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Community Development Financial Institutions (CDFIs): Overview and Selected Issues

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SUMMARY

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Community Development Financial Institutions (CDFIs): Overview and Selected Issues

The Community Development Financial Institutions (CDFI) Fund was created by the Riegle Community Development Regulatory Improvement Act of 1994 (P.L. 103-325) to promote economic development in distressed urban and rural communities. The CDFI Fund can certify banks, credit unions, nonprofit loan funds, microloan funds, and (for-profit and nonprofit) venture capital funds that can demonstrate having a primary mission of promoting community development. After certification, CDFIs become eligible for financial awards and other assistance provided by the CDFI Fund that promotes community development in markets comprised of economically distressed people and places.

CDFIs are essentially a type of public-private partnership established to advance financial inclusion, the policy goal designed to increase the accessibility of traditionally underserved populations and markets to affordable financial services and products. CDFIs accomplish this goal by serving people and businesses that traditional financial institutions cannot make their predominant focus. Higher-risk clients are more likely to have weak credit histories or face above-normal levels of income volatility, making them generally more costly to serve. Consequently, traditional institutions, which must manage their liquidity and other financial risks to support public confidence in the overall financial system, often focus primarily on markets consisting of higher credit quality borrowers rather than on higher-risk borrowers.

CDFIs are tasked with acquiring circumstantial and more granular information about customers with less traditional financial characteristics. CDFIs subsequently use this information to match their customers with suitable financial products. Because their portfolios consist of localized and highly customized loans made to higher-risk borrowers, CDFIs have limited access to the conventional markets where traditional financial institutions acquire the funds to originate loans. Instead, CDFIs rely on a combination of public and private funding that includes grants, awards, and donations. These subsidies are used to offset the heightened costs of loss mitigation efforts that CDFIs incur while advancing their financial inclusion mission. Consequently, these public and private subsidies arguably provide CDFIs a financial advantage over both traditional and subprime lenders that attempt to serve higher-risk clients.

The CDFI business model requires both public and private subsidies for several reasons. Private funding is needed to supplement any gaps in public funding, which may occur following government budgets cuts or modification of requirements. The ability to obtain private sector funding may also signal a CDFI's expertise with respect to serving higher-risk clients or serve as an endorsement of a CDFI's specific mission-related activities. Furthermore, a substantive share of private sector funding mitigates the risk that a CDFI would shift to the public sector the additional costs and elevated default risks that stem from serving higher-risk clients.

Public and private stakeholders are interested in the CDFI industry's ability to help higher-risk clients gain access to capital and succeed, but measuring and evaluating that performance is difficult. Because CDFIs must engage in more default mitigation activities compared to traditional financial institutions, the interpretation of metrics used to measure their financial strength and performance is more ambiguous. Furthermore, data collection gaps and other issues complicate the ability to directly link CDFIs' activities to their clients. Even if more data were available, however, CDFIs' customers in underserved areas face greater income volatility and would be expected to fail more often than conventional borrowers. In short, measuring the extent that CDFI activities in underserved markets are advancing financial inclusion is challenging.

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Introduction

The Community Development Financial Institutions (CDFI) Fund was created by the Riegle Community Development Regulatory Improvement Act of 1994 (P.L. 103-325)[1] within the U.S. Department of the Treasury to promote economic development in distressed urban and rural communities, particularly through certifying and supporting CDFIs.[2] The CDFI Fund is authorized to certify banks, credit unions, nonprofit loan funds, microloan funds, and (for-profit and nonprofit) venture capital funds as designated CDFIs. Financial institutions that wish to become CDFIs must meet specified eligibility criteria, such as demonstrating that their primary mission is to promote community development by serving economically distressed people and places.[3] With the CDFI designation, these institutions are eligible to receive financial awards and other assistance from the CDFI Fund.[4]

Congress has formalized systems for various categories of financial intermediaries—such as banks, credit unions, the Federal Home Loan Bank System, and CDFIs—all of which facilitate linking borrowers with savers.[5] When creating these formal systems, Congress usually encourages covered financial intermediaries—even if they predominantly serve more creditworthy borrowers—to provide financial services and products to underserved populations and markets when feasible to do so and in a prudent manner. The CDFI Fund and designated CDFIs, however, were established to focus predominantly on financially distressed borrowers and areas.[6] CDFIs, which are essentially a type of public-private partnership, promote accessibility of traditionally underserved populations and markets to affordable financial services and products, the policy goal generally referred to as *financial inclusion*.[7]

Traditional financial institutions generally do not focus primarily on customers with higher default propensities, referred to as subprime borrowers, due to profitability and risk exposure concerns. Subprime customers often require more labor-intensive counseling, underwriting, monitoring, and servicing (e.g., loan workouts) to mitigate even costlier outcomes (e.g., defaults) that would negatively affect both borrowers and lenders. They also often require nontraditional

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[1] See U.S. Department of the Treasury, "Community Development Financial Institutions Fund," http://www.cdfifund.gov/who_we_are/about_us.asp.

[2] See Federal Reserve Bank of Richmond, *Community Development Financial Institutions: A Unique Partnership for Banks*, Special Issue 2011, pp. 1-7, https://www.richmondfed.org/~/media/richmondfedorg/community_development/resource_centers/cdfi/pdf/cdfi-special-2011.pdf.

[3] For more information, see CDFI Fund, "CDFI Certification," https://www.cdfifund.gov/programs-training/certification/cdfi.

[4] Office of the Comptroller of the Currency (OCC), *CDFI Certification for National Banks and Federal Savings Associations*, March 2014, http://www.occ.gov/topics/community-affairs/publications/fact-sheets/fact-sheet-cdfi-certification.pdf.

[5] For background on the CDFI industry prior to the 1994 statute, see Nellie R. Santiago, Thomas T. Holyoke, and Ross D. Levi, "Turning David and Goliath into the Odd Couple: How the New Community Reinvestment Act Promotes Community Development Financial Institutions," *Journal of Law and Policy*, vol. 6, no. 2 (1998), pp. 571-651.

[6] See CDFI Fund, *The CDFI Fund: Empowering Underserved Communities*, https://www.cdfifund.gov/sites/cdfi/files/documents/cdfi_brochure-updated-dec2017.pdf.

[7] The term *public-private partnership* is often used in the context of completing or operating large-scale government projects (e.g., infrastructure) with various percentages of funding support from the private sector. In this context, *public-private partnership* refers to using limited federal resources to attract private sector investment into low- and moderate-income communities. See CDFI Fund, "How Do the CDFI Fund's Programs Work?," https://www.cdfifund.gov/sites/cdfi/files/documents/cdfi_infogrpahic_v03aaf.pdf. For more information about financial inclusion efforts, see CRS Report R45979, *Financial Inclusion and Credit Access Policy Issues*, by Cheryl R. Cooper; and CRS In Focus IF11631, *Financial Inclusion: Access to Bank Accounts*, by Cheryl R. Cooper.

financial products (e.g., loans for short-term emergencies, credit repair). Thus, financial intermediaries must limit their exposure to above-normal risks and additional costs that could threaten both their actual and perceived financial well-being.

If broad financial stability concerns precipitate the neglect of higher-risk customers' needs, the CDFI industry's public-private partnership structure may be able to help fill the void.[8] CDFIs can absorb the increased risks and costs associated with subprime lending because they receive funding in the form of public and private subsidies, grants, and awards. Subsidized funds give CDFIs a cost advantage over both traditional and non-CDFI subprime lenders when offering financial services to higher-risk customers. This financial support also provides CDFIs with another funding source to meet cash flow (liquidity) needs typically faced by traditional financial institutions.

Measuring CDFIs' performance and effectiveness is challenging. Certain performance metrics are difficult to fully understand because the large volume of activity to mitigate default losses, which is essential when serving nontraditional borrowers, adds ambiguity to the usual interpretations. Data collection gaps also exist, particularly in regard to the lending activities of small institutions and small loans with nonstandardized (financial) characteristics.[9] Furthermore, greater income volatility experienced in underserved communities can undermine efforts facilitated by CDFIs toward financial inclusion.

This report begins with an overview of the CDFI industry. It then explains the target markets served by CDFIs as well as the higher costs associated with serving these niche segments. Next, challenges related to evaluating the performance and effectiveness of CDFIs are discussed. The CDFIs' public and private funding sources are summarized. Finally, the report provides considerations for Congress.

CDFI Industry: Composition, Size, Product Lines

Depository institutions (i.e., for-profit banks and nonprofit credit unions), loan funds, and venture capital funds may become designated CDFIs.

- Depository institutions provide financial services to savers (via accepting checking and savings deposits) and borrowers (via providing consumer and business loans). The deposits, generally insured by the federal government (up to an account limit), are a low-cost and largely stable source of funds to provide loans. Depositories also have prudential government regulators monitoring their financial safety and soundness practices. For example, depositories must hold reserves to buffer against financial losses due to borrowers' defaults. Many CDFI depositories consist of small community banks (defined in this report as having $1 billion in assets or less) and similarly sized or smaller credit unions.[10]

[8] See Brent C. Smith, "The Sources and Uses of Funds for Community Development Financial Institutions: The Role of the Nonprofit Intermediary," *Nonprofit and Voluntary Sector Quarterly*, vol. 37, no. 1 (March 2008), pp. 19-38.

[9] See CRS In Focus IF11742, *Too Small to Collect Big Data: Financial Inclusion Implications*, by Darryl E. Getter.

[10] A more extensive definition of a *community bank* incorporates its functions along with asset size. See Federal Deposit Insurance Corporation (FDIC), *FDIC Community Banking Study*, December 2012, http://www.fdic.gov/regulations/resources/cbi/report/cbi-full.pdf; and CRS In Focus IF11048, *Introduction to Bank Regulation: Credit Unions and Community Banks: A Comparison*, by Darryl E. Getter.

- Nonprofit and micro loan funds, which tend to target specific projects, are nondepository financial entities without access to federally insured deposits.[11] Instead, loan funds rely on multiple fundraising strategies.[12] Loan funds borrow or accept grants and awards from public or private sources. Various types of private sector investors include pension funds, university endowments, various types of financial institutions, (philanthropic) foundations, and individuals. Some of these private sector sources may donate funds. Loan funds also adopt various types of business models. *Revolving* loan funds, which rely upon the repayment of principal and interest to replenish funds that were used to make loans, can reduce some dependence on ongoing grant support.[13] Their ability to make new loans, however, may still be limited until after various percentages of the outstanding balances of existing loans are repaid.[14] Some loan funds issue debt securities to investors (in exchange for cash) that must be repaid with interest, and some micro loan funds may use crowdfunding.[15]
- For-profit and nonprofit venture capital funds are non-bank financial entities that make equity investments rather than loans. When providing funds, venture capital firms do not receive repayments of principal and interest as in the case of a traditional loan obligation. Instead, they have ownership interests (equity stakes) and receive an unspecified return linked to the fluctuating value of a specific investment. A CDFI venture capitalist, for example, may invest directly in a startup or a small business located in an underserved area.

As of September 30, 2021, the CDFI Fund reported 1,271 certified CDFIs that were comprised of 566 (45%) loan funds and 16 (1%) of venture capital funds, which do not collect federally insured deposits; and 387 (30%) credit unions, 168 (13%) banks, and 134 (11%) depository institution holding companies, which collect federally insured deposits.[16] Thus, loan funds make up the largest share of CDFIs. However, 689 (54%) of the CDFI industry consists of banks and credit unions that interact directly with the public. The CDFI Fund also reported that CDFI credit unions held 61.1% of all CDFI industry assets in 2020.[17]

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[11] Some loan funds may be referred to as community development loan funds. For more information, see OCC, *Community Development Loan Funds: Partnership Opportunities for Banks*, October 2014, https://www.occ.gov/publications-and-resources/publications/community-affairs/community-developments-insights/pub-insights-oct-2014.pdf.

[12] Despite not having prudential regulators, loan funds are subject to the applicable disclosure and investor protection regulations promulgated by the Securities and Exchange Commission (SEC).

[13] For more information about loan funds as well as an example of a type of loan funds, see CRS In Focus IF11449, *Economic Development Revolving Loan Funds (ED-RLFs)*, by Julie M. Lawhorn.

[14] See Charles Tansey et al., *Capital Markets, CDFIs, and Organizational Credit Risk* (Durham, NH: Carsey Institute, 2010), p. 4, https://www.cdfifund.gov/sites/cdfi/files/documents/capital-markets-cdfis-and-organizational-credit-risk.pdf.

[15] See SEC, "Updated Investor Bulletin: Crowdfunding for Investors," May 10, 2017, https://www.sec.gov/oiea/investor-alerts-bulletins/ib_crowdfunding-.html.

[16] See Department of the Treasury, Office of Inspector General, *Audit of the Community Development Financial Institutions Fund's Financial Statements for Fiscal Years 2021 and 2020*, December 15, 2021, p. 12, https://www.cdfifund.gov/sites/cdfi/files/2021-12/FY2021_Agency_Financial_Report.pdf.

[17] Although credit unions have membership restrictions, they are allowed to add underserved areas to their membership fields and provide financial services in those designated areas. See National Credit Union Administration (NCUA), "Expanding Service to Underserved Areas: Application Guidance," https://www.ncua.gov/support-services/credit-union-resources-expansion/field-membership-expansion/serving-underserved/expanding-service-underserved-areas-application.

The CDFI industry represents a small percentage of the overall U.S. financial system. In 2020, the 1,271 CDFIs collectively held $151.8 billion in assets (loans).[18] By comparison, the credit union industry in 2020 consisted of 5,099 federally insured institutions that collectively held $1.16 trillion in assets, and 4,074 small community banks, defined as having $1 billion or less in total assets, collectively held $1.158 trillion in assets.[19] The CDFI industry is approximately 13% of the credit union industry's size, 13% of the small community banks' size, or 6.5% of both groups combined. The CDFI industry size would fall to 3.5% if their total assets were calculated as a percentage of total assets held by credit unions and all community banks (if community banks are defined as having $10 billion or less in assets). Furthermore, if these calculations included assets held by all depositories and other nondepository financial institutions (without CDFI designations), then the percentage of CDFI representation in the U.S. financial system would be less than 1%.

