Expanding CDFI Coverage in Underserved Areas

Financial Resources for CDFI Expansion

Expansion by Existing CDFIs
Kansas City, MO

August 20, 2015

US DEPARTMENT OF THE TREASURY CDFI FUND CAPACITY BUILDING INITIATIVE

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Agenda

- Overview of Types of Financial Resources
- Financial Resources for Expansion
- Capitalization Trends and Resources by CDFI type

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CDFIs Need Two Types of Financial Resources

Any expansion of coverage needs financial resources

1) **Operating** Funds ($ to pay for operations)
   1) Earned income
   2) Operating grants (primarily loan funds)

2) **Capital** ($ to lend)
   – Debt
   – Equity or net assets
      • Grants, operating surpluses, equity investments

Operating Funds

- Loan funds
  – Generate ~ 70% of total operating expenses through earned income
  – Balance from operating grants
    • Programmatic and general operating support
- Credit unions and Banks
  – Generate ~ 100% of total operating expenses through earned income
  – Banks and credit unions do not depend on grants for operations

How CDFIs are Capitalized

	Debt	Subordinated Debt	Equity
Loan Fund	• Unsecured loans • Secured loans	• Subordinated Debt • EQ2	• Net Assets (non-profits), Equity
Venture Fund	• Unsecured loans • Secured loans	• Subordinated Debt	• Equity
Credit Union	• Member shares Non-member deposits	• Secondary Capital	• Retained Earnings • Capital grants
Bank	• Deposits (Primary) • Unsecured loans • Repurchase Agreements • FHLB Borrowings		• Equity • Common Securities • Preferred Securities

Capitalization Considerations

- Capital structure
  - % debt; % equity
- Debt Characteristics
  - Term
  - Rate
  - Senior vs subordinated
  - Secured vs unsecured
- Equity/Net Assets
  - Any restrictions?
- Diversity, predictability, and sources of capital
- Capitalization strategies for growth
- Managing liquidity

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Financial Resources for Expansion

- Federal Home Loan Bank (FHLB)
- CDFI Bond Guarantee Program
- New Markets Tax Credit Program (NMTC)

Federal Home Loan Bank (FHLB)

- Why do CDFIs want to join the FHLB?
  - Capital
  - Affordable Housing and Community Development Programs
  - Capital Markets Expertise

CDFI Bond Guarantee Program

- New investment vehicle created by Small Business Jobs Act of 2010
- New source of government guaranteed, long-term (up to 30 years) debt for CDFIs
- Provides access to responsible financing for disadvantaged communities at meaningful volumes, affordable costs, and long-term
- http://www.cdfifund.gov/bond

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CDFI Bond Guarantee Program

- The Treasury Department may guarantee up to 10 bonds per year, each at a minimum of $100 million
  - If borrowing less than $100 million, individual CDFIs can partner with other CDFIs to aggregate to a bond issue of at least $100 million
- All bond borrowings must be for community or economic development purposes in low-income or underserved rural areas.
  - Up to 30 years
  - General recourse obligation & secured by loans receivable that meet program requirements

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CDFI Bond Guarantee Program

Based on program requirements, the most practical uses of the bond proceeds are for longer term, real estate based financing, such as:

- Affordable multi-family and home mortgages
- Community facilities
  - Charter Schools
  - Day Care Centers
  - Healthcare facilities
- Commercial real estate
- Owner-occupied office buildings

New Markets Tax Credit (NMTC) Program

- Provides a tax incentive for investments in Community Development Entities to make loans and investments in low-income and targeted communities
- Need to be Community Development Entity (CDE) to apply
  - Mission
  - Accountability to community
  - CDFIs are automatically CDEs
- CDEs invest substantially all of the proceeds they receive to make Qualified Low-Income Community Investment in Qualified Active Low-Income Community Businesses
- Approximately 30% of Allocations to CDFIs
- http://www.cdfifund.gov/nmtc

Capitalization for Loan Funds

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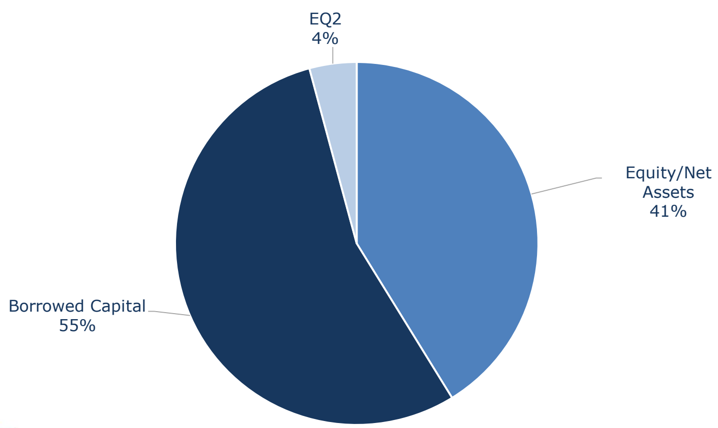
Loan Fund Capitalization



