



FINANCING APPROACHES

CDFI financing support from banks can be classified in three forms: equity investments, which represent capital arising from investment in CDFIs; debt, which represents funds loaned to CDFIs; and deposits, which are funds placed in CDFI depository institutions, typically earning interest and insured by a federal governmental agency.

Investment activities for banks must be consistent with the regulatory guidance and requirements as discussed in Section V. For consideration under the CRA, a bank's investment activities must serve community development purposes and be consistent with safe and sound banking requirements. Also, as discussed further in Section V, for most community banks and large retail institutions, the CDFI's purpose and activities should cover their assessment area or the statewide or regional area that includes the assessment area.

A. Equity

Equity capital is a resource that enables CDFIs to raise additional funds through debt in order to lend to low- and moderate-income borrowers. Equity capital acts as a cushion to protect senior debt investors from losses and increase the earnings of CDFIs. It also enhances CDFIs' financing flexibility.

Equity investments cover a wide array of capital source types, including the following:

Grants

Grants are charitable, philanthropic financial awards to nonprofit CDFIs. Banks can provide capital grants to build the equity capital of qualifying nonprofit CDFIs. Restricted grant funding can be specifically targeted for predefined activities. Common categories of grants are capital for a CDFI loan pool and operating grants, which underwrite the costs to administer the loan pool and provide technical assistance to borrowers.

Equity Equivalents (EQ2s)

Equity equivalent investments, or EQ2s, are long-term, fully subordinated debt instruments with features such as rolling terms and limited right-to-accelerate payments that allow them to function in a manner similar to equity. CDFIs can leverage these instruments with senior debt to build their lending capacity. Only nonprofit CDFIs use EQ2s.

An EQ2 is generally defined by the following six attributes:

1. It is carried as an investment on the investor's balance sheet in accordance with GAAP.
2. It is a general obligation of the CDFI that is not secured by any of the CDFI's assets.
3. An EQ2 is fully subordinated to the right of repayment of all the CDFI's other creditors, current and future.
4. It does not give the investor the right to accelerate payment unless the CDFI ceases normal operations.
5. It carries an interest rate that is not tied to any income received by the CDFI.

6. An EQ2 has a rolling term without a specified maturity.²⁸

Regulators may view instruments with these six attributes similar to other preferred stock investments and, therefore, may consider them as equity investments. CDFI investors have used a variety of instruments. Not all are the same with respect to subordination, maturity, or other key terms. If any of the six attributes above is missing, the financial instrument would be treated as subordinated debt under banking regulatory requirements.²⁹

Bank investors should consider the following options when discussing the investment with regulators for purposes of the CRA and be able to provide supporting documentation of the following:

1. *CRA consideration under the lending test if the EQ2 activities are categorized as lending activities.*

The investing bank may claim a pro rata share of the incremental community development loans made by the CDFI in which the bank has invested, provided these loans benefit the bank's assessment area(s) or a broader statewide or regional area that includes the assessment area(s). The bank's pro rata share of loans originated should generally be equal to the percentage of equity capital (permanent capital and EQ2s) provided by the bank investor.

2. *CRA consideration under the investment test if the EQ2 is accounted for as an investment.*

The amount of the qualified investment is the total amount of the institution's investment in the CDFI at the time of the investment. After the examination where the full amount of the initial investment was considered, the book value would continue to be considered in future examinations as long as the investment is held.³⁰

3. *Consideration under the lending test and investment test if the EQ2 supports lending and investment activities.*

The amount attributed to the lending test would equal the bank's pro rata share of community development loans originated by the CDFI during the period under review. The amount of the bank investment not allocated to the lending activities would be considered under the investment test at the time of the investment and in the future as long as it is held.³¹ There can be no "double counting."

Ownership Interest in For-Profit Limited Partnership or Limited Liability Company

Some for-profit CDFI venture capital funds raise equity through limited partnerships or limited liability corporations that issue ownership interests. Of the 13 certified CDFI venture capital funds, 4 are for-profit institutions.³²

28 Center for Community Development Investments, "Equity Equivalent Investments," CRA Investment Handbook (Federal Reserve Bank of San Francisco: March 2010), pp. 30-33.

29 Community Investments, "Equity Equivalent Investments," (Federal Reserve Board of San Francisco, March 2002), p. 10. Available at http://www.frbsf.org/community-development/files/community_investments_March_2002.pdf.

30 Office of the Comptroller of the Currency, Federal Deposit Insurance Corporation, Federal Reserve Board, Office of Thrift Supervision. "Interpretive Letter #784, 12 U.S.C. 2901. June 1997. Available at <http://www.occ.gov/static/interpretations-and-precedents/jun97/cra784.pdf>.