The primary product lines of CDFIs are consumer, residential real estate, and small business loans. By the end of FY2020, the CDFI Fund reported that the *consumer finance* category accounted for 36.8% of the dollar amount and 83.2% of the products offered by CDFIs.[20] The consumer finance category includes loans for health, education, emergency, credit repair, debt consolidation, and other consumer purposes. These products are likely to consist of payday alternative loans, secured credit cards, prepayment cards, or installment loans.[21] In addition, CDFIs provide mainstream financial products with longer-term maturities such as residential mortgages, automobile loans, and student loans. The *residential real estate financing* category, which represents 34.7% of the dollar amount but 6% of the products offered, includes loans for the purchase, construction, and renovation of single-family residential and rental housing as well as for multifamily housing. Credit cards, which are revolving loans that allow for continuous access to credit as long as borrowers make at least periodic minimum payments, are also considered a mainstream financial product despite being open-ended without a definite maturity date. (CDFI depositories can also offer mainstream checking and savings accounts.) The CDFI Fund, however, does not report a ratio of consumer products with more mainstream features relative to those without, which could inform about the extent CDFI customers are eligible to use traditional financial products to meet their needs.

Additionally, a Federal Reserve survey of CDFIs—which was conducted in 2021 and received 345 responses, representing 27% of all certified CDFIs—found that many CDFIs, particularly CDFI loan funds, reported small business lending to be their primary or secondary line of business.[22] Although not as prominent, CDFIs provide credit products to finance multifamily

[18] See Department of the Treasury, Office of Inspector General, *Audit of the Community Development Financial Institutions Fund's Financial Statements for Fiscal Years 2021 and 2020*, p. 12.

[19] See NCUA, *2019 Annual Report*, https://www.ncua.gov/files/annual-reports/annual-report-2020.pdf; and FDIC, *Quarterly Banking Profile Fourth Quarter 2020*, https://www.fdic.gov/analysis/quarterly-banking-profile/fdic-quarterly/2021-vol15-1/fdic-v15n1-4q2020.pdf. Because the banking industry is comparably larger than the credit union industry, a *small community bank* is defined as having assets of $1 billion or less in this report. For 2020, the banking industry held $21.884 trillion in assets. Using the $10 billion definition of *community bank*, this segment of the banking system held $3.2 trillion in assets in 2020. For more information, see CRS In Focus IF11048, *Introduction to Bank Regulation: Credit Unions and Community Banks: A Comparison*, by Darryl E. Getter.

[20] See CDFI Fund, *CDFI Annual Certification and Data Collection Report (ACR): A Snapshot for Fiscal Year 2020*, October 2021, https://www.cdfifund.gov/sites/cdfi/files/2021-10/ACR_Public_Report_Final_10062021_508Compliant_v2.pdf.

[21] Credit unions offer payday alternative loan products. For more information, see CRS Report R44868, *Short-Term, Small-Dollar Lending: Policy Issues and Implications*, by Darryl E. Getter.

[22] See Surekha Carpenter et al., *2021 CDFI Survey Key Findings*, Federal Reserve System, August 12, 2021, https://fedcommunities.org/data/2021-cdfi-survey-key-findings/.

(e.g., apartment buildings, senior residence facilities and nursing homes) and commercial (e.g., medical and healthcare facilities, educational facilities) structures.

CDFI Niche Markets

Financial institutions serve different market segments.[23] CDFIs serve a specific customer segment that is more costly for traditional financial intermediaries to serve, as explained in this section.

Defining and Reporting of Target Markets

CFDIs must have a primary mission of promoting community development to maintain certification and qualify for financial assistance awards. The CDFI Fund requires that 60% of a CDFI's financial products (e.g., loans) must be deployed in an approved *target market* or *eligible market*, which is defined as one or more (1) investment areas or (2) targeted populations.[24]

- *Investment area* refers to a geographic area that meets requirements set forth in Title 12, Section 1805.201(b)(3)(ii)(D), of the *Code of Federal Regulations* and would have a significant unmet need for loans, equity investments, or other financial products or services or is wholly located within an Empowerment Zone currently in effect or Enterprise Community (as designated under Section 1391 of the Internal Revenue Code of 1986 [26 U.S.C. 1391]).[25]
- For a specified geographic area, target populations consist of individuals from the following populations. First, *low-income targeted population* is defined as individuals whose family income, adjusted for family size, is *not more than* (1) for metropolitan areas, 80% of the area median family income in metropolitan areas; and (2) for nonmetropolitan areas, the greater of 80% of the area median family income or 80% of the statewide nonmetropolitan area median family income. Second, other targeted populations include African Americans, Hispanics, Native Americans, Native Alaskans residing in Alaska, Native Hawaiians residing in Hawaii, other Pacific Islanders residing in other Pacific Islands, and other groups with CDFI Fund approval.

[23] For example, wholesale banks provide services to large clients, such as large corporations and other financial institutions, rather than retail clients, such as individuals and small businesses. Individual credit unions serve customers that share an occupational or geographical association. Limited purpose banks offer a narrow product line such as a concentration in credit card lending.

[24] See 12 C.F.R. §1805.201, Certification as a Community Development Financial Institution, https://www.law.cornell.edu/cfr/text/12/1805.201; CDFI Fund, *CDFI Program & NACA Program SF-424 & TA Application Guidance*, February 18, 2021, p. 45 Appendix A, https://www.cdfifund.gov/sites/cdfi/files/2021-05/3_FY21_CDFI_NACA_TA_Application_Guidance.pdf; CDFI Fund, "Update from CDFI Fund Director Jodie Harris: CDFI Fund Expands Target Market Eligibility for Payroll Protection Program Lending," December 9, 2020, https://www.cdfifund.gov/news/402; and CDFI Fund, *CDFI Program & NACA Program: SF-424, Base-FA Application, and Supplemental FA Applications Guidance*, February 18, 2021, p. 33, https://www.cdfifund.gov/sites/cdfi/files/2021-02/3.%20FA%20Application%20Guidance%20FY%202021.pdf. The CDFI Fund appears to use the terms *target market* and *eligible market* interchangeably.

[25] For more information about equity investments, see Beth Lipson, "Equity Equivalent Investments," *Community Investments*, vol. 14, no. 1 (March 2002), pp. 10-12, https://www.cdfifund.gov/sites/cdfi/files/documents/(22)-equity-equivalent-investments.pdf. For more information about Empowerment Zones and Enterprise Communities, see CRS Report R41639, *Empowerment Zones, Enterprise Communities, and Renewal Communities: Comparative Overview and Analysis*, by Donald J. Marples.

The CDFI Fund administers the Bank Enterprise Award (BEA), which relies upon two definitions—*distressed communities* and *persistent poverty counties* (PPCs)—to define the market that a CDFI bank must serve to qualify for the award.

- A distressed community must be a continuous area of general local government that (1) has a population of at least 4,000 if located in a metropolitan statistical area; (2) has a population of at least 1,000 in nonmetropolitan areas; or (3) is located entirely within an Indian reservation.[26] Additionally, at least 30% of eligible residents in the community must have incomes below the national poverty level (as published by the U.S. Census Bureau), and the community must have an unemployment rate at least 1.5 times greater than the national average (as determined by the U.S. Bureau of Labor Statistics' most recent data).[27]
- A PPC is any county, including county equivalent areas in Puerto Rico, that has had 20% or more of its population living in poverty over the past 30 years or any other territory or possession of the United States that has had 20% or more of its population living in poverty over the past 30 years, as measured by the U.S. Census Bureau.[28] PPCs do not need to be located in a CDFI's approved target market. However, only qualified activities that occur in areas determined by the CDFI Fund to be distressed communities will count toward eligibility for a BEA award.[29] The CDFI Fund adopted these administrative procedures to ensure that at least 10% of funds designated for the BEA are used to support PPCs.[30]

The CDFI Fund also relies upon CDFIs to serve communities with specific needs. In addition to the PPCs, the CDFI Fund provides supplementary awards to support the following programs:

- The Healthy Food Financing Initiative is part of a multiagency effort to combat food deserts.[31] The CDFI Fund provides grants to CDFIs that subsequently target organizations serving low-income neighborhoods with limited access to affordable and nutritious food.
- The CDFI Fund initiated a capacity-building program to expand credit and other financial services to people with disabilities. Disabilities may increase the difficulty to maintain gainful employment, thus increasing the difficulty to qualify for financial loan products provided by traditional financial institutions.

[26] 12 C.F.R. §1806.200(b)(1).

[27] See CDFI Fund, "Bank Enterprise Award Program," https://www.cdfifund.gov/programs-training/programs/bank-enterprise-award.

[28] Specifically, the data from U.S. Census Bureau includes the decennial censuses, the American Community Survey, and the Island Areas Decennial Census. For more information, see "Persistent Poverty Counties—CDFI Fund," https://view.officeapps.live.com/op/view.aspx?src=https%3A%2F%2Fwww.cdfifund.gov%2Fsites%2Fcdfi%2Ffiles%2F2021-05%2F12_FY21_CDFI_NACA_Persistent_Poverty_Counties_2011_2015_ACS_and_Island_Areas_Decennial_Census.xlsx.

[29] See CDFI Fund, *Bank Enterprise Award Program 2020 CIMS User Instructions*, https://www.cdfifund.gov/sites/cdfi/files/documents/7.-fy-2020-bea-program-application-cims-instructions.pdf.

[30] See CDFI Fund, *Expanding Opportunity: The CDFI Fund's FY 2019 Year in Review*, https://www.cdfifund.gov/sites/cdfi/files/documents/cdfi_annual-report-2019_final-3.30.20_508_final.pdf.

[31] Other agencies involved in the HHFI include the Departments of the Treasury, Agriculture, and Health and Human Services.

The demographic characteristics for this program include people with autism, veterans, elderly, and generally people who may be impaired from working.[32]

- The Economic Mobility Corps (EMC) is a joint initiative of the CDFI Fund and AmeriCorps designed to enhance the capacity of CDFIs to provide financial literacy, financial planning, budgeting, saving, and other financial counseling.[33] EMC volunteers receive training in financial counseling and financial literary and are then placed in various CDFIs to work with residents in target markets and eligible markets.[34] Any organization—and not just CDFIs—may apply for EMC awards to place AmeriCorps service volunteers in CDFIs.

In 2016, the CDFI Fund required CDFIs to submit Annual Certification and Data Collection Reports (ACR).[35] The CDFI Fund uses ACRs to ensure that its awards are disbursed to intermediaries predominantly engaged with serving the people and communities consistent with its mission. ACR data may also facilitate better understanding of the types of financial products obtained by customers and the development of a policy map comprised of CDFI target markets.

In 2020, the CDFI Fund solicited public comments on proposed data modifications to ACR and to introduce the Certification Transaction Level Report, which is designed to standardize and automate the data collection process.[36] Additionally, the CDFI Information Mapping System (CIMS), which maps census tracts and counties based upon the CDFI Fund's various program criteria, would identify the localities that either fully or partially qualify as distressed communities.[37] Since October 1, 2012, CDFIs have been required to use the U.S. Census Bureau data, available at CIMS, to designate and reaffirm their target markets.[38]

[32] See CDFI Fund, "Access for All: Expanding CDFI Market Impact in the Disability Community," https://www.cdfifund.gov/programs-training/training-ta/access-for-all; and CDFI Fund, *Expanding the Capacity of CDFIs to Serve People with Disabilities*, December 4-5, 2019, https://www.cdfifund.gov/sites/cdfi/files/documents/in-person-workshop-training-presentation.pdf.

[33] See CDFI Fund, "Apply Now for $1.9 Million in FY 2022 Economic Mobility Corps Funding," September 24, 2021, https://www.cdfifund.gov/node/1004951; and AmeriCorps, "AmeriCorps and CDFI Fund Launch Economic Mobility Corps," press release, August 11, 2021, https://americorps.gov/newsroom/press-release/americorps-cdfi-fund-launch-economic-mobility-corps. For more information about AmeriCorp, see CRS Report RL33931, *The Corporation for National and Community Service: Overview of Programs and Funding*, by Joselynn H. Fountain and Abigail R. Overbay.

[34] For more information, see CRS Report R46941, *Financial Literacy and Financial Education Policy Issues*, by Cheryl R. Cooper.

[35] See CDFI Fund, "CDFI Certification, Step 2: Reporting," https://www.cdfifund.gov/programs-training/certification/cdfi/reporting-step.

[36] See CDFI Fund, "Agency Information Collection Activities; Proposed Collect: Comment Request," 85 *Federal Register* 27274-27275, May 7, 2020; and CDFI Fund, "Annual Certification and Data Collection Report and Certification Transaction Level Report: Overview of Request for Public Comment," May 2020, https://www.cdfifund.gov/sites/cdfi/files/documents/slides-ctlr-and-acr-may-final.pdf.

[37] See CDFI Fund, "Community Development Financial Institutions Fund Mapping System (CIMS)," https://www.cdfifund.gov/Pages/mapping-system.aspx.

[38] See CDFI Fund, "Target Markets Based on 2011-2015 American Community Survey Census Data," October 1, 2018, https://www.cdfifund.gov/news/325.

