

Missions Possible: How U.S. CDFIs Meet Financial And Social Missions, And The Rating Implications That Follow



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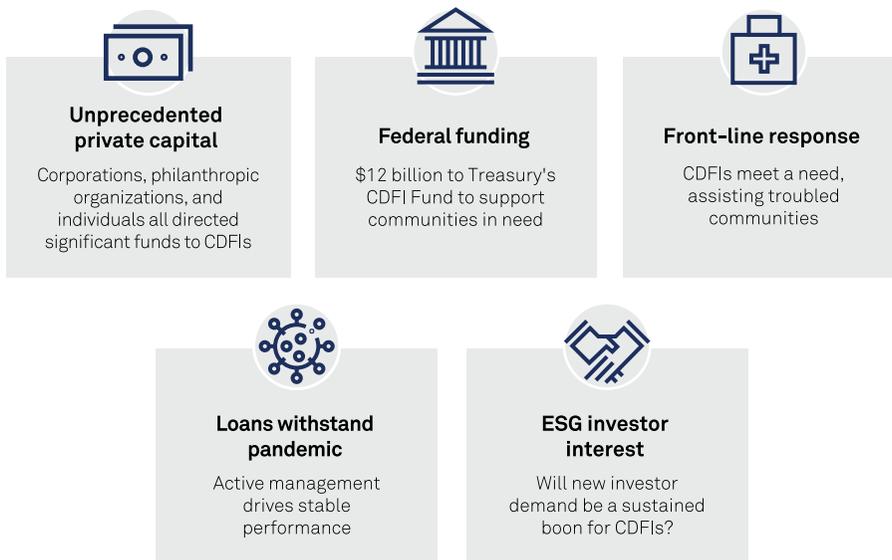
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What We're Watching - CDFIs



By The Numbers



Key 2019 ratios and five-year trends



Near-Term Factors Affecting CDFIs

In 2021, we anticipate ratings will remain stable. Although we expect some increase in U.S. community development financial institutions' (CDFIs) nonperforming assets (NPAs), particularly those with higher levels of commercial loans, these risks are already receding, and we expect mitigation efforts will continue throughout the year.

Loan portfolio growth slowed in the past two years, stabilizing equity ratios and ratings for most organizations. We expect this trend will continue during our outlook period. In addition, increased competition in various regions and lending sectors (for example, charter schools in certain communities) and limited federal funding awards (such as New Market Tax Credits [NMTC]) have slowed some loan portfolio expansions. Rated CDFIs have also pursued off-balance-sheet lending structures and participation loans, where they do not own a loan in its entirety but join other lenders in funding projects while still meeting their social mission. We believe this strategy lowers a CDFI's risk profile.

On-balance-sheet loan portfolio growth will be among the lowest since 2015. We believe loan prepayments and repayments for some CDFIs might outpace loan originations. A caveat to this is that many rated entities are eligible to participate as lenders in the Paycheck Protection Program (PPP). Therefore, some loan portfolios could show a large increase in PPP loan originations, but we expect most of these loans will remain on balance sheets for only a short time until they are forgiven and CDFIs are repaid by the federal government.

Outstanding debt growth will similarly slow. We expect CDFIs instead will use short-term, low-interest cost lines of credit (LOCs) and pandemic-related grant capital received in 2020. In addition, CDFIs recently increased their use of publicly rated retail notes, which allow for smaller incremental debt issuances and mitigate negative arbitrage, and we expect this trend will continue.

Rated CDFIs will continue to attract additional federal, philanthropic, and private funding. We believe this funding will likely lead to innovative lending structures in collaboration with private sector corporations. We also expect that the branding of CDFI bond or note offerings as social

bonds and the transparency of the use of proceeds of those bonds will become common practice and continue to attract environmental, social, and governance (ESG)-motivated investors.

CDFIs were first responders for pandemic relief

CDFI lending slowed significantly as the COVID-19 pandemic began to affect small businesses and construction projects halted across the country, creating uncertainty about the ultimate effects on portfolios. In response, and after ending fiscal 2019 with generally strong balance sheets and available liquidity, some organizations opted to draw on LOCs to further prepare for a possible pandemic-driven cash crunch. At the same time, they contacted all at-risk borrowers, stress-tested loan portfolios, tightened underwriting standards, and kept open lines of communication with their lenders and boards. CDFIs adhered to their "know-your-customer" rule and patient capital approach throughout the pandemic.

