A Foundation Guide to Investing

in Community Development Financial Institutions

PHILANTHROPY NORTHWEST

Dear colleagues and friends,

Many of us in philanthropy are seeking to address diversity, equity and inclusion in our communities. Historically, large segments of the U.S. population—mostly poor, rural and minority communities—have been excluded from full and equitable access to economic opportunities. At the Northwest Area Foundation, we have found that supporting Community Development Financial Institutions (CDFIs) through grants and program-related investments are powerful ways to increase access to capital in our priority communities. Born out of the anti-poverty innovations of the 1960s and 1970s, CDFIs are a proven means of moving capital beyond barriers of race, income and zip code. CDFIs serve both rural and urban communities, and they have particularly helped us partner effectively with Native American communities.

In the following pages, I invite you to consider whether a CDFI investment might be right for your foundation and mission. Your board and staff members can use this guide to examine the basic processes of building a relationship with a CDFI and structuring the investment. This will help you assess your appetite and readiness to directly engage in the local economy.

Throughout this guide we provide personal insights from Northwest Area Foundation and Meyer Memorial Trust, two Philanthropy Northwest members with a track record of providing strategic support to CDFIs. We hope these comments will help demystify CDFIs and the investing process.

Over the years, Northwest Area Foundation has increased its understanding and appreciation for what CDFIs can do and I would be happy to share this journey with you. I also know that many more Philanthropy Northwest members are partnering with CDFIs and hope to hear more about your stories as well. We look forward to engaging with you on your community investing journey.

I'd also like to thank Satterberg Foundation for their generous investment in Philanthropy Northwest and for making this publication possible.

Warm regards,

Kevin Walker
CEO, Northwest Area Foundation
Board Chair, Philanthropy Northwest

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Why Invest in a CDFI Loan Fund

Community Development Financial Institutions (CDFIs) pool capital from multiple investors to make community impact loans. Foundations value deep local knowledge and strong ties to underserved communities. They also value the leverage achieved when CDFIs combine foundation investments with funds from banks or the government. The money is used to finance business, affordable housing and facilities like theaters, clinics and nonprofit office space.

Additionally, CDFIs offer technical assistance in the communities they serve. They help individuals manage profitable businesses, and they train and support organizations so they can build and operate apartment houses, clinics, stores, theaters and more.

CDFI loan funds usually operate as nonprofits and are certified by the United States Department of Treasury, but they are not regulated. The Treasury tests to see that the primary activity of a CDFI is financing, and that its work benefits low and moderate income people and places. While there are CDFI banks and credit unions, this guide refers only to nonprofit CDFI loan funds.

CDFI investments work well for foundations that want the impact of direct investment in local businesses and facilities, but don't want to build foundation capacity to deliver loans and manage loan risk. The CDFI is staffed with loan officers and has built all the systems needed to market and manage a loan portfolio. Their staff tends to have intimate community relationships, so they are successful in finding the high-impact transactions that foundation investors seek.

The final advantage CDFIs offer foundations is that they cushion financial risk by spreading the foundation's dollars over a diversified portfolio of loans. They also professionally monitor and manage risk, and hold loan loss reserves. These costs are factored into the CDFI business model and the interest rate that CDFIs offer investors.

Setting Your Investing Intention

The first step when considering any kind of impact investing is to clarify your intentions for financial returns, mission impact and operational costs. This allows you to seek and choose a CDFI that is well-matched with your foundation's strategy, culture and budget.

To start the conversation, you can ask board members which potential CDFI investing outcomes are important to them: Do they envision helping small businesses? Building affordable housing units? Supporting sustainable agriculture? See the list on the facing page for a list of common loan types.

Another important conversation addresses how investing can further your foundation's work toward diversity, equity and inclusion. In many communities, access to capital is highly affected by racial discrimination and economic stratification. Most CDFIs can help the foundation work directly on these issues, for instance there are many CDFIs that focus on Latino, African-American or immigrant people; Native American CDFIs are specifically chartered.

The board should also discuss its expectations for financial return and operational costs. Are they willing to accept returns similar to fixed income holdings in the endowment, as is common for CDFI investments? What staff and consultant time is the board willing to devote to a CDFI investment? The answers to these questions will define your foundation's investing intention and create a clear path for setting up an investment relationship with a CDFI.

WHICH OUTCOMES ARE MOST IMPORTANT TO YOU?

