

Community Investments Vol. 9, Issue 2 Community Development Financial Institutions: A Primer

Author(s): Fred Mendez, Community Investment Specialist, Federal Reserve Bank of San Francisco
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There has been much discussion about an innovative group of financial institutions called community development financial institutions (CDFIs) whose purpose is to tap previously ignored or underserved market opportunities. These financial institutions are focused on community development activities that rebuild distressed and neglected communities through a variety of lending, investment, social support and educational activities. The purpose of this article is to shed some light on what CDFIs are, the role of the Department of Treasury's CDFI Fund, the different types of CDFIs, and how financial institutions can partner with them as part of a Community Reinvestment Act (CRA) strategy.

According to the Riegle Community Development and Regulatory Improvement Act of 1994, CDFIs are specialized financial institutions that:

- Have a primary mission of promoting community development;
- Serve an investment area or targeted population;
- Provide development services and equity investments or loans;
- Maintain accountability to residents of its investment area or targeted population; and
- Are not a public agency or institution.

Given these parameters, and the fact that a depository institution holding company may only be considered a CDFI if it and its subsidiaries/affiliates collectively meet the primary mission and accountability criterion, it would be rare for a bank, bank holding company or bank-owned community development corporation to be considered a CDFI.

The legislation also created a CDFI Fund within the U.S. Department of Treasury to "promote economic revitalization and community development through investment in and assistance to community development financial institutions." The Fund distributes public money on a competitive/matching basis and grants CDFI designation to either new or existing entities that fit the parameters defining CDFIs. In recent testimony before the House Subcommittee on VA, HUD, and Independent Agencies, CDFI Director Kirsten Moy defined the role of the Fund as:

- Investing directly in CDFIs that satisfy high quality standards and raise private matching funds;
- Providing training and technical assistance to improve the capacity of CDFIs; and
- Implementing secondary market initiatives that draw in new sources of private institutional capital to support the activities of CDFIs.

CDFIs serve the markets that conventional financial institutions are not well-positioned to serve in a variety of ways and through a variety of structures. CDFIs can be chartered as financial institutions or credit unions. Their structure can include community development loan funds, community development venture capital funds, micro-enterprise loan funds, community development corporations, and multibank lending consortia. They can target different populations and geographies with a wide range of financial products and services such as: commercial loans and investments to start or expand small businesses, loans to first-time home buyers, loans to rehabilitate

rental housing and loans for community facilities. CDFIs also provide an equally broad range of technical assistance.

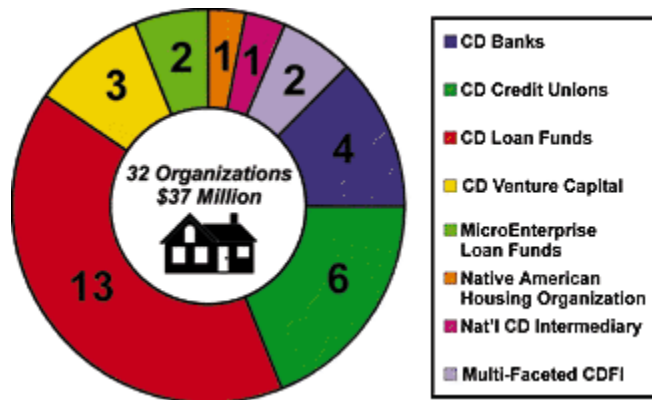
One example of a CDFI is the Cascadia Revolving Fund, based in Seattle, which has been financing small businesses in Washington and parts of Oregon since 1985. This organization focuses mostly in urban and rural communities that have been hit hard by an economic transition away from forestry and fishing. Cascadia helps these communities by financing small businesses that promote employment among displaced natural resource workers and financing businesses involved in recycling and other environmental ventures. In addition, by partnering with financial institutions, Cascadia has been very successful in originating Small Business Administration loans. In 1996, the CDFI Fund awarded Cascadia a \$600,000 grant that will enable the organization to broaden its service to low-income residents in Washington and Oregon.

Another example is the Santa Cruz Community Credit Union. This full-service \$20 million CDFI has been providing a wide variety of services--savings, checking, credit cards, ATMs, telephone banking, consumer, real estate, and business loans--to its 6,100 members since 1977. It has an excellent track record as a small business lender, lending over \$37 million as of July, 1996, to small businesses, cooperatives and nonprofit service providers. Its specialty has been small business loans to minority- and women-owned businesses that do not have access to conventional financing. An additional lending focus has been agricultural loans to environmentally friendly farms that provide organic products to various retail food outlets. A \$1 million grant from the CDFI Fund in 1996 will allow Santa Cruz Community Credit Union to open a new branch office serving the low-income residents of the city of Watsonville, California.