Banking Deserts, Remote Banking, and Physical CDFI Locations

A banking desert exists in a census tract area with no physical financial institutions, such as a credit union or bank branch, located within a 10-mile radius from the tract's center.[39] (In addition to banks and credit unions, a *financial services desert* also lacks a physical presence of check-cashing, payday loan, and other non-bank alternative financial service providers.) Areas with banking deserts tend to have low-income and minority populations, higher housing vacancy rates, and are more likely to occur in rural tracts.[40] The concern that banking deserts may rise increases with the decline in the number of physical branches.[41]

Although the demand for physical branch services may have decreased more broadly as online banking services have grown, a physical CDFI location may still be useful for the following reasons.[42] Banking deserts, particularly those in rural areas, may lack broadband access.[43] Online financial services cannot be provided without broadband access as well as secure (encrypted) WiFi access. In addition, rather than collecting traditional financial information in digital form, CDFIs collect *soft* information, which requires detailed elaboration and is normally collected from customers in person at physical locations.[44] Furthermore, CDFIs may need to stay in close geographical proximity to their customers to monitor their changing financial circumstances as well as any collateral (e.g., local real estate) used to secure any loans. For these reasons, even though offering more web-based and mobile banking services may reduce costs, CDFIs may face challenges attempting to automate some services.[45] Generally speaking, banks (or other financial institutions) in vulnerable locations tend to be vulnerable themselves to the localized financial risks faced by their clientele.[46]

The Higher Costs to Serve and Service Target Markets

Given the target market requirements, certified CDFIs are likely to be principally engaged in *risk-based* or *subprime* lending.[47] CDFI customers with impaired or limited credit histories typically

[39] See Drew Dahl and Michelle Franke, "Banking Deserts Become a Concern as Branches Dry Up," Federal Reserve Bank of St. Louis, July 25, 2017, https://www.stlouisfed.org/publications/regional-economist/second-quarter-2017/banking-deserts-become-a-concern-as-branches-dry-up. Similarly, a Community Reinvestment Act desert is a location where banks do not have a large concentration of deposits. See OCC, "Community Reinvestment Act Regulations," 85 *Federal Register* 34748, June 5, 2020.

[40] See CDFI Fund, *BEA Program Awardee Provides Affordable Banking Access to Rural Alabamans: United Bank, Atmore, Alabama*, January 13, 2020, https://www.cdfifund.gov/sites/cdfi/files/documents/bea-impact-story-1-13-20c.pdf.

[41] See Dahl and Franke, *Banking Deserts Become a Concern*.

[42] See Donald P. Morgan, Maxim L. Pinkovskiy, and Bryan Yang, "Banking Deserts, Branch Closings, and Soft Information," Federal Reserve Bank of New York, March 7, 2016, https://libertystreeteconomics.newyorkfed.org/2016/03/banking-deserts-branch-closings-and-soft-information/.

[43] *Broadband access* refers to the ability to transmit data over a high-speed internet connection, which enhances commercial, educational, and social activities. See U.S. Government Accountability Office (GAO), *Broadband: FCC Is Taking Steps to Accurately Map Locations That Lack Access*, September 2021, GAO-21-104447, https://www.gao.gov/assets/720/716822.pdf.

[44] For more information about soft information, see CRS In Focus IF11742, *Too Small to Collect Big Data: Financial Inclusion Implications*, by Darryl E. Getter; and Morgan, Pinkovskiy, and Yang, "Banking Deserts, Branch Closings, and Soft Information."

[45] See Thomas F. Siems and Jonathan A. Scott, "Adapting to the Digital Age: Community Bank Tech Usage," Conference of State Bank Supervisors, February 15, 2022, https://www.csbs.org/newsroom/adapting-digital-age-community-bank-tech-usage; and CDFI Fund, *Training Module: Organic Capital Growth—New Revenue Strategies*, https://www.cdfifund.gov/sites/cdfi/files/Documents/7%20Revenue%20Strategies_Training%20Deck.pdf.

[46] See Dahl and Franke, *Banking Deserts Become a Concern*; and David Benson, Serafin Grundl, and Richard Windle, "How Do Rural and Urban Retail Banking Customers Differ?," Board of Governors of the Federal Reserve System, June 12, 2020, https://www.federalreserve.gov/econres/notes/feds-notes/how-do-rural-and-urban-retail-banking-customers-differ-20200612.htm.

[47] There is no consensus definition of *subprime* relative to prime borrowers. The definitions may vary by certain attributes (e.g., personal or business credit scores, whether a derogatory incident appears on an applicant's credit history, whether the borrower received a loan from a lender specializing in lending to borrowers with impaired or

conduct fewer transactions with traditional depositories.[48] Small business startups that lack comprehensive financial and performance data or sufficient collateral to secure loans may be considered subprime borrowers.[49] Small businesses that operate in distressed communities may also be considered subprime borrowers that face less predictable revenues streams.[50] For example, developers of multifamily projects in CDFI target-market communities may face greater difficulty generating the cash flows necessary to repay loans without raising future rents on low- and moderate-income tenants, thus defeating the purpose of building affordable housing.[51] A survey of CDFIs corroborates that income loss was the most significant challenge facing their clients in 2020 and 2021.[52]

CDFIs, therefore, rely extensively on *relationship lending*, which allows lenders to better understand their customers' financial risks. Although relationship lending is also important for prime borrowers, it requires even more meticulous interaction with higher-risk consumers and businesses located in distressed communities—and also incurs more costs. Extensive relationship lending requires gathering *soft information*, which contains circumstantial details for borrowers with less traditional financial information and records.[53] By contrast, traditional data—such as credit scores, recent pay stubs or tax returns, business licenses for self-employed applicants, or other documentation pertaining to the ability to repay loans—is easily accessible and often convertible to a digital format.[54] For CDFIs, originating loans—evaluating lending risks, providing financial education programs, providing flexible underwriting criteria, offering less mainstream and more specialized financial products (e.g., credit repair, debt consolidation, and small-dollar loans for emergencies), and pricing loans—is typically a more manual process and generally more costly relative to automated processes that can be more readily adopted for traditional customers.[55]

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nonexistent credit histories). Furthermore, the financial attributes and thresholds to segment prime and subprime borrowers can vary by credit market (e.g., automobile loan, residential mortgage, business loan). For the purposes of this report, prime borrowers are those with traditional financial attributes that would be deemed creditworthy; subprime borrowers are those with nontraditional financial attributes that would increase the difficulty to be approved for credit.

[48] See Lehn Benjamin, Julia Sass Rubin, and Sean Zielenbach, "Community Development Financial Institutions: Current Issues and Future Prospects," *Journal of Urban Affairs*, vol. 26, no. 2 (2004), pp. 177-195.

[49] See CRS Report R45878, *Small Business Credit Markets and Selected Policy Issues*, by Darryl E. Getter.

[50] See Board of Governors of the Federal Reserve System, "Community Development Financial Institutions: Promoting Economic Growth and Opportunity, Speech by Chairman Ben S. Bernanke," November 1, 2006, https://www.federalreserve.gov/newsevents/speech/bernanke20061101a.htm; and Carla Dickstein et al., *The Role of CDFIs in Addressing the Subprime Mortgage Market: A Case Analysis of New England*, CDFI Fund, October 2008, https://www.cdfifund.gov/sites/cdfi/files/documents/the-role-of-cdfis-in-addressing-the-subprime-mortgage-market-a-case-analysis-of-new-england.pdf.

[51] See CRS Report R46480, *Multifamily Housing Finance and Selected Policy Issues*, by Darryl E. Getter.

[52] See Carpenter et al., *2021 CDFI Survey Key Findings*.

[53] See Matt Hanauer et al., "Community Banks' Ongoing Role in the U.S. Economy," Federal Reserve Bank of Kansas City, June 4, 2021, https://www.kansascityfed.org/research/economic-review/community-banks-ongoing-role-in-the-us-economy/; and Board of Governors of the Federal Reserve System, "Community Development Financial Institutions."

[54] See CRS Report R44125, *Consumer Credit Reporting, Credit Bureaus, Credit Scoring, and Related Policy Issues*, by Cheryl R. Cooper and Darryl E. Getter.

[55] With traditional, more standardized financial risks, borrowers can obtain more competitively priced loans. For more information regarding the costs of manual relative to automated underwriting of consumer loans, see Consumer Financial Protection Bureau, "Payday, Vehicle Title, and Certain High-Cost Installment Loans," 82 *Federal Register* 54472-54921, November 17, 2017. For more information on the use of quantifiable metrics by large banks and automated underwriting, see FDIC, *2018 FDIC Small Business Lending Survey*, https://www.fdic.gov/bank/historical/sbls/full-survey.pdf; American Bankers Association, *The State of Digital Lending: Results of an American Bankers*

After origination, loans require *servicing*, which can be done by a lender or contracted to a third party for a fee. For performing loans, servicing entails collecting and remitting the principal and interest payments. For a nonperforming loan, meaning that payment is not made in full or behind schedule, servicing requires greater monitoring of and interfacing with borrowers. Servicers may have to deploy various loss mitigation strategies such as forbearance or restructuring the initial loan terms. Thus, as in the case of underwriting, servicing CDFIs' customers is also more costly due to greater interaction with higher-risk customers to avert defaults.[56]

In small business lending, prospective clients sometimes lack the eligible collateral to secure a loan.[57] In these cases, lenders may require *loan (debt) covenants*, which are contractual requirements to assure that a borrower's initial financial standing at underwriting remains in place over the life of a loan.[58] For the duration of a loan, a borrower would be required to abide by one or more covenant terms such as providing audited financial statements, maintaining a minimum cash reserve, maintaining a constant debt-to-net assets ratio or other relevant financial ratios, or limiting new acquisitions or assets sales. Loan covenants, therefore, allow lenders to monitor changes in borrowers' financial conditions and better anticipate changes in default risk. Borrowers in violation of loan covenants typically risk paying penalties, having their loan rates increased, having to put forth more collateral, or having their loans terminated.

CDFI lenders, however, are likely to make greater use of loss mitigation strategies—rather than loan covenants with stringent financial consequences—to address higher default risks of small business borrowers operating in their target market areas. Furthermore, in comparison to non-CDFIs that deploy loan covenants that may contain financial consequences, CDFI lenders bear more costs following a rise in default risk especially with smaller size loans that are less likely to generate enough revenues to offset the additional servicing costs. In sum, CDFI lending costs more per transaction (relative to more traditional lending) given that the loan origination, servicing, and monitoring tasks are more demanding and labor intensive.

Evaluating Performance and Effectiveness of CDFIs

CDFIs fund a significant portion of their lending activities with financial awards from both public and private sector sources. By subsidizing the heightened costs and risks, the public and private sector funding allows CDFIs to facilitate the transitioning of nontraditional customers into mainstream financial markets, thus furthering financial inclusion goals. (In this report, the section entitled "Public and Private Funding Sources" summarizes the various funding awards and fundraising activities undertaken by CDFIs.) In view of the subsidies, public and private

Association Research Study, 2018, https://www.aba.com/Products/Endorsed/Documents/ABADigitalLending-Report.pdf; and CRS In Focus IF11742, *Too Small to Collect Big Data: Financial Inclusion Implications*, by Darryl E. Getter.

[56] See Nancy Andrews, "Strength in Adversity: Community Capital Faces Up to the Economic Crisis," *Federal Reserve Bank of San Francisco Community Investments*, vol. 21, no. 3 (Winter 2009/2010), p. 8, https://www.frbsf.org/community-development/files/andrews_nancy.pdf; and Federal Housing Finance Agency (FHFA), "Federal Home Loan Bank Membership for Community Development Financial Institutions," 75 *Federal Register* 678-704, January 5, 2010.

[57] For example, if a restaurant defaulted on a loan, a lender may not be able to recoup losses by attempting to resell an inventory of perishable food items.

[58] See Ronald J. Mann, "The Role of Secured Credit in Small-Business Lending," *Georgetown Law Journal*, vol. 86, no. 1 (1997), pp. 1-44.

stakeholders want to better understand CDFI performance and effectiveness. Measuring these criteria is difficult as a result of various data issues, discussed in this section.

Evaluating the Financial Performance of CDFIs

Prudential regulators generally require their regulated entities to demonstrate various levels of resiliency to key financial risks linked to their product lines.[59] Tailoring prudential standards for the CDFI industry is challenging because (1) CDFI financial institutions vary by type, and (2) each CDFI institution—including the ones that are of the same type—have portfolios consisting of localized and highly customized loans.[60] Despite these challenges, the CDFI Fund has adopted a set of minimum and prudent standards (MAPS), some described in **Table 1** at the end of this section, similar to the CAMELS composite rating system for prudentially regulated depositories.[61] Because CDFI depositories already have government prudential regulators, the MAPS are particularly useful to assess nondepository CDFIs such as loan funds that lack prudential regulators.[62]

CDFIs are required to report and substantiate MAPS metrics to signal their expertise in risk-based lending when applying for awards and grants as well as when raising funds from both the public and private sectors. CDFIs must demonstrate financial health to the CDFI Fund as well as other sponsors to avoid what may be referred to as a *misaligned incentive* problem in public-private partnerships, in which one partner shifts larger shares of risks and costs to the other partner.[63] In this case, acceptable MAPS demonstrate that a CDFI is not merely making higher-risk loans that would require costly loss mitigation. Having acceptable MAPS arguably reflects best practices and possibly some innovation in serving the higher-risk market segment. The CDFI Fund,

[59] Risks vary among financial institutions based upon the types of financial services they provide. For example, institutions that lend or provide insurance—but do not provide savings or checking services—face default risk and little daily liquidity risk. Depositories, however, face default risk and higher levels of liquidity risk due to their daily cash needs. Financial institutions specializing in higher-risk subprime borrowers may face higher default risks relative to those that serve more traditional prime borrowers. For this reason, prudential regulations, which can frequently be adopted in the form of various ratio requirements, can be tailored to fit different types of institutions.

[60] See Opportunity Finance Network, *CDFI Liquidity and Cash Management: Definitions, Practices, and Examples*, November 2015, https://cdn.ofn.org/uploads/2022/01/24093357/performance-counts-paper-liquidity-cash-management.pdf.

[61] The CAMELS acronym stands for Capital adequacy, Asset quality, Management capability, Earnings, Liquidity, and Sensitivity to various financial and market risks. A scale of 1 to 5 may be used, with 1 being the highest rating for the CDFI Fund. See CDFI Fund, "Fiscal Year 2021 CDFI Rapid Response Program Application Evaluation Process," https://www.cdfifund.gov/sites/cdfi/files/2021-02/4.%20CDFI%20RRP%20Evaluation%20Process.pdf; and CDFI Fund, "FY 2021 CDFI Program and NACA Program Base-Financial Assistance Application Evaluation Process," https://www.cdfifund.gov/sites/cdfi/files/2021-05/4_FY_2021_CDFI_NACA_Base_FA_Evaluation_Process.pdf. (For prudential regulators of depository institutions, 1 is the highest value and 5 is the lowest value for CAMELS ratings.)

