

## Community Development Loan Funds: Partnership Opportunities for Banks

### Abstract

This *Insights* report describes how partnerships between banks and community development loan funds (CDLF), when structured and implemented appropriately, can help banks and CDLFs further their business and civic goals. The report illustrates several types of bank-CDLF partnerships and discusses how those partnerships are often organized and sustained. The report also has a resource directory that provides links to additional information and help in finding a CDLF partner.

The information in this report was obtained from a variety of sources,<sup>1</sup> including banks and CDLFs active in these partnerships. The report offers a general overview of bank-CDLF partnerships, with the intent to provide a starting point for those new to the partnerships, as well as suggestions regarding new approaches for those experienced in the field.

### I. What Are Community Development Loan Funds?

CDLFs are nonregulated, typically nonprofit organizations that provide loans and development services to one or more types of customers.

CDLFs are a type of community development financial institution (CDFI). CDFIs are private financial institutions dedicated to delivering responsible, affordable lending to low-income and underserved communities so that these communities can join the economic mainstream.<sup>2</sup> CDFIs are mission-driven, meaning that they measure their success through nonfinancial as well as financial returns. The mission may be revitalizing a neighborhood; helping a specific population, such as immigrant women in poverty, become economically self-sufficient; or building certain assets, such as affordable housing, charter schools, or health care centers, to serve low-income and underserved communities.

<sup>1</sup> For a list of the data sources used to describe CDLFs, see appendix E.

<sup>2</sup> This definition is adapted from one used by the [Opportunity Finance Network](#), a national network of CDFIs, and is applied to a broad group of organizations. In addition, some CDFIs (see estimates on page 4) choose to be certified by the U.S. Department of the Treasury's [CDFI Fund](#). Certification requires, among other criteria, that the institution has a primary mission of improving the social or economic conditions of underserved people or distressed communities and is accountable to those people or communities. In this report, "CDFI" refers to the broad type of organization and "certified CDFI" refers to an organization certified by the CDFI Fund.

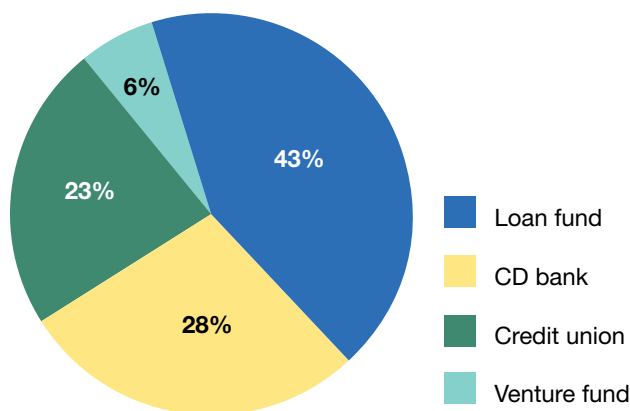
CDFIs provide financial services to individuals, small businesses, community service providers, and community-based organizations. CDFIs often lend to borrowers that may not meet a mainstream institution’s underwriting criteria. They serve hard-to-reach borrowers with specialized lending products and detailed expertise in niche markets. CDFIs typically manage the risks of their lending through the provision of borrower development services and by accessing public and philanthropic subsidies. “High-touch” technical assistance, such as business planning and homeowner counseling, helps borrowers succeed, often resulting in fewer delinquencies and defaults. Subsidies allow CDFIs to manage risk by lowering the cost of capital to the intended beneficiaries; providing the flexibility to offer nontraditional terms and underwriting criteria that seek to match borrowers’ ability to repay; and helping CDFIs establish higher reserves to offset potential losses.

There are four types<sup>3</sup> of CDFIs, as defined by their business models and legal structures:

- Community development banks (CD banks) and savings associations are for-profit corporations that are chartered and regulated by federal or state regulatory agencies. These banks’ deposits are insured by the Federal Deposit Insurance Corporation (FDIC).
- Community development credit unions are nonprofit financial cooperatives owned by their members. Federal credit unions are regulated by the National Credit Union Administration, which also insures their deposits.
- Community development venture capital funds are for-profit entities that provide equity and debt with equity-like features to small and midsize businesses in distressed communities.
- CDLFs are nonregulated, typically nonprofit organizations that provide loans and development services to one or more types of customers. In this *Insights* report, we focus on bank partnerships with CDLFs.

The estimated percentage of CDFIs by type is shown in figure 1, and the estimated percentage of CDFI assets by type is shown in figure 2.

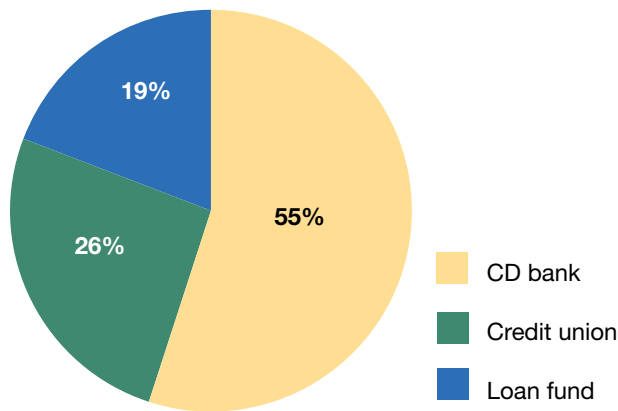
**Figure 1: Estimated Percentage of CDFIs in the United States by Institution Type**



Source: CDFI Data Project 2008.

<sup>3</sup> The CDFI Fund recognizes five types of CDFIs, further distinguishing banks from bank holding companies.

**Figure 2: Percentage of Total CDFI Assets by Institution Type<sup>4</sup>**



Source: CDFI Data Project 2008.

CDLFs range in size from less than \$200,000 in assets under management to more than \$1 billion.<sup>5</sup> The median CDLF-reported assets are approximately \$7.5 million.<sup>6</sup> CDLFs raise capital through grants and loans from other institutions, including banks, government agencies, philanthropic organizations, and individuals. CDLFs are typically “spread lenders,” meaning they borrow lending capital at low interest rates and then relend those funds to borrowers at slightly higher rates. In addition to their lending activities, CDLFs often provide development services to borrowers, such as training and technical assistance to start-up businesses or financial literacy education and homeownership training to new home buyers. CDLFs earn a financial return from their lending activity, but rarely is that return sufficient to sustain the organization.<sup>7</sup> To be financially sustainable, CDLFs typically require some combination of credit enhancements and ongoing operating subsidies, commonly from public and philanthropic sources.

CDLFs are often not required to be licensed or chartered, making it difficult to gauge the definitive size of the industry. In 2010, the CDFI Data Project estimated that there were 1,295 CDLFs, operating in all 50 states, the District of Columbia, and Puerto Rico. The U.S. Department of the Treasury’s CDFI Fund, dedicated to expanding the industry, certifies CDLFs and other types of financial institutions as CDFIs. This certification is a

<sup>4</sup> Comparable information for venture capital funds was not available.

<sup>5</sup> CDFI Data Project, *Community Development Financial Institutions: Providing Capital, Building Communities, Creating Impact* (8th ed., 2010). Based on fiscal year 2008 data. The CDFI Data Project included the Aspen Institute, National Community Investment Fund, National Federation of Community Development Credit Unions, and the Opportunity Finance Network.

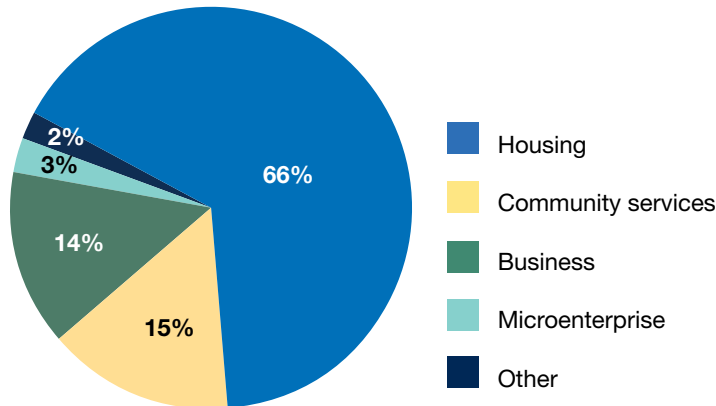
<sup>6</sup> Ibid.