Lending activity picked up as the pandemic's effects became more defined. Underwriting standards remained tight and new lending focused on assisting businesses in low-income communities that needed financing the most. Although initially excluded as eligible lenders in the PPP, CDFIs were included in the program in May 2020, with billions of dollars designated for their lending programs, and they became financial first responders for much-needed pandemic relief.

At the same time, in recognition of racial inequality issues following the murder of George Floyd, CDFIs dedicated new capital to support diverse borrowers, including historically Black colleges and universities and developers and entrepreneurs from various racial and ethnic backgrounds. One CDFI included in its long-term strategic plan a goal to

reach \$5 billion in investments over the next decade to advance racial equity, while another committed to a \$3.5 billion national initiative dedicated to end racism in housing.

Private and public funding increases during times of stress

CDFIs were recognized by private and public stakeholders for their reliability and efficiency in distributing funds to communities most affected by the pandemic. An unprecedented amount of money flowed into the CDFI sector from private and philanthropic institutions, from large banks such as Goldman Sachs and Bank of America, companies such as Google and Starbucks, and large foundations such as the Ford Foundation and the MacArthur Foundation. Most notably, MacKenzie Scott donated more than \$4 billion to 384 mission-driven organizations; more than 30 CDFIs received some of her largest grants. Five of the 11 rated CDFIs received between \$10 million and \$50 million from Scott through unrestricted grants, which allow for significantly more flexibility in how funds are spent than do more common donor-restricted grants.

The sector also secured unprecedented funding from the federal government. In December 2020, Congress passed the \$900 billion Omnibus Appropriations and COVID-19 Relief Bill with \$12 billion set aside for CDFIs: \$9 billion for CDFI banks, credit unions, and minority depository institutions and \$3 billion in emergency support through the CDFI Fund to provide grants and expand lending and investments in low-income communities. CDFI loan funds were eligible for the latter. In addition, the CDFI Fund's budget was increased, the NMTC program (administered by the CDFI Fund) was extended, and an additional \$15 billion of PPP money was set aside for CDFIs to lend. This extensive federal support, combined with the private and philanthropic institutional funding, allowed institutions to stabilize their financial positions and continue operations.

ESG: CDFIs are riding the wave

We recognize CDFIs as "double bottom line" financial institutions; that is, they remain financially solvent while fulfilling a social purpose in the communities they serve. This has meant maintaining favorable financial metrics to attract private capital while meeting the aim of extending affordable lending options for in-need communities. Rated institutions have found a good balance in their double bottom lines. They have managed to attract private capital at a steady pace that has allowed them to expand, while committing to offering diverse lending choices to clients that otherwise have limited options.

CDFIs are well positioned to benefit from the increased interest in ESG-linked investments. With decades of experience lending to communities in need and demonstrating good stewardship of this capital, they have a long record of achieving positive social outcomes. Continuing this trend, institutions recently issued more than \$400 million of social bonds, the proceeds of which were certified by third parties to meet certain United Nations Sustainability Development Goals. We understand that these social bonds attracted significant interest from ESG-motivated investors, reducing the cost of capital in certain cases, and expanding the investor base for CDFIs.

Table 1 lists some, but not all, common social outcomes reported by rated CDFIs since their inception, encompassing more than \$51 billion invested in communities throughout the country. Other outcomes not listed in the table include support for foreclosure prevention, healthy food businesses, generation of solar electricity, and commercial and community facility space.

Table 1

Cumulative Social Outcomes Of Rated CDFIs

| | |
|---|----------------|
| \$ invested in communities | 51,550,000,000 |
| People positively affected or jobs created | 6,296,177 |
| Patients served by health care facilities financed by CDFIs | 5,110,897 |
| Homes financed (created or preserved) | 997,596 |
| Children served by schools and youth programs financed by CDFIs | 434,566 |
| Child care slots created, preserved, or enhanced | 319,942 |
| Jobs created or retained | 114,808 |

Source: CDFI annual reports and websites.

Credit Trends In Recent Years

Key Takeaways

- Social outcomes continue to expand and attract new capital, including unprecedented levels of private and public grants
- Fast-growing loan portfolios typically generate high interest spreads, albeit at the cost of sometimes weakening equity and leverage ratios
- In the past few years, debt outpaced growth in equity for many CDFIs, leading to some lower credit profiles
- Strong, nimble management is a strength for the sector

Since 2015, S&P Global Ratings has assigned issuer credit ratings (ICRs) to 11 CDFIs in the U.S., nine of which have issued approximately \$1.4 billion of publicly rated general obligation (GO) debt.