[62] See CDFI Fund, "Appendix B: CAMELS Key Considerations and Ratios," https://www.cdfifund.gov/sites/cdfi/files/documents/camels-key-considerations-and-ratios.pdf; CDFI Fund, "Fiscal Year 2021 CDFI Rapid Response Program Application Evaluation Process;" Oweesta Corporation, *Native CDFI Capital Access Convening 2018*, June 12-14, 2018, https://www.oweesta.org/wp-content/uploads/2018/07/CAMELS-Session-2018.pdf; and Bethany Chaney, *Community Development Financial Institutions: A Study on Growth and Sustainability*, Mary Reynolds Babcock Foundation, June 2011, p. 36, https://www.cdfifund.gov/sites/cdfi/files/documents/(64)-cdfis-a-study-on-growth-and-sustainability.pdf. The CDFI Funds uses both MAPS and MPS acronyms for minimum and prudent standards.

[63] See Peter V. Schaeffer and Scott Loveridge, "Toward an Understanding of Types of Public-Private Cooperation," *Public Performance and Management Review*, vol. 26, no. 2 (December 2002), pp. 169-189; and Margaret H. Lemos and Guy-Uriel Charles, "Public Programs, Private Financing," *Law and Contemporary Problems*, vol. 81, no. 137 (2018), pp. 137-160.

therefore, takes into account MAPS (along with factors such as past track record) when determining whether and how much financial support to provide CDFI applicants.

In addition, MAPS are important when CDFIs seek funding from other sources. Banks require CDFIs to exhibit tolerable levels of financial health before providing financial support.[64] The Federal Home Loan Bank system requires member depository institutions to have prudential federal or state regulators; nondepository CDFIs must comply with MAPS to become members.[65] MAPS, therefore, may provide CDFI sponsors with some indication of a CDFI's ability to manage risk.

Interpreting individual MAPS at face value may provide limited information about the specific circumstances of an individual CDFI. For example

- The *deployment ratio*, computed as the gross number of loans outstanding divided by total available funds for lending, measures the amount of a CDFI's available funds that have been lent or invested. Deployment ratios vary by type and among individual CDFIs.[66] A low deployment ratio may indicate that a CDFI may need to increase lending volume. Some CDFIs, however, may not deploy all of their available funding for various reasons. Some applicants in target market areas pose excessive amounts of financial risk, which could jeopardize future public and private funding awards. Some CDFIs may lack staffing capacity to quickly process a volume increase in loan applications. Some CDFIs may face greater competition with non-CDFI lenders. Some CDFI depositories may not have sufficient amounts of capital or net worth reserves as required by their prudential regulators to buffer against the higher amounts of risk. One study found that both banks and loan funds cited that some prospective deals pose too much risk, CDFI banks in the study were more likely to cite greater competition, and loan funds were more likely to cite lack of staffing capacity.[67] A 2021 CDFI Survey found that over 75% of surveyed CDFIs cited limited staffing and funding as preventing them from providing more services.[68]
- The *self-sufficiency ratio*, the ratio of earned income to total operating expenses (over a year), can gauge a CDFI's need for financial assistance.[69] Interpretation of the self-sufficiency ratio, however, may not be straightforward.[70] The self-sufficiency ratio does not reveal information about a CDFI's default experience. A CDFI's other MAPS—such as its delinquency ratio, loan loss reserve ratio, portfolio at risk ratio, and change in portfolio at risk ratio—would also require examining. Nevertheless, CDFIs without prudential regulators would not be

[64] Specifically, banks are allowed to make investments to CDFIs that are at least *adequately capitalized* by their safety and soundness regulators. See FDIC, *Risk Management Manual of Examination Policies: Part II—CAMELS, 2.1 Capital*, http://www.fdic.gov/regulations/safety/manual/section2-1.pdf.

[65] See CRS Report R46499, *The Federal Home Loan Bank (FHLB) System and Selected Policy Issues*, by Darryl E. Getter.

[66] See Lolita Sereleas, Ruth Barber, and Moira Warnement, *Deployment Strategies for CDFI Small Business Lenders*, Opportunity Finance Network, January 2014, https://www.cdfifund.gov/sites/cdfi/files/documents/deployment_strategies_ta_memo.pdf.

[67] See Sereleas, Barber, and Moira Warnement, *Deployment Strategies for CDFI Small Business Lenders*.

[68] See Carpenter et al., *2021 CDFI Survey Key Findings*.

[69] See Chaney, *Community Development Financial Institutions*.

[70] See Valentina Hartarska, *Community Development Financial Institutions: Board Size and Diversity as Governance Mechanisms*, FDIC, September 2006, pp. 1-37, https://www.fdic.gov/analysis/cfr/working-papers/2006/2006-11.pdf.

required to write-off nonperforming assets or halt lending following a wave of defaults.[71] Likewise, because CDFIs tend to quickly intervene to mitigate losses stemming from distressed loans, the efficacy of those outcomes would not necessarily be captured by those ratios and still require further scrutiny. Lastly, the self-sufficiency ratio does not distinguish between the types of financial products a CDFI offers or whether the CDFI relies more on awards or more traditional funding.

Using multiple MAPS to assess CDFI performance while fulfilling their missions is still challenging, which may be illustrated using CDFI credit unions as an example. The CDFI Fund reported that CDFI credit unions had the highest deployment ratios in FY2020.[72] In addition, the mean self-sufficiency ratios of the 223 credit unions reporting in FY2020 was 1.0, which is above the 0.40 target for nonprofit firms shown in **Table 1** below. In FY2020, CDFI credit unions also reported the highest mean (per unit) amounts of total charge-offs, total recoveries, and loans 90 days or more past due. The funding awards to CDFI credit unions, therefore, subsidized the costs of loss mitigation activities that would have otherwise translated into large losses for traditional and subprime lenders without CDFI designations.[73] In other words, if the subsidies indirectly allow CDFIs to remain in compliance with their prudential reserve requirements, yet the higher costs and default losses incurred while serving these niche markets appear to be shifted onto sponsors rather than abated, then CDFIs may arguably benefit more from the subsidies than their customers.[74] Furthermore, determining the feasibility of expanding target markets arguably becomes more difficult when financial metrics have contradictory interpretations and information about CDFI profitability is limited.[75]

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[71] See Jeremy Nowak, *CDFI Futures: An Industry at a Crossroads*, Opportunity Finance Network, March 2016, p. 10, https://ofn.org/sites/default/files/resources/PDFs/Publications/NowakPaper_FINAL.pdf.

[72] See CDFI Fund, *CDFI Annual Certification and Data Collection Report (ACR): A Snapshot for Fiscal Year 2020*, October 2021, https://www.cdfifund.gov/sites/cdfi/files/2021-10/ACR_Public_Report_Final_10062021_508Compliant_v2.pdf.

[73] The aggregate amount of funding awarded by the CDFI Fund to credit unions or other financial institution by type in a fiscal year could not be confirmed when this report was published. The CDFI Fund did report that 18 credit unions received $19.4 million from the BEA program during FY2019 compared to four loan funds and one bank that collectively received $5 million. See CDFI Fund, *Expanding Opportunity*.

[74] Economic theory states that the *inelastic* side of a market, which would be less responsive to changes in prices as a result of having fewer choices, benefits more from a subsidy. In this case, higher-risk customers can choose among CDFIs and non-CDFI lenders (subprime and, under certain circumstances, prime) to obtain financial products. Thus market competition may still have a greater influence on market pricing than a subsidy. Because CDFIs must supply financial products primarily in target markets (and credit unions to their memberships), a subsidy is more likely to reduce the costs to serve their established clientele rather than to compete on price. For more information, see Robert Frank et al., *Principles of Microeconomics*, 8th ed. (McGraw-Hill, 2022). For more information on the field of membership and prudential requirements for credit unions, see CRS Report R46360, *The Credit Union System: Developments in Lending and Prudential Risk Management*, by Darryl E. Getter. In the economics banking literature, a *zombie* is defined as a weak financial institution that would be insolvent in the absence of subsidies, which distort the true costs of the default risks associated with serving unprofitable borrowers and can lead to a misallocation of credit that can reduce economic productivity and growth. For more information, see Joe Peek and Eric S. Rosengren, "Unnatural Selection: Perverse Incentives and the Misallocation of Credit in Japan," *American Economic Review*, vol. 95, no. 4 (September 2005), pp. 1144-1166; Ricardo J. Caballero, Takeo Hoshi, and Anil K. Kashyap, "Zombie Lending and Depressed Restructuring in Japan," *American Economic Review*, vol. 98, no. 5 (December 2008), pp. 1943-1977; and Viral Acharya, Simone Lenzu, and Olivier Wang, *Zombie Lending and Policy Traps*, working paper, October 29, 2021, https://voxeu.org/article/zombie-lending-and-policy-traps.

[75] See Michael Ogden, "New Partnership Announces a Bold CDFI Expansion Nationwide," *Credit Union Times*, December 17, 2020, https://www.cutimes.com/2020/12/17/new-partnership-announces-a-bold-cdfi-expansion-nationwide/. The CDFI Fund does not report the return on average assets for the CDFI industry or by institution type.

Another performance interpretation issue can arise when calculating the percentage of funds used by a CDFI in its target market. For example, a CDFI must have at least 60% of its financial activities, measured either in number or dollar amount of its total activities, occur in at least one eligible target market.[76] Suppose a CDFI depository made numerous small dollar loans in its target market area but only a few large (e.g., mortgage) loans outside of its target market area. In this case, the percentage of dollars deployed in a target market could fall below 60% even though 60% or more products were provided to the target market.[77] For this reason, the CDFI Fund has proposed lowering the minimum dollar threshold to 50%.[78]

Table 1. CDFI Fund's Minimum and Prudent Standards (MAPS): Selected Metrics, Definitions, and Key Considerations

MAPS Metric Name	Definition and Explanation	Considerations and Targets
Annual Net Charge-Off Ratio	The sum of total loans charged off minus recoveries, divided by total loans receivable.	Asset quality
Current Ratio	Total current assets divided by current liabilities.	Liquidity Target Value = 1.25 Target Value for Native CDFIs > 1.0
Deployment Ratio	The total gross loans outstanding divided by a CDFI's total available funds that can be used for lending.	Liquidity CDFI Fund historical target > 50%
Earnings Ratio (Income Ratio)	Total revenue divided by total expenses.	Earnings
Loan Loss (Reserves) Ratio	The total amount of loan loss reserves (that can be used to buffer against loan loss) divided by the total amount of loans outstanding. This ratio, which has similarities to certain bank capital-asset ratios, measures a CDFI's vulnerability to *anticipated* loan defaults.	Asset quality
Net Asset Ratio	Total net assets (equity) divided by total assets. This ratio, which has similarities to certain bank capital-asset ratios, measures a CDFI's vulnerability to *unanticipated* loan defaults.	Capital adequacy CDFI Fund Historical target > 20%
Net Income		Earnings Target value >0

[76] A CDFI that does not meet the 60% threshold in terms of either number or dollar amount can provide an explanation to the CDFI Fund, which has the right to accept or reject the explanation. See CDFI Fund, "Announcement Type: Notice and Request for Information," 82 *Federal Register* 2251-2254, January 9, 2017.

[77] See letter from Terry Ratigan, Senior CDFI Specialist, Inclusiv, to Tanya McInnis, Program Manager, Office of Certification, Compliance, Monitoring and Evaluation, CDFI Fund, November 4, 2020, https://www.inclusiv.org/wp-content/uploads/2020/11/Inclusiv-Comments-CDFI-Certification-Application-11-2020.pdf.

[78] See CDFI Fund, "Notice of Information Collection and Request for Public Comment," 85 *Federal Register* 27275-27278, May 7, 2020.

MAPS Metric Name	Definition and Explanation	Considerations and Targets
Operating Liquidity (Cash) Ratio	The total amount of unrestricted cash and cash equivalents divided by 25% of total operating expenses for the four most recently completed quarters, which measures whether a CDFI has sufficient liquidity to cover at least three months of operating expenses.	Liquidity Target value ≥1.0
Portfolio Concentration Risk	The percentage of loans outstanding to a particular industry divided by total loans in portfolio, which measures the degree of concentration a CDFI's lending portfolio has to risk stemming from a particular industry.	Sensitivity to future market changes and concentration risk
Portfolio at Risk	The total amount of loans delinquent by 30+, 60+, or 90+ days divided by the total outstanding loans in portfolio.	Asset quality Target values: Affordable Housing (First Lien) ≤ 7% Affordable Housing (Second Lien) ≤ 7% Business Loans ≤ 10% Consumer Loans ≤ 12%
Reliance on Largest Funding Source	Revenue from largest fund/total revenue.	Earnings
Self-Sufficiency Ratio	The ratio of earned income to total operating expenses [over a year].	Earnings Target for nonprofit CDFIs ≥ 0.40 Target for for-profit CDFIs ≥ 0.70
Troubled Debt Restructures (TDR) Ratio	TDRs/total loans receivable.	Asset quality

Sources: Oweesta Corporation and the CDFI Fund.

Note: The target values presented in this table, which have been obtained from an Oweesta presentation, should be interpreted as an informal guide and not as an official requirement of the CDFI Fund.

Evaluating the Effectiveness of CDFIs

The ability to directly link CDFIs' activities to improvements in financial inclusion is difficult due to various data collecting and reporting issues.

