CDFI Funds

TL;DR

CDFI Funds are certified by the US Treasury as organizations dedicated to providing capital to underserved communities. Many CDFIs make use of grants in addition to earned income to sustain their operations.

Overview

The Community Development Financial Institutions (CDFI) Fund is an agency of the US Department of the Treasury, established through the Riegle Community Development and Regulatory Improvement Act of 1994. The mission of the CDFI Fund is to increase the capacity of financial institutions to provide credit, capital, and financial services to underserved markets.

Financial institutions, including banks, credit unions, loan funds, and venture capital funds, can apply to the CDFI Fund for formal certification as a CDFI. In recent years, CDFI-certified institutions have proven their worth to the economy as a key resource for excluded populations. On average, CDFIs extend nearly 75% of their lending capital in distressed areas and to underserved communities, with a special focus on rural areas, persistent poverty counties (PPCs), and high poverty census tracts. As participant lenders in the 2020-21 Paycheck Protection Program (PPP), CDFIs outperformed traditional financial institutionson nearly every measure of program effectiveness, especially in reaching very small and minority-owned businesses.

The CDFI Fund offers a variety of financial programs to provide capital to registered CDFIs. Two common and relevant CDFI institution structures are loan funds and venture capital funds.

What is a CDFI Loan Fund?

Community development loan funds (CDLFs) provide debt financing and development services to businesses, organizations, and individuals in low-income communities.

There are four main types of loan funds: microenterprise, small business, housing, and community service organizations. Each is defined by the client served, though many loan funds serve more than one type of client in a single institution. CDLFs tend to be nonprofit and governed by boards of directors with community representation.

CDLFs must designate at least 60% of financing activities to one or more low- to moderate-income or underserved communities.

What is a CDFI Venture Capital Fund?

Community development venture capital (CDVC) funds provide equity and debt with equity features for small and medium-sized businesses in distressed communities. They can be either for-profit or nonprofit and typically include community representation. Many, but not all, seek and receive certification from the CDFI Fund of the Department of Treasury.

The largest group of investors in CDVC funds is banks, followed by foundations, government and other socially motivated institutions, and individuals. Banks that invest in CDVC funds are motivated to do so in large part by the CRA. More than half of the capital invested in community development venture capital funds comes from banks, so banks constitute a vital component of investors in the industry.

CDVC Funds must designate at least 60% of financing activities to one or more low- to moderate-income or underserved communities.

CDFI Fund Programs

The following programs from the Department of the Treasury's CDFI Fund *directly* provide capital and other resources for certified CDLFs and CDVCs:

CDFI Program: The CDFI Program offers both Financial Assistance and Technical Assistance awards to CDFIs. These competitive awards support and enhance the ability of these organizations to meet the needs of the communities they serve.

Financial Assistance awards are made in the form of loans, grants, equity investments, and deposits that CDFIs are required to match dollar-for-dollar with nonfederal funds. This requirement enables CDFIs to multiply the impact of federal investment to meet the demand for affordable financial products in economically distressed communities. Both Financial and Technical Assistance awards empower CDFIs to grow, achieve organizational sustainability, and contribute to the revitalization of the communities they serve.

Small Dollar Loan Program (SDL): The Small Dollar Loan Program (SDL Program) is a new program authorized by the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010. The fiscal year (FY) 2021 funding round is the first award round of the program. The SDL Program was created to help Certified CDFIs address the issue of expanding consumer access to mainstream financial institutions and provide alternatives to high-cost small-dollar loans. The program was also created to help unbanked and underbanked populations build credit, access affordable capital, and allow greater access into the mainstream financial system.

Through the SDL Program, the CDFI Fund will provide:

- **Grants for Loan Loss Reserves (LLRs):** The awards will enable a CDFI to establish a loan loss reserve fund in order to defray the costs of establishing or maintaining a small dollar loan program.

- **Grants for Technical Assistance (TA):** The awards will support technology, staff support, and other eligible activities to enable a Certified CDFI to establish and maintain a small-dollar loan program.

SDL Program grants may only be used to support small dollar loan programs offering small-dollar loans to consumers that:

- are made in amounts that do not exceed $2,500
- must be repaid in installments
- have no prepayment penalty
- have payments that are reported to at least one of the consumer reporting agencies that compiles and maintains files on consumers on a nationwide basis

Capital Magnet Fund: Through the Capital Magnet Fund, the CDFI Fund competitively awards funds to CDFIs and qualified nonprofit housing organizations. These awards can be used to finance affordable housing activities as well as related economic development activities and community service facilities, with the objective of attracting private capital to economically distressed communities, including underserved rural areas. Funding for the Capital Magnet Fund comes from allocations made by the government-sponsored enterprises Fannie Mae and Freddie Mac and varies from year to year.