A spike in loan demand contributes to lower ratings

Organizations have taken on a larger debt burden, limiting growth in equity and leading to lower ratings. Capitalization and leverage metrics are key to our credit analysis, with a heavy focus on equity (that is, net assets). Although these ratios have remained strong in recent years, the increase in total debt exceeded the increase in equity and thus negatively pressured ratings. This resulted in our lowering some ratings and assigning lower ratings to some new issuers. The average CDFI rating category in 2015 was 'AA', falling two notches to 'A+' in 2020, albeit with almost four times as many rated entities (see table 2).

Table 2

CDFI Rating History

--Issuer credit rating as of Dec. 31--

| CDFI | 2015 | 2016 | 2017 | 2018 | 2019 | 2020 |
|---|-------------|-----------------|--------------|-------------|-------------|-------------|
| Housing Trust Silicon Valley | AA-/Stable | AA-/Stable | AA-/Stable | AA-/Stable | AA-/Stable | AA-/Stal |
| Reinvestment Fund, Inc. | AA/Stable | AA/Stable | AA/Stable | AA-/Stable | A+/Stable | A+/Stab |
| Clearinghouse Community Development Financial Institution | AA/Stable | AA/Watch Neg | AA-/Negative | A-/Stable | A-/Stable | A-/Stabl |
| Local Initiatives Support Corp. | | AA/Stable | AA/Stable | AA/Stable | AA-/Stable | AA-/Stal |
| Capital Impact Partners | | | AA/Stable | AA-/Stable | A/Stable | A/Stable |

| | | | | | | |
|--------------------------------|----|----|----|------------|-------------|----------|
| Century Housing Corp. | | | | AA-/Stable | AA-/Stable | AA-/Stal |
| Raza Development Fund, Inc. | | | | AA-/Stable | AA-/Stable | AA-/Stal |
| Enterprise Community Loan Fund | | | | AA-/Stable | A+/Stable | A+/Stab |
| Community Preservation Corp. | | | | | AA-/Stable | AA-/Stal |
| Low Income Investment Fund | | | | | A-/Positive | A-/Posit |
| BlueHub Loan Fund | | | | | | A-/Stabl |
| Average rating category | AA | AA | AA | AA- | A+ | A+ |
| N/A--Not applicable. | | | | | | |



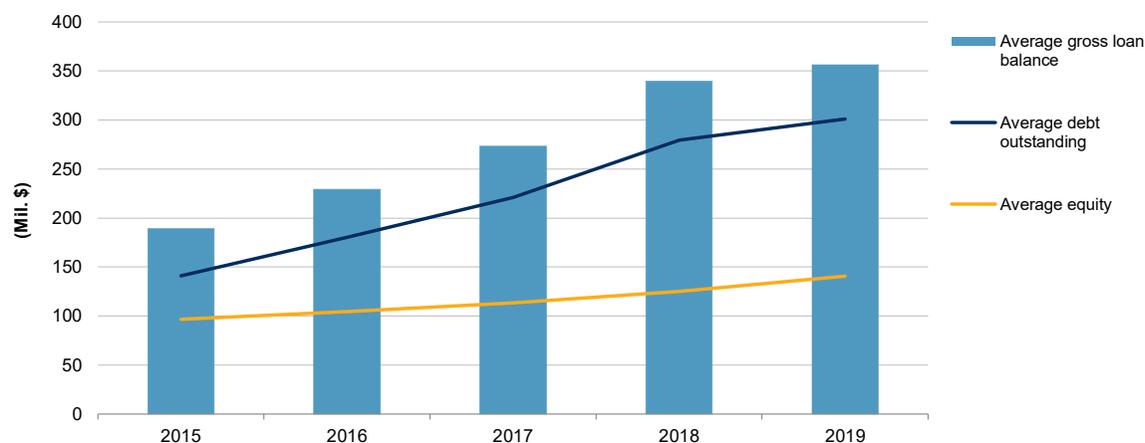
CDFI balance sheets have undergone substantial changes. Since the Great Recession, a substantial amount of grants from federal and philanthropic sources, combined with limited opportunities to on-lend that capital during a lull in the business cycle, resulted in CDFIs building significant equity on their balance sheets. Starting about six years ago as the economy recovered, organizations used their equity to rapidly expand their lending portfolios and reach more borrowers. Between 2015 and 2019, six of the rated CDFIs' loan portfolios more than doubled.

