Impact of the Current Banking Environment on the CDFI Community

Rising Rates and Constrained Capital Resulting in Higher Costs for Underserved Borrowers and Limiting the Reach of Mission-Driven Lenders to Fill Gaps

CDFI Impact

Community Development Financial Institutions (CDFIs) are mission-driven lenders committed to lending to and investing in communities that struggle to gain access to affordable and flexible loans necessary for economic development, housing, and job creation in low and moderate-income communities. CDFIs are needed now more than ever, especially in rural and urban areas that are not well-served by mainstream financial institutions.

CDFIs work to meet their borrowers where they are by offering affordable and flexible loan terms. CDFIs often provide technical assistance and guidance to their borrowers, putting them and their communities on a pathway to success. This model has worked remarkably well: Data shows that CDFI borrowers have low default rates which have contributed to CDFI net charge-off rate averages of 0.51%, all while providing critically needed access to capital for small businesses, nonprofits, consumers, affordable housing developers, and others seeking to bring resources to underserved markets.

CDFI's Need for Low-cost, Flexible Capital

Access to low-cost (<4%) debt capital that is flexible to support a CDFI's mission is vital to equitable access to capital in underserved communities. Like other market-based lenders, however, CDFIs must contend with the pressure of the current interest rate and banking environment. The rise in interest rates has triggered cascading negative impacts on CDFI borrowers, including higher loan payments that hurt their cash flow and less capital from CDFIs to meet the growing demand for CDFI lending. This in turn means less refinancing flexibility, and lower loan amounts which puts pressure on philanthropy and other soft funding sources.

As mission-driven lenders, CDFIs are attempting to mitigate these impacts by working with their borrowers whenever possible by reducing spreads, seeking soft sources for blending down the cost of funds, and extending terms to avoid costly refinancing for their borrowers. However, **CDFIs are limited by the cost and nature of the funds to which they have access.** CDFIs source funds largely from banks (who are typically driven by their Community Reinvestment Act obligations), as well as philanthropies, government, retirement plans, and others interested in making an impact in the communities they serve. These investors also expect a return tied to the market, limiting CDFIs' options.

Summary

- Current interest rate and capital market environment significantly constraining CDFI capital and their ability to meet borrower needs, negatively impacting underserved communities and borrowers, especially those in urban and rural communities
- It's not only high rates, but the constricted type, cost, and amount of capital they provide to CDFIs and how those funds can be used
- For CDFIs to achieve their missions and fill gaps, they need access to low-cost, flexible capital essential to meet current demands and future growth of the CDFI community

Summary of Challenges

- CDFIs are having difficulty finding low-cost (<4%) capital from banking partners
- Since the banking environment is tightening, banks are not offering the loans they used to, so CDFIs are having to increase loan amounts to meet the higher demand
- At the same time, CDFIs have less capital to deploy to meet this higher demand since their existing loans are not being refinanced and staying on their balance sheets
- Higher rates also mean higher payments for CDFI borrowers and put a strain on other sources of funds, including philanthropy and soft funding
- In all, CDFIs are being forced to do more with less, with few options for additional capital to meet the growing needs

Impact of Current Interest Rate and Banking Environment on CDFIs and Their Borrowers

- ***Higher rates mean higher payments for borrowers.*** Higher interest rates mean increased debt payments and cashflow burdens for small businesses, affordable housing developments, nonprofits, and other CDFI borrowers. These higher rates hurt small businesses and threaten the feasibility of high-impact projects in communities.
- ***Capital is less flexible, making impactful CDFI work more difficult.*** Banks are reconsidering and reevaluating the type, cost, and amount of capital they provide to CDFIs, and many are restricting the use of those funds due to market pressures. Banks specifically are conserving capital and maximizing rate arbitrages due to increased scrutiny of their balance sheet composition and the rapid upward trend and corresponding devaluation of medium and longer-term bonds. An easy place to cut low-cost deployment is CDFI's.
- ***Lending dollars can't go as far.*** In addition to higher borrowing costs, CDFI borrowers – from small businesses to affordable housing – are experiencing higher costs related to labor, construction, and more. For underserved borrowers, costs have increased significantly but their ability to pass those costs on to consumers has not. This has squeezed already tight cashflows and limited the capacity of CDFI borrowers to responsibly assume more debt. These dynamics have increased the demand for CDFI capital, constraining the ability of CDFIs to meet their pipeline demands.
- ***With fewer existing loans being repaid, there is less capital to redeploy.*** At the same time that demand has grown, many borrowers are not able to refinance their loans as quickly as they used to. This means that CDFIs must hold these loans on their balance sheets longer than normal, preventing them from redeploying these dollars to meet the current demand. This means CDFIs must find new capital to meet their pipeline needs.
- ***Higher rates put pressure on CDFI operations.*** Capital currently provided by banks is often being offered at market rates (6-8% on average). CDFIs cover staff, technical assistance, and operating expenses utilizing the spread in the interest they make between their cost of borrowing and the rates on their borrowers. The increasing cost of capital means CDFIs must narrow their margins in order to care for borrowers and meet their missions. Doing so can quickly compromise the ability of CDFIs to ensure operational stability for their organizations.
- ***CDFI core missions and reputation at risk in the communities they serve.*** Being forced to offer above-market rates to disadvantaged borrowers runs counter to one of the fundamental objectives of CDFI impact lending: to improve access to affordable capital for disadvantaged groups, including racial minorities, women, Native communities, and borrowers in rural areas. Limiting CDFIs' ability to meet this objective creates potential reputational risk for capital providers and CDFIs in the communities we serve and limits our ability to hold tight to our core missions as CDFIs.

What Does the CDFI Community Need?

Until CDFIs have consistent and predictable access to lower costs and flexible funds, they – and their borrowers – will be especially vulnerable and negatively impacted by these fluctuations. Now is the time to provide better and permanent sources of flexible, low-cost capital to CDFIs. This will help them reduce the impact of the current rate environment while also enhancing their ability to achieve their missions in the future. Finding new sources of low-cost, flexible capital for CDFIs will be especially critical as rates are not likely to return to the pre-pandemic environment.

We need an all-hands-on-deck approach to provide a variety of low-cost, flexible sources of funds to CDFIs. We must work with all partners who want to be part of the impact lending community – including the public and private sector and at all levels, including: *(1) Governments at thefederal and state levels; (2) Financial institutions; (3) Corporations; and (4) Philanthropy.*

We must also be willing to get creative and think outside the box to help create tools, programs, and access to low-cost, flexible debt capital to help not only keep the CDFI community stable but to help CDFIs meet the growing demand from our communities.