- Target areas with CDFI depositories might contribute to declines in unbanked or underbanked households, which can lead to establishing formal credit histories and transitioning to mainstream financial products. Neither the Federal Deposit Insurance Corporation (FDIC) survey of unbanked households nor its survey of household use of banking services, however, ask respondents, who are likely to lack familiarity with the CDFI Fund, whether they rely upon depositories with CDFI designations.[79] Furthermore, as previously discussed, a ratio of nontraditional to mainstream financial products that are included in the CDFI Fund's consumer finance category is not reported, which might also provide

[79] See FDIC, "2017 FDIC National Survey of Unbanked and Underbanked Households," December 17, 2021, https://www.fdic.gov/analysis/household-survey/2017/index.html; and FDIC, "How America Banks: Household Use of Banking and Financial Services," December 17, 2021, https://www.fdic.gov/analysis/household-survey/index.html.

insight about the extent CDFI intermediation lowers transaction and information costs in target markets.

- The Home Mortgage Disclosure Act of 1975 (HMDA; P.L. 94-200, 12 U.S.C. §§2801-2809) requires originators to disclose mortgage information to facilitate the monitoring of lending activity. On April 16, 2020, the Consumer Financial Protection Bureau (CFPB) issued a final rule implementing modified loan-volume thresholds for reporting open- and closed-ended loans via Regulation C.[80] Going forward, the revised thresholds are likely to have the greatest impact on HMDA data collected from less densely populated areas, although the overall impact on HMDA reporting may be minimal.[81] The specific effect of this change on CDFI mortgage reporting is ambiguous. Although raising the threshold would likely result in less reporting by rural CDFIs, it may not matter if these CDFIs were unable to provide enough traditional mortgages to higher-risk borrowers under the lower threshold.[82] Additionally, lenders that underwrite and make the mortgage credit decisions are responsible for HMDA reporting. Therefore, CDFIs that act as brokers on behalf of the ultimate lenders would not need to report.[83]
- CDFIs report on numbers and dollar amounts of small business lending in target markets, but the CDFI Fund may not collect credit applications information that may be useful for comparing applicant experiences from non-CDFIs that serve similar small businesses. On September 1, 2021, the CFPB issued a proposed rule for Section 1071 of the 2010 Dodd-Frank Wall Street Reform and Consumer Protection Act (P.L. 111-203).[84] Section 1071 requires financial institutions to collect data pertaining to credit applications for women-owned, minority-owned, and small businesses. The data would be reported annually to the CFPB, thus being conceptually similar to the HMDA database. Using CDFI Fund ACR data from FY2019, the CFPB estimates that 340 nondepository CDFIs are engaged in small business lending; 240 of these would meet the proposed reporting threshold of originating at least 25 covered credit transactions for small businesses in each of the two preceding calendar years. In addition, reporting financial institutions would likely be able to identify whether they are CDFIs, thus linking some small business lending activities to the CDFI industry. The CFPB received comments from stakeholders estimating that compliance with the rule (once finalized) may

[80] See CFPB, "Consumer Financial Protection Bureau Issues Final Rule Raising Data Reporting Thresholds Under the Home Mortgage Disclosure Act," April 16, 2020, https://www.consumerfinance.gov/about-us/newsroom/cfpb-issues-final-rule-raising-data-reporting-thresholds-under-hmda/; and CFPB, "Home Mortgage Disclosure Reporting Requirements (HMDA)," https://www.consumerfinance.gov/compliance/compliance-resources/mortgage-resources/hmda-reporting-requirements/.

[81] See GAO, Home Mortgage Disclosure Act: Reporting Exemptions Had a Minimal Impact on Data Availability, but Additional Information Would Enhance Oversight, GAO-21-350, May 17, 2021, https://www.gao.gov/assets/gao-21-350.pdf.

[82] See Emily Wavering Corcoran, "Follow the Money: Rural and Urban CDFIs in the Fifth District," Federal Reserve Bank of Richmond, December 19, 2019, https://www.richmondfed.org/research/regional_economy/regional_matters/2019/rm_12_19_2019_cdfis.

[83] The HMDA data do not provide an indicator for a reporting institution to indicate whether it is also a CDFI.

[84] See CFPB, "Small Business Lending Data Collection Under the Equal Credit Opportunity Act (Regulation B)," September 1, 2021, https://www.consumerfinance.gov/rules-policy/rules-under-development/small-business-lending-data-collection-under-equal-credit-opportunity-act-regulation-b/; and CFPB, "Small Business Lending Data Collection Under the Equal Credit Opportunity Act (Regulation B)," 86 *Federal Register* 56356-56606, October 8, 2021.

take up to three years, particularly for those nondepository CDFIs that were generally subject only to CDFI Fund reporting requirements.

For populations that lack access to the traditional financial system, income volatility may still undermine any progress made toward credit repair, reducing debt balances, increasing savings, and repaying small business loans—all efforts facilitated by CDFIs. In 2020 and 2021, CDFIs reported that the most significant factor facing their clients is the loss of income or revenue, which may arguably be considered an exogenous or random happenstance.[85] For this reason, measuring the effectiveness of this industry may still be challenging—even with greater data collection and reporting—given that their activities occur in areas characterized by above-normal levels of income volatility that CDFIs cannot control.

Public and Private Funding Sources

This section summarizes the public and private funding sources for CDFIs. For sake of comparison, the textbox below summarizes how traditional intermediaries obtain the funds to serve their clients with more standard financial risk attributes.

Traditional (Wholesale) Funding Methods and Liquidity Risks

Financial intermediators originate consumer loans, business loans, and purchase bonds—all of which are longer-term assets that can be held in their lending portfolios. Financial intermediaries obtain the funds used to make the loans via sequences of shorter-term borrowings. The *lending spread* is the difference between yield earned by making longer-term loans at higher interest rates and the yields paid from borrowing successive sequences of shorter-term loans at lower rates. Lending spreads generate profits (i.e., revenues minus costs) for financial intermediaries, particularly if they retain loans in their asset portfolios. (Some financial intermediaries, however, act more like brokers, meaning that they receive a fee for originating a loan on behalf of other financial entities that would subsequently create the lending spreads.)

Because profitable lending spreads are created using loans with different maturities, namely long-term loans (assets) funded with short-term loans (liabilities), access to cash or other short-term loans is vital. In addition to holding some cash reserves, depository intermediaries (i.e., banks and credit unions) can obtain short-term funding by collecting federally insured checking and savings deposits and paying interest to their depositors. Depositories and nondepository intermediaries, which do not have access to federally insured deposits, may obtain funds from *wholesale funding markets*, where financial intermediaries borrow and lend cash funds to each other. For example, an intermediary may enter into a repurchase agreement contract to sell an asset held in portfolio for cash and simultaneously commit to repurchase it on a future date at a higher price. The borrowed proceeds can be used to repay existing short-term loans or fund new longer-term customer loans. Some intermediaries may obtain cash funds by issuing their own debt securities, which are similar to bonds, to third-party investors. In sum, stable operations of traditional financial intermediaries and the financial system as a whole depends upon access to short-term loans and their timely repayment. (A systemic risk event, which has historically led to financial system disruptions, can emerge when financial entities begin to question whether they will receive timely payments from other financial entities.)

CDFIs—and particularly nondepository CDFIs—fund loans by relying considerably on *net assets* rather than short-term borrowing. Net assets are analogous to a bank's equity or a credit union's net worth, defined as the difference between assets (e.g., long-term consumer and business loans) and liabilities (e.g., short-term borrowings). CDFIs rely on net assets, which consist largely of subsidized and donated funds due to limited access to private funding markets, for the following reasons.[86]

[85] See Carpenter et al., *2021 CDFI Survey Key Findings*.

[86] See Mark Pinsky, *Growing Opportunities in Bank/CDFI Partnerships*, OCC, 2002, http://www.occ.gov/static/community-affairs/community-developments-newsletter/Summer-01.pdf.

- CDFI loan portfolios and particularly CDFI loan fund portfolios, which are typically comprised of loans with above-normal default risk levels, frequently lack sufficient comparable historical performance data on loan repayment patterns (e.g., loan defaults and prepayment rates).[87] Payment history lapses and geographical concentrations, which require manual underwriting of loan originations (as opposed to automated underwriting that would rely on greater data observations), limit the ability to compare or understand the embedded financial risks of niche CDFI loans and, therefore, raises questions about the accuracy of CDFI loan pricing.[88] For this reason, wholesale lenders either will not accept CDFI loans as collateral for short-term borrowings or charge much higher rates.[89] The pricing issues also limit the ability of CDFIs to sell loans in secondary loan markets. Thus, when providing funds to CDFIs, wholesale lenders must generally be willing to accept lower returns or longer investment horizons, which better suits the CDFIs' business model by alleviating the recurrent need to repay shorter-term loans.[90]
- Small financial institutions typically lack loan portfolios sufficiently large enough to justify the expense to acquire funding from wholesale market lenders, where many large financial entities borrow cash funds from each other. Consequently, the higher costs typically incurred with equity funding may still be a less expensive alternative for financial institutions with small loan portfolios.

The net assets of CDFIs are often acquired via awards or grants from the CDFI Fund, other federally related sources, for-profit banks, and philanthropy.[91] The low- and no-cost funding allows CDFIs to better absorb the heightened loss mitigation costs that can reduce bad outcomes for borrowers.[92] The ability to deploy low- or no-cost funding to originate loans for higher-risk borrowers provides CDFIs with a financial advantage over both traditional and subprime lenders competing in this market.

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[87] See Michael Swack, Jack Northrup, and Eric Hangen, *CDFI Industry Analysis: Summary Report*, University of New Hampshire Carsey Institute, May 2, 2012, https://www.cdfifund.gov/sites/cdfi/files/documents/carsey-report-pr-042512.pdf.

[88] See Charles Tansey et al., "Making Sense of CDFI Financial Statements," in *Capital Markets, CDFIs, and Organizational Credit Risk* (Durham, NH: Carsey Institute, 2010), p. 222, https://www.cdfifund.gov/sites/cdfi/files/documents/capital-markets-cdfis-and-organizational-credit-risk.pdf.

[89] For more information on how CDFIs typically fund loans, see Swack, Northrup, and Hangen, *CDFI Industry Analysis*.

[90] See GAO, *Community Development Capital Initiative: Status of the Program Investments and Participants*, GAO-15-542, May 2015, p. 17, https://www.gao.gov/assets/gao-15-542.pdf.

[91] See Willa Seldon and Isabelle Brantley, "Back to the Future: Why Philanthropies Should (Re)turn to CDFIs to Support an Equitable Recovery from COVID-19," Bridgespan Group, August 4, 2020, https://www.bridgespan.org/insights/library/philanthropy/why-philanthropies-should-re-turn-to-cdfis.

[92] Wolff and Ratcliffe (78-79) find that CDFI delinquency rates on first-lien loans may be high, but they are less likely to reach serious delinquency or foreclosure compared to Federal Housing Administration or subprime loans, which are the appropriate comparison for the level of risk of CDFI loans. Sarah Wolff and Janneke Ratcliffe, "The Role of CDFIs in Home Ownership Finance," October 2008, https://www.cdfifund.gov/sites/cdfi/files/documents/the-role-of-community-development-financial.pdf; and Carla Dickstein et al., "The Role of CDFIs in Addressing the Subprime Mortgage Market: A Case Analysis of New England," October 2008, https://www.cdfifund.gov/sites/cdfi/files/documents/the-role-of-cdfis-in-addressing-the-subprime-mortgage-market-a-case-analysis-of-new-england.pdf.

CDFIs' Access to Federally Subsidized Funding

The federal government provides CDFIs with low- or no-cost funds to support their mission of financial inclusion. After certifying CDFIs, the CDFI Fund administers the funding programs described below.[93] CDFIs may apply for the following programs administered by the CDFI Fund.

- **Financial Assistance (FA) and Technical Assistance (TA).** The CDFI Fund provides FA and TA monetary awards to qualified CDFIs.[94] The monetary awards, however, are subject to restrictions. For example, CDFI applicants must generally demonstrate that any award can be matched dollar-for-dollar with a grant (as opposed to a loan) from a nonfederal source, and an entity (or its affiliate) cannot receive more than $5 million in awards within a three-year period. However, these restrictions may vary with congressional actions. For example, P.L. 111-5 waived the dollar-for-dollar matching requirement in FY2009, FY2010, and FY2011. The requirement was reinstated for FY2012. The CFDI Fund may specify other requirements in the applicable notice of funds availability.[95]
- **Native American CDFI Assistance (NACA) Program.** Native American CDFIs may receive funding awards via the NACA component of the CDFI program. Native American CDFIs *primarily serve* (defined at 50% or more of an applicant's activities) Native Communities (defined as Native American, Alaska Native, and Native Hawaiian communities). The CDFI Fund certifies new Native CDFIs and issues financial assistance and technical assistance monetary awards to facilitate capital access in Native Communities via its authority.[96]
- **Bank Enterprise Award (BEA).** CDFIs whose deposits are insured by the FDIC may apply for the CDFI Fund's BEA program.[97] The BEA provides formula-based grants to banks, including CDFI-designated banks, to provide loans, equity investments, grants, and technical assistance to CDFIs.[98] The CDFI Fund measures increases in an applicant's lending, investment, and service activities relative to a baseline of similar, qualified activities conducted by the applicant in the previous application cycle. In contrast to the CDFI Fund's awards based upon proposed future projects, BEA awards are *retrospective*, meaning that applicants

[93] For more detailed information, see CDFI Fund, "Searchable Awards Database," https://www.cdfifund.gov/awards/state-awards; and CRS Report R47169, *Community Development Financial Institutions (CDFI) Fund: Overview and Programs*, by Donald J. Marples and Darryl E. Getter.

[94] Laws pertaining to the CDFI Fund's financial assistance and technical assistance are located in 46 U.S.C. §§1805.300-1805.303.

[95] 12 C.F.R. §1806.200(b)(2).

[96] See Section 117(c) of the Riegle Act. NACA made its first awards in 2002 following the November 2001 release of the Native American Lending Study, which was directed by Congress to study lending and investment practices on Indian reservations, For the results of this study, see CDFI Fund, *The Report of the Native American Lending Study*, November 2001, http://www.cdfifund.gov/docs/2001_nacta_lending_study.pdf.