<sup>7</sup> According to a study of 148 CDLFs using fiscal year 2005 data, the median organizational self-sufficiency ratio (earned income/total operating expenses) was 63 percent. Only 11 percent of the CDLFs reported ratios of 100 percent or more. See Kirsten Moy et al, *Approaches to CDFI Sustainability*, Aspen Institute (October 2008). Similarly, a 2012 study using a slightly different definition of self-sufficiency found that between 2006 and 2009, median self-sufficiency of loan fund activities of a group of 282 CDLFs ranged from 46 percent to 57 percent. The study found that larger CDLFs tended to earn a greater portion of their revenue from operations. See Michael Swack, Jack Northrup, and Eric Hangen, *CDFI Industry Analysis: Summary Report*, Carsey Institute at the University of New Hampshire (May 2, 2012).

requirement for participation in most CDFI Fund programs.<sup>8</sup> As of December 15, 2013, the CDFI Fund reported 808 certified CDFIs, of which 492 (61 percent) were certified CDLFs.<sup>9</sup>

Affordable housing financing is CDLFs' largest lending activity, followed by financing community service facilities and small business lending.<sup>10</sup> More recently, however, public funding has fueled an increase in CDLF lending to small businesses<sup>11</sup> and other nonhousing lending (see figure 3).

**Figure 3: Percentage of CDLF Direct Financing Outstanding**



Source: CDFI Data Project 2008.

Bank-CDLF partnerships are collaborations around common or complementary goals that blend traditional bank lending with specialized and subsidized CDLF lending. In this *Insights* report, we describe four types of partnerships:

- Referrals
- Participation lending
- Lending consortiums
- Institutional support for CDLFs

Each type offers banks the ability to expand their lending to a broader group of borrowers and manage risks in ways that banks cannot do alone.

## II. Why Are CDLFs of Interest to Banks?

Partnerships with CDLFs can help banks serve existing customer needs. CDLFs make loans that conventional lenders are often reluctant to make, including loans to start

<sup>8</sup> Certification is not required for partnerships with banks, but it can have regulatory benefits that make partnerships attractive. For instance, CDFIs are exempt from the Consumer Financial Protection Bureau's ability-to-repay requirements, provided they meet certain other applicable requirements (ability-to-repay requirement under the Truth in Lending Act (Regulation Z) 12 CFR 1026.43(a)(3)(v)(A) and (B)). Bank investments in CDFIs are not subject to deduction from regulatory capital pursuant to the revised regulatory capital rules (Basel III) (78 Fed. Reg. 62164, October 11, 2013), because such investments are not considered investments in the capital of unconsolidated financial institutions.

<sup>9</sup> CDFI Fund news release, "CDFI Fund Releases Updated Certified CDFI Results" (December 19, 2013).

<sup>10</sup> CDFI Data Project, *Community Development Financial Institutions*.

<sup>11</sup> Examples of such funding include the Treasury Department's Small Business Lending Fund and the U.S. Small Business Administration's (SBA) Community Advantage Program.

businesses and community facilities or for uses such as acquisition and predevelopment. CDLFs can typically offer flexibility in loan terms, including high loan-to-value ratios, deferred principal repayments, subordination, and unsecured loans. CDLFs can serve customers outside of the banks' risk profile by funding all (through a referral) or a portion (through a loan participation) of a customer's loan request. A CDLF can also help bank customers be more successful by providing technical assistance or counseling to first-time home buyers or new small business owners.

CDLFs can help banks reach new customers. CDLFs may have expert knowledge of specific populations and markets, and can help banks serve hard-to-reach or nontraditional customers. In some cases, banks have developed formal and informal referral relationships with CDLFs, with each helping to get customers to the appropriate lender.

Partnerships with CDLFs can also help banks meet the credit needs of the communities they serve. Many public agencies and philanthropic institutions collaborate with CDLFs as an efficient and effective way of applying subsidies to address community issues.<sup>12</sup> CDLFs blend subsidies with specialized expertise and traditional debt, expanding the scale and impact of those subsidies. Banks are a significant source of that lending capital to CDLFs, through grants, loans, or equity-equivalent investments, or through participation lending with CDLFs.

Most CDLFs are formed to use subsidies and develop and apply specialized knowledge to address complex community issues, such as affordable housing, education (charter schools), health (community health facilities and access to healthy food), and economic development (entrepreneurship and job creation). CDLFs are often experts in using public programs, and in some cases these programs' subsidies are limited to nonprofit CDLFs. The mission focus of CDLFs helps sustain long-term efforts on these complex issues. CDLFs are often involved in initiating, sustaining, improving, and reinventing community development strategies. These efforts may involve evaluating the effectiveness of efforts and convening stakeholders around new approaches.

Bank relationships with CDLFs can generate additional bank business by allowing the banks to make loans and reach customers they would not normally be able to reach. In addition, the CDLF can be a bank customer, generating deposit accounts, treasury services, and loans for working capital or senior debt. The relationship can also lead to greater participation in community development projects, such as construction loans or the purchase of low-income housing or new markets tax credits.

Banks may also be eligible for public incentives when partnering with a CDLF. Bank investments and loans to CDFIs, including CDLFs, may be eligible for Community Reinvestment Act (CRA) consideration. This is discussed in more detail in section IV, "What Are the Risks and Regulatory Considerations?"

FDIC-insured depository institutions are also eligible for awards through the CDFI Fund's Bank Enterprise Award Program (BEA Program). The BEA Program provides financial incentives for banks to expand investments in certified CDFIs, including CDLFs, and to increase lending, investment, and service activities in economically distressed communities. The program works by providing formula-based grants to

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<sup>12</sup> Martin D. Abravanel, Nancy M. Pindus, and Brett Theodos, "What Makes for a Smart Community or Economic Development Subsidy? A Program Evaluation Perspective," *Smart Subsidy for Community Development*, Federal Reserve Bank of Boston and Aspen Institute (July 2011).

applicants that increase their qualified activities over a defined period (usually one year). Since its inception, the CDFI Fund has awarded approximately \$358 million through the BEA Program.<sup>13</sup>

States also offer incentives for banks or other lenders to invest in CDFIs, including CDLFs, or their projects. For example, Tennessee offers a franchise and excise tax credit for financial institutions investing in CDFIs at below-market rates for extended terms.<sup>14</sup>

Banks may also receive reputational benefits for partnering with CDFIs, including CDLFs. Investments or loans to CDFIs show a bank's commitment to reaching populations or communities that it would be otherwise unable to serve. In addition, these partnerships can result in high-profile projects and initiatives that achieve significant public benefits.

### **III. How Do Banks Partner With CDLFs?**

Banks partner with CDLFs in a variety of ways. The descriptions below illustrate several common types of partnerships. Banks and CDLFs are also exploring innovations such as joint product development or fee-for-service relationships. The key to these partnerships is that the bank sees the CDLF as a collaborator in its efforts to serve the credit needs of the bank's customers and community. Both parties have considerable flexibility to customize the relationship to fit the opportunities available and the capacities of the partners.

#### **Referrals**

In a referral relationship, banks and CDLFs recognize each other as collaborators in the marketplace, with each specializing in different segments of the market and each willing to direct borrowers to the appropriate lender. For example, consider the following scenario. A bank customer approaches a commercial loan officer for a small business loan, but during the review the bank finds that the customer does not meet its lending requirements. The customer does, however, meet the lending requirements of a local CDLF, to which the bank directs the customer for further review. This type of relationship is often called a "second chance loan program." The CDLF may be able to make the loan or provide technical assistance<sup>15</sup> to improve the business's performance.

Similarly, a CDLF may have a borrower that, after working with the CDLF, has been able to establish a credit history and track record of business performance. That business may now be considered "bankable," and the CDLF may refer it to a commercial bank for its next business loan.

Referral arrangements can be formal or informal. Formal referral processes can involve written agreements and established procedures. Staff at the bank or CDLF may receive fees or other financial incentives when making referrals. In some cases, the two parties may try to make the process as seamless as possible for the borrower, including using a single application and conducting business in a single location.

Informal referral relationships are much more common. In an informal system, loan

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<sup>13</sup> CDFI Fund news release, "FY 2012 Funding Round of BEA Program Now Open" (June 20, 2012).

<sup>14</sup> Tennessee Department of Revenue, *Franchise and Excise Tax Guide*, "Financial Institution Loans to Eligible Housing Entities," 32.

<sup>15</sup> Technical assistance to businesses can include business coaching, designing accounting systems, financial statement preparation, financial management, marketing, and Web site development.

officers from the bank and CDLF agree to work cooperatively to help their customers receive loans. These informal relationships are built and nurtured over time and operate with a high degree of trust and a clear, shared sense of the appropriate lending institution for a given borrower. Informal relationships are unstructured and may end when lending staff turns over.