Although consistent with their social missions, some CDFIs' significant loan portfolio growth weakened certain financial ratios we use to assess credit quality. In addition to grant capital, several institutions used debt

instruments to finance portfolio expansions. Between 2015 and 2019, the average gross loan balance among rated CDFIs increased by 88% (average assets rose by 80%) while total debt outstanding increased by 113% (chart 1). In the same period, average equity rose by a much slower 46%, largely due to the addition of debt to finance these new loans.

Chart 1

Average Equity And Debt Among Rated CDFIs



Source: S&P Global Ratings.

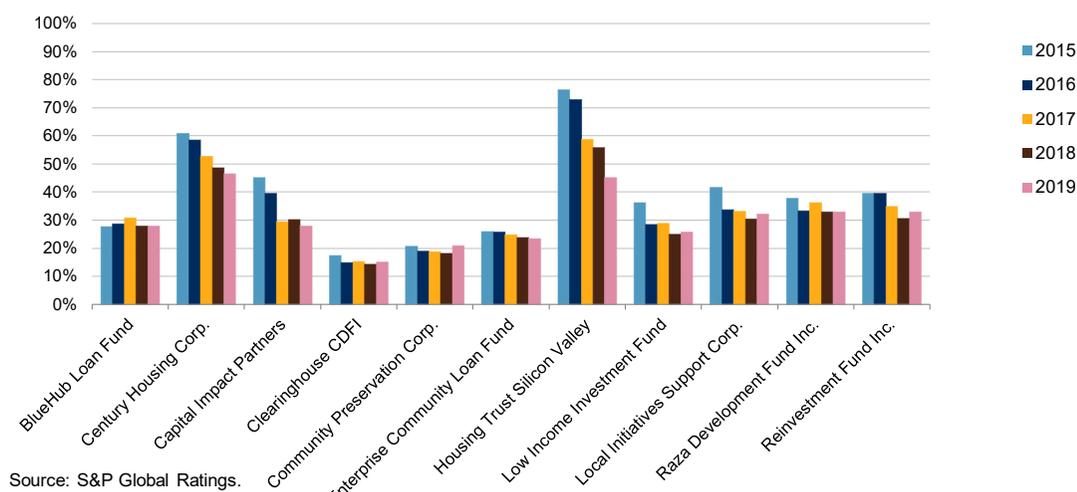
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Loan portfolios primarily consist of early-financing loans and multifamily housing projects. CDFIs have largely remained focused on lending at the early stages of a project, offering short- to medium-term loans, sometimes before the project begins generating cash flow. On average, more than half of loan portfolios consist of acquisition or construction loans, with permanent loans averaging 30%. Multifamily projects comprise about half of the average loan portfolio (52%), while charter schools and health care facilities are other common property types, averaging 26% and 11% of portfolios, respectively. Three of the rated CDFIs focus at least 90% of their lending on multifamily properties. In recent years, some lending strategies have shifted based on market opportunities, though most portfolios have maintained a steady portfolio composition.

Equity was a key factor behind rating actions. In 2019, equity decreased to 30% of total assets from 39% in 2015 (chart 2). We believe this indicates that, on average, there are fewer resources available to sustain operations during difficult circumstances or to fund programs that further CDFIs' missions. (Note that this does not consider the significant funding received in fiscal 2020.) For some organizations, the equity to total assets ratio has been stable over the past five years, while for others, it has declined as loan portfolios and debt increased quickly. Maintaining a minimum 20% equity to total assets has been strategic for some rated CDFIs for a variety of reasons, including requirements from their lenders, such as the Federal Home Loan Bank (FHLB) system.

Chart 2

Equity-To-Assets Ratio Trends



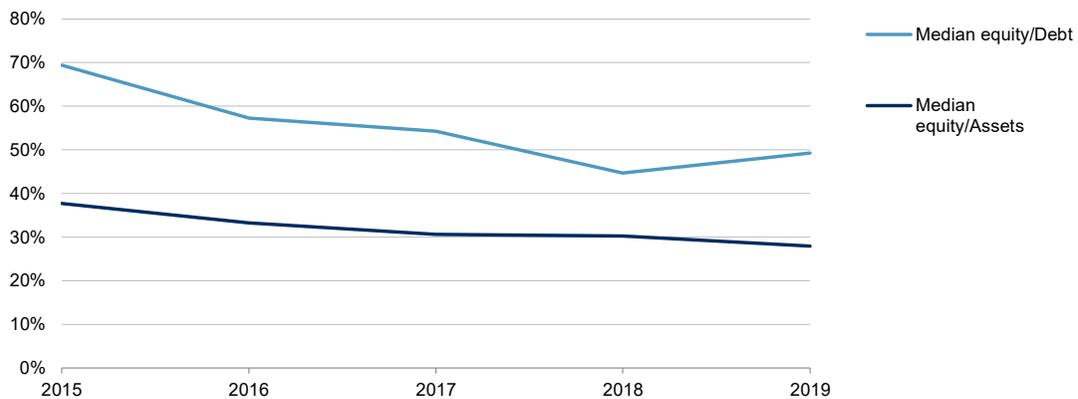
Source: S&P Global Ratings.
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Institutions' leverage has increased in recent years. As with the ratio of equity to total assets, equity to debt has similarly been strained. In 2015, the median equity to debt ratio was 69%. As CDFIs incurred more debt obligations, including publicly rated bonds, this ratio fell to 49% by 2019 (chart 3). Some organizations used their new debt proceeds to refund existing debt that carried higher interest rates, which we view as a credit positive; conversely, debt issuance to finance additional loan growth has