[97] See CDFI Fund, *Bank Enterprise Award Program: Maximizing Investments in Distressed Communities*, https://www.cdfifund.gov/sites/cdfi/files/documents/cdfi7205_fs_bea_updatedaug2020.pdf.

[98] The BEA was originally authorized by the Bank Enterprise Act of 1991 in the Agriculture, Rural Development, Food and Drug Administration, and Related Agencies Appropriations Act, 1992 (P.L. 102-142). Prior to the creation of the CDFI Fund, the BEA was administered by the OCC and the FDIC. Section 114 of the Riegle Community Development and Regulatory Improvement Act of 1994 (P.L. 103-325) moved the BEA under the operations of the CDFI Fund.

receive awards for activities they have already completed.[99] The retrospective awards allow bank recipients to offset some of the financial risks associated with making riskier loans and, therefore, satisfy prudential capital (equity) requirements.

- **New Markets Tax Credits (NMTC) Program.** CDFIs may acquire equity investments by participating in the NMTC program. After receiving the Community Development Entity (CDE) certification by the CFDI Fund, a CDFI may apply for NMTCs, also allocated by the CDFI Fund.[100] The NMTC is a competitively awarded nonrefundable tax credit intended to encourage qualified investors to support CDEs that operate in eligible low-income communities.[101] Once awarded an allocation of NMTCs, CDEs that are CDFIs may award NMTCs to taxpaying entities in exchange for equity investments.[102] (A bank, for example, that makes equity investments in CDFIs can reduce its tax liabilities via obtaining NMTCs.)
- **Capital Magnet Fund (CMF).** The CMF was established by the Housing and Economic Recovery Act of 2008 (P.L. 110-289) to competitively award grants to CDFIs and other nonprofit housing organizations for the development, rehabilitation, and purchase of affordable housing and economic development projects in distressed communities.
- **CDFI Bond Guarantee Program (BGP).** The BGP was established in 2010 to provide CDFIs with access to long-term funding, also known as patient capital, to reduce conventional funding risk, which arises when intermediaries acquire funding via sequences of short-term loans and risk greater volatility in short-term rates.[103] Treasury was initially given the authority to guarantee up to 10 bonds per year, each at a minimum of $100 million with maturities not to exceed 30 years. Authorized CDFIs (referred to as qualified issuers) would sell the bonds to the Federal Financing Bank (FFB) in exchange for cash proceeds that would need to

[99] The CDFI Fund publishes a more in-depth account of its BEA application process regularly in the program's notice of funds availability. For example, see Department of the Treasury, "Community Development Financial Institutions Fund—Funding Opportunity Title: Notice of Funds Availability (NOFA) Inviting Applications for the Fiscal Year (FY) 2017 Funding Round of the Bank Enterprise Award Program (BEA Program)," 82 *Federal Register* 45663-45674, September 29, 2017.

[100] A certified CDE is a domestic corporation or partnership that is an intermediary vehicle for the provision of loans, investments, or financial counseling in low-income communities. CDFIs automatically qualify as CDEs. The NMTC was established as part of the Community Renewal Tax Relief Act of 2000 (P.L. 106-554, Title II, Subtitle C). For information about the application requirements to become a CDE and obtain NMTCs, see https://www.novoco.com/new_markets/resource_files/cde/CDE_Q_A_0705.pdf.

[101] As a nonrefundable tax credit, the NMTC can be used to reduce tax liability toward, but not below, zero. By contrast, a refundable tax credit can be used to reduce tax liability beyond zero, enabling a taxpayer to receive a refund.

[102] Investors must retain their interest in qualified equity investments throughout the seven-year period to receive the full tax credit of 39% or risk forfeiture of such interest. For the first three years of the investment, the taxpayer/investor receives a credit equal to 5% of the total amount paid for the stock or capital interest at the time of purchase. For the final four years, the value of the credit is 6% annually. For more information, see CRS Report RL34402, *New Markets Tax Credit: An Introduction*, by Donald J. Marples and Sean Lowry.

[103] The Small Business Jobs Act of 2010 (P.L. 111-240) authorized the BGP on September 27, 2010. The funds must be used to fund lending and basic financial services for community or economic development (e.g., affordable housing for low-income individuals, businesses that provide jobs for low-income people or are owned by low-income individuals). For more information, see CDFI Fund, "CDFI Bond Guarantee Program," https://www.cdfifund.gov/programs-training/Programs/cdfi-bond/Pages/default.aspx.

be repaid with interest (to the FFB).[104] The authorized CDFIs would subsequently use the cash proceeds to make short-term loans to other CDFIs. Stated differently, the BGP would allow qualified CDFIs issuers to acquire federally guaranteed funds and then provide long-term wholesale funding to other CDFIs. (The CDFI borrower of funds must have collateral to obtain a loan from an authorized CDFI, thus having similarities to a repurchase agreement.)

- **Small Dollar Loan (SDL) Program.** The SDL program, authorized by the Dodd-Frank Act (P.L. 111-203), provides funding for SDLs.[105] SDLs are consumer loans with relatively low initial principal amounts (often less than $1,000) with relatively short repayment periods (generally for a small number of weeks or months).[106] SDLs funded by grants from the SDL program cannot exceed $2,500, must be repaid in installments, and cannot have any prepayment penalties. Furthermore, SDL repayments must be reported to a least one of the consumer reporting agencies that compiles and maintains files on consumers on a nationwide basis, thus having similarities to payday alternative loans offered by credit unions.[107] The CDFI Fund also provides CDFIs with funds to defray the cost of establishing an SDL program.[108]

During emergencies, Congress has authorized the CDFI Fund to provide additional financial assistance. In response to COVID-19, for example, Treasury provided CDFIs with additional financial support pursuant to Sections 522 and 523, Division N, of the Consolidated Appropriations Act, 2021 (P.L. 116-260).

- **Emergency Capital Investment Program (ECIP).** Section 522 created the ECIP, which authorized Treasury to purchase up to $9 billion of equity shares in CDFI depository institutions and minority depository institutions (MDIs).[109] The ECIP investments would boost the capital buffers held by depositories against heightened default risks stemming from the pandemic.[110] As a result, these depositories would be able to remain in compliance with their prudential requirements and continue lending. Of the $9 billion, $4 billion is set aside for CDFIs and MDIs with less than $2 billion in assets, and of that, at least $2 billion is set aside for CDFIs and MDIs with less than $500 million in assets.[111] In October 2021, Treasury announced that 204 institutions had requested almost

[104] The FFB is a U.S. government corporation under the general supervision and direction of Treasury.

[105] See CDFI Fund, "Small Dollar Loan Program," https://www.cdfifund.gov/programs-training/programs/sdlp.

[106] See CRS Report R44868, *Short-Term, Small-Dollar Lending: Policy Issues and Implications*, by Darryl E. Getter.

[107] See NCUA, "Payday Alternative Loans," 84 Federal Register 51942-51952, October 1, 2019; and CRS Report R46360, *The Credit Union System: Developments in Lending and Prudential Risk Management*, by Darryl E. Getter.

[108] See CDFI Fund, "CDFI Fund Releases Application Demand for FY2021 Round of Small Dollar Loan Program," July 30, 2021, https://www.cdfifund.gov/news/443.

[109] See CDFI Fund, "Treasury to Invest $9 Billion in Community Development Financial Institutions and Minority Depository Institutions Through Emergency Capital Investment Program (ECIP)," press release, March 4, 2021, https://home.treasury.gov/news/press-releases/jy0047.

[110] ECIP is also conceptually similar to the Troubled Asset Relief Program implemented in October 2008. See CRS Report R41427, *Troubled Asset Relief Program (TARP): Implementation and Status*, by Baird Webel.

[111] See CDFI Fund, "Emergency Capital Investment Program," https://home.treasury.gov/policy-issues/coronavirus/assistance-for-small-businesses/emergency-capital-investment-program.

$12.9 billion ($3.9 billion more than the program size limit) of ECIP investments.[112]

- **CDFI Rapid Response Program.** Section 523 appropriated an additional $3 billion of emergency grant funding for CDFIs to help their communities respond to the economic impact of the COVID-19 pandemic. Pursuant to Section 523, the CDFI Fund opened the first funding round for the CDFI Rapid Response Program in February 2021 to provide $1.25 billion to CDFIs.[113] By June 2021, those funds were awarded to 863 CDFIs.[114]

CDFIs may apply and compete for financial awards provided by other departments in Treasury, other federal agencies, and federally related agencies or incentives. The list below provides examples of federal and federally related funding programs, but it is not all-inclusive.

- The State Small Business Credit Initiative (SSBCI), a Treasury program authorized by the Small Business Jobs Act of 2010 (P.L. 111-240), was initially created to provide assistance to small businesses following the Great Recession (2007-2009).[115] In response to the pandemic, the American Rescue Plan Act of 2021 (P.L. 117-2) reauthorized the SSBCI, which will provide a combined $10 billion to small businesses in the states, the District of Columbia, territories, and tribal governments.[116] CDFIs can provide loans or investments to small businesses supported by SSBCI funds.[117]
- The U.S. Department of Agriculture (USDA) has a variety of grant programs that CDFIs can apply for and subsequently provide loans in rural communities.[118] For example, the Intermediary Relending Program, the Rural Microentrepreneur Assistance Program, and Value-Added Producer Grants provide loans or grants to financial intermediaries to support businesses and economic development in rural communities.[119]
- Each Federal Home Loan Bank district has an Affordable Housing Program that provides grants on a competitive basis to membership institutions, which may

[112] See U.S. Department of the Treasury, "Treasury Sees Robust Demand for Emergency Capital Investment," October 18, 2021, https://home.treasury.gov/system/files/136/ECIP-Demand-Announcement-10-18-2021.pdf.

[113] See CDFI Fund, "Treasury's Community Development Financial Institutions Fund Opens Funding Round for CDFI Rapid Response Program," press release, February 25, 2021, https://home.treasury.gov/news/press-releases/jy0035.

[114] See CDFI Fund, "U.S. Treasury Awards $1.25 Billion to Support Economic Relief in Communities Affected by COVID-19," June 15, 2021, https://www.cdfifund.gov/news/420.

[115] See CRS Report R42581, *State Small Business Credit Initiative: Implementation and Funding Issues*, by Robert Jay Dilger, Grant A. Driessen, and Adam G. Levin.

[116] See Department of the Treasury, "State Small Business Credit Initiative (SSBCI)," https://home.treasury.gov/policy-issues/small-business-programs/state-small-business-credit-initiative-ssbci.

[117] See U.S. Congress, House Committee on Small Business, Subcommittee on Economic Growth, Tax, and Capital Access, *Can Opportunity Zones Address Concerns in the Small Business Economy*, testimony of Jennifer A. Vasiloff, Chief External Affairs Officer, Opportunity Finance Network, 116th Cong., 1st sess., October 17, 2019.

[118] See U.S. Congress, House Committee on Small Business, Subcommittee on Economic Growth, Tax, and Capital Access, *Can Opportunity Zones Address Concerns in the Small Business Economy*, testimony of Jennifer A. Vasiloff, Chief External Affairs Officer, Opportunity Finance Network, 116th Cong., 1st sess., October 17, 2019.

[119] For more information, see USDA, "Intermediary Relending Program," https://www.rd.usda.gov/programs-services/business-programs/intermediary-relending-program; USDA, "Rural Microentrepreneur Assistance Program," https://www.rd.usda.gov/programs-services/business-programs/rural-microentrepreneur-assistance-program; and USDA, "Value Added Producer Grants," https://www.rd.usda.gov/programs-services/business-programs/value-added-producer-grants.

include CDFIs.[120] The grants can be used to support the acquisition, construction, or rehabilitation of affordable rental housing and for single-family housing programs for veterans, those with disabilities, or other designated needs.[121]

- CDFIs may obtain financing from banking firms that are covered by the Community Reinvestment Act (CRA; P.L. 95-128).[122] By providing net assets to CDFIs that originate loans (particularly in the locations where they collect deposits), banks may obtain CRA credits that receive consideration when applying for branches, mergers, and acquisitions, among other things. Banks often provide funds to CDFIs through *equity equivalent investments* (EQ2s), which are debt instruments issued by CDFIs with a continuous rolling (indeterminate) maturity. EQ2s, from a bank's perspective, are analogous to holding convertible preferred stock with a regularly scheduled repayment.[123]
- The Community Development Block Grant (CDBG) program, administered by the Department of Housing and Urban Development (HUD), allocates federal assistance to state and local governments to support neighborhood revitalization and community and economic development efforts.[124] CDFIs, particularly loan funds, may be eligible for CDBG funds to carry out activities that would create or retain jobs in their target market areas or be located within HUD-approved *neighborhood revitalization strategy areas*.[125]
- Numerous federal government agencies (e.g., HUD, USDA, the Small Business Administration) and certain federally related entities guarantee loans for low- and moderate-income borrowers or for borrowers who reside or operate businesses in underserved locations. Federally insured loans may cover some or all of the default risk depending upon the specific federal guaranty program. After receiving subsidized funds, a CDFI (as well as other traditional financial institutions) can originate loans that meet the eligibility requirements for various federal guarantees, thus protecting the funds that were lent.

CDFIs' Access to Selected Private Funding Sources

Despite access to public funding, CDFIs still need access to alternative funding sources for the following reasons. First, many CDFIs have greater funding needs than is available in CDFI grants and awards, and they must raise private sector funds to even qualify for certain awards.[126] Some

[120] For more information, see CRS Report R46499, *The Federal Home Loan Bank (FHLB) System and Selected Policy Issues*, by Darryl E. Getter.

[121] For a summary, see FHLBanks, *Affordable Housing 2020 Awards: FHLBank 2020 AHP Overview*, at https://fhlbanks.com/affordable-housing-2020-awards/.

[122] See CRS Report R43661, *The Effectiveness of the Community Reinvestment Act*, by Darryl E. Getter.