What are the advantages of participating in a referral relationship? For banks, a referral relationship with a CDLF helps the bank keep customers for deposit accounts or other services not offered by the CDLF. The customer may appreciate the bank's effort to help with the loan, even if the bank is not able to make that loan directly. In addition, the loan and technical assistance from the CDLF helps develop the borrower's credit history and business performance, so the borrower will be more likely to access bank credit in the future.

For the CDLF, referral programs can be a good source of potential borrowers. Close relationships with bank partners can help CDLFs gain access to borrowers that meet their loan guidelines. In addition, the relationship with the bank can help establish a clear pathway for CDLF borrowers that are ready for mainstream financial products.

### **Purchase of Securities or Tax Credit Investments**

CDLFs may bundle and sell community development loans on the secondary market. CDLFs may also offer new markets tax credits in exchange for investments in community development projects or loan pools. These investment options may offer an attractive risk/return financial benefit and may be eligible for CRA consideration.<sup>16</sup>

### **Participation Loans**

Participation loans<sup>17</sup> are used when a borrower's request cannot be served by a single lender, usually because of the size of the loan or other risk factors. For example, a small business borrower makes a loan request to fund an expansion of her or his business. That expansion is projected to increase the size of the business and double current revenues. A bank is interested in the loan—the borrower is a long-term customer—but the amount of the loan exceeds the bank's legal lending limit. In addition, the bank finds sufficient collateral and cash flow history to support only 75 percent of the loan request. The remainder does not fit the bank's credit policy.

A CDLF agrees to participate in the transaction by making a loan for 25 percent of the borrower's original loan request. Both the bank and the CDLF use their own application and underwriting criteria in their reviews. In this case, the CDLF loan is subordinated to the bank loan. Under different circumstances, the bank and the CDLF may agree to share risks equally. In that case the two loans would be *pari passu*, with both lenders having equal rights to payments and equal seniority.

In a participation loan, the two parties do not always have to agree in advance to participate. For instance, a CDLF may make a loan to finance the construction of a community health facility. Once construction is complete, the project is stabilized, and

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<sup>16</sup> Office of the Comptroller of the Currency (OCC), *Effective Strategies for Community Development Finance* (2000).

<sup>17</sup> The accounting guidance for loan participations is discussed in Accounting Standards Codification (ASC) 860, "Transfers and Servicing." Specifically, banks and CDLFs should consider the guidance to determine whether the loan participation structure meets the definition of participating interest (ASC 860-10-40-6a) and, if applicable, whether a transfer of such interest would be accounted for as a sale or as a secured borrowing.

the interim loan converts to a permanent loan, the CDLF may sell a portion of the loan to a bank lender. This provides a performing note to the bank and increases liquidity for the CDLF.

Loan participations help banks make loans that they would not normally be able to make because of legal lending limits or credit or collateral issues. The participations also help banks manage risk more effectively.

### **Lender Consortiums**

In a lender consortium, two or more financial institutions agree to lend to a group of borrowers under common application and underwriting criteria.<sup>18</sup> Lender consortiums allow individual lenders to engage in larger transactions than they would be able to alone. They also allow the participating lenders to share risk.<sup>19</sup>

A lender consortium may be certified as a CDFI. To receive certification, the consortium must have a primary mission of community development, serve one or more target markets, be accountable to those markets, and provide development services in conjunction with its financing services. CDFI designation and nonprofit tax-exempt status help the consortium gain access to subsidies from public and philanthropic sources.

For example, a lender consortium is formed to provide long-term permanent mortgage capital to affordable housing rental properties.<sup>20</sup> A CDLF organizes 15 banks to participate. Each bank pledges \$250,000 to \$5 million of capital over the next three years. The banks are also required to pay a fee to cover shared staff and overhead. All investing banks are given a seat on the governing board and assignments to serve on various board committees.

The CDLF provides expertise in financing affordable multifamily housing using low-income housing tax credits. It develops a common application and underwriting criteria that are approved by the board. It also forms an advisory committee or other mechanism that allows the consortium to be responsive and accountable to the market it is designed to serve. The CDLF develops a pipeline of loan requests that are approved by the loan committee. Once construction is complete and the property is stabilized, each participating bank purchases a portion of that property's loan based on its pledged share of the fund. Each bank receives principal and interest payments on its portion of the loan and has an assignment of collateral commensurate to its share. The CDLF typically services the loan, establishes risk reserve pools, and performs asset management functions over the length of the investments.

For banks, a CDLF loan consortium improves access to CRA-eligible transactions at lower costs and more competitive rates than the banks would be likely to get otherwise. The pooled risk structure, the CDLFs' experience, and specialized asset management services help reduce risk in the transaction. Loan consortiums are particularly beneficial to smaller community banks that cannot otherwise participate in larger community development projects. For CDLFs, a consortium provides lending capital at scale, with

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<sup>18</sup> For case studies and more information on multibank community development corporations (CDC), including some lender consortiums, see "Multibank CDCs: Pooling Resources to Strengthen Communities," *Community Developments Investments*, OCC (Fall 2008).

<sup>19</sup> Banks and CDLFs should consider the accounting guidance for loan participation in ASC 860, "Transfers and Servicing," as well as consolidation accounting guidance in ASC 810, "Consolidation."

<sup>20</sup> Examples include the Community Investment Corporation (Chicago), Impact Community Capital, Hope of Kentucky, and the Community Investment Corporation of the Carolinas.



limited risk to the CDLF. The lender consortium gives the CDLF access to lenders that are engaged in the process of financing affordable housing and are willing to put capital at risk.

## **Institutional Support of CDLFs**

When banks provide institutional support for CDLFs, they may provide loans, lines of credit, grants, in-kind contributions, volunteer staff time and expertise, or equity investments to help the CDLF grow and fulfill its mission. For example, suppose a bank decides it wants to help low-income households purchase homes. After careful review, the bank elects to partner with a local nonprofit CDLF that has developed a comprehensive set of services—homeownership counseling, realty services, down payment assistance, and affordable-housing financing—that help low-income households become homeowners. The CDLF has a good track record, and plans to steadily increase the number of clients purchasing homes over the next five years.

### **Grants**

The bank has numerous choices on how best to partner. Grants are often the most difficult funds for CDLFs to access, but they offer considerable value. Grants can be used to

- help cover the costs of a CDLF’s operations.
- fund the infrastructure needed for effective operations (such as accounting systems or marketing strategies).
- provide seed capital to develop new products or lines of business.
- provide the capital base that helps an organization weather changes in its environment or respond to opportunities as they arise.

Grants may also allow a CDLF to leverage additional capital beyond the grant amount.<sup>21</sup> For example, grants can be used to fund a loan-loss reserve that allows a CDLF to borrow funds from other sources, such as the federal HOME Investment Partnership Program, state housing finance agencies, or philanthropic-program-related investments.<sup>22</sup>

### **Loans**

Banks may also supplement the capitalization of loan funds with senior debt, or offer a line of credit that provides liquidity for loans that a CDLF originates and later sells on the secondary market. CDLFs typically prefer the cost of loan fund debt to be as low as possible and the term as long as possible. Our research indicates that banks generally made loans with terms of five to seven years. These loans are often below market rate,<sup>23</sup> given that the CDLF will relend the funds, consistent with its mission, with a slight mark-up to cover costs.

Banks may also support CDLFs through lines of credit that help the organization manage its cash flows.

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<sup>21</sup> Swack, Northrup, and Hangen, *CDFI Industry Analysis*.

<sup>22</sup> Sources for small business loan capital include the SBA’s Microloan Program and the U.S. Department of Agriculture (USDA) Intermediary Relending Program.

<sup>23</sup> If the loan is at below-market rates, banks should consider the accounting guidance in ASC 830-35, “Imputation of Interest,” when recording and measuring the loan.

## Equity Equivalent Investments

Equity equivalent investments (EQ2) have attributes that are characteristic of both debt and equity. EQ2s allow nonprofit CDLFs to strengthen their capital structures and leverage additional debt capital with investments other than grants. Like permanent capital, EQ2s increase a CDLF's debt capacity by protecting senior lenders from losses. Unlike permanent capital, however, the investment must be repaid and interest payments are required during its term. A more thorough discussion of EQ2s can be found in appendix A.

## Other Types of Support

Banks also offer traditional banking services to CDLFs, including checking accounts, credit cards, and treasury services.

Banks may be able to assist CDLFs through volunteer or in-kind support. In our research, CDLFs reported considerable value from senior bank staff serving on the nonprofit's board or board committees. The lending expertise helped CDLFs further develop their lending programs. Participation on a CDLF's board by senior bank staff often helped the CDLF in fundraising efforts and aligning CDLF efforts with civic priorities. Banks have also provided CDLFs with in-kind donations, such as office space or equipment, or allowed CDLFs to set up booths in bank branches for outreach efforts.