stressed capitalization and leverage ratios. However, an average ratio of 50% equity to debt is still typically stronger than that of traditional U.S. lending organizations.

Chart 3

CDFIs' Median Equity Ratios



Source: S&P Global Ratings.

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Although structures vary, debt profiles do not currently present an inherent credit or liquidity risk. Rated organizations generally have conservative debt profiles, with mostly matched assets to liabilities and strong debt management policies, in our opinion. Most debt includes low interest rate loans with favorable terms. CDFIs' ability to issue GO bonds with an S&P Global Ratings ICR allows organizations to obtain longer-term, more flexible financing than is generally available through traditional financing sources.

Patient capital, strong underwriting, and oversight keep defaults low and profitability consistent

Asset quality is, and historically has been, very strong for rated CDFIs.

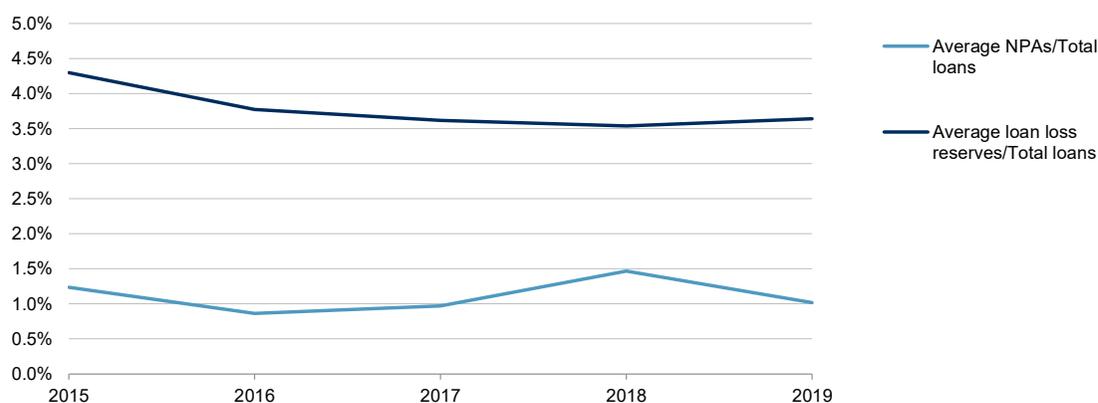
We define NPAs as loans at least 60 days delinquent or impaired.

Between fiscal years 2015 and 2019, they averaged 1.1% of total balances of loans and real estate owned, with only three CDFIs reporting NPAs

higher than 1% in 2019 (chart 4). The slight increase in fiscal 2018 was primarily due to a timing issue for one entity's construction loans missing payments before entering into maturity extension agreements.

Chart 4

Asset Quality Remains Strong, With Ample Reserves Available



Source: S&P Global Ratings. NPAs--Nonperforming assets.
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Strong loan performance starts with strong management and underwriting standards. In our opinion, rated CDFIs generally exhibit very strong, nimble leadership, who strategically position portfolios to best meet their organizations' financial and social bottom lines. This involves a hands-on approach to lending and a "know-your-customer" model that helps promote very strong asset quality (that is, loan performance) and consistent profitability. Part of this model includes robust underwriting standards that incorporate a variety of project risks; we consider this a credit strength. Their thorough internal risk rating procedures and personalized communication allow CDFI staff to identify and help borrowers at risk of missing payments and develop appropriate repayment strategies.

Patient capital is a tenet of CDFIs' lending philosophy, particularly due to the nature of early-financing loans and the possibility for construction delays. Extension agreements are not uncommon, particularly for early-

financing loans that require additional (interest-paying) months before the projects begin to generate revenue.

