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Impact Investing Through Community Development Financial Institutions (CDFIs)

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The current political and economic climate has focused attention on justice and values, leading more organization, advisors and clients to discuss social impact investing. We've seen companies like Netflix NFLX +2.2% invest $100 million to financial institutions that serve black communities. Twitter, PayPal PYPL +3.3% and Square SQ +7.3% followed suit instituting corporate initiatives combating racial injustice and poverty, using Community

Development Financial Institutions (CDFIs) as a primary vehicle. Even the government has gotten involved as the SBA used CDFIs to promote access to capital in the latest round of Paycheck Protection Program loans. And as we start Black History Month, this conversation will continue to resurface.

Despite being around for decades, many people still don't know what CDFIs are or how to use them. I want to give an overview of CDFIs and provide some useful resources for how you can use them to align your desire for social justice with your investing.

What is a CDFI?

CDFIs are private financial institutions that are 100% dedicated to delivering responsible, affordable lending to help low-income, low-wealth, and other disadvantaged people and communities join the economic mainstream. They focus on supporting economic growth at the community level, usually by financing small, minority-owned businesses, microenterprises, affordable housing, nonprofit and volunteer organizations, and services essential to revitalizing low-income neighborhoods. Their goal is to help people become financially self-sufficient while also contributing to economic growth through community redevelopment.

CDFIs establish relationships with their borrowers and help them navigate some of the technical, challenging aspects of owning and operating their own businesses. By financing such organizations, CDFIs spark job growth and retention in hard-to-serve markets across the nation. Ideally both borrowers and the CDFI win. Borrowers receive guidance that makes them more successful, while the CDFI gains deeper knowledge of the local market and community. Also, by providing technical assistance, CDFIs increase the likelihood that the borrower will be successful and pay back their loan, thus generating new funds to be lent.

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CDFIs fall into four categories:

- ***Community development banks***: These federally insured banks are organized like traditional banks. but they are required to direct at least 60% of their financing to low- and moderate-income communities.
- ***Community development credit unions***: These cooperatives are designed to provide financial services to their individual members. The National Credit Union Administration charters, supervises, and insures federal credit unions and insures the deposits up to $250,000 per share owner, per insured credit union.
- ***Community development loan funds***: These funds lend to build local businesses, affordable housing, and community facilities. Their borrowers are small businesses, nonprofit organizations, charter schools, individuals, and organizations involved in community development projects. Loan funds also provide financial counseling to individual and business borrowers.
- ***Community development venture capital Funds***: Venture capital funds pool investor money to make equity investments in private operating companies that yield financial returns while accomplishing community development goals. They also provide

equity and management expertise to small businesses, often owned by minorities, that have the potential for rapid growth.

Like many mission-driven businesses, CDFIs strive to be profitable, but profits aren't their only or even their main goal. They put community first, not the shareholder. They measure their success through their impact on the communities they serve. They also focus on social responsibility and inclusion.

The impact and performance of CDFIs

The Riegle Community Development and Regulatory Improvement Act (Riegle Act) of 1994 established the CDFI Fund FISI +1.5%, which certifies CDFIs, as part of the U.S. Department of Treasury. The fund has certified more than 1,100 CDFIs. They exist in every state and the District of Columbia, serving both rural and urban communities. Nationwide, the CDFI industry manages more than $222 billion, creating jobs, affordable housing, financial health, and opportunity for all.

According to the Opportunity Finance Network (OFN), a network of CDFIs, through its fiscal year 2018, its member CDFIs provided more than $75 billion in lending. This led to the creation or maintenance of 1.56 million jobs, the start or expansion of 419,150 businesses and microenterprises, and the development or rehabilitation of over 2.1 million housing units and 11,592 community facility projects.

Not only do CDFIs provide effective and efficient funding to their communities, they continue to increase the amount of money that goes into local businesses. OFN member CDFIs experienced average growth rates in business lending of 7.2% during recessionary years (2007–2009) and 13.2% during post-recessionary years (2010–2016). For comparison, the U.S.

Small Business Administration (SBA) 7(a) loan rates averaged -13.6% during recession and 17.3% post-recession.

Not only did CDFIs increase business lending from 2007–2009 while SBA 7(a) lending decreased, they also had lower net charge-off ratios (the difference between gross charge-offs and any subsequent recoveries of delinquent debt). CDFIs averaged a 4.1% net charge-off ratio during this time compared to SBA's 7(a) 13.9%. From 2005–2016, net charge-off ratios for CDFI business lending averaged only 2.9% versus 6.5% for SBA 7(a) lending.

A research report conducted for the CDFI Fund's Office of Financial Strategies and Financial Research found that CDFI banks and credit unions "have no more risk of financial failure than mainstream financial institutions." It also found that, despite serving predominantly low-income markets, CDFI banks and credit unions "had virtually the same level of performance" as mainstream financial institutions, and in fact CDFIs were even "more efficient than mainstream institutions."

How to invest in CDFIs

CDFIs receive most of their funding from three sources: banks, the federal government, and institutional investors. Despite their varied funding sources, the demand for capital still outweighs the supply. This is where individual investors like you can come in.

The most common type of CDFI investment is through a community development loan fund. Loan funds pool capital from many investors to reduce risk by diversifying their loan portfolios. Several funds now have formal offerings and are registered to offer their notes in multiple states. Others operate less formally, and reach out to investors as an extension of their local fundraising efforts.

These investments have a large social impact, but they can also reduce overall volatility when incorporated into diversified portfolios. A Morgan Stanley study of more than 10,000 equity mutual funds over seven years, found that, on average, impact investing funds had lower volatility than comparable non-impact funds.

Calvert Impact Capital, a highly regarded, well-developed social impact organization, provides a variety of impact funds. You can directly invest online in Calvert's Community Investment Notes. Calvert's platform offers assessment tools that can save you time in trying to evaluate their impact investments.

For more investment options, check out CNote. This technology platform acts as a bridge between individual investors and CDFIs, pooling small investments and funneling them to partner with CDFIs. The platform supports a variety of account types and customers including personal, trust, and business accounts. The CNote Flagship Fund, for example, accepts investments from investors of any net worth. You can invest in certified CDFIs that are working to improve community development. You can also earn 2.75% with only a 30-month term and flexible quarterly liquidity if you need your money early. CNote also supports financial advisors who want to invest and manage their clients' funds. And, CNote partners with institutional investors, foundations, large banks, and other traditional financial institutions

Depository CDFIs, such as community development banks and credit unions, get capital from customers and nonmember depositors. So, you can invest directly with these institutions as well. These CDFIs generally offer a modest, fixed rate of return, depending on current interest rates and the length of the investment. OFN offers a searchable data base, which you can filter by the organization type, area served and lending type among other things. You can also find a state-by-state list of CDFIs here: cdfi.org/state-profiles/

Keep in mind that each CDFIs is different. There is no single model for CDFIs across the country because each one serves the needs of its local community. This makes it a little more difficult to evaluate the risk of an individual CDFI. You must conduct substantial due diligence to ensure a specific organization matches the risk profile, impact objectives, and financial strength you seek. Companies, such as Aeris give external ratings to help investors make sure their priorities are aligned before they invest.

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