Banks and CDLFs participating in institutional partnerships have found the relationships very rewarding. For the CDLF, the partnership can significantly increase the scale of its operations and help the CDLF attract additional subsidies and gain supportive public policies. The bank can earn CRA consideration and substantive reputational benefits for its efforts. The bank may also generate additional business opportunities for its lending and other services.

Like any growing business, CDLFs must develop their underlying business capacity, as well as their lending capacity, in order to be effective. A CDLF needs to balance its mission, organizational capacity, and capital structure<sup>24</sup> to maintain institutional health. Expansions in capacity often require investments in the basic infrastructure of the organization, including marketing and market research, product development, underwriting and risk management, and customer service.<sup>25</sup> Growth requires careful planning.<sup>26</sup> Bank partners need to thoroughly understand a CDLF's growth strategy, and the level of capitalization necessary to achieve that growth. Working capital, usually in the form of grants, is necessary to build these new capacities. Our research found that banks combined grants to build organizational capacity with the loans and other types of support they made to increase a CDLF's lending capital.

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<sup>24</sup> The capital structure is represented on an organization's balance sheet in terms of assets, liabilities, and net assets. See Clara Miller, "Hidden in Plain Sight: Understanding Nonprofit Capital Structure," *Nonprofit Quarterly* (Spring 2003).

<sup>25</sup> Elaine L. Edgcomb, Joyce A. Klein, and Luz Gomez, *Dollars for Dreams: Scaling Microlending in the United States*, Aspen Institute (May 2010).

<sup>26</sup> Gregory A. Ratliff and Kirsten S. Moy, "New Pathways to Scale for Community Development Finance," *Profitwise News and Views*, Federal Reserve Bank of Chicago (December 2004).

## Support for the CDLF Field

Some banks have invested in supporting groups of CDLFs, or the field of CDLFs as a whole. These efforts are typically of a greater scale than are used in developing individual institutions. Initiatives of this type can include

- opportunities to highlight and share promising practices through publications, conferences, and awards.
- facilitated peer learning around topics challenging multiple CDLFs.
- demonstration projects to develop new products and services.
- infrastructure development, such as a secondary market for loan products, centralized loan underwriting or processing, or a multi-organizational contract for credit reporting.
- competitive grants and technical assistance that encourage collaboration across multiple CDLFs, or across multiple civic institutions.

## IV. What Are the Risks and Regulatory Considerations?

When partnering with a CDLF, a bank needs to identify the risks inherent in the relationship and develop strategies to mitigate those risks. In this section, we focus on some of the characteristic risks that may arise when partnering with CDLFs and consider efforts banks have used to manage and mitigate those risks. We also discuss some of the regulatory considerations in these partnerships.

As discussed earlier, CDLFs have a business model that allows them to lend in traditionally underserved markets. They are typically nonprofit organizations with a double or triple bottom line orientation<sup>27</sup> that puts their organizational mission on an equal footing with financial performance. To accomplish this goal, they combine public and philanthropic subsidies with rigorous market discipline. CDLFs are typically specialized lenders with deep expertise in particular markets and established relationships with major stakeholders. By offering supporting services, CDLFs develop a customer's capacity—to manage finances, to attend to the responsibilities of homeowners, to grow a business—that fulfills the CDLF's mission and reduces lending risk.

Banks typically investigate and document a CDLF's ability to manage and fulfill this double or triple bottom line orientation as a first step in due diligence. The process often starts with a review of a CDLF's knowledge of the market being served and its track record of lending and mission success. The due diligence includes interviewing key personnel and exploring their backgrounds and tenures with the organization. The background and capabilities of board leadership, particularly the board's ability to manage a double or triple bottom line orientation, are important issues to explore. The board must be able to oversee staff. Key partners, including the principal source(s) of subsidies for the CDLF, should be consulted. Banks should also document the type and quality of support services and evaluate the impact of those services on customer development and loan performance.

When evaluating an organization's financial performance, it is important to keep in mind some of the unique features of CDLFs. As noted earlier, CDLFs are typically spread lenders, meaning they borrow their loan funds from a variety of sources and then relend those funds at a higher rate. The cost of those borrowed funds influences the rates offered to the CDLF's borrowers and the earnings that the CDLF is able to achieve from its

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<sup>27</sup> Double bottom line orientation refers to “the simultaneous pursuit of financial and social returns on investment.” The triple bottom line expands that orientation to include “financial, social, and environmental” returns. See Institute for Social Entrepreneurs, “[Social Enterprise Terminology: A Practical Lexicon for Social Entrepreneurs](#).”

lending operations. The terms and conditions of the borrowed funds also influence the types of lending products the CDLF offers and the risks it can reasonably take in its lending.

CDLFs are nonregulated institutions and are not required to submit standardized reports, such as the call reports required of regulated financial institutions. Even with audited financial statements, how CDLFs report financial performance measures may vary.<sup>28</sup> Banks should understand the terms used in the CDLF's financial statements and how financial ratios are calculated by a particular CDLF. Banks should also understand how the CDLF identifies and manages risk.<sup>29</sup>

Operating expenses are typically the largest portion of a CDLF's expenses, dwarfing the cost of funds and loan-loss expense. Operating expenses are typically greater than 50 percent, and can exceed 70 percent of overall expenses,<sup>30</sup> with larger CDLFs tending to have a lower percentage of operating expenses. Rather than focusing on a particular ratio, banks looking to partner with a CDLF should understand the organization's capacity to deliver services, manage its affairs, weather stresses, and position itself for future opportunities.<sup>31</sup>

Banks may look to certifications or third parties for assistance in evaluating a CDLF partner. Many CDLFs pursue CDFI certification because it is required for eligibility in specific CDFI Fund programs. CDFI certification, however, does not constitute an opinion by the CDFI Fund as to the effectiveness or financial viability of an organization; certification confirms the organization's mission of community development and its provision of products and services to economically distressed communities.

The CDFI Assessment and Rating System (CARS)<sup>32</sup> is a comprehensive third-party rating system provided by Aeris (formerly CARS Inc.) for nonregulated CDFIs. The CARS rating is based on a two-part assessment approach. A CDFI's overall financial strength is assessed using a standardized rating system, while an impact assessment is made based on the CDFI's own evidence of how its activities contribute to its mission. Banks and other investors have used CARS ratings to augment their due diligence, assist in ongoing monitoring of investments, and identify new investment opportunities. While CARS ratings may be a valuable source of information, consideration of such ratings should be supplemented with due diligence processes and analyses appropriate for the bank and its proposed partnership with the CDLF.<sup>33</sup>

Finding the right CDLF partner can be a challenge, but good research techniques and effective underwriting are often rewarded. Networking with community partners is often a good first step in the search process. The CDFI Fund maintains lists of certified CDFIs

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<sup>28</sup> Although CDFI financial reporting is not currently standardized, an industry-led effort by professionals in the CDFI sector, Performance Counts, is advocating for change in this area. For more information, see Opportunity Finance Network, "[Performance Counts: Best Practices in CDFI Financial Statements and Management](#)."

<sup>29</sup> "Most loan funds do not have a definable or recognizable risk management system. Those that do generally outperform the others, but this may be a function of asset size." Swack, Northrup, and Hangen, *CDFI Industry Analysis*.

<sup>30</sup> Ibid.

<sup>31</sup> For more information, see Clara Miller, "Risk Minus Cash Equals Crisis: The Flap About General Operating Support," *State of Philanthropy 2004*, National Committee for Responsible Philanthropy (2004).

<sup>32</sup> For more information on CARS, see "[CARS on the Road: Edition 7](#)" or [www.aerisinsight.com](http://www.aerisinsight.com).

<sup>33</sup> From the OCC final rule removing nationally recognized statistical rating organization's rating references, per section 939A of the Dodd-Frank Wall Street Reform and Consumer Protection Act, 77 Fed. Reg. 35253-35254 (June 13, 2012).

and awardees on its Web site.<sup>34</sup> Trade and advocacy associations such as the Opportunity Finance Network (OFN)<sup>35</sup> and the Aspen Institute<sup>36</sup> offer lists and searchable databases of CDLFs. Banks can search published lists of awardees of government programs used by CDFIs, such as the U.S. Small Business Administration's (SBA) Community Advantage.<sup>37</sup> State banking associations have sponsored community development lending consortiums.<sup>38</sup> Community Affairs staff at the OCC<sup>39</sup> and other regulatory agencies can also be effective partners in the search process.