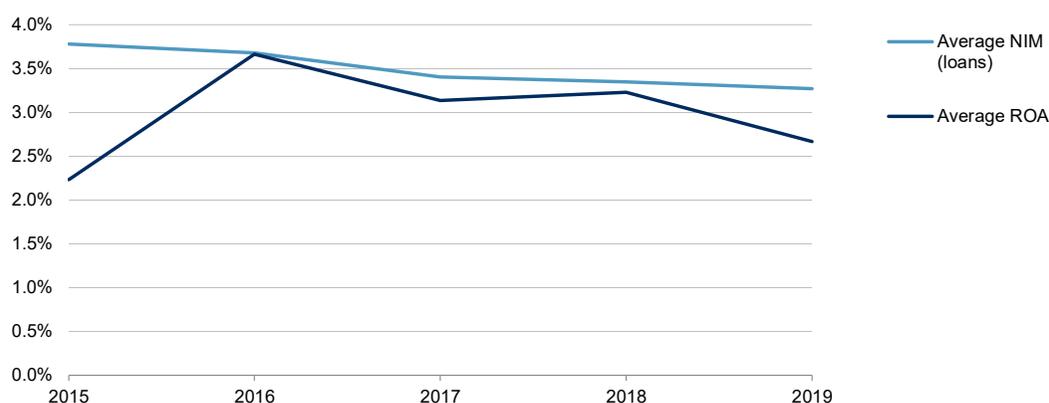
Loan loss reserves more than exceed NPAs and net charge-offs. Even with generally very low NPAs, most rated CDFIs conservatively reserve for potential loan losses, setting aside an average of 4% of their total loans to manage risk according to their internal credit assessments, which we view as more than adequate. Institutions typically assess each loan individually, assign an internal risk rating to determine the appropriate recovery method, and monitor the ongoing performance of that loan throughout the year; a weak internal risk rating may require additional reserves. We believe that loan loss reserves are sufficient to absorb the actual loss experience of loan portfolios (net charge-offs), which is below 1% for most rated organizations.

The pandemic and related recession resulted in a sudden increase in delinquencies and forbearances. From the early days of the pandemic, CDFI management teams proactively communicated with potentially at-risk borrowers and offered full or partial payment deferrals. For example, one entity proactively granted deferrals for 16% of its portfolio due to management's expectation that those loans would be negatively affected by the pandemic (primarily commercial and multifamily properties with limited housing subsidies). Most of these loans are now repaying and were restructured to have a balloon payment at the end of the loan term to capture any missed payments. Such payment deferrals reflect a temporary credit weakness, in our opinion, and has generally already receded for most rated CDFIs. Even at the peak of deferrals, we believed organizations had the financial strength, flexibility, and resources to perform at the current ratings and withstand near-term loan-payment disruptions.

Grant income spurs return on assets trends, but profitability remains strong. In addition to interest income from loans, CDFIs can derive a large portion of revenues from external sources, such as grants, that contain certain restrictions. Grant income is recorded in the year the grant is received, while grant expenses (or releases from donor restrictions) occur in the year the money is spent. This has created some volatility and is the primary reason for fluctuations in one of our profitability metrics, return on assets (ROA) (see chart 5). Average ROA was 2.7% in fiscal 2019 compared with 3.7% in fiscal 2016, with some CDFIs ending a fiscal year with negative ROA, partly reflecting this grant-driven fluctuation.