Source: OFN Member Survey, FY2013

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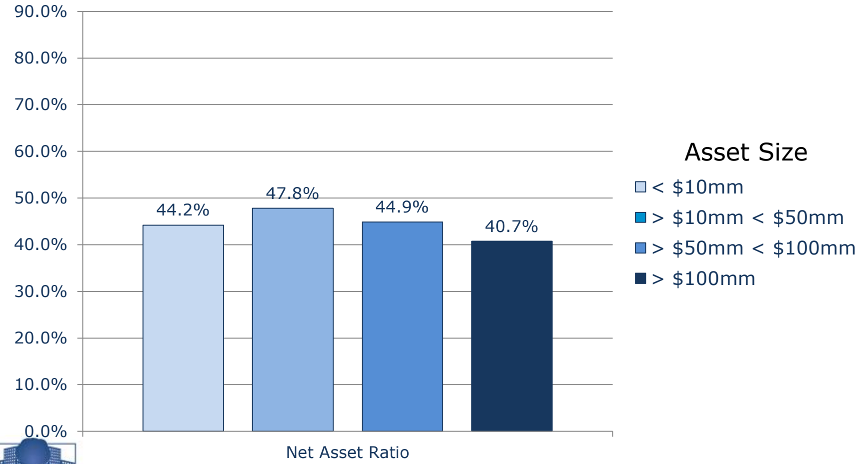
Net Asset Ratio By Loan Fund Asset Size



Source: OFN Member Survey, FY2013

Equity/Net Assets: Loan Funds

- Equity for non-profit loan funds = capital grants; retained earnings
- Hard to raise/not a lot of sources
- CDFI Fund has been the largest source of equity for the industry
- Lack of equity could hamper an ability of loan fund to grow and leverage
- Loan funds needs to determine appropriate equity/net asset %

Courtesy of: The Fundamentals of the Opportunity Finance Industry program.

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Sources of Loan Fund Borrowed Funds

Source	% of Borrowed Funds
Banks/Thrifts/Credit Unions	29%
Federal Government	23%
Foundations	14%
Other	5%
State/Local Government	8%
Corporations	7%
Religious Institutions	5%
Individuals	3%
Non-Depository Financial Institutions	4%
National Intermediary	2%

Source: OFN Member Survey, FY2013

Average Loan Fund Cost and Term of Borrowed Funds

Cost of borrowed funds	Term of borrowed funds
2.4%	115 months

Source: OFN Member Survey, FY2013

Capitalization Trends: Loan Funds

- Community Reinvestment Act (CRA)'s importance varies depending on the policy environment and strength of regulatory enforcement
- Advocacy efforts have led to new and expanding sources of capital
  - SBA: SBA Community Advantage Program; SBA 504 program; SBA microloan program
  - Loan funds access to FHLB System
  - CDFI Bond Guarantee program
- More secured lending than in the past
- Investors have increasing focus on unrestricted net assets
- Loan funds need to focus more on longer-term balance sheet management

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Federal Home Loan Bank

- History of the Federal Home Loan Bank
  - 2008: Housing and Economic Reform Act (HERA) opens membership for CDFIs
  - September 2010: First CDFI Loan Fund Member
  - March 2011: First CDFI Loan Fund Borrowing
- 34 members as of 3/31/15 with at least one non-depository CDFI in all districts
- As of 3/30/2015, ten CDFIs with $121 million outstanding

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Ratings for Loan Funds

- Purpose
  - Increase flow of capital to loan funds
  - Promote loan fund performance as primary criterion determining flow of capital
  - Focus on unregulated loan funds
- Products
  - Rating - Comprehensive, third-party assessment of a loan fund's impact performance and financial strength and performance (2 ratings)
  - Ratings on 82 loan funds
  - Approximately 50 subscribers
  - Information Services & Quarterly Data (new)
- aerisinsight.com