Capital Magnet Fund awards must be used to leverage housing and economic development investments at least 10 times the size of the award amount. Award recipients are able to utilize Capital Magnet Fund awards to create financing tools such as loan loss reserves, loan funds, equity funds, risk-sharing loans, and loan guarantees. At least 70% of Capital Magnet Fund dollars must be used to finance affordable housing, and recipients may use up to 30% of funds to finance economic development activities linked to affordable housing.

New Markets Tax Credit (NMTC): Through the NMTC program, the CDFI Fund allocates tax credit authority to Community Development Entities (CDEs) through a competitive application process. CDEs are financial intermediaries through which private capital flows from an investor to a qualified business located in a low-income community. Organizations that are CDFIs automatically qualify as CDEs and need only register electronically via the CDFI Fund's website. CDEs use their authority to offer tax credits to investors in exchange for equity in the CDE. Using the capital from these equity investments, CDEs can make loans and investments to businesses operating in low-income communities on better rates and terms and more flexible features than the market. In exchange for investing in CDEs, investors claim a tax credit worth 39% of their original CDE equity stake, which is claimed over a seven-year period. A certain form of CDE, called a New Markets Venture Capital (NMVC) Fund, operates much like a CDVC fund but is exclusively dedicated to investing in NMTC-eligible businesses and entities.

The following programs from the CDFI Fund *indirectly* provide capital and other resources for certified CDLFs and CDVCs:

CDFI Bond Guarantee Program: Unlike other CDFI Fund programs, the CDFI Bond Guarantee Program does not offer grants or direct loans; instead, it is a federal credit subsidy program. Qualified entities (large CDFIs or their designees) issue bonds that are guaranteed by the federal government and use the bond proceeds to extend credit to the broader CDFI industry for community development purposes or to refinance certain existing obligations. As a Qualified Issuer, a Certified CDFI applies to the CDFI Fund for authorization to issue bonds worth a minimum of $100M. The CDFI Fund provides a 100% guarantee on these bonds, up to $1B per year. The Qualified Issuer then sells the government-backed bonds to the Federal Financing Bank. Each bond has a maximum maturity of 30 years. The Qualified Issuer must use the proceeds from the bond sale to extend credit to other CDFIs. As a result, Qualified Issuers serve as a “go-between” financier to the broader CDFI industry. Most CDFIs participate in this program as secondary borrowers.

Bank Enterprise Award Program (BEA): Rewards FDIC-insured banks and thrift banks for increasing their investments in CDFIs—thereby increasing capital sources for CDFI loan funds and CDVC funds.

Additional programs from the CDFI fund include: Native Initiatives, CDFI Rapid Response Program, & Capacity Building Initiative

Fund Criteria

When is this fund model a good fit for fund managers?

CDLFs and CDVCs are typically associated with economic development initiatives and, as such, are most often managed by nonprofit organizations or fund managers with some affiliation with community development. Because of the unique organizational structure of these funds and their mission-oriented nature, CDLFs and CDVCs are often spun-out of existing nonprofits, governmental entities, or other community economic development organizations. One such example is the Cincinnati Minority Business Accelerator, which, after running an accelerator program for 16 years, ultimately decided to launch its own CDVC fund to invest in local Black-owned businesses.

Successful CDLF managers tend to have backgrounds in banking, private credit, and economic development work. Top CDVC fund managers share many of the same traits—especially experience in traditional venture capital and impact investing. For fund managers with a strong economic development mission and a comfort interfacing with federal government entities, CDFI funds may be a good fit.

Benefits vs. Costs

Benefits

Low Cost of Capital: Grants and low-interest loans via the CDFI Fund can offset operational expenses related to higher costs of customer acquisition, marketing and outreach, and loan loss reserves—all of which are associated with the task of bringing capital products to otherwise underserved markets.

High Quality Communities of Practice: Industry trade groups for CDVC fund managers (CDVCA) and for CDLF managers (OFN). Well publicized events, industry leaders, and a high degree of industry camaraderie.

Community Reinvestment Act (CRA) Capital: Banks and other depository institutions often invest in, lend to, or make donations to CDFI entities to satisfy requirements of the Community Reinvestment Act—a source of capital that many CDFIs heavily rely upon.

Costs

Bureaucracy: CDFI certification can be a tedious process, and annual compliance reporting does create an administrative burden for fund managers.

Demographic Limitations: Obligations to deliver at least 60% of financial products to business or individuals of low-to-moderate income or from underserved communities can be challenging in certain geographies or business sectors.

Higher Costs of Doing Business: Bringing capital products to historically underserved entrepreneurs and market segments can often mean increased costs of doing business.

Fund Pricing & Terms

CDFI Loan Funds (CDLFs)

Average Fund Size: In 2019 the average CDFI loan fund had assets of $49M.

Subscription Amount: Typically minimum fund-level investment around $100K, although third-party pooled funds such as CNote collect smaller investments from nonaccredited investors and allow secondhand exposure to CDFI funds at much smaller subscription amounts.