- ☐ Support small businesses
- ☐ Provide affordable housing
- ☐ Build opportunity in Native American communities
- ☐ Support sustainable natural resource-based companies
- ☐ Improve environmental quality and/or preserve habitat
- ☐ Address diversity, equity and inclusion issues
- ☐ Help redevelop buildings and neighborhoods
- ☐ Assist nonprofits to own and maintain their buildings
- ☐ Create jobs with major community businesses
- ☐ Invest locally
- ☐ Improve the mission profile of the endowment
- ☐ Go beyond grants by making Program Related Investments (PRIs)
- ☐ Invest with little or no direct operational cost for the foundation
- ☐ Provide modest financial returns to the foundation

"We view Native American CDFIs as key institutions in their communities. Funding them is part of our commitment to invest 40% of our foundation funding in native-led organizations."

KARLA MILLER
Program Director,
Northwest Area Foundation

"CDFIs are really the entrepreneurs in the ecosystem. They have been willing to develop a program in an area of interest to us. We have a candid conversation about our goals, they see if the lending will pencil, and, if it does, they do it. Some can even leverage your capital with their capital."

SAYER JONES
Director of Mission Related Investing,
Meyer Memorial Trust

Finding the Right CDFI

Once you and your board members understand your investing intention, you can begin to explore CDFIs and the main categories of CDFI lending, while determing your investing intention.

AFFORDABLE HOUSING LENDERS manage a pool of investor funds that they lend to local nonprofit housing developers. These local developers combine your loan with government funds (often borrowed) and private grants. The housing that is built or rehabilitated could be multi-unit family rentals, single-family homes or mobile home cooperatives. The housing may help veterans, seniors or people with disabilities. Green building features may also increase the mission impact.

SMALL BUSINESS LENDERS manage a pool of investor funds they lend to individual business owners. These CDFIs combine capital from government, bank, foundation and individual loans and grants. The loan funds generally focus on a specific neighborhood, city, state or multi-state region. They may target mission themes such as rural, neighborhood, food, high technology, new entrepreneurs, migrants, growth companies, green business, women, under-served populations, etc.

COMMUNITY FACILITY LENDERS finance charter schools, health clinics, arts or cultural centers and nonprofit offices. Like other CDFI pools, the capital is a combination of grants and loans from government, banks, foundations and individuals.

NATIVE AMERICAN CDFIs perform any of the functions listed above in Native American communities.

EXPLORE MISSION IMPACTS BY CDFI TYPE

Mission Impacts	CDFI Type		
	Small business	Affordable housing	Community facilities
Invest locally	X	X	X
Start businesses or support entrepreneurs	X		
Create jobs	X		X
Target businesses in particular sectors (sustainable food, high-tech, etc.)	X		
Revitalize a specific neighborhood	X	X	X
Empower community groups by race, income, age, gender, veteran status, etc.	X	X	X
Home ownership & individual asset building		X	
High quality affordable housing		X	
Green businesses	X		
Green buildings		X	X
Build nonprofit assets			X
"Place-making" via cultural centers			X
Buildings for community health, schools, childcare, recreation, arts			X
Childcare	X		X
Native American CDFIs perform the above lending specifically in Native American communities.			

"The majority of our PRIs are to CDFIs, and we helped most of the CDFIs in the region get off the ground. They are a key partner in so many ways for us. We wish we had more CDFIs in the Pacific Northwest. It is harder to lend to the smaller CDFIs—they are better suited to grants."

SAYER JONES
Director of Mission Related Investing, Meyer Memorial Trust

NARROWING THE SEARCH

When you are ready to narrow your search to a specific CDFI or Native American CDFI, there are several national databases that can help:

- **Opportunity Finance Network**
  ofn.org/cdfi-locator
- **US Department of Treasury**
  cdfifund.gov/what_we_do/need_a_loan.asp
- **AERIS**
  aerisinsight.com
- **Oweesta**
  oweesta.org

You can use these databases to find a CDFI doing work that you care about in your state or region. Some web research will help you choose organizations to contact and meet with. For many, you will find both investor information and structured offerings described on the web. If you like what you see, deeper underwriting can begin.

CDFI Investor Profiles

Northwest Area Foundation (NWAF) serves Minnesota, North and South Dakota, Montana, Washington, Oregon and Iowa. NWAF's CDFI loans are part of a $16 million pool of investments that qualify as Program Related Investments (PRIs), though they are held as part of the endowment portfolio. The foundation has a particular commitment to funding Native American CDFIs and provides detailed information on that sector on the NWAF website.

"We are looking for investments that dovetail with our grant portfolios in enterprise development, work opportunity, access to capital and financial inclusion. CDFIs do what we are trying to do, and they strengthen the fiber of the community," says Program Director Karla Miller.

Miller and her colleague, Program Officer Nikki Fosterboth, worked in the CDFI industry prior to joining the foundation. They carry out most of the CDFI lending functions for NWAF.