Chart 5

Average ROA And NIM



Source: S&P Global Ratings. NIM--Net interest margins. ROA--Return on assets.
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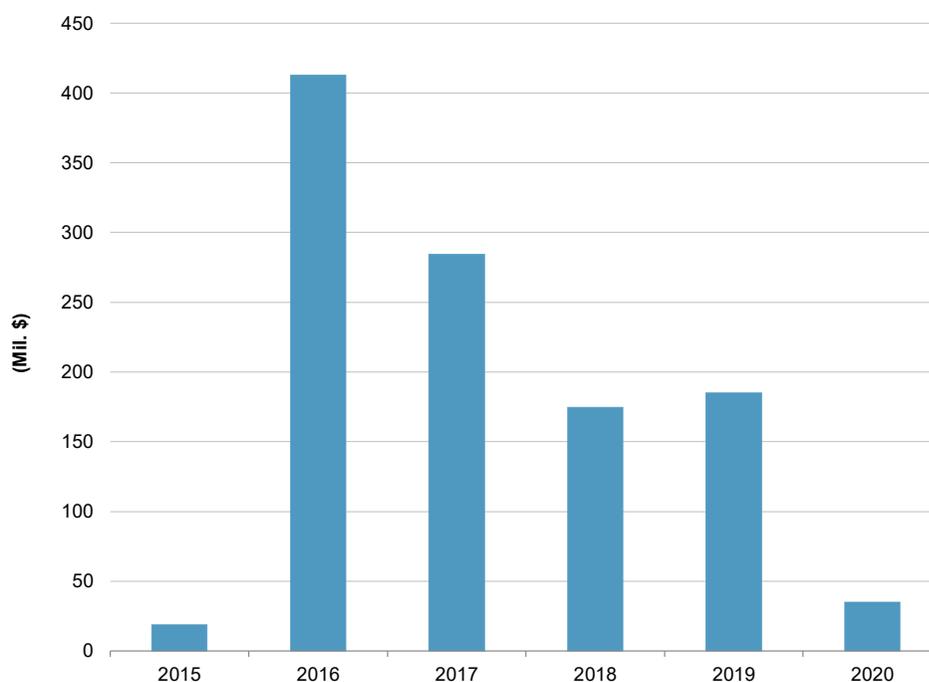
CDFI Fund grants are volatile, but an important source of funding.

Donor-restricted grants, such as those from philanthropic organizations and awards from the CDFI Fund, can generate more than a third of a CDFI's total revenue in a given fiscal year, followed by a year in which they account for less than 10%. Since 2015, rated organizations have received approximately \$1.1 billion in awards from the CDFI Fund, mostly through the NMTC Program, which uses tax credits to incentivize private investment in distressed communities (see chart 6). NMTC allocations are

different from other CDFI Fund awards, such as the Capital Magnet Fund (CMF) grant, which can be used to finance affordable housing activities, related economic development activities, and community service facilities; rated organizations have received about \$113 million in CMF grants since 2015. Sharp decreases in these types of awards or slowdowns in grants from other sources can simultaneously cause fluctuations in profitability and diminish lending capacity; in these scenarios, CDFIs have rapidly attracted other sources of funding or adapted their strategies to available resources.

Chart 6

CDFI Fund Awards For Rated CDFIs (2015-2020)



Source: S&P Global Ratings.

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Net interest margin for loans has remained stable for rated CDFIs.

Another measure of profitability, net interest margin (NIM) for loans, assesses the spread between the loan interest earned and interest expense. Removing the volatility of grants, and to an extent investment

income, NIM for loans is a more stable ratio than ROA. Average NIM for loans was 3.3% in fiscal 2019 and 3.8% in fiscal 2015. In general, over this five-year period, the lending landscape became more competitive and access to 0% or very low interest rate funding became more limited. Still, average CDFI NIM is comparable with, if not slightly higher than, that of traditional U.S. lending organizations, which have reported a decrease in NIM for the past 10 years.

Ability to manage their NIM for loans could be key to CDFIs' continued profitability. With about 70% of rated CDFIs' total assets consisting of earnings-generating mortgage loans, there is an emphasis on maintaining a healthy interest spread to remain profitable and self-sustaining. NIM for loans is generally lower for those CDFIs whose loans comprise a smaller percentage of total assets. In fiscal 2019, the outstanding balance of loans to total assets ranged from 36% to 85%; in that same year, the respective NIM for loans was 1.5% and 2.6%, for those organizations.

Short-term investments and external liquidity are typically available to cover short-term financial needs. Aside from loans, other assets include short- and long-term investments, with the former composing an average of 17% of total assets in fiscal 2019, down slightly from 19% in fiscal 2015. While each organization's liquidity profile varies, we may view a low or significantly weakened ratio of short-term investments to total assets as a credit risk, depending on a CDFI's ability to address potential liquidity risks.

Beyond holding liquid assets on their balance sheets, several rated CDFIs manage their liquidity needs through external revolving LOCs, from banks and other financial institutions, that are either unrestricted, intended for working capital, or restricted for certain purposes (such as certain types of lending). Usage of external liquidity varies based on needs and strategies, with recent draws of between 3%-20% of the amount

available. For example, some institutions drew on their external liquidity facilities during the 2018 federal shutdown, or to cover potential stresses during the pandemic.

CDFI Primer

CDFIs are private, mission-driven organizations offering lending options and financial services to primarily low-income, underserved communities.

