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CDFIs: Crucial Partners in the Public Finance Ecosystem

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Community development financial institutions (CDFIs) are vital partners with state and local governments in projects aimed at assisting communities of people with low and moderate incomes (LMI communities) across the United States. Serving as intermediaries between public, philanthropic, and private sources of capital, CDFIs help deploy resources to improve economic opportunity in these communities. Government entities at all levels (federal, state, and local) work with nongovernmental actors, and CDFIs have been such partners, particularly for investments related to infrastructure as well as real estate for affordable housing and small business development in LMI communities. In this article, we examine how CDFIs can better leverage public funds and utilize subsidized financing mechanisms, such as loan funds and other debt instruments, to invest in LMI communities. Could CDFIs make investments at a larger and more sustainable scale if they had expanded access to public finance mechanisms? Are there opportunities for CDFIs and public and private actors to work together in new ways to increase the funding needed in the most disinvested places?

To begin to answer these questions, the Federal Reserve Bank of Chicago partnered with the Kresge Foundation and experts from the public finance community to convene almost 40 leaders from a diverse set of CDFIs. Both large and small CDFIs (in terms of their asset holdings) based in both rural and urban places throughout the country were represented at the convening held in Detroit, Michigan, in early 2024. The convening provided us an opportunity to hear about CDFIs' experiences in accessing public resources to make investments in LMI communities. Attendees shared their perspectives on the interventions that are needed to better support and enhance the role of CDFIs as co-investors in public finance ecosystems across the nation.

While many CDFIs successfully leverage public resources, CDFI leaders shared at the convening that they thought changes in legislation or program designs were needed to lower the barriers their firms face in using public funds or financing tools. Additionally, participants generally agreed on the following as the key takeaways from the convening:

- Actors from multiple sectors (such as state and local governments, intermediary organizations, and foundations) have roles to play in improving CDFI participation in public finance opportunities.
- Capacity-building within the CDFI industry (and among federal, state, and local policymakers) to learn about (and explain) the available public resources would not only strengthen CDFIs' understanding of such resources, but also generate among public administrators greater awareness about the opportunities to work with CDFIs.
- In order to replicate successful strategies, CDFIs and government partners must consider the potential shifts that are needed in the legislative or regulatory environment and take into account the diversity that exists across CDFIs (in terms of their organizational histories, capacities, and experiences).

Overview of public finance and CDFI practices leveraging public finance resources

In the past few years, large-scale, time-bound federal aid resources have been allocated to states and localities across the United States. For instance, both the \$1.85 trillion American Rescue Plan Act (ARPA) and the \$1.2 trillion Infrastructure Investment and Jobs Act (IIJA) were signed into law in 2021 to help states and municipalities—and the people they serve—recover from the pandemic and address infrastructure problems. More recently, the Inflation Reduction Act (IRA), the

Justice40 Initiative, the Greenhouse Gas Reduction Fund (GGRF), and other federal legislation and programs have infused state and local governments with additional federal money to help them tackle other issues. Several of these federal laws and programs have encouraged these governments to incorporate equity principles while deploying federal aid in their jurisdictions. Moreover, these laws and programs have created meaningful roles for nongovernmental actors, such as CDFIs and other nonprofits, to come to the table as partners to leverage federal grant funds. Federal grant programs, however, are just one component of the public finance strategies that states and municipalities use.

