use them over and over," Ms. Chapel said.

Foundations are also getting more creative about leveraging their assets through structures like CDFIs. The $4 billion Kresge Foundation in Troy, Mich., is leading a group of nine foundations, a non-profit lender and a health system that has committed $33 million to a new community investment guarantee pool that will provide a crucial backstop for an expected $150 million in loans for small businesses, affordable housing, and climate change mitigation projects in underserved communities.

For investors wanting to make an impact, the benefits can be mutual. Dave Kirkpatrick, co-founder and a managing director at SJF Ventures, a Durham, N.C.-based impact venture capital fund with $260 million under management, also co-chairs Impact Capital Managers, a network of 47 North American impact venture capital and private equity funds with $11 billion under management.

He noted that many ICM members got their start with the federal CDFI program. While the private funds invest in private companies with private capital, the underlying portfolio companies delivering social and environmental results often rely on government programs like CDFI, he said.