Meyer Memorial Trust (MMT) serves Oregon. It maintains a PRI loan pool of $22 million, about half of which has been lent to CDFIs. While many PRIs have been renewed, MMT's impact investing strategy is evolving and the foundation no longer actively seeks investments for this PRI pool.

"A strong and long-lasting relationship is the best way to work with a CDFI. As CDFIs work in a place over time, they build relationships. They build lending infrastructure. They figure out how to address particular financing challenges for particular kinds of lending," says Director of Mission Related Investing Sayer Jones.

Jones has a public accounting background and handles most of MMT's CDFI lending activities.

Underwriting the CDFI for Financial Strength and Mission Impact

Underwriting is a careful investigation of two fundamental questions:

1. **Will the CDFI repay the foundation investment at the interest rate proposed?**
2. **Can the CDFI deploy the invested funds to achieve mission impacts desired by the foundation?**

Underwriting includes examining financial statements, audits and annual reports. But it is not all numbers; investors also interview staff and request information about the mission track record of the CDFI, and the experience of the CDFI staff. All of these factors help the foundation decide whether the CDFI investment makes sense for the foundation.

Some foundations have policies governing impact investing underwriting. They may also have staff who can conduct the process because they have appropriate program or financial experience. If not, foundations often contract for some or all of the underwriting process.

The nonprofit AERIS (aerisinsight.com) can provide comprehensive CDFI underwriting reports, covering both financial and mission performance of CDFIs. Some financial advisors will also underwrite CDFIs for their clients. This is most common among specialized impact investment financial advisers.

Financial underwriting questions are typically addressed by examining two or three years of the CDFI's audited financial statements. Key questions for specific parts of both the balance sheet and income/expense statement are listed on the next page. They explore balance sheet strength, operating history as shown in the income/expense statements, good deployment of investor funds and the quality of the CDFI lending program.

Mission underwriting will be familiar territory for most grantmakers. Here the foundation assesses organizational effectiveness, verifies measurable mission accomplishments and decides whether the impacts align adequately with the foundation mission. Key questions in these areas are also listed on the next page.

"We are in the process of bringing more program officers into underwriting, so that PRIs are a true tool across our grant portfolios. To deepen our underwriting capacity, we pull in the foundation investment staff, and have a team of program officers look at underwriting together.

I go to the balance sheet first. It helps me see their scale and what kind of entity I am working with. I like to see the cash, total assets, liabilities. Where is their money coming from? Do they have a stable financial structure?"

KARLA MILLER
Program Director,
Northwest Area Foundation

"You don't need an MBA to do this. The maturity level of the CDFIs themselves make underwriting much less challenging. Their financial information and knowledge can be very good and easy to work with."