Public finance commonly refers to the various ways that governments spend and raise money. U.S. state and local governments can raise money from different avenues of public finance to the extent that they are enabled to do so by their frameworks of fiscal governance—meaning the laws and policies that empower them to raise and spend money. The primary funding sources that are traditionally parts of a government’s fiscal base are as follows: 1) own-source revenues from taxes (e.g., property taxes, sales taxes, income taxes, and corporate taxes); 2) nontax own-source revenues (e.g., charges, fines, fees, payments in lieu of taxes, developer exactions, and impact fees); 3) revenues raised from a higher level of government that are forms of intergovernmental aid (e.g., federal or state grants); 4) funding raised from outside investors that creates a loan or liability that the government must repay (i.e., money raised from municipal bonds, notes, commercial paper, and other forms of debt); and 5) funding raised from philanthropic sources, structured as grants, program-related investments, or other forms. Additionally, there are other public finance vehicles that are more complex (e.g., public–private partnerships, tax credit programs, and tax increment financing guarantees). Jurisdictions vary in whether and how they use these mechanisms, as well as in what they’re used for (e.g., to fund infrastructure projects versus to support operating needs). Our convening allowed us to explore the opportunities that CDFIs currently have to partner with state and local governments and leverage these different forms of funding—through grants, loans, and/or (subsidized) financing mechanisms, depending on the sources of revenues and frameworks of fiscal governance.

CDFI participants who joined us shared a range of experiences leveraging public finance resources successfully to invest in LMI communities—a few select examples of which are summarized in figure 1.

1. Examples of CDFIs leveraging different public finance funding sources

Public finance avenue	Summary
Own-source revenues	A CDFI was able to secure funding from the City of Detroit’s general fund to carry out neighborhood development investments in alignment with the City of Detroit’s objectives and the mission of the CDFI to serve communities of people with low incomes in the state.
Debt instruments	A CDFI was able to partner with the Washington State Water Authority to create a revolving loan fund (using the authority’s funding). The revolving loan fund was used to make loans to homeowners with low incomes who needed funding to make improvements to decentralized septic systems.
Intergovernmental revenues and philanthropic funds	A CDFI was able to combine a grant from a foundation with funding from the American Rescue Plan Act, a form of intergovernmental aid, to create a revolving loan fund that invests in affordable housing projects and solutions for food deserts and other place-based needs in Macon–Bibb County, Georgia.

At the convening, participants discussed several other examples of CDFIs that have leveraged public finance resources as part of their community investment strategies (including those focusing on ways to build and improve affordable housing, as well as broadband, water, sewer, and other infrastructure). That said, experts who joined the convening generally agreed that CDFIs’ experiences with leveraging public finance resources lacked uniformity. Moreover, these experiences did not reflect any discernable trends by different CDFI industry metrics—e.g., by firm characteristics, such as assets under management, operating structure, or geography.

What are the challenges and barriers to CDFI utilization of public finance resources?

Despite the many positive examples of how CDFIs are leveraging public finance resources, several CDFI leaders at the convening reported that their firms underutilize public finance strategies because of challenges and barriers in accessing, analyzing, and adopting them. Participants who joined us widely reported capacity constraints at individual CDFIs to determine and decipher—and among states and localities to disseminate and explain—the range of public finance tools and

strategies that may exist. Moreover, experts observed that the laws that govern public finance are complex, place-based, and dynamic. Currently, there is no centralized resource that helps CDFIs understand all the laws that govern existing public finance systems or that tracks changes in laws that may shift state and local government frameworks for public finance, enabling (or hindering) the formation of partnerships with CDFIs.

Several CDFI leaders also shared that even when they do find they have strong access to public finance tools, pursuing a public finance opportunity may not always make sense after weighing the costs and benefits. For example, many CDFI leaders reported that high compliance and administrative burdens associated with federal grant reporting inhibit their ability or desire to pursue federal intergovernmental aid. Although participants acknowledged recent efforts by the federal government to make it easier to apply for federal grants and comply with their rules (e.g., by streamlining and clarifying requirements for getting funding), they said this is an aspect of public finance that they hope will continue to receive greater attention and reform.

Additionally, some CDFI leaders who joined us reported that some federal grant programs require specialized technical expertise and staff competencies that are often outside the traditional skill sets of CDFI staff (e.g., they said expertise on climate change is important when accessing federal money from the Greenhouse Gas Reduction Fund and implementing programs). Leaders who articulated these concerns reported that they may not be able to retain staff hired to support local efforts funded by such bespoke federal grant programs when these time-limited programs end. These considerations, coupled with the risk of clawback provisions in many federal bills, are factors that inform the decisions at many CDFIs to not pursue intergovernmental funding in the form of grants.

