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Community Development Financial Institutions: Critical capital for small businesses

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Key takeaways

- Community Development Financial Institutions (CDFIs) have received heightened attention recently. A recent Bank of America White Paper underscores the Bank's view of the important role that CDFIs play in the financial ecosystem, particularly in addressing lingering inequities in the financial markets, and highlights specific recommendations to support this additional source of capital for small businesses.

- As the financial services industry addresses long-standing gaps in access to credit and strives for economic inclusion, traditional banks continue to deepen their existing CDFI partnerships. The presence of CDFIs in low-to-moderate income (LMI) communities and hands-on due diligence practices mitigate loan losses and foreclosures. In order to continue their positive impact on underserved communities, CDFIs require additional support to address long-term strategic and industry changes.

- Local access to capital is an essential channel for economic growth, development and the creation of sustainable communities. The White Paper concludes that one of the most promising means of achieving those ends is through support for CDFIs, but acknowledges that only through advocacy among industry leaders, government agencies and the private sector will such positive impact be achievable.

The CDFI story

In 1994, the US Treasury Department established the Community Development Financial Institutions (CDFI) Fund, a major source of short- and long-term funding for certified CDFIs. Its programs fund community revitalization efforts among more than 1,300 mission-driven lending institutions, support low-to-moderate income communities through assistance and investment of federal dollars, and leverage private sector capital and incentivize bank and institutional investment.

CDFIs have often been lenders of first resort to small and minority-owned businesses in underserved, vulnerable, and low-to-moderate income (LMI) communities. They can be community development banks or credit unions, loan funds or venture capital funds and often serve minority-, women-, or veteran-owned businesses in communities across the US. Larger financial institutions can develop strong working relationships with CDFIs, whose mission-driven purpose gives them a unique opportunity to have an impact on market segments that – owing to regulatory and risk thresholds – may not be feasible for large banks, according to the White Paper. Beyond access to credit, CDFIs also offer mentoring, training, and technical assistance to businesses.

The value of CDFIs was evident during the pandemic, as they were able to effectively channel much-needed government pandemic funding to small businesses. Their localized decision making, deep community knowledge and flexible financing to prioritize needs of communities, gives CDFIs a comparative advantage. As such, heightened attention is now being directed to these lenders with the establishment of a bipartisan Community Development Finance Caucus and the Economic Opportunity Coalition (EOC).

As the financial services industry addresses long-standing gaps in access to credit and strives for economic inclusion, traditional banks continue to deepen their existing CDFI partnerships. These partnerships are important given the uneven economic effects of the COVID-19 pandemic and the associated shutdowns that continue to disrupt many parts of the economy and communities.

The Bank of America White Paper underscores why CDFIs need continued support through advocacy among industry leaders, government agencies and the private sector in order to serve as a critical source of capital, and offers actionable suggestions for support.

White Paper recommendations and opportunities for advocacy

1. Increase awareness of CDFI products and services

Continue to seek out mutually beneficial partnerships that can enable CDFIs to reach a large enough scale to reduce costs to their borrowers. Partner on marketing and educational events, and even on transaction and digital platform technology, to help expand CDFIs' reach in the communities they serve.

2. Formalize traditional bank-to-CDFI referral processes

Develop a bank-to-CDFI referral channel with strong processes that are consistent with fair lending practices. At traditional banks, establish points of contact who understand the needs of small businesses and foster a strong bank-to-CDFI connection that can enable borrowers to maintain their bank relationships while having access to CDFI products that may not be available from traditional banks.

3. Engage in continued federal- and industry-level dialogue

See to it that industry participants are prepared to articulate investment opportunities and recommend improvements to existing regulatory and legislative frameworks in order to help to better align business models with client interests while preventing disparate impact or treatment, especially among the most vulnerable and at-risk populations.

4. Make the Community Advantage (CA) Loan Program permanent

Make the CA loan program permanent so that it remains dedicated to providing technical assistance to small businesses in underserved markets. Its permanence can make more CDFIs willing to invest the time and resources to become CA lenders. Reexamine underwriting requirements, lender eligibility, loan limits and guarantees to help increase funding available through CDFI lenders.

5. Expand the Small Business Administration (SBA) Microloan program

Review the terms of the SBA Microloan program and consider increasing the number of eligible lenders. Make efforts to automate and digitize the SBA loan technology platforms in order to shorten loan processing times and allow businesses to receive credit faster and more seamlessly.

6. Incentivize innovative public-private partnerships

Deepen mutually beneficial public-private partnerships among government agencies, foundations, financial institutions, CDFIs, advocacy groups and even equity investors. Innovation around investment models can be transformative for directing capital to CDFIs.

7. Address CDFI loan loss reserves

Explore whether the use of philanthropic grants as loan loss reserves or establish a loan loss pool backed by the Department of the Treasury. Approaches like these can allow CDFIs to expand their loan products with more flexible and potentially higher risk underwriting criteria.

8. Increase funding and streamline CDFI certification

Support efforts to have the Department of the Treasury increase the funding for CDFI programs. In addition, streamline the CDFI certification process.

9. Increase liquidity and capitalization through federal programs

Support government-backed guarantee programs, equity or subordinate funding, and multi-year grants from the CDFI Fund that can provide long-term flexibility and low-cost capital to CDFIs.

10. Review requirements under the CDFI Bond Guarantee Program

Increase the accessibility of the bond program to smaller-sized certified CDFIs by reviewing eligibility criteria and both the minimum guarantee amount and end-loan underwriting parameters.

The bottom line

The mission-driven purpose that defines the important role that CDFIs play in the financial ecosystem helps them address lingering inequities in the financial markets. According to the White Paper, emerging research suggests the pandemic has materially worsened intergenerational equity and wealth gaps for minority small business owners. And transformations in customer experiences, technological innovation, digitalization and automation during the pandemic have shifted the ways in which households, businesses, and communities interact with financial institutions. Currently, it is difficult for CDFIs to scale financing and augment their capital base. The White Paper indicates that within the changing landscape, CDFIs will have difficulty maintaining their current service offerings while at the same time expanding their reach. It underscores that in order to continue their positive impact on underserved communities, CDFIs require additional support to address long-term strategic and industry changes and that any meaningful response is complex, dynamic, and requires both legislative action and the active participation by motivated private-sector players.

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