SAYER JONES
Director of Mission Related Investing,
Meyer Memorial Trust

QUESTIONS TO ASK WHEN UNDERWRITING

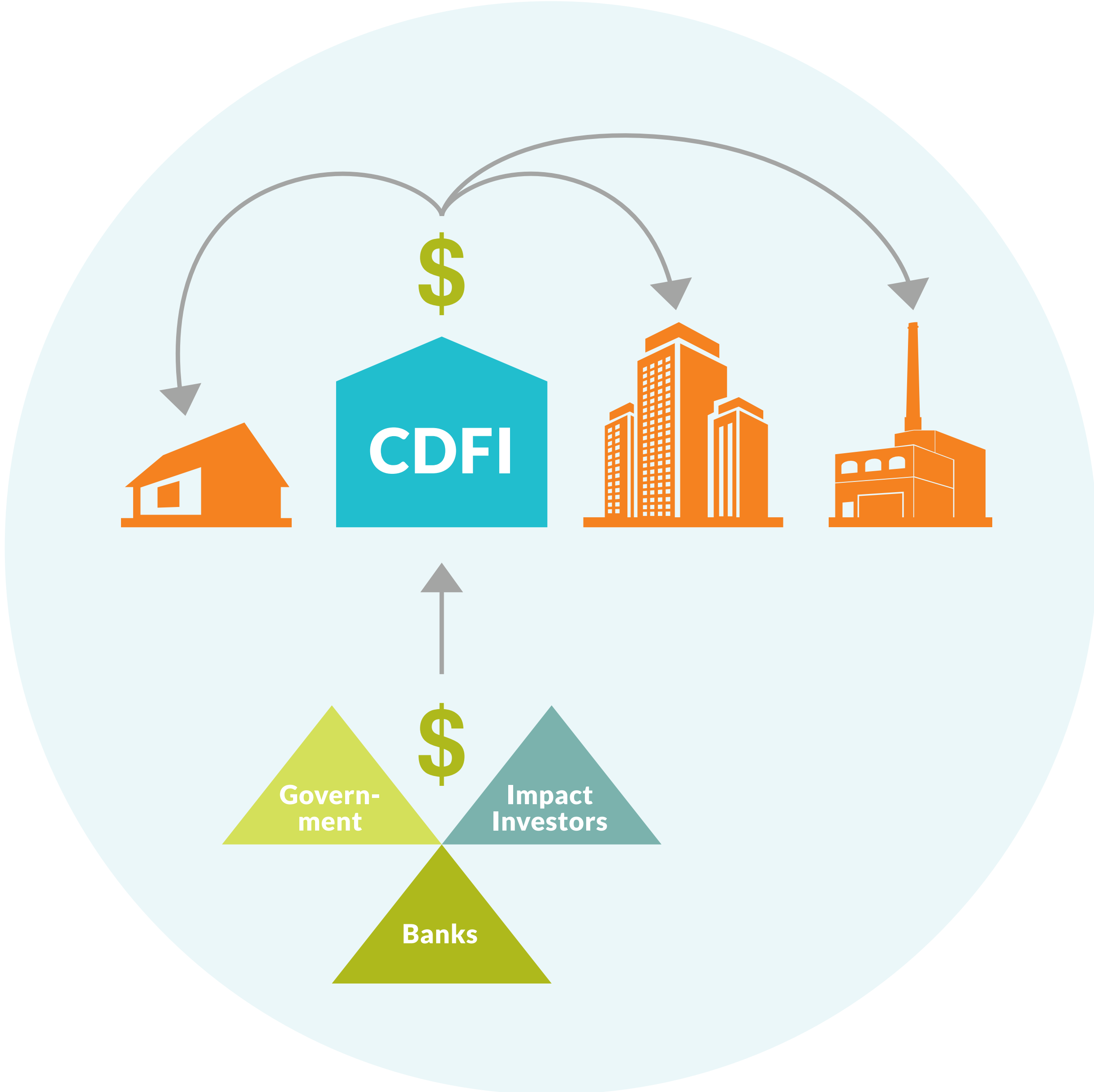
Financial

- ☐ Is the CDFI balance sheet solid?
  - Are assets, net assets and unrestricted net assets positive and growing year to year?
  - Are operating reserves healthy?
- ☐ Is the CDFI successful at earning income and raising grants to cover operating expenses?
  - Does the income/expense statement show positive operating results each year?
  - What percent of expenses are paid through earned loan revenue?
  - Are grants and contributions sufficient? Request a list of funders to call if you wish.
- ☐ Does the CDFI get money "out on the street?"
  - Check loans outstanding in the assets section of the balance sheet. Is it growing each year?
  - What percent of loan assets are deployed vs. idle?
- ☐ Does the CDFI make good loans with solid repayment? Are reserves for loan losses adequate?
  - The audit footnotes usually disclose impaired loan data.
  - Ask the policy for loan losses (what percent of loans outstanding is reserved) and compare to see actual losses in recent years.
  - Check the balance sheet for actual reserves the CDFI is holding.
- ☐ Who else invests in the CDFI?
  - Debt holders are disclosed in audit footnotes.
  - You can also request a list of investors whom you may call if you wish.

Mission & Organizational Capacity

- ☐ How many people, businesses or projects are reached by the CDFI lending?
- ☐ What are the demographics of these beneficiaries and of the areas where they live?
- ☐ What are the quantifiable outcomes the CDFI counts, such as production of housing units, business start ups and job creation?
- ☐ Does the CDFI have specialized lending programs in areas of importance to the foundation, such as arts-related businesses, minority lending, neighborhood or rural revitalization, agriculture, etc?
- ☐ Who are the leaders and principle staff? Is capacity strong and does commitment appear good? Is the CDFI culture a good fit with the foundation? Ask about staff turnover, especially in lending positions.
- ☐ Request a list of all loans made in the previous six months. Do the projects resonate with the foundation? Can you imagine publicizing these loans on the foundation website?
- ☐ Is the CDFI rated by AERIS (aerisinsight.com) for financial and mission effectiveness?

CDFIs PUT INVESTOR MONEY TO WORK IN COMMUNITIES



Structuring and Executing the CDFI Loan

Most loans are executed with a promissory note, which is a simple loan contract outlining the expectations of both parties for use and repayment of the loan. There is a balancing act in setting terms—on one hand, foundations want to support CDFI success and mission accomplishment. On the other hand, foundations seek financial return and strict assurances that they will be paid back in full. A fairly standard range of terms has evolved to hit this balance over the 25+ years that CDFIs have accepted investments. Common loan terms are listed on the facing page.