Subscription Period: Low-interest loans or bonds to CDFI entities typically structured over 5-7 years. LP investments in loan funds typically structured over 7- to 10-year hold periods.

Management Fee: N/A	**Carried Interest:** N/A	**Preferred Return:** N/A

GP Commitment: All operational expenses, loan loss reserves

Investment Period: N/A—capital constantly recycling

Fund Life: Ongoing/perpetual

Community Development Venture Capital Funds (CDVCs)

Average Fund Size: In 2019 the average CDVC fund had assets of roughly $25M.

Subscription Amount: CDVC funds typically have a minimum LP commitment around $100K.

Subscription Period: 7-10 years on average

Management Fee: Similar to VC industry average, typically around 2%

Carried Interest: Similar to Private Equity industry average, typically around 20%

Preferred Return: Similar to Private Equity industry average, typically around 8%

GP Commitment: All operating expenses, CDFI certification, and compliance.

Investment Period: For CDVC funds providing solely equity investments, investing takes place from first fundraising close to years three to five. For CDVC funds providing debt with equity features, lending can take place for the entire lifetime of the fund.

Fund Life: 7-10 years

FAQs

What are the reporting requirements for a CDFI?

All CDFIs are required to complete an annual certification report to keep their CDFI certification. This report must be submitted within 90 days of the end of the organization's fiscal year, and may use unaudited financials.

Does registering as a CDFI come with guaranteed funding?

No. CDFI certification simply enables an organization to participate in programming and apply for grants from the CDFI Fund. It also typically helps fundraising efforts, especially with organizations whose investments are guided by Community Reinvestment Act obligations.

How many CDFIs are currently certified?

According to the CDFI Fund, there are currently 1,200+ registered CDFI entitles.

What kind of activities do CDFIs engage in (besides lending)?

CDFIs also frequently provide some form of technical assistance to small businesses in the communities in which they operate. This assistance can range from general networking and informal community events to specific training programs and direct consulting engagements with small businesses.

How can I find a CDFI near me?

Opportunity Finance Network (OFN), an industry trade group for CDFIs, maintains a searchable database here. Entrepreneurs can also use the Connect2Capital Marketplace to be matched with an eligible CDFI lender based on business funding needs and location.

Opportunities to Build & Improve

FinTech innovation: CDFI Loan Funds are increasingly competing with well-funded, direct-to-consumer Silicon Valley financial technology companies like Square, Toast, Kabbage, and more. These companies leverage data and technology to bring capital products to entrepreneurs—often at rates much higher than CDFIs are offering. CDFIs must adopt technology and marketing best practices if they wish to educate entrepreneurs, compete for business, and be seen as legitimate options in the ever-changing capital marketplace.

CDVC attention: While CDLFs have enjoyed a recent rise to prominence in conversations around community economic development and equitable access to capital, CDVC funds remain conspicuously absent from many of these discussions. A national trade association for CDVC funds, the Certified Development Venture Capital Alliance (CDVCA), is working on increasing access and visibility for CDVCs across the US.

CDFI Fund Case Study

Cincinnati USA Regional Chamber

Overview

The Cincinnati Minority Business Accelerator's inaugural investment fund, "MBA Fund 1" was launched in 2022 and is planned to soon be certified as a CDVC fund. Because of this forthcoming certification, MBA Fund 1 has been able to raise nearly $50M from regional and national banks due to their motivations to satisfy Community Reinvestment Act requirements. MBA Fund 1's unique approach to investing in and creating Black-owned businesses in Cincinnati means that the fund will deploy the majority of its capital to underserved entrepreneurs, making it a safe fund-level investment from a CRA standpoint.

The process of certifying as a CDVC is not entirely straightforward, which has led the MBA Fund 1 team to devise a careful strategy for approaching the process. The CDFI Fund will not certify an entity without any existing investments, so the MBA Fund must accept some investments, hold a "first close" for their fundraising, and make at least one investment in a CDFI eligible business before submitting their application to the Treasury. Then, once the entity is certified as a CDFI, the remainder of the fund investors who required certification before investing will complete their investments, and the fund will close with a hopeful $100M of capital to invest in the community.

Investment Strategy

MBA Fund 1 will invest over a 10-year period in private businesses—at least 75% of which will be in and around the Cincinnati area. The fund will make use of an innovative, multimodal investment approach, offering the following capital products:

- Traditional equity investments
- Revenue-based investments
- Traditional term loans
- Ownership acquisition financing & private equity investments

Fund Structure

Management Company: The Cincinnati Minority Business Accelerator, a subsidiary of the Cincinnati Area Chamber of Commerce

Fund: MBA Fund 1, LLC

GP: MBA Fund 1 Management, LLC

Fund Terms

Fund Size: $100M

GP Commitment: TBD

Investment Period: 5 years

Fund Life: 10 years

Management Fee: 2% of committed capital

Carried Interest: 20%

Preferred Return: 8%

Key Person: Darrin Redus