Municipal bonds, notes, and other debt instruments (e.g., commercial paper) are generally authorized by law in all 50 U.S. states. In many cases, where debt instruments fund a public project and the issuer meets the criteria in the IRC—or the federal Internal Revenue Code of 1986, as amended—bonds and notes may qualify for tax exemption. Standing at \$4.1 trillion (as of 2024:Q2), the U.S. municipal bond market offers a consistent source of investor liquidity for fixed income debt instruments (including bonds and notes) that governments and CDFIs sell to raise money for projects, but CDFI leaders articulated mixed experiences with using that avenue of public finance. Many CDFI leaders reported uneven experiences with bringing deals to market that could qualify for the IRC federal tax-exemption subsidy and in-state tax exemption—key features that are considered essential to achieving the lowest cost of capital for the life of the debt service obligation associated with bonds, notes, or other forms of debt issuance. Several leaders also pointed out the other challenges that CDFIs face when bringing fixed income debt to market: They talked about the costs in the deal preparation process (e.g., fees for bond counsel and disclosure counsel and fees associated with the preparation of an official statement or private placement memorandum). They also discussed the cost, time, and staff experience that may be required when pursuing an issuer rating from the national rating agencies (Standard & Poor’s Global Ratings, Moody’s, and Fitch Ratings).

Among CDFI leaders who had experienced success in raising money via debt issuances in the capital markets, one common concern was raised: some CDFIs’ lack of access to refunding vehicles that states and localities use to restructure an existing debt service obligation, usually in response to changes in the interest rate environment. Refunding transactions is a key mechanism that municipal debt issuers use to restructure outstanding debt to achieve present value savings or change onerous covenants that were part of the initial debt issuance transaction. If CDFIs cannot engage in refunding transactions like states and municipalities, a debt service burden can saddle their balance sheets, hindering their ability to make further investments in LMI communities.

What would it take for CDFIs to access public finance resources more broadly?

Participants agreed that there is no simple solution to support CDFIs that want to expand their use of public finance instruments, but they identified some approaches that could potentially help. CDFI leaders generally agreed that they need to build their capacity to better understand not only the full range of public finance resources available in their jurisdictions, but also how to potentially deploy such resources as part of their community and economic development strategies. According to participants, the CDFI sector would benefit from knowledge sharing of successful strategies for leveraging public finance. For instance, a compilation of the lessons learned from well-implemented public finance strategies at the state or local government level could serve as a type of “playbook” to assist CDFIs in understanding the options that might be available to them in the target jurisdictions.

CDFI leaders noted that cultivating good working relationships with state and federal policymakers is important, since they can develop pathways for CDFIs to gain expanded access to public finance tools and leverage more resources for LMI communities. Some CDFI leaders also stated that state and federal policymakers could benefit from gaining a greater awareness of CDFI needs for expanded resources from public finance ecosystems. For example, by understanding such needs and helping CDFIs to meet them, policymakers might gain insights on which CDFIs could move public finance dollars more efficiently to end-users through their pre-existing channels.

Other CDFI leaders who joined us suggested changes that should be considered in the context of specific public finance programs—including the Federal Home Loan Bank (FHLB) system—to broaden CDFIs’ access to, and use of, that specific avenue. The FHLB legislation, for example, makes available low-cost funds for member institutions to use for mortgages. Certified CDFIs are eligible for FHLB membership and can join the regional FHLB serving the state where their home office is located.¹ At the convening, participants identified some solutions, such as credit enhancements, to help (nondepository) CDFIs gain access to FHLB wholesale funding, given that many FHLBs impose discounts on the value of collateral from (nondepository) CDFIs. Participants also noted that some FHLBs have their own programs to support community development, such as the Community First Fund created by the Federal Home Loan Bank of Chicago; these FHLB programs offer direct lending to CDFI members and nonmembers.²