There are more than 1,100 CDFIs in the U.S. in the form of loan funds, community development banks, credit unions, venture capital funds, and microloan funds; more than 50% of CDFIs identify as loan funds. The sector's roots date back to the 1970s when community organizations countered bias banking practices, such as redlining and predatory lending, and advocated for increased investment in economically depressed communities. The sector's formal creation came after the passing of the Riegle Community Development and Regulatory Improvement Act of 1994, which created the U.S. Department of the Treasury's CDFI Fund . Since its inception, the CDFI Fund supports the sector with a variety of programs, including loans, grants, and technical assistance. The sector expanded significantly after the revised Community Reinvestment Act (CRA) regulations in 1995 that recognized CDFI investments as qualified CRA activity. The sector has expanded from fewer than 200 certified CDFIs with less than \$5 billion in total assets in the mid-1990s to now serving all 50 states, Washington, D.C., Puerto Rico, and Guam, with over \$170 billion in total assets.

The 11 rated CDFIs are a small portion of all institutions nationally but are representative of the largest and oldest in the sector (those with total assets above \$100 million). All CDFIs we rate are structured as loan funds

and 10 are registered as 501(c)(3) nonprofit organizations. Most rated CDFIs finance loans nationally with a network of satellite offices in various states, while three concentrate in one state or region.

These entities specialize in financing loans for a variety of community projects, including multifamily housing, education (such as charter schools), commercial projects (such as healthy food commerce), and community facilities (such as health care). They also can add new loan types based on specific community needs and available funding (most recently, early childhood education). Although loan terms vary for each institution, rated CDFIs specialize in originating short-term early financing loans (construction, renovation, predevelopment, and acquisition), with most loans coming due within five years. In addition, significant portions of their lending activity is dedicated to Low Income Housing Tax Credit, NMTC, and other subsidized projects. Generally, rated institutions' borrower bases are developers that have years- or decades-long working relationships with the CDFIs.

While these entities have a variety of funding sources, most obtain capital from the federal government (for example, through the CDFI Fund's Bond Guarantee Program), financial institutions (FHLBs, CRA-motivated banks), and various philanthropic organizations, high net-worth individuals, and civic organizations. Since 2017, nine rated CDFIs have used S&P Global Ratings' ICRs to access the capital markets with GO bonds and notes issuances to support their lending programs and refinance higher-interest rate debt. In addition to diversifying their funding sources, access to low-interest capital markets debt has allowed institutions to further their missions by offering their borrowers longer-term loans, all while having fewer restrictions on the use of proceeds compared with traditional sources of funding.

Most management teams have decades of experience in the sector and have successfully implemented various lending and investment strategies over the years. The organizations operate with robust and long-established policies and procedures that govern their lending platforms and monitoring practices. They also operate under strong oversight via their boards of directors who represent a diversity of sectors, including financial, legal, small business, nonprofit, and community activism.

The combination of strong management teams, oversight, robust internal infrastructures, and the willingness to adapt to unforeseen market events has resulted in minimal historical loan loss for the rated entities. They have long track records demonstrating their abilities to develop and execute on prudent strategic initiatives that support both their financial and social bottom lines. The depth and breadth of lending teams, and their sometimes-national network of affiliates or lending partners, enable CDFIs to better understand a project's likelihood of success before deploying capital, and to work directly with borrowers in difficult circumstances.

CDFI ratios and terms

We use the ratios listed below to analyze CDFIs' financial performance and earnings quality. Although we might incorporate other ratios on a case-by-case basis, these ratios provide a benchmark by which to compare institutions.

Capital adequacy and equity ratios. Net equity to total assets, net equity (including reserves) to total loans, net equity to total debt, and net equity to total GO debt measure an organization's capital base available to promote investor confidence and absorb operating deficiencies.

Profitability ratios. Return on average assets is the most comprehensive measure of an organization's performance. However, when evaluating ROA, it is necessary to examine both the amount and quality of the reported earnings.

Net interest income margin. This ratio measures the most important source of quality earnings: net interest income. It is affected by the volume and type of earning assets, as well as the cost of funds. The key to continued profitability is an organization's ability to manage its NIM.

Asset quality ratios. Nonperforming assets to total loans, net charge-offs to NPAs, loan loss reserves to loans, and loan loss reserves to NPAs measure the diversity and quality of an organization's portfolio of earning assets. Net charge-offs are an indication of the actual loss experience of the loan portfolio, while loan loss reserves should be adequate to absorb those losses.

Liquidity ratios. Total loans to total assets and total investments to total assets measure an organization's liquid versus illiquid assets. Short-term investments to total assets measure an organization's ability to access funds for short-term demands.

This report does not constitute a rating action.

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