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Standard and Poor's Rating

- New Entrant in Rating Loan Funds
- Loan Funds Rated to Date
  - Clearinghouse CDFI: For-profit loan funds
  - Housing Trust Silicon Valley: Not-for-profit loan funds
- Potential Access to New Capital Sources
  - Corporate Treasurers
  - State Treasurers
  - Impact Investors
- Emerging Trend: Too early to draw conclusions

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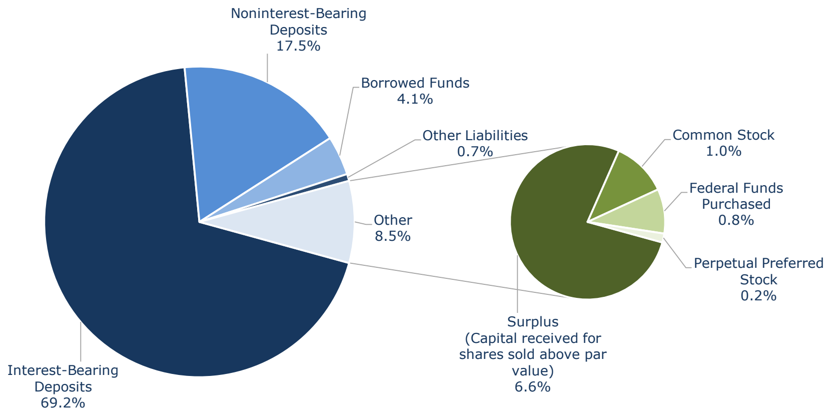
Capitalization for Banks

Capitalization Trends: Banks

- After the financial crisis, regulators have increased scrutiny of banks' capital plans
- Regulators expect all banks to prepare and implement capital plans, which lay out how the bank will raise sufficient capital to support the bank's strategic plan and absorb losses
- It is becoming more difficult for CDFI Banks to raise capital
  - Growing competition from other banks and non-bank financial service providers has decreased small bank earnings
  - New regulatory requirements increase costs and limit or severely limit future growth of past sources of acceptable regulatory capital such as Trust Preferred Securities and various kinds of preferred stock
- Reduced earnings and growing compliance costs have led more banks to consider mergers and acquisitions

Bank Capitalization



Source: FFIEC call reports, Q1 2015

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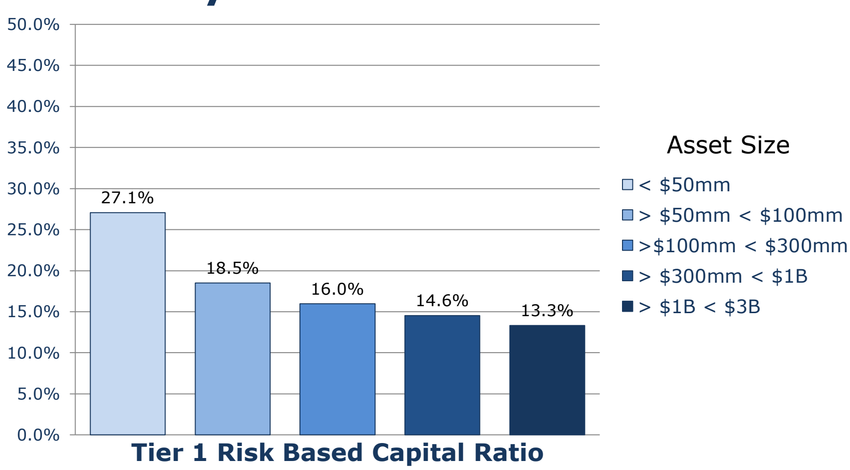
Tier 1 Risk Based Capital Ratio By CDFI Bank Asset Size



Source: FFIEC call reports, Q1 2015

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Equity: Banks

- CDFI banks face significant challenges in raising regulator approved equity capital from traditional capital markets due to lack of scale and the fact that only a small portion are publicly traded
- Sources of equity capital include:
  - Institutional investors, private equity (only for banks with assets over $1.5 billion; most institutional investors won't consider offerings smaller than $20 million)
  - Public offerings
  - Private Equity Funds
- Private investors require a clear exit strategy (e.g. an IPO or selling to a larger institution)
- Many CDFI banks opt to remain privately held in order to avoid becoming driven primarily by quarterly earnings and to maintain their mission focus and local control

Capitalization for Venture Capital Funds

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Capitalization Trends: Venture Capital Funds