Many CDFIs have a standard promissory note for investors. The foundation can use this note as a starting point, working with its own legal and financial counsel to add or subtract terms and language. The foundation may have, or develop, its own standard CDFI promissory note and use that to start negotiating loan terms.

COMMON LOAN TERMS AND CONSIDERATIONS:

- **Loan amount**: Some foundations decide on the right loan amount by asking the question: How much money am I willing to restructure as a grant if this loan "goes south?" This is particularly appropriate during the first years of making CDFI investments while the board and staff build confidence and familiarity with CDFIs.
- **Loan term in years**: CDFI loans are usually two to five years in length but can be longer. CDFIs like to match the length of investor loans with the length of the loans they make in the community. Housing loan periods can be very long, while business loans are rarely longer than five to seven years.
- **Interest rate**: Usually 0–5%, with many loans priced around 2%. Interest may vary with the length of loan.
- **Payment provisions**: Most CDFI loans are set up with regular interest-only payments. The principal amount is paid in lump sum at loan maturity. Very few CDFI loans are amortized to pay principal and interest throughout the loan term.
- **Reporting obligations**: Most foundations require quarterly or annual financial reports along with written reporting on the impact outcomes achieved by the CDFI.
- **Pledges of security**: A majority of CDFI investments are unsecured.
- **Default provisions**: These outline the conditions, usually non-payment, that will trigger the foundation to put the loan in default and proceed to try to collect the principal and interest due.
- **Covenants**: For example, some foundations require that the CDFI maintain a certain level of loan loss reserves or net unrestricted assets. These covenants are usually monitored by the CDFI's auditors.

"We have standard loan documents that we originally put together with legal counsel. They meet PRI requirements for our charitable purpose. Most CDFIs accept our proposed terms. A few push back on one or two things and we work through the terms."

KARLA MILLER
Program Director,
Northwest Area Foundation

"It helps everybody to have a standardized, transparent note. Ours is five years and collateralized if possible with UCC filings. Everyone knows exactly what we do, and why—it's not random.

We structure a few covenants after we understand what is normal financial performance for comparable institutions. We don't want burdensome covenants—we will cover a few specific risks from the underwriting, things that would signal calling in the capital."

SAYER JONES
Director of Mission
Related Investing,
Meyer Memorial Trust

Managing the Loan Relationship

Once the funds are "out the door," the relationship shifts to monitoring mode. Here are the main monitoring activities a foundation can expect:

RECEIVING PAYMENTS ON-TIME is the best and most obvious indication that a CDFI borrower is healthy and that the foundation loan is on track.

EXAMINING QUARTERLY FINANCIAL REPORTS and asking questions on any matters of concern.

GIVING SPECIAL ATTENTION TO THE ANNUAL AUDIT, especially its footnotes, where business practices and financial issues are most clearly laid out.

READING WRITTEN REPORTS AND MAKING SITE VISITS to see that their CDFI borrowers have achieved both the quantity and quality of impact promised.

CDFIs have proved to be very reliable borrowers with only a trace level of defaulting with investors. If the CDFI relationship proves fruitful, it is not unusual for foundations to renew a CDFI loan at term, rather than accept repayment of the loan principal. Most CDFIs will initiate a request for the foundation to consider renewing its investment about 12 months before the principal is due in a lump sum. This gives both parties time to plan for either paying or receiving the funds, and to revisit loan terms if the investment is to be renewed.

"We do a thorough annual assessment, reading all the financial statements, and having a conversation with the borrower. This is how you understand the environment in which the CDFI works. That is so important."

KARLA MILLER
Program Director,
Northwest Area Foundation

"We would like to be working with our CDFI partners 100 years from now. When you are a regional, place-based funder you have to think of CDFIs like family: you will need them at some point.

A strong and long-lasting relationship is the best way to work with a CDFI. As they work over time, they build relationships in the market. They build lending infrastructure. They figure out how to address particular financing challenges for particular kinds of lending."

SAYER JONES
Director of Mission
Related Investing,
Meyer Memorial Trust

Philanthropy Northwest is committed to building capacity for impact investing among our members. We are happy to share resources and connect you with other impact investors in the membership. Consultants at The Giving Practice can work directly with you and your board at any stage of your investing journey.

This publication was created by Rosalie Sheehy Cates, Philanthropy Northwest Impact Investing Fellow, with financial support from Satterberg Foundation.

2101 Fourth Avenue, Suite 650
Seattle, WA 98121
206-443-8430

info@philanthropynw.org
philanthropynw.org
@philanthropynw
philanthropynw