A third example of the diversity found among CDFIs is the Tampa Bay Community Reinvestment Corporation (TBCRC). This CDFI is a multibank

community development lending organization with 34 financial institution members and a \$50 million loan pool dedicated to financing multi-family affordable housing in the Tampa Bay region of Florida. By pooling the resources of its financial institution members, TBCRC is able to: (1) make larger loans for more significant projects in more diverse locations than could its individual members, (2) spread lending risks over more projects which allows member financial institutions to increase lending activity and better accommodate the special needs of low- and moderate-income residents, and (3) offer specialized lending expertise. The TBCRC did not receive grant support from the CDFI Fund, but it received designation as a CDFI in 1996.

During the first round of CDFI funding in July 1996, the Fund received a total of 268 grant applications for over \$37 million in funding. It selected 32 organizations representing 46 states plus the District of Columbia. Approximately 50% of the funds will serve predominantly urban areas. Another 25% will serve predominantly rural areas; the balance will serve a combination of both. A breakdown of the selected organizations can be seen in the accompanying graphic:



The CDFI Fund also has a cash award program called the Bank Enterprise Award (BEA) Program. This program rewards financial institutions that increase their efforts to lend and invest in distressed communities by participating with CDFIs or creating their own innovative lending products

and services. In 1996, 38 banks and thrifts from 18 states and the District of Columbia were granted \$13.1 million in Bank Enterprise Awards. The awards ranged in size from over \$1.5 million to Bank of America's Community Development Bank in Walnut Creek, California, to almost \$4,000 to Stock Yards Bank & Trust Company in Louisville, Kentucky.

Many CDFIs rely on financial institution investments, loans, and technical expertise in order to effectively perform their community development mission. The Community Reinvestment Act regulation encourages financial institutions to participate in community development activities by defining them as lending, investment, and financial services-related activities in: (1) affordable housing (including multi-family rental housing) for low- or moderate-income individuals; (2) community services targeted to low- or moderate-income individuals; (3) promotion of economic development by financing or investing in small businesses or farms; or (4) revitalization and stabilization of low- or moderate-income geographies. These activities need not be directly offered by financial institutions, but can be made available through a partnership with CDFIs that serve an area which includes a financial institution's assessment area.

Large financial institutions, defined as those financial institutions with assets of more than \$250 million and/or affiliates of a bank holding company with total banking and thrift assets of over \$1 billion, receive CRA consideration under the lending test for their participation in loans originated by a CDFI. If a large financial institution decides to make a loan directly to the CDFI instead of participating in each individual deal, it must show its regulator the list of loans originated by the CDFI (which used the financial institution's loan) in order to remain eligible under the lending test for multiple years. Under the investment test, a large financial institution receives CRA consideration for its investment, deposit, purchase of membership shares or grants to the CDFI. In addition, participation by a financial institution's employees on a CDFI loan committee, board of directors or any other

financial services-related role falls within the parameters set by the regulation for the service test.

Small financial institutions (financial institutions with less than \$250 million in assets that are independent or affiliates of a holding company with total banking and thrift assets of less than \$1 billion) that participate in loans originated through a consortium, or a loan made directly to a consortium which then generates other community development loans, helps satisfy the small bank CRA requirements. Regulatory examination staff will examine this information when they consider whether the bank is meeting the needs of individuals of different income levels or businesses of different revenue size. Partnerships between CDFIs and small financial institutions are an effective way to penetrate markets they would find difficult to serve individually. In addition, community development lending acts as a compensating factor for a low loan-to-deposit ratio because there is a bigger "bang for the buck" by leveraging a relatively small loan into significantly larger community development projects. Recent clarifications in the regulation state that small financial institutions will receive positive consideration for a satisfactory CRA rating if they are involved in community development investments that are lending-related. Other investment and service activities provided to a CDFI will allow small financial institutions to be eligible for an outstanding CRA rating.

It is important to view community development financial institutions as an integral part of our nation's financial industry. With moderate and guided government assistance, these nontraditional private financial institutions are poised to meet the challenges that face distressed communities. With the additional support and participation from traditional financial institutions, CDFIs are an important first step in restoring market forces in our nation's distressed communities. Their impact goes beyond targeted populations and geographies; they are a catalyst for the democratization of capital and credit.

About the Author:



Fred Mendez is a Community Investment Specialist for the Federal Reserve Bank of San Francisco. Since joining the Federal Reserve in 1993, Fred has acted as a liaison between financial institutions and their communities, promoting public/private partnerships, advising community development lending organizations on regulatory matters surrounding consortia and community development lending, and researching legal and commercial issues to facilitate the flow of capital to Native American lands. He has also educated both the lending and non-profit community about community reinvestment requirements, the secondary market, community development lending, fair lending legislation, and bank reform issues.