Banks contributing to a CDLF's loan capital, including through lender consortiums, often structure the transaction in ways that minimize credit and reputation risk. The term and rate of the loan influence the cost and type of lending products the CDLF can offer its borrowers. The type and position of collateral similarly have implications for the products offered. In our research, banks recommended that potential investors thoroughly understand the target market for the loan fund, the underwriting standards used in loan decisions, and the asset management and risk assessment procedures used by the CDLF. These bankers also recommended that institutions seeking to partner with a CDLF be notified of any significant changes in the CDLF's business plan, underwriting criteria, lending products, or service area. When investing in loan consortiums, banks should have access to the loan documentation necessary to value the loans and determine collateral coverage. As part of their investment, bank investors may want to inquire about participating on a CDLF's loan review committee or board of directors. This type of participation may be highly valued by a CDLF as it works to develop its lending and risk management capacities. Finally, as previously noted, providing operating support in addition to lending capital helps the CDLF build the capacity necessary to effectively deploy and manage additional lending capital.

### **Community Reinvestment Act Considerations**

The "Interagency Questions and Answers on Community Reinvestment" (Q&As) explicitly recognize community development loans,<sup>40</sup> community development services, and qualified investments<sup>41</sup> 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.

A bank may receive consideration for a loan to a CDFI in different ways, depending on the loan amount and structure. Banks evaluated as large institutions must report loans that meet the definition of a small business loan<sup>42</sup> as small business loans if the loan amount is \$1 million or less, even if the loan also has a primary purpose of community development. For other institutions subject to a community development test, and for small institutions at the bank's option, examiners will consider loans that have a primary

<sup>34</sup> See [www.cdfifund.gov/](http://www.cdfifund.gov/).

<sup>35</sup> See the OFN's "CDFI Locator" tool.

<sup>36</sup> The Aspen Institute offers [MicroTracker](#) for finding microenterprise development organizations.

<sup>37</sup> See the SBA's "[Community Advantage Approved Lenders](#)."

<sup>38</sup> For example, the Association of Reinvestment Consortia for Housing or the [Center for Community Lending](#).

<sup>39</sup> See the OCC's "[Community Affairs Contacts](#)."

<sup>40</sup> "Community Reinvestment Act: Interagency Questions and Answers Regarding Community Reinvestment" (CRA Q&As), 75 Fed. Reg. 11648, section \_\_.12(h)-1 (March 11, 2010).

<sup>41</sup> *Ibid*, 11652, section \_\_.12(t)-4.

<sup>42</sup> "[Reports of Condition and Income Instructions, Schedule RC-C, Part II](#)."

purpose of community development regardless of the loan amount. Additionally, large institutions may have business loans in amounts greater than \$1 million considered as community development loans provided they meet the geographic requirements and have a primary purpose of community development.

Investments in CDFIs can take a variety of forms, including deposits,<sup>43</sup> membership shares, EQ2s, and grants. EQ2s are a special form of investment that is discussed in greater detail in appendix A. Banks may receive CRA consideration based on the amount of an investment or a pro rata share of the loans made as a result of that investment. Under some circumstances, an institution may also choose to receive partial consideration for each: a portion of the investment under the investment test, and a portion of its pro rata share of loans under the lending test.<sup>44</sup>

Technical assistance to CDFIs, including developing loan application and underwriting standards, lending employees, or serving on boards and committees of CDFIs, is eligible for CRA consideration.<sup>45</sup> Other examples of services include developing secondary market vehicles or programs, assisting in financial product marketing, furnishing financial services training for staff, contributing accounting or bookkeeping services, and assisting in fundraising. Loan referrals may receive CRA consideration if it is bank policy to refer “second chance” loans to a CDFI after the bank reviews the borrower’s eligibility for bank financing.

The loans and investments may support an organization that covers an area larger than the bank’s assessment area(s) and still receive CRA consideration. The bank’s assessment area(s) need not receive immediate or direct benefit provided that the mandate of the organization includes serving geographies or individuals within the bank’s assessment area(s). Examiners also consider certain other community development activities. As long as the bank has been responsive to community needs and opportunities in its assessment area(s), examiners consider community development activities that benefit geographies or individuals located somewhere within a broader statewide or regional area that includes the bank’s assessment area(s), even if the activities do not benefit the assessment area(s).<sup>46</sup>

### **Legal Authority: Loans and Charitable Contributions**

Banks may make loans to CDLFs under their normal lending authority.<sup>47</sup> Banks may support community and economic development activities by providing contributions<sup>48</sup> to CDLFs, community development intermediaries, or foundations.

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<sup>43</sup> CDLFs, however, do not take deposits, unlike CDFI banks and credit unions.

<sup>44</sup> “CRA Q&As,” 75 Fed. Reg. 11648, section \_\_.23(b)-1 (March 11, 2010).

<sup>45</sup> “CRA Q&As,” 75 Fed. Reg. 11648, section \_\_.12(i)-1 (March 11, 2010).

<sup>46</sup> “Community Reinvestment Act: Interagency Questions and Answers Regarding Community Reinvestment; Notice,” 78 Fed. Reg. 69678, section \_\_.12(h)-6 (November 20, 2013).

<sup>47</sup> 12 USC 24(Seventh) for national banks, 12 USC 1464(c) for federal savings associations (FSA).

<sup>48</sup> 12 USC 24(Eighth) for national banks. Through their incidental powers, FSAs are authorized to make reasonable charitable contributions that promote better public relations and provide beneficial advertising for the FSA. See [Opinion Chief Counsel, OTS](#) (November 12, 1992) and [“Community Development Investment Authority: A Guide to the Federal Laws & Regulations Governing Community Development Activities of Savings Associations”](#) (December 1998).

## Legal Authority: Investments

Banks may make equity or debt investments in nonprofit or for-profit CDLFs, community development projects, or other organizations that support community and economic development initiatives.<sup>49</sup> The investments may support a variety of activities that are designed primarily to promote the public welfare, including real estate development, equity and near-equity loans for start-up and expanding businesses, activities that revitalize or stabilize a government-designated area, or other activities that supplement or enhance a bank's traditional lending. The investments may also be used to help a CDLF leverage financing from other sources.

Through investment in a for-profit CDLF, banks may hold an ownership position. In addition, banks may serve as advisers; lend senior and executive staff; contribute facilities, equipment, and expertise; and sit as directors, along with community leaders, on the governing boards of CDLFs.

**National banks:** Under the OCC's public welfare investment (PWI) authority, as specified in [12 USC 24\(Eleventh\)](#) and the OCC's implementing regulation, [12 CFR 24](#), a national bank or national bank subsidiary may make an investment directly or indirectly if (1) the investment primarily benefits low- and moderate-income (LMI) individuals, LMI areas, or other areas targeted by a governmental entity for redevelopment, or (2) the investment would receive consideration as a qualified investment under [12 CFR 25.23](#) of the OCC's [CRA regulation](#). Because bank investments in CDLFs typically meet these criteria, the investments are generally eligible under this authority.

The OCC's PWI regulation requires that a national bank's aggregate PWIs and outstanding commitments, including any proposed investment, cannot exceed 15 percent of the bank's capital and surplus. A national bank needs written OCC approval, however, for its aggregate PWIs to exceed 5 percent of capital and surplus. Furthermore, a national bank's debt or equity investment in a CDLF and other PWIs may not expose it to unlimited liability.

The PWI regulation requires national banks to notify the OCC either through an after-the-fact notification or before the approval request process.<sup>50</sup> Generally, a national bank completes the CD-1-National Bank Community Development (Part 24) Investments form to provide information about its PWI and sends the completed form to the OCC's Community Affairs Department. Each national bank making a PWI must maintain in its files information adequate to demonstrate that its investments meet the public welfare beneficiary standards and investment limit requirements.

**Federal savings associations:** In addition to their general lending and investment authorities, federal savings associations (FSA) may use the following authorities to make PWIs, including investments in projects involving CDLFs:

- Community development-related equity investments in real estate, under the [Home Owners' Loan Act](#) (HOLA) 5(c)(3)(A), as further clarified in

<sup>49</sup> 12 USC 24(Eleventh) and 12 CFR 24 for national banks, 12 USC 1464(c) and 12 CFR 160.30 for FSAs.

<sup>50</sup> Under 12 CFR 24.5(a), a national bank that is an "eligible bank," consistent with 12 CFR 24.4(a), may make a PWI and provide an after-the-fact notification to the OCC within 10 days after it makes the investment. The investment must be consistent with the public welfare beneficiary criteria under 12 CFR 24.3, and the bank's aggregate investments under 12 CFR 24 may not exceed 5 percent of its capital and surplus. Under 12 CFR 24.5(b), if a national bank does not meet the requirements for the after-the-fact notification process, the bank must submit an investment proposal, which requires OCC approval before the bank makes its PWI.