[123] When the company is profitable, preferred stockholders receive dividends at regular intervals. If a publicly traded company is liquidated, its creditors are paid first, followed by its preferred stockholders, and the common stockholders of the firm are paid last with whatever proceeds are left over. Preferred stockholders, therefore, provide *subordinate* or *mezzanine* financing. For specific legal attributes of this financial instrument, see Beth Lipson, "Equity Equivalent Investments," *Community Investments*, vol. 14, no. 1 (March 2002), pp. 10-12.

[124] For more information, see CRS Report R43520, *Community Development Block Grants and Related Programs: A Primer*, by Joseph V. Jaroscak.

[125] For more information, see HUD, Community Development Block Grant Program: Guide to National Objectives and Eligible Activities for Entitlement Communities, https://www.huduser.gov/portal/oup/files/cdbgguide.pdf.

[126] See Brett Theodos and Eric Hangen, *Tracking the Unequal Distribution of Community Development Funding in the U.S.*, Urban Institute, January 31, 2019, https://www.urban.org/sites/default/files/publication/99704/

awards provided by the CDFI Fund (e.g., financial assistance, technical assistance) require CDFIs to raise private funds, which may lessen a misaligned incentive problem, namely, to engage in lending activities that would require costly loss mitigation. Second, CDFIs tend to request more funding than they typically receive, which is exacerbated when federal programs experience budget cuts or changes in eligibility requirements, as highlighted in the following examples.[127]

- Contributions to the CMF, which must be made by Fannie Mae and Freddie Mac rather than through appropriations, were initially suspended in 2008 after Fannie and Freddie were placed under conservatorship.[128] Furthermore, when applying for CMF competitive awards, a CDFI must demonstrate in the application that the cost of the eligible activity equals at least 10 times the amount of the potential funding award.[129]
- Appropriations delays resulted in delays implementing the BGP. Congress also reduced the program's potential lending authority of $1 billion annually (for four years of authorization) to $500 million annually.[130]

In short, CDFIs essentially compete with each other for limited subsidized funding awards and, therefore, must also rely upon private funding sources, discussed in this section.

Funding Sources for CDFI Depositories

The CDFI depository institutions, representing 54% of all CDFIs in 2020, can collect and pay interest on federally insured deposits, which are typically less expensive sources of funds relative to borrowing in the short-term financial money markets. Small depositories, however, collectively

tracking_the_unequal_distribution_of_community_development_funding_in_the_us_2.pdf.

[127] See Department of the Treasury, Office of Inspector General, *Audit of the Community Development Financial Institutions Fund's Financial Statements for Fiscal Years 2021 and 2020*.

[128] See CRS Report R44525, *Fannie Mae and Freddie Mac in Conservatorship: Frequently Asked Questions*, by Darryl E. Getter. Instead, the Consolidation Appropriations Act, 2010 (P.L. 111-117) appropriated $80 million for the initial funding of the CMF for FY2010. See CDFI Fund, *Agency Financial Report FY 2011*, November 16, 2011, p. 8, https://www.cdfifund.gov/sites/cdfi/files/documents/cdfi-fund-fy-2011-agency-financial-report-final-11-16-11.pdf. Appropriations for the CMF were discontinued in FY2011. The contribution requirements by Fannie Mae and Freddie Mac were reinstated in 2014. See FHFA, "FHFA Statement on the Housing Trust Fund and Capital Magnet Fund," December 11, 2014, http://www.fhfa.gov/Media/PublicAffairs/Pages/FHFA-Statement-on-the-Housing-Trust-Fund-and-Capital-Magnet-Fund.aspx. Fannie and Freddie contributed $100 million to the CMF in 2015. See FHFA, "Housing Trust Fund," 80 Federal Register 15885-15887, March 26, 2015; and FHFA, Office of the Inspector General, Audit of FHFA's Oversight of the Enterprises' Affordable Housing Set-Asides and Allocations, September 24, 2018, pp. 11-13, https://www.fhfaoig.gov/Content/Files/AUD-2018-012%20FHFA%20Oversight%20of%20Affordable%20Housing.pdf.

[129] See CDFI Fund, "Funding Opportunities: Capital Magnet Fund; 2021 Funding Round," 86 *Federal Register* 50773-50789, September 10, 2021. During FY2020, 27 of the total 48 awardees of CMF were certified CDFIs, representing 2% of the CDFI industry. See CDFI Fund, "FY 2020 Capital Magnet Fund (CMF) Application Evaluation Process," https://www.cdfifund.gov/sites/cdfi/files/2021-04/FY_2020_Capital_Magnet_Fund_Application_Review_Process_0.pdf.

[130] Congress reduced the program's potential lending authority of $4 billion ($1 billion annually for four years of authorization) to $1 billion between 2010 and 2014 due to delays in appropriating budget authority for new direct loan obligations under the program. The Consolidated and Further Continuing Appropriations Act, 2015 (P.L. 113-235), reauthorized the program and limited the total loan amount supported by the bonds in FY2015 to $750 million. The Consolidated Appropriations Act, 2016 (P.L. 114-113), extended authority to guarantee bonds in FY2016 to support $750 million in CDFI lending. The Consolidated Appropriations Act, 2017 (P.L. 115-31), limited the CDFI lending supported by the bonds issued in FY2017 to $500 million. See CDFI Fund, *FY 2021 CDFI Bond Guarantee Program Application Period Now Open*, March 3, 2021, https://www.cdfifund.gov/node/1004796.

hold substantially fewer deposits (relative to large banks).[131] Furthermore, CDFI depositories that serve predominantly economically distressed markets are likely to collect even fewer deposits relative to comparable small depositories without CDFI designations. Nevertheless, CDFI depositories would collect low-cost deposits.[132]

As previously stated, 30% of CDFIs are credit unions that collectively hold 61.1% of CDFI industry assets in 2020. The National Credit Union Administration (NCUA), the primary regulator of credit unions, sponsors initiatives to support the mission and liquidity of small credit unions (less than $100 million in assets), eligible low-income designated credit unions, and minority credit unions with various exemptions and grants.[133] CDFI credit unions are exempt from the statutory cap on member business lending.[134] Credit unions are also eligible for grants and low-interest loans from the Community Development Revolving Loan Fund.[135] In short, NCUA can provide CDFI credit unions with access to funding at a lower cost relative to other options outside of the credit union system, which can help alleviate liquidity pressures.

The Federal Home Loan Bank (FHLB) System

CDFIs can apply to become members of the FHLB system, a government-sponsored enterprise, to gain access to short-term funding.[136] Each district FHLB provides its members liquidity in the form of *advances*, which are cash loans. FHLB members may also receive discounted advances via the FHLB's Community Investment Program, which is designed to support residential and housing development in areas meeting certain eligibility requirements, as well as via the FHLB's Community Investment Cash Advance program, which is designed to support broader community and economic development.[137]

As of the fourth quarter of 2020, 64 CDFIs were members of the FHLB system, representing 5% of all CDFIs in 2020.[138] Relying on FHLB advances may be a less feasible option for many CDFIs for the following reasons.

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[131] In 2019, 5,236 credit unions collected $1.22 trillion in deposits in 2019, while 4,381 small community bank collected $964 billion in deposits. By contrast, the remaining 796 banks that reported in 2019 collected $13.57 trillion in deposits. See NCUA, *2019 Annual Report*, https://www.ncua.gov/files/annual-reports/annual-report-2019.pdf; and FDIC, *Quarterly Banking Profile Fourth Quarter 2019*, https://www.fdic.gov/analysis/quarterly-banking-profile/qbp/2019dec/qbp.pdf.

[132] See Kirsten Moy et al., *Approaches to CDFI Sustainability*, Aspen Institute, July 2008, p. 10, Table 1, https://www.aspeninstitute.org/wp-content/uploads/files/content/docs/CDFISustainabilityStudy11.08.pdf.

[133] See NCUA, *Credit Union Resources and Expansion*, https://www.ncua.gov/support-services/credit-union-resources-expansion.

[134] For those credit unions exempt from the business lending cap, their overall size may still limit the extent of their business lending activities. For more information, see CRS Report R46360, *The Credit Union System: Developments in Lending and Prudential Risk Management*, by Darryl E. Getter.

[135] See NCUA, "Community Development Revolving Loan Fund Access for Credit Unions," 86 *Federal Register* 17854-17857, April 6, 2021.

[136] See CRS Report R46499, *The Federal Home Loan Bank (FHLB) System and Selected Policy Issues*, by Darryl E. Getter.

[137] For an example of the criteria that would qualify for a discounted advance, see FHLB of Indianapolis, "Community Investment Program", https://www.fhlbi.com/products-services/community-investment-and-housing/community-and-economic-development/community-investment-program; and FHLB of Cincinnati, "Community Investment Cash Advances," https://www.fhlbcin.com/housing-programs/community-investment-cash-advances/.

[138] See Cliff Rosenthal and Daniel Randall, *The Evolution of CDFIs and Their Growing Partnership Opportunity with the FHLBNY*, FHLB of New York, April 29, 2021, p. 6, https://www.fhlbny.com/wp-content/uploads/2021/04/FHLBNY-CDFI-Webinar_042921.pdf.

- Member institutions must place a minimum paid-in capital stock investment as a condition to become and remain members of their district FHLB. These capital requirements increase the costs for CDFIs, particular many of the smaller CDFIs that are loan funds, to join the FHLB system.[139] Furthermore, joining the FHLB system may be more cost-effective for CDFIs with large asset portfolios but less so for those with much smaller lending portfolios.[140]
- FHLB advances are collateralized by members' assets, such as mortgages, mortgage-related assets, and certain small business loans. By contrast, certain loans that may be suitable for underserved markets (e.g., chattel loans) as well as other nonstandard CDFI loans that cannot be quickly liquidated may be considered ineligible collateral for FHLB advances.[141]
- CDFI loan funds may specialize in certain types of lending. For example, while some CDFIs have a primary focus on underwriting and raising funds for housing, others may focus on community and small businesses. FHLB membership eligibility, however, requires nondepository institutions to have mortgage-related assets that reflect a commitment to housing finance as determined by the discretion of a FHLB.[142] Nondepository CDFIs without a primary housing focus, therefore, may not be granted FHLB membership. Failure of a nondepository CDFI would likely not have a material financial impact on a regional FHLB.[143] However, an affected FHLB must incur additional costs if it must sell distressed assets (i.e., non-housing loans) held by a failed CDFI lacking both a primary housing focus and a receiver such as the FDIC or NCUA.[144]

The Farm Credit System (FCS)

The FCS is a nationwide financial cooperative consisting of four district banks and member lending institutions that collectively operate as a government-sponsored enterprise.[145] After raising funds by selling bonds to private investors, the FCS acts as either a direct lender to eligible individuals and businesses (those unable to qualify for commercial loans from a depository) or as a wholesale lender to its member institutions. As a direct lender, the FCS has the authority to make certain agricultural and rural loans that can be used to purchase land, livestock,

[139] See GAO, Federal Home Loan Banks: Collateral Requirements Discourage Some Community Development Financial Institutions from Seeking Membership, GAO-15-352, April 5, 2015, https://www.gao.gov/products/gao-15-352.

[140] See Rosenthal and Randall, *The Evolution of CDFIs*, p. 6.

[141] Chattel loans are used to finance personal property that is not permanently attached to land. If borrowers were to default, the ability of lenders to recover losses on personal property is more difficult. For more information pertaining to manufactured housing chattel loans, see CRS Report R46746, *Fannie Mae and Freddie Mac: Recent Administrative Developments*, by Darryl E. Getter.

[142] See FHFA, "Members of Federal Home Loan Banks," 81 *Federal Register* 3281, January 20, 2016.

[143] See Federal Housing Finance Board, "Federal Home Loan Bank Membership for Community Development Financial Institutions," 75 *Federal Register* 680, January 5, 2010.

[144] See Karan Kaul and Laurie Goodman, *Should Nonbank Mortgage Companies Be Permitted to Become Federal Home Loan Bank Members*, Urban Institute, June 2020, https://www.urban.org/sites/default/files/publication/102400/should-nonbank-mortgage-companies-be-permitted-to-become-federal-home-loan-bank-members.pdf.

[145] See CRS Report RS21278, *Farm Credit System*, by Jim Monke; CRS Report R46914, *An Overview of Rural Credit Markets*, coordinated by Andrew P. Scott; and Farm Credit Administration, *2020 Annual Report*, https://www.fca.gov/template-fca/about/2020AnnualReport.pdf.

equipment, and other supplies as well as to construct buildings or make farm improvements.[146] As wholesale lenders, the FCS's district banks can lend funds to their member financial institutions, which subsequently provide similar agricultural and rural loans. In addition, the FCS provides loans to other financial institutions (OFIs), which are nonmembers that are significantly involved in lending to borrowers eligible to receive loans from the FCS. Some CDFIs—specifically some Native CDFIs, for example—participate as OFIs with the FCS to obtain the low-cost funding available to its member institutions.[147] As of December 31, 2020, the FCS reported providing 18 OFIs with loans of $839 million but did not report separately on CDFI-designated OFIs.[148]

CDFI Securities Offerings

Some CDFI loan funds and CDFI venture capital funds may offer debt securities to the private sector in exchange for funding. CDFIs can use these funds to support impact investing—also referred to as environmental, social, and governance (ESG) investing—which involves providing financial support to firms focusing on environmental issues, social issues, and governance (e.g., a firm's self-governance and integrity when conducting business).[149] If ESG or impact investment opportunities arise in a target market area, some CDFIs may issue either rated or unrated securities to meet certain funding requirements:

- Some CDFIs can issue short-term debt securities and subsequently use the funding to offer financial support for economic security, health and healthy food, environmental sustainability, women- and minority-owned businesses, and other causes.[150] These CDFIs can raise funds either directly for their borrowers or for the benefit of other CDFIs.[151] Instead of relying on short-term borrowings to fund long-term loans, debt securities may be issued for maturities equal to or even greater than the maturities of customer loans retained in lending portfolios.[152] CDFI-issued securities can receive ratings based on the financial strength of a CDFI issuer to withstand changes in its operating environment. These ratings may be provided by independent rating agencies that specialize in assessing impact investments.[153] Although CDFIs under most circumstances would pay for

[146] See USDA, "Grants and Loans," https://www.usda.gov/topics/farming/grants-and-loans.