- Typically capitalized 100% by equity investment interests in VC fund
  - Limited partnership interest in partnership or membership invest in LLC
- Investors are typically pari passu in fund, although some foundations will donate returns above a certain level on a PRI to associated not-for-profit for legal reasons
- Investor return dependent on success of fund's investments, less organizational expenses, fund costs, management fees, and carried interest
- Investment commitment is made up front, and returns are received as investments are exited
- CDFI Fund grants may go to associated not-for-profit to invest in fund alongside other investors

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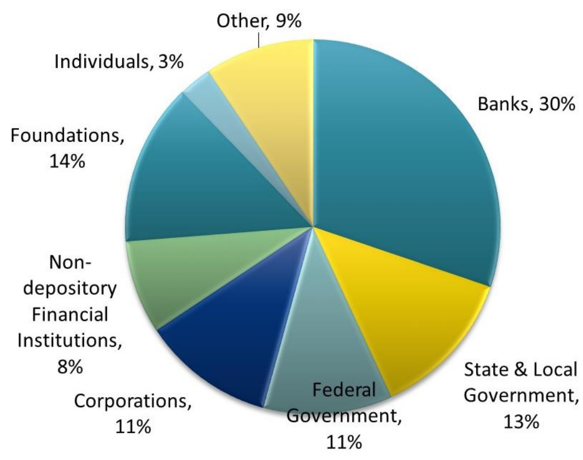
Sources of Capital for CDVC Funds



Source: Community Development Venture Capital Alliance

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Capitalization for Credit Unions

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Capital Structure of Credit Unions

- Non-profit, member owned cooperatives
- Regulated and insured depositories
- Regulators require minimum Net Worth Ratio of 7% (equity/total assets)

Credit Union Balance Sheet

Regular Reserves		$55,000	
Other Reserves		$5,000	
Undivided Earnings	$10,000		
Total Equity		$70,000	Net Worth = 7%
Total Liabilities		$930,000	
Total Assets		$1,000,000	

- Median Net Worth Ratios:
  - 11.5% for all credit unions
  - 10.4% for CDFI credit unions

Source: NCUA 5300 Call Reports

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Net Worth: The Key to Growth

- Deposits are primary source of loan capital for credit unions
  - Ability to increase deposits determined by amount equity
- Permanent equity can only increase through retained earnings and grants
  - Credit unions cannot raise equity on capital markets or sell ownership shares to outside investors
- Slow, incremental growth of net worth a major constraint on growth for CDFI credit unions
- Financial crisis increased regulatory pressure to maintain higher net worth ratios
  - Greatest pressure on CDFI credit unions serving low-income markets, perceived by regulators to be higher risk
  - Some credit unions forced to reduce deposits to boost net worth ratio
  - Increased need for alternative capital to fuel continuous growth

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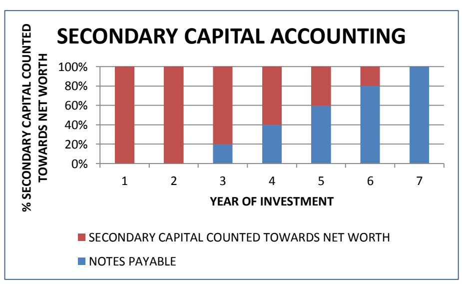
Secondary Capital for Credit Unions

- Deeply subordinated loan that counts as regulatory net worth
  - Enables credit unions to increase assets, lending
- Created by Federation in mid-1990s with regulatory approval for all low-income designated credit unions in 1997
- Loans must be at least 5 years, typically interest only with balloon repayment at maturity.
  - Portion that counts towards equity declines during final five years of loan.



Source: NCUA Regulations Section 701.34

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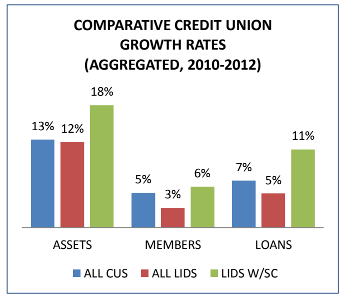
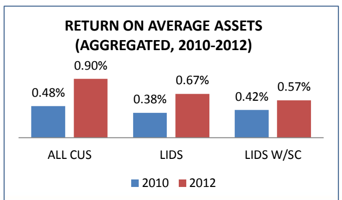
Secondary Capital Impact on Credit Unions

Low-income designated credit unions with secondary capital:

- Increased primary capital
- Increased efficiency and earnings
- Grew faster than peers without secondary capital in terms of:
  - Total assets
  - Total members
  - Total loans





Source: National Federation of Community Development Credit Unions Working Paper. Secondary Capital: An analysis of the impact of secondary capital equity investments on low-income designated and community development credit unions. December 2013