31 Center for Community Development Investments, "Equity Equivalent Investments," CRA Investment Handbook (Federal Reserve Bank of San Francisco: March 2010).

32 U.S. Department of the Treasury CDFI Fund, "Community Development Financial Institution Fund – List of Certified Community Development Financial Institutions (CDFIs) with Contact Information as of March 31, 2014.

In qualifying for-profit CDFI venture capital funds, the investor receives a return on investment that is dependent on the returns from the fund's underlying investments in small businesses. At closing, some CDFI venture capital funds will distribute invested capital plus earnings over time to investors. Other CDFI venture capital funds will distribute earnings as they accrue rather than wait for the fund to reach its completion.³³

Stocks

A share of stock is an instrument that signifies an ownership interest in a corporation. CDFI banks and some CDFI venture capital funds raise equity capital by issuing stock.

B. Debt

CDFIs often rely on loans from banks and other investors. Debt financing can be structured to earn interest at either a below market or market rate. As long as the geographic requirements of CRA are met, and the loan is made in a safe and sound manner, community banks may receive CRA consideration for loans to or in collaboration with CDFIs that primarily serve a community development purpose.

Line of credit

A line of credit is an arrangement in which the bank investor extends a specified amount of unsecured credit to a CDFI for a specified period of time. The CDFI can borrow as it needs from the line of credit, up to the established limit.

Loans

Community banks can provide CDFIs short- and long-term loans, which can be secured or unsecured. Interest rates and length of the investment terms can vary. Investors who choose a lower rate of return and longer investment terms help CDFIs provide less costly and more responsive financing to low-income borrowers, and pay for services such as technical assistance to help borrowers use their financing effectively. The types of technical assistance provided by a CDFI depend on the needs of its market. Technical assistance can include credit counseling, business training, homebuyer education, consumer education and financial literacy, and savings programs.

Secondary Capital

Secondary capital is an uninsured, subordinated debt instrument that offers investors an opportunity to invest in CDFI credit unions. The instrument is subordinate to all other claims on the net worth of the credit union and may not be pledged by investors as security on another obligation. Secondary capital has a five-year minimum maturity and is not redeemable prior to maturity. The instrument acts like equity and enhances the net worth of credit unions, which improves their ability to absorb losses.

The only credit unions permitted to accept secondary capital are those that have been designated "low-income" credit unions by the NCUA. The majority of CDFI certified credit unions have been approved by NCUA to accept secondary capital.

Asset-Backed Securities

Asset-backed securities are financial securities whose value and income payments are derived from and collateralized by a pool of loans with similar characteristics. A CDFI bundles a group

³³ The FDIC may review the limited liability corporation or limited partnership structure to ensure that the bank is insulated properly against unlimited liability.

of its community development loans and sells shares in the repayment stream to investors. The pooling of loans with one or more layers of credit enhancement into securities spreads credit risk across multiple loans and reduces each investor's exposure.

The Community Reinvestment Fund, a national CDFI and financial intermediary, pioneered this structure with its securitizations of community development loans. The organization buys community development loans from CDFIs and other community development lenders and pools them into asset-backed securities. The securities feature credit enhancements and are split into tranches with different risk classes and sold to investors through private placement.³⁴

Guarantees

Guarantees are instruments guaranteeing the payment of a CDFI's debt obligations. Guarantee options include letters of credit, which are used to enhance the creditworthiness of a CDFI borrower receiving a loan from a third-party lender. Letters of credit are considered community development lending-related activity for CRA purposes if the institution provides information on the activity that documents its purpose.

C. Deposits

Deposits are funds placed in interest-bearing accounts in CDFI depositories. Deposits in FDIC-insured CDFI banks are insured up to the maximum allowed by law. NCUA provides similar coverage for deposits in insured CDFI credit unions.

CDFI depositories offer various types of deposits at market rates, including certificates of deposit, Money Market Deposit Accounts, and savings accounts. Certificates of deposit are offered at various maturities.

Deposits can receive consideration as a community development investment.

Nonmember Deposits

Nonmember deposits are instruments that pay a fixed amount of interest in CDFI credit unions. These deposits are made by individuals and organizations that are not members of the institution. These deposits do not confer ownership rights of the CDFI credit union to the depositor.

A CDFI credit union must have a low-income designation from NCUA to be eligible to receive nonmember deposits.

³⁴ Community Reinvestment Fund, "Capital for Communities – Opportunities for People." Available at <http://www.crfusa.com>.