- [12 CFR 160.30](#).
- May 10, 1995, [opinion](#).<sup>51</sup>
- Investments in service corporations and lower-tier entities for community development investments, under [12 CFR 159](#).<sup>52</sup>
- De minimis investments, under [12 CFR 160.36](#).<sup>53</sup>

If an investment can be made under more than one authority, an FSA may designate under which authority the investment has been or will be made.

Generally, an FSA is not required to seek approval from, or provide notice to, the OCC for PWIs using the de minimis authority (12 CFR 160.36) or equity investments in real estate (HOLA 5(c)(3)(A)) that comply with the May 10, 1995, [opinion](#).<sup>54</sup> If the institution does not qualify for expedited treatment pursuant to [12 CFR 116.5](#), however, it is required to provide notice to the OCC (Community Affairs Department) at least 14 calendar days before making an equity investment in real estate. Investments in service corporations and lower-tier entities for community development activities, under 12 CFR 159, are subject to prior notice to, or approval by, the OCC. The FSA should follow the filing requirements outlined under [12 CFR 159.11](#).

### **Legal Authority: Community Development Securities**

Banks may also purchase community development securities (CD securities) from CDLFs.<sup>55</sup> These are securities backed by interests in pools of community development loans, such as loans to borrowers in LMI areas or to small businesses. Typically, nationally recognized statistical rating agencies do not rate these securities.

National banks may purchase and hold these unrated securities if the bank concludes, based on reliable estimates, that the obligor will be able to satisfy its obligations under the security, and if the bank believes that the security may be sold with reasonable promptness at a price that corresponds reasonably to its fair value.

<sup>51</sup> Under HOLA 5(c)(3)(A), 12 USC 1464(c)(3)(A), the FSA may make investments in real property and obligations secured by liens on real property located in areas “receiving concentrated development assistance by a local government under Title I of the Housing and Community Development Act of 1974” (HCDA). To be permissible for investment, the real estate (including low-income housing tax credit projects) must be located within a geographic area or neighborhood that receives assistance or is covered by, for example, the U.S. Department of Housing and Urban Development’s Community Development Block Grant (CDBG) program. Under 12 CFR 160.30, which covers the general lending and investment powers of FSAs, the FSA’s aggregate community development loans and equity investments may not exceed 5 percent of its total assets. Within that limitation, the FSA’s aggregate equity investments may not exceed 2 percent of its total assets. The qualitative standards for such loans and investments are explained in an [opinion of the OTS Chief Counsel](#), dated May 10, 1995. If the FSA meets all the standards, it is not required to provide notice to the OCC. If the FSA’s equity investment does not meet the qualitative standards in the May 10, 1995, letter, it must seek a no-action letter from the OCC by giving at least 14 calendar days’ notice to the OCC (Community Affairs Department) before making the investment.

<sup>52</sup> Under the authority of 12 CFR 159, an FSA may make investments in service corporations and lower-tier entities that engage in community development activities. A service corporation may engage in certain preapproved activities, including those that serve primarily community, inner-city, or community development purposes. An FSA may invest up to 3 percent of its assets in service corporations, but any amount exceeding 2 percent must serve “primarily community, inner-city, or community development purposes.”

<sup>53</sup> Under the de minimis authority, the FSA may invest, in the aggregate, less than or equal to the greater of 1 percent of capital or \$250,000 in community development investments of the type permitted for a national bank under [12 CFR 24](#), such as investments in CDLFs. An FSA using the de minimis investment authority to make an investment of the type that is permitted for a national bank generally does not need to provide notice to the OCC. The FSA should, however, maintain records that document the investment’s permissibility consistent with the public welfare requirements of 12 CFR 24.

<sup>54</sup> The FSA should maintain appropriate documentation to ensure that its community development investments conform to the statutory and regulatory requirements governing those investment authorities.

<sup>55</sup> 12 CFR 1 for national banks; 12 CFR 160.30, 160.32, and 160.40 for FSAs.



National banks may purchase securities acquired on the basis of reliable estimates, including CD securities, in an aggregate amount no greater than 5 percent of the bank's capital and surplus.<sup>56</sup>

FSAs may purchase unrated CD securities pursuant to various statutory and regulatory provisions. FSAs may purchase these securities pursuant to pass-through authority if the underlying loan assets would be permissible if invested in directly. Lending and percentage-of-assets limits may apply, depending on the legal authority that permits investment in the underlying asset.<sup>57</sup> If the authority to invest in underlying loan assets is a community development investment authority, the limit of 5 percent of assets in HOLA 5(c)(3) would apply in addition to the lending limit.<sup>58</sup> If the authority to invest in underlying loan assets is the residential real property lending authority, the investment, although subject to the lending limit, would not be subject to percentage-of-assets limits.<sup>59</sup> Other sources of authority may also be available.<sup>60</sup>

A bank's acquisition of CD securities must be consistent with safe and sound business practices.

## **V. What Other Organizations Support CDLFs?**

In previous sections, we described CDLFs and their partnerships with banks. In this section, we look at the national infrastructure supporting the CDLF industry and discuss the role CDLFs play in deploying public and private capital to underserved communities.

The CDFI Fund, within the Treasury Department, was created to promote economic revitalization and community development through investment in and assistance to CDFIs. The CDFI Fund certifies CDFIs, offers competitive funding for financial and technical assistance, manages a capacity-building initiative, and implements an incentive program (the Bank Enterprise Awards) that rewards banks for investing in CDFIs, including investments in CDLFs. The CDFI Fund also manages the distribution of two important sources of capital for community development, the New Markets Tax Credit Program and the CDFI Bond Guarantee Program.

Philanthropy has played a critical role in the growth and development of the field. Major players in the philanthropic community provided seed capital, research and development funds, and leadership in the industry's early years. Much of the current philanthropic support for the field comes in the form of program-related investments (PRI). These are low-cost loans and equity investments provided at below-market rates to support charitable activity. Unlike grants, PRIs are repaid to the philanthropic donor and usually provide a modest rate of return through interest or appreciation.

Socially conscious investors, including individuals, pension funds, and corporations, have been strong supporters of the industry. The CARS rating system, described earlier, can be a useful tool for socially conscious investors to find and underwrite CDLFs.

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<sup>56</sup> 12 CFR 1.3(i).

<sup>57</sup> 12 CFR 160.32; [Opinion P-96-4](#) Chief Counsel OTS (March 28, 1996).

<sup>58</sup> 12 USC 1464(c)(3).

<sup>59</sup> 12 USC 1464(c)(1)(B); [Opinion P-96-4](#) Chief Counsel OTS (March 28, 1996).

<sup>60</sup> [Opinion P-96-4](#) Chief Counsel OTS (March 28, 1996) (e.g., authority to invest in corporate debt securities, assuming that the issuer is a corporation, and the security is marketable, 12 CFR 160.40, and authority to invest in mortgage-related securities, 12 USC 1464(c)(1)(R)).

Numerous federal agencies use CDLFs as part of their delivery system. The SBA's Community Advantage Program provides a path for CDLFs to make 7(a) loans. The SBA's Microloan Program and Small Business Intermediary Lending Pilot Program, and the U.S. Department of Agriculture's Rural Microentrepreneur Assistance and Intermediary Relending programs, offer lending capital to CDLFs. The Housing and Economic Recovery Act of 2008 opened up Federal Home Loan Bank (FHLB) membership to CDLFs, allowing them to borrow at the advance window.

## **VI. How Do Banks Staff and Manage CDLF Partnerships?**

Banks considering partnerships with CDLFs need to consider the costs as well as the benefits of the partnerships.

Large banks with multistate service areas often have staff dedicated to community development activities, allowing these banks to undertake what can be labor-intensive outreach and underwriting efforts to find and select CDLF partners. These banks tend to have large service areas that include many CDLFs. They are also able to develop specialized products for CDLFs, and have the back office capacity necessary to service these products. In our research, several large banks reported that their senior debt lending and bank services to CDLFs can be modestly profitable. Some banks seek nonprofit CDLFs as commercial banking clients for deposit and other basic banking services, including secured lines of credit.

Grants and EQ2s provided at rates below a bank's cost of funds obviously are not profitable. As discussed above, however, this type of support is often necessary to develop the capital base and core infrastructure needed for more sophisticated operations. Some banks choose to provide this type of support to develop the relationships that allow the bank to engage in the business partnerships described in this *Insights* report. Several large banks have developed signature efforts to build capacity in the industry, combining capital with technical assistance and peer learning.