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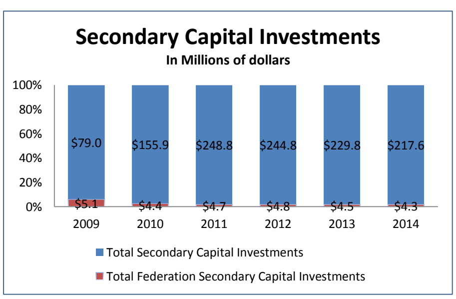
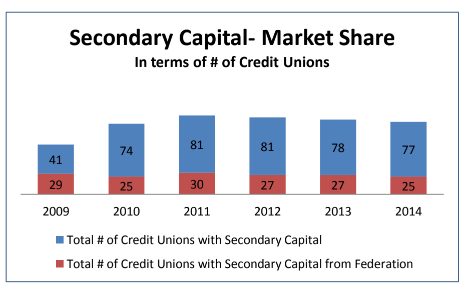
Secondary Capital Investments, 2009-2014



- Federation's CDI Program has high market penetration and diversity in institution types and sizes.
- Nearly one-third of all credit unions with secondary capital are Federation investees.
- Federation advocacy helped establish 2009 CDCI Program that doubled total secondary capital.
- Federation remains largest private secondary capital investor.



Source: NCUA 5300 Call Reports 2009-2014

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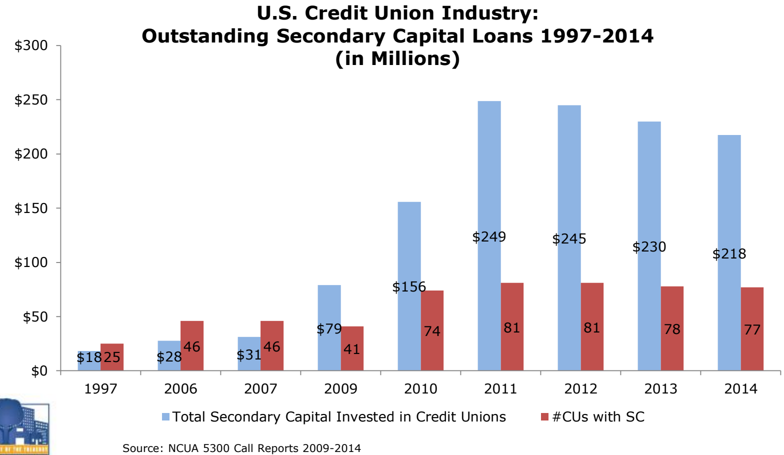
Secondary Capital Historical Growth



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A New Launch: Amortizing Secondary Capital

- Federation advocacy with NCUA addressed two limitations of original interest-only, balloon repayment secondary capital loan
  - Limited demand for product that becomes an increasing liability for credit unions over last five years
  - Limited supply of secondary capital from investors that find balloon repayment structure too risky
- In 2015 NCUA approves fully amortizing secondary capital loans to increases value for credit unions and reduce risks for investors.
- Federation establishes new secondary capital loan product and broadens investor partnerships, securing initial $10 million investment and $500,000 equity capital from large, national bank

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New Product Structure

Streamlined Secondary Capital Approval Offers Benefits to Credit Unions, Investors

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NCUA Adds Flexibility, Transparency through Supervision Process

ALEXANDRIA, Va. (April 6, 2015) – Low-income credit unions and investors will find secondary capital processes easier under revisions to the National Credit Union Administration's supervisory policies.

"Under my Regulatory Modernization Initiative, NCUA seeks to lift compliance burdens from credit unions where it's prudent and consistent with safety and soundness," Board Chairman Debbie Matz said. "Sometimes, that's accomplished through regulation; other times, through supervisory changes. The supervisory changes related to supplemental capital make it easier for low-income credit unions to obtain, and give investors greater clarity and confidence. We've also added more flexibility and transparency."

Matz said the changes to the agency's National Supervision Policy Manual were aimed at achieving two goals: expediting the approval of secondary capital requests by regional offices and making it possible for credit unions that have secondary capital to return portions of the loans that no longer count towards net worth.

The revised procedures can be found in the updated section of the agency's National Supervision Policy Manual, available online here.

Secondary capital helps low-income credit unions expand services and maintain capital levels by supplementing net worth.

- Regulatory changes streamline application and repayments
- Change to prime market product
- Focus on high performing, growth-oriented credit unions that serve majority low-income communities
- Increased capital for impact investments in low-income credit unions with reduced risk to investors

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Questions?

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