[147] See GAO, *Indian Issues: Agricultural Credit Needs and Barriers to Lending on Tribal Lands*, GAO-19-464, May 2019, https://www.gao.gov/assets/700/699447.pdf; and Joe Boomgaard, "Native American Agriculture Fund Spins Off New Financial Institution to Help Native Farmers," *Tribal Business News*, December 20, 2021, https://tribalbusinessnews.com/sections/food-agriculture/13742-native-american-agriculture-fund-spins-off-new-financial-institution-to-help-native-farmers.

[148] See Farm Credit Administration, *2020 Annual Report*, p. 16.

[149] See Rosalie Sheehy Cates and Chris Larson, *Connecting CDFIs to the Socially Responsible Investor Community*, Triple Bottom Line Collaborative, October 2010, https://www.cdfifund.gov/sites/cdfi/files/documents/connecting-cdfis-to-the-socially-responsible-investor-commun.pdf; and CRS In Focus IF11716, *Introduction to Financial Services: Environmental, Social, and Governance (ESG) Issues*, by Raj Gnanarajah and Gary Shorter.

[150] See Aeris, "Aeris Announces 14 New CDFI Ratings," January 7, 2021, https://www.aerisinsight.com/2021/01/07/aeris-announces-14-new-cdfi-ratings/.

[151] See CNote, "Offering Circular," March 4, 2021, https://www.sec.gov/Archives/edgar/data/0001683145/000121465921002710/r34210253g2.htm.

[152] See Elise Balboni and Anna Smukowski, *CDFIs and the Capital Markets: Tapping into Impact Investors*, Local Initiatives Support Corporation, June 2020, https://www.lisc.org/media/filer_public/01/23/0123a940-dada-4c37-9db2-12cae1853859/062920_report_cdfis_capital_markets.pdf.

[153] See Aeris, "Aeris Announces 14 New CDFI Ratings."

ratings, a strong credit rating may increase the attractiveness of these debt issuances to investors and perhaps allow issuers to pay lower yields.[154]

- Rather than issue investment-grade-rated securities, some CDFIs may choose to issue speculative (e.g., non-investment-grade rated or non-rated) securities that typically trade less frequently than higher-rated bonds. However, they may cost less to issue and be more suitable for small issuers or for financing small projects.[155] The Securities and Exchange Commission's (SEC's) Regulation D provides an exemption from the normal registration process for entities that want to raise funds using a nonpublic, private placement of (unrated) securities. Regulation D requires no general solicitation under most circumstances, the securities cannot be resold, and the issuance cannot exceed certain dollar amounts subject to specific restrictions.[156] Despite lower issuance costs, investors typically expect to be compensated at higher rates of return for agreeing to hold speculative securities. During periods of low interest rates on government securities, however, speculative securities may become more attractive such that investors may be willing to accept relatively lower compensation for holding more risk, resulting in access to cheaper funding for issuers during this particular period.[157]

The Capacity Building Initiative (CBI)

The CDFI Fund provides technical assistance and training to CDFIs via the CBI program. The CBI helps CDFIs develop greater expertise in underwriting and other operating issues. For example, CBI awards may provide CDFIs with background on securities markets and regulations, thereby increasing their capacity to facilitate small business lending and ESG investments.[158]

Crowdfunding on Behalf of Small Businesses

CDFIs may participate in crowdfunding, which refers to use of the internet by small businesses to raise funding through limited contributions from a large number of contributors and guided by Regulation Crowdfunding.[159] For example, a CDFI may serve as a crowdfunding platform to raise funds on behalf of a small business operating in its target market, and the collected proceeds can be used for the Community Advantage program to increase access to loans guaranteed by the Small Business Administration (SBA).[160] CDFIs can register with the SEC as *funding portals*,

[154] See Capital Institute, "CARS: A Performance Evaluation Tool," March 27, 2010, https://capitalinstitute.org/blog/cars-performance-evaluation-tool/.

[155] See Capital Institute, "CARS: A Performance Evaluation Tool."

[156] For more information, see SEC, *Investor Bulletin: Private Placements Under Regulation D*, September 24, 2014, https://www.investor.gov/introduction-investing/general-resources/news-alerts/alerts-bulletins/investor-bulletins-31; and Raffi Garnighian, Gonzalo Go, and Anna Pinedo, *General Solicitation and General Advertising*, Mayer Brown, June 21, 2021, https://www.mayerbrown.com/-/media/files/perspectives-events/publications/2019/08/on-point—general-solicitation.pdf.

[157] See Sam Goldfarb, "Search for Yield Leads Bond Buyers to Unrated Debt," *Wall Street Journal*, September 5, 2021, https://www.wsj.com/articles/search-for-yield-leads-bond-buyers-to-unrated-debt-11630834201.

[158] See CDFI Fund, "Innovations in Small Business Lending," February 25, 2012, https://www.cdfifund.gov/programs-training/training-ta/resource-banks/innovations-in-small-business-lending.

[159] See Financial Industry Regulatory Authority, *Crowdfunding and the JOBS Act: What Investors Should Know*, https://www.finra.org/investors/alerts/crowdfunding-and-jobs-act.

[160] For more information, see CDFI Fund, "New SBA Community Advantage Initiative Opens 7(a) Loan Program to CDFIs," December 15, 2010, https://www.cdfifund.gov/news/66. The SBA requires financial intermediaries to deposit

defined as crowdfunding intermediaries (rather than as brokers).[161] Afterwards, a CDFI can provide a crowdfunding platform, which is the internet website that provides the information about the project(s) in need of funding and electronically collects the proceeds contributed by crowdfunding participants. In 2012, the SEC finalized a rule implementing the Jumpstart Our Business Startups Act (JOBS Act; P.L. 112-106), increasing access to low-cost capital by allowing an exemption from the normal (and costly) registration and filing requirements for entities (meeting certain requirements) to make low-dollar security offerings via crowdfunding.[162] On November 2, 2020, the SEC increased the threshold limit from $1 million to $5 million over a 12-month period, thus allowing crowdfunding to become a more viable low-cost funding option for various businesses.[163]

Congressional Considerations

The CDFIs' target markets are comprised of higher-risk customers that are more costly to serve in comparison to prime borrowers. CDFIs rely considerably on public and private grants, awards, and donations to obtain the net assets to fund their lending portfolios, which are comprised of higher-risk loans. By subsidizing the costs to provide extensive amounts of loss mitigation, CDFIs gain a financial advantage over both traditional and subprime lenders that enable them to serve higher-risk borrowers and promote financial inclusion.

Policies to mitigate societal costs that can arise if financial institutions make loans to borrowers who are more likely to have repayment problems inadvertently limit making credit available to

10% or 15% of the outstanding balance of a guaranteed loan in a microloan revolving fund account or loan loss reserve fund account. See SBA, "Operate as an Intermediary," https://www.sba.gov/partners/lenders/microloan-program/operate-intermediary; SBA, *SBA Microloan Program, Session: Loan Side Basics*, https://www.sba.gov/sites/default/files/files/Loan%20Side%20Basics.pdf; CRS Report R41057, *Small Business Administration Microloan Program*, by Robert Jay Dilger and Anthony A. Cilluffo; Stephen Umberger, "U.S. Small Business Administration Loan Funds Available to Purchase Commercial Real Estate," SBA, https://www.sba.gov/content/u-s-small-business-administration-loan-funds-available-purchase-commercial-real-estate; and Frank Altman, President and CEO, Capital Reinvestment Fund, USA, letter to U.S. Securities and Exchange Commission, February 3, 2014, https://www.sec.gov/comments/s7-09-13/s70913-224.pdf.

[161] Specifically, a funding portal that is a crowdfunding intermediary does not (1) offer investment advice or recommendations; (2) solicit purchases, sales, or offers to buy securities offered or displayed on its website or portal; (3) compensate employees, agents, or others persons for such solicitation or based on the sale of securities displayed or referenced on its website or portal; (4) hold, manage, possess, or otherwise handle investor funds or securities; or (5) engage in such other activities as the SEC, by rule, determines appropriate. See SEC, "Jumpstart Our Business Startups Act Frequently Asked Questions About Crowdfunding Intermediaries," May 7, 2012, https://www.sec.gov/divisions/marketreg/tmjobsact-crowdfundingintermediariesfaq.htm. For more information, see SEC, "Registration of Funding Portals: A Small Entity Compliance Guide," https://www.sec.gov/divisions/marketreg/tmcompliance/fpregistrationguide.htm; John Hamilton, President, City First Enterprises, to U.S. Securities and Exchange Commission, February 3, 2014, https://www.sec.gov/comments/s7-09-13/s70913-228.pdf; and CRS Report R45221, *Capital Markets, Securities Offerings, and Related Policy Issues*, by Eva Su.

[162] See SEC, "Crowdfunding," 80 Federal Register 71387-71680, November 16, 2015; and CRS Report R45308, *JOBS and Investor Confidence Act (House-Amended S. 488): Capital Markets Provisions*, coordinated by Eva Su.

[163] See SEC, "SEC Harmonizes and Improves 'Patchwork' Exempt Offering Framework," November 2, 2020, https://www.sec.gov/news/press-release/2020-273; and SEC, "Facilitating Capital Formation and Expanding Investment Opportunities by Improving Access to Capital in Private Markets," 86 *Federal Register* 3496-3605, January 14, 2021. The final rule also eliminated investment limits for accredited investors and revised the calculation methods used for nonaccredited investors. The SEC defines *accredited investor* as an individual earning gross income exceeding $200,000 (or $300,000 with a spouse) in each of the two most recent years with an expectation of earning the same income in the current year. For a more detailed explanation, see CRS In Focus IF11278, *Accredited Investor Definition and Private Securities Markets*, by Eva Su.

some borrowers with the potential to become more creditworthy.[164] For example, prudential regulations for traditional depository institutions are designed to sustain sufficient liquidity and capital reserves to buffer against default losses, thereby mitigating widespread public pessimism and loss of confidence in the banking and financial system.[165] Frequent loan defaults, liquidity disruptions, or declines in asset prices (e.g., market value of loans) that occur more frequently with transactions involving higher-risk populations—those who have with impaired credit histories or face greater income volatility—pose greater costs for prudentially regulated institutions.[166] Consequently, policies that support the CDFI industry's mission may complement policies that promote the stability of financial institutions, particularly if the latter policies, which preclude taking above-normal risks, discourage greater accommodation of higher-risk customers.[167] Alternatively, CDFIs may still be considered weak financial institutions that may face insolvency in the absence of subsidies, which distort the true costs of the default risks associated with serving unprofitable borrowers. Hence, subsidies deployed to counterbalance residual effects that stem from various prudential policies may still result in a less productive use of funds.

Another factor for consideration is the willingness of the private sector to support financial inclusion efforts. As a type of public-private partnership, CDFIs are required to raise funds from the private sector to mitigate the risk of a CDFI shifting additional costs and higher financial default risks to the public sector as well as to supplement the unevenness or decline in available public funding. The sustainability of the CDFI industry's public-private partnership approach, therefore, may signal the extent to which private lenders are willing to put their funds at risk to support financial inclusion.[168]

Various metrics related to the overall performance and effectiveness of CDFIs may demonstrate the progress they have made toward financial inclusion—but data challenges exist. For example, large amounts of servicing and loss mitigation adds ambiguity to some CDFI performance metrics. Data collection gaps impede the ability to measure CDFI industry effectiveness. Furthermore, the scarcity of comparable data concerning the lending of other small lenders on

[164] Stated differently, policies to correct a negative externality may be regressive. For a discussion on the regressivity of a Pigouvian tax, see Benjamin B. Lockwood and Dmitry Taubinsky, *Regressive Sin Taxes*, National Bureau of Economic Research, Working Paper no. 23085, March 2017, https://www.nber.org/system/files/working_papers/w23085/w23085.pdf.

[165] See CRS Report R40417, *Macroprudential Oversight: Monitoring Systemic Risk in the Financial System*, by Darryl E. Getter.

[166] See CRS Report R44573, *Overview of the Prudential Regulatory Framework for U.S. Banks: Basel III and the Dodd-Frank Act*, by Darryl E. Getter.

[167] In contrast to what economists refer to as a Pigouvian tax, which raises the cost of a practice that arguably imposes a societal cost (negative externality) and discourages the practice, a Pigouvian subsidy lowers the cost of a practice that arguably increases a societal benefit. For example, capital requirements for depositories discourage excessive risk-taking, thus resembling a Pigouvian tax designed to reduce a negative externality (e.g., bank runs). (Note that capital requirements are not taxes paid to government. The point here is that the cost of an activity has increased.) Likewise, subsidies to absorb the additional costs to serve higher-risk populations may be considered a Pigouvian correction to the extent they lessen the negative externality of financial exclusion, which may arise from prudential regulations. For examples of Pigouvian subsidy applications, see Nathaniel Hendren, Camille Landais, and Johannnes Spinnewijn, *Choice in Insurance Markets: A Pigouvian Approach to Social Insurance Design*, National Bureau of Economic Research, Working Paper no. 27842, September 2020, https://www.nber.org/papers/w27842; and Lily L. Batchelder, Fred T. Goldberg Jr., and Peter R. Orszag, "Efficiency and Tax Incentives: The Case for Refundable Tax Credits," *Stanford Law Review*, vol. 59, no. 1 (2006), pp. 23-76.

[168] See Timothy Besley and Maitreesh Ghatak, "Profit with Purpose? A Theory of Social Enterprise," *American Economic Journal: Economic Policy 2017*, vol. 9, no. 3 (August 2017), pp. 19-58.

these populations and areas is scarce, making it difficult to demonstrate that CDFIs have an impact beyond those provided by other small lenders that do not receive these subsidies. Even if

better data were available, CDFI customers face greater income volatility, which can still undermine any benefits provided by CDFIs.

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