Community banks tend to partner with CDLFs in their day-to-day lending activities, including referral and loan participation relationships. These efforts often grow out of the informal efforts of bank staff working with CDLF staff to find new options to get profitable deals done. Community banks are able to leverage CDLFs' expertise in government loan programs. Smaller banks can often be more flexible in adopting new partnerships and in meeting the needs of individual borrowers.

Lender consortiums may also be a good fit for smaller banks. Several banks can pool resources to hire specialized staff for community development lending, including outreach, underwriting, loan servicing, and asset management.

## **VII. What Barriers Have Constrained the Growth of Bank-CDLF Partnerships?**

Several factors have limited the growth of bank-CDLF partnerships.

As has been mentioned previously, finding the right partner can be a challenge. CDLFs are not evenly distributed across the country, they operate at varying degrees of scale, and individual CDLFs can be very specialized in their lending. As a result, sometimes finding the right partner in a specific geography can be difficult. There are a number of efforts designed to address this issue. The CDFI Fund is trying to grow the industry and broaden lending through capacity-building efforts. Other national efforts are increasing the

number of CDLFs that lend to small businesses, broadening access to federal programs (by creating loan-loss reserve funds, for example), and promoting more integrated civic community development strategies.<sup>61</sup>

The amount of lending capital available to CDLFs is limited. New sources of capital are being explored, including socially conscious investors and crowdfunding.<sup>62</sup> FHLB membership and the CDFI Bond Guarantee Program promise to significantly expand the industry's lending capital base. Some industry leaders are exploring how CDLFs can access the larger capital markets.<sup>63</sup>

Bank-CDLF partnerships take time and effort to develop, and the benefits are not widely understood in the industry. Large banks and community banks tend to partner with CDLFs differently. Banks and CDLFs may see each other as competitors. Banks and CDLFs would be more likely to participate in partnerships if they had a greater understanding of the opportunities available and the options that could be tailored to suit their circumstances. The goal of this *Insights* report is to increase this understanding.

## VIII. Conclusion

Bank partnerships with CDLFs can be very rewarding to the bank and the CDLF. By working together, risk can be managed more effectively, and more customers can be served. CDLFs can bring subsidies and expertise to the transaction, but often need lending capital and operational capacity to expand their lending activity. When banks and CDLFs work together, each finds that the relationship furthers its business and civic goals.

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<sup>61</sup> For example, see [Living Cities' Integration Initiative](#).

<sup>62</sup> Crowdfunding is defined as "The practice of funding a project or venture by raising small amounts of money from a large number of people, typically via the Internet," *Oxford Dictionaries*.

<sup>63</sup> Charles Tansey, Michael Swack, Michael Tansey, and Vicky Stein, *Capital Markets, CDFIs, and Organizational Credit Risk*, Carsey Institute at the University of New Hampshire (October 13, 2010).

## Appendix A: Equity Equivalent Investments

Nonprofit organizations have limited means to raise capital. Typically, they raise equity either through public or philanthropic gifts (grants) or through retained earnings. Unlike for-profit entities, nonprofit entities cannot raise capital through stock offerings, because no one can legally hold a true equity interest in a nonprofit organization. EQ2s were created to provide an alternative means for nonprofit organizations to raise capital. EQ2s, although debt, behave much like equity for the nonprofit organization while providing a return to the investor.

EQ2s allow nonprofit CDLFs to build capital and leverage additional debt capital to increase lending capacity. Like permanent capital, EQ2s protect senior lenders from losses. Unlike permanent capital, however, the investment must be repaid.

At the end of fiscal year 2008, 50 CDLFs had secured \$179 million through EQ2s. This investment accounted for approximately 5 percent of the \$4.3 billion in loan capital held by the reporting nonprofit lenders.<sup>64</sup> EQ2s have primarily come from banks, although they may also come from corporations, foundations, universities, or other institutions. EQ2s typically provide long-term debt at low cost, with an average term of 101 months, and an average rate of 2.6 percent.<sup>65</sup>

EQ2s benefit investors by providing an investment option other than grants. As noted above, although an EQ2 affords the CDLF with many of the benefits of capital, the investor has the ability to recover its initial investment, unlike a grant. Typically, the investor receives ongoing interest payments through the term of its investment, with the principal returned at maturity.

### Bank Treatment of EQ2s

When the EQ2 is recorded as an investment on the bank investor's balance sheet, the bank—in accordance with generally accepted accounting principles (GAAP)—has the option of receiving CRA consideration for the transaction under the investment test. The bank can choose from three options:

1. The bank can receive consideration for the full amount of the investment over the term of the loan.
2. The bank can receive consideration under the lending test for a pro rata share of the community development loans made by the CDLF.
3. In some circumstances, the bank may receive consideration for part of its investment under the lending test and also receive consideration under the investment test.

For example, suppose a bank makes a \$2.5 million EQ2 in a CDLF for 10 years. The EQ2 makes up 25 percent of the CDLF's equity at the time of the investment. Under the first alternative, the bank would receive investment test consideration for a \$2.5 million qualified investment during the CRA evaluation period in which it was made, and as an outstanding investment during subsequent periods while it remains outstanding.

If it chooses the second alternative, the bank would receive lending test consideration for a pro rata share of the loans made by the CDLF over the period of time being considered in the CRA exam. Suppose, over this period of time, the CDLF originates \$24 million

<sup>64</sup> CDFI Data Project, *Community Development Financial Institutions*.

<sup>65</sup> OFN, "Presentation for OCC's Community Affairs Meeting" (October 27, 2010).

in community development loans. The bank would be eligible for consideration of 25 percent of this amount (based upon the EQ2's share of the CDLF's equity at the time of investment), or \$6 million in community development loans.

In some circumstances, an institution may receive consideration for part of an investment under the lending test and also receive consideration under the investment test for the part of the investment that was not considered under the lending test.<sup>66</sup>

### **History and Permissibility of Bank Investments in EQ2s**

EQ2s were developed by the National Community Capital Association<sup>67</sup> (NCCA) and Citibank, with the support of the Ford Foundation. The NCCA initially proposed that an EQ2 must meet six conditions:<sup>68</sup>

1. The EQ2 is carried as an investment on the investor's balance sheet in accordance with GAAP.
2. The EQ2 is a general obligation of the CDFI that is not secured by any of the CDFI's assets.
3. The EQ2 is fully subordinated to the right of repayment of all of the CDFI's other creditors.
4. The EQ2 does not give the investor the right to accelerate payment unless the CDFI ceases normal operations (e.g., goes into bankruptcy or changes its line of business).
5. The EQ2 carries an interest rate that is not tied to any income received by the CDFI.
6. The EQ2 has a rolling term and therefore an indeterminate maturity.

The NCCA developed a sample agreement<sup>69</sup> that CDLFs could use in structuring an EQ2.

In 1996, the banking regulatory agencies recognized EQ2s as investments eligible for CRA consideration.<sup>70</sup> This initial recognition was based on an EQ2 that met the investor-represented conditions described in the NCCA's initial conceptualization. The regulatory agencies, however, did not define minimum standards for EQ2s; rather, the agencies based their response on the investor's representations. The NCCA standards, then, are not an industry requirement.

In 1997, the regulatory agencies offered additional guidance, saying that EQ2s "would not have to conform precisely to the model<sup>71</sup> addressed in the June 27, 1996, letter," provided that the instruments have attributes that are characteristic of traditional equity investments.<sup>72</sup> The OCC first recognized an EQ2 in January 1997.

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<sup>66</sup> "CRA Q&As," 75 Fed. Reg. 11648, 11659, section \_\_.12(h) – 1 (March 11, 2010). The combination would most likely be considered if the CDLF itself made qualified investments.

<sup>67</sup> The NCCA is the forerunner of the OFN.

<sup>68</sup> Beth Lipson, "Equity Equivalent Investments," *Community Investments*, Federal Reserve Bank of San Francisco (March 2002).

<sup>69</sup> See [www.cdfifund.gov](http://www.cdfifund.gov).

<sup>70</sup> Federal Financial Institutions Examination Council (FFIEC), *Interagency CRA Interpretive Letter*.

<sup>71</sup> The March 28, 1997, *CRA Interpretive Letter* specifically notes that the interest rate of the EQ2 does not have to be below market and that the tenor of the investment does not have to be 10 years.

<sup>72</sup> FFIEC, *Interagency CRA Interpretive Letter* (May 30, 1997).

## **EQ2s as Public Welfare Investments**

Equity or debt instruments that have a primary purpose of community development and that primarily benefit LMI individuals, LMI areas, or other areas targeted for redevelopment may be made under the public welfare authority. As noted above, however, for an EQ2 to be considered as an investment under the CRA, the investment must be recorded as an investment security on the bank's balance sheet. For the investment to be accounted for as an investment security on the bank's balance sheet, the bank should account for the investment security on a trade date basis and the investment should meet the definition of a security (debt or equity) under GAAP. The determination of whether or not the investment is a loan or a security for accounting purposes requires judgment and consideration of the facts, circumstances, and nature of the investment. The definition of a security under GAAP can be found in ASC 320-10-15, "Investments—Debt and Equity Securities," and is summarized below:

- Instrument is issued in either bearer or registered form (i.e., the issuing entity keeps records of the owner or owners).
- Instrument is commonly recognized in any area in which it is issued or dealt in as an investment.
- Instrument is one of a class or series or by its terms is divisible into a class or series of shares, participations, interests, or obligations.

## **Appendix B: Case Studies**

### **Case Study One: Lender Consortiums for Neighborhood Stabilization**

In California, banks are working together to stabilize neighborhoods hit hard by the foreclosure crisis. They are funding stabilization efforts through debt and equity-like investments in a nonprofit CDLF. This regional loan fund provides financing to local nonprofit housing developers to finance the acquisition and rehabilitation of houses abandoned because of foreclosure. The bank funds are blended with public subsidies, significantly increasing the volume of transactions that could be done through public funds alone. The public subsidies reduce the cost of funds to the borrowers and reduce risk to the bank debt holders. Bank partners receive a modest but positive return on their loans and investments. The houses provide affordable homeownership opportunities for LMI families.

### **Case Study Two: Business Loan Participation Program**

In rural Georgia, a bank is having a difficult time making a loan to a small business borrower looking to expand her business. The loan request conforms to most components of the bank's credit policy. The borrower has a good credit history and the projected cash flow, if achieved, will be more than sufficient to repay the note. Collateral values do not conform to the bank's underwriting policy, however, and the borrower has insufficient cash to fill the gap. A local nonprofit CDLF, using funds provided through a state small business financing program, agrees to participate with the bank on the loan. The CDLF participation loan covers 40 percent of the borrower's request. The CDLF loan is subordinated to the bank loan and is offered at a slightly lower rate. The bank is able to say "yes" to the customer on the financing and also provide deposit account and credit card services to the now-growing business.

### **Case Study Three: Microenterprise Program With Linked Bank Services**

In Omaha, Neb., a CDLF is providing small business loans to refugee women, many of whom are living in poverty. The women use the loans, which start at \$1,500, to start or expand what are often home-based businesses. The CDLF provides the program participants with extensive training in financial literacy and small business development. All of the program participants are expected to open a savings account and contribute at least \$2 a week in savings, in addition to the payments they make on their loans. Local banks teamed with other corporate and philanthropic partners to provide the start-up capital for the CDLF and much of the loan pool capital. The banks also provide low-cost savings and checking accounts with automated teller machine (ATM) cards to the program participants. Virtually all of the loans made through the loan fund are repaid. The loan payments are reported to a credit bureau, helping program participants build a credit history that will make it easier to access mainstream financial products in the future.

**Appendix C: OCC Information Resources**

**[OCC CDFI and Community Development Bank Resource Directory](#)**

**[OCC Public Welfare Investment Authority Resource Directory](#)**



## **Appendix D: Advocacy Organizations and Financial Intermediaries for CDFIs**

**CapNexus:** A searchable online database and matching service for community development finance opportunities that allows loan originators, interested buyers, and financing partners to meet.

**CDFI Assessment and Ratings System (CARS):** A comprehensive, third-party assessment of individual CDFIs' social impact, financial strength, and financial performance. CARS can be an important tool for investors in CDFIs. The Web site offers information for CDFIs interested in participating in the ratings system.

**CDFI Coalition:** A group that advocates on behalf of the CDFI industry and educates the public about community development finance. The CDFI Coalition is a primary source of information about the CDFI field for the general public, the news media, public officials, private sector lenders, and CDFIs.

**Center for Community Lending (CCL):** An organization that conducts and sponsors research about community lending, promotes the revitalization of distressed and underserved neighborhoods, works to eliminate discrimination in lending, and promotes the equality of opportunity for access to credit. The Web site includes a list of mission-based lenders.

**Community Reinvestment Fund (CRF):** A nonprofit organization that provides a secondary market for community development loans originated by CDFIs. The CRF also provides loan servicing and portfolio management services, as well as lender training and technical assistance to community-based lenders.

**Global Impact Investment Ratings System (GIIRS):** A comprehensive and transparent system for assessing the social and environmental impact of companies and funds through a ratings and analytics approach.

**NeighborWorks America:** NeighborWorks promotes affordable housing and community development through a network of 235 independent, community-based nonprofit organizations serving more than 4,500 communities nationwide. A directory of organizations participating in this network can be found at <http://nw.org/network/Utilities/NWOLookup.asp>.

**Opportunity Finance Network (OFN):** A national membership organization of CDFIs that identify and invest in opportunities to benefit low-income and low-wealth people in the United States. The OFN's members include community development credit unions, community development venture capital funds, and microenterprise lenders. The OFN provides a searchable database of CDFIs.

**The Forum for Sustainable and Responsible Investment (US SIF):** A U.S. membership association for professionals, firms, institutions, and organizations engaged in socially responsible and sustainable investing. US SIF and its members advance investment practices that consider environmental, social, and corporate governance criteria to generate long-term competitive financial returns and positive societal impact. US SIF's members include investment management and advisory firms, mutual fund companies, research firms, financial planners and advisers, broker-dealers, banks, credit

unions, community development organizations, and nonprofit associations, and pension funds, foundations, and other asset owners. US SIF members practice socially responsible investing through methods such as portfolio selection analysis, shareholder advocacy, and community investing.

### **Microenterprise Development**

**Aspen Institute FIELD Program:** The Aspen Institute's Microenterprise Fund for Innovation, Effectiveness and Learning Dissemination (FIELD) Program identifies, develops, and disseminates best practices and educates funders, policymakers, and others about microenterprise in the United States as an antipoverty strategy.

**Association for Enterprise Opportunity (AEO):** A membership organization dedicated to promoting microenterprise in the United States. The AEO provides its members with a forum, information, and a voice to promote microenterprise for people and communities with limited access to economic resources. The AEO maintains a variety of resources for microenterprise practitioners on its Web site.

**MicroTracker:** A searchable database maintained by the Aspen Institute's FIELD Program that provides information on almost 700 U.S. microenterprise programs, along with key facts on organizations' products, services, and scale as reported in the program's U.S. Microenterprise Census.

## Appendix E: Data Sources Used in This Document

CDLFs are not required to be licensed or chartered or to produce regular standardized financial reports, making it difficult to get a definitive understanding of the size and characteristics of the industry. In this report, we have drawn on a number of studies that have attempted to understand the field. Each of these reports has strengths and weaknesses, and all recognize that the sample of institutions examined in the studies may or may not be representative of the industry as a whole.

In order to understand the general characteristics of the CDFI field, and how CDLFs compare to other types of CDFIs, we've drawn primarily from *Community Development Financial Institutions: Providing Capital, Building Communities, Creating Impact*, 8th edition (2010). This report was developed by the CDFI Data Project, an industry collaborative that, through 2010, conducted an annual review of financial and nonfinancial indicators from certified and noncertified CDFIs. The 2010 report, the most recent, was based on FY 2008 data from 495 CDFIs.

More detailed assessments of CDLFs are drawn from *CDFI Industry Analysis: Summary Report* (2012). This report was developed by the Carsey Institute, under contract to NeighborWorks America and the CDFI Fund, to conduct a detailed analysis of a large sample of CDFIs on issues of capitalization, liquidity, portfolio performance, and risk management by CDFIs from 2005 to 2010. The financial information on CDLFs is drawn from 282 certified CDLFs that applied for funding from the CDFI Fund in 2010. The information is based on self-reported FY 2009 data.

Additional information on CDLF sustainability was drawn from *Approaches to CDFI Sustainability*, a 2008 report developed by the Aspen Institute under contract to the CDFI Fund. This report drew on data from the CDFI Data Project and Microtest, a database of performance indicators from a self-selected sample of organizations engaged in microenterprise lending and entrepreneurial technical assistance. This dataset included certified and noncertified CDLFs.

David Black was the primary author of this report. *Community Developments Insights* reports differ from OCC bulletins and regulations in that they do not reflect agency policy and should not be considered definitive regulatory or supervisory guidance. Some of the information used in the preparation of this paper was obtained from publicly available sources. These sources are considered reliable, but the use of this information does not constitute an endorsement of its accuracy by the Office of the Comptroller of the Currency.