Participants at the convening also suggested potential ways to lessen some of the barriers that CDFIs face when accessing the capital markets to raise money via the sale of bonds, notes, and other debt instruments. Several federal tax credit programs have enabled state and local governments to issue debt at a zero percent interest rate for certain infrastructure sectors, for a time-limited duration, and in certain geographic areas known as enterprise zones, which face income and economic development barriers. Notable examples of such programs are the Clean Renewable Energy Bonds and the Qualified Zone Academy Bonds programs. The Tax Cuts and Jobs Act of 2017 repealed the authority to issue tax credit bonds after December 31, 2017. When such programs were active and eligible for use, however, investors of the bonds received a tax credit from the U.S. Department of the Treasury, along with the return of principal from the municipality, rather than interest payments. The municipal issuer of the bonds would use the government revenues that were pledged as the security for the bonds to pay the return of principal to the investor. Experts at the convening suggested that future legislation (if any) authorizing new tax credit bond programs for municipalities could be extended to CDFIs to create pathways for CDFIs to have similar access to zero percent borrowing. In that framework, CDFIs would be authorized to pay the return of principal with private dollars that they pledge as security for the bonds while investors would receive a tax credit from the U.S. Treasury, instead of interest payments.

Participants widely acknowledged that state and local officials charged with public finance decision-making have an important role to play, as they often help shape the environment for public finance strategy, policy, and practice. According to many participants, state and local officials could help by elevating successful collaborations between municipalities and CDFIs to memorialize accomplishments, share knowledge, and spark dialogue between CDFIs and key government staff members (e.g., city attorneys, city managers, and treasurers). In Michigan, for example, state officials had been in conversation with CDFIs about investments in childcare long before the ARPA provided grant dollars to CDFIs for investments in childcare facilities. This pre-existing relationship paved the way for the state to approach CDFIs to act as intermediaries for moving emergency grant dollars into childcare facilities across the state.

State and municipal leaders who are creating collaborative investment vehicles and coalitions with a mission-aligned focus to facilitate expanded investment into LMI communities also can play an important role in bringing CDFIs to the public finance table. In Michigan and New York, for example, the formation of collaborative investment vehicles has served as a powerful avenue to channel catalytic capital to CDFIs, according to CDFI leaders. Coupled with education or technical assistance, these resource coalitions potentially help CDFI leaders understand state and local investment objectives and priorities; and they can offer a model to nonprofit/civil-sector-led coalitions (e.g., the Clean Communities Investment Accelerator) emerging within the CDFI sector to leverage federal and state funds.

Experts who joined us at the event highlighted other initiatives that some municipal governments are adopting to expand CDFIs’ access to public finance opportunities. Participants shared the example of the CDFI Friendly Fort Worth effort in Texas—where an independent, not-for-profit organization was established solely to match CDFIs to financing needs in the City of Fort Worth. Participants at the convening also observed that such intermediary organizations and associations in the CDFI sector can help bridge awareness and information gaps about accessing public finance resources. Intermediary organizations were also called upon by participants to help lead strategies that could bring about policy changes in the state public finance landscape. Many CDFIs reported lacking staff or resources to advocate for themselves in state legislative policy settings or to analyze how state laws could be changed to allow CDFIs to participate more as co-investors in LMI communities leveraging public finance funding sources; several convening participants articulated how intermediary organizations might play a leadership role in that area.

Participants expressed how CDFIs can also help bridge the gap in trust between local governments and the people and organizations that need scarce public finance dollars the most. As some participants noted, people in many, if not most, of the chronically disinvested communities often associate local government with generations of broken promises; and even when they can access public finance dollars, residents and community-serving organizations often hesitate to work with government to ensure those dollars are spent wisely. CDFIs broadly share the same goals as the public sector, but CDFIs may be considered as more trustworthy partners by people from many of these communities.

Participants also discussed how charitable foundations can help CDFIs be more responsive to public finance opportunities. For example, CDFI leaders encouraged foundations to consider their role as direct purchasers of bond issuances by CDFIs, observing that foundations could serve as an important source of liquidity and potentially contribute to lowering the cost of capital for CDFIs. Foundations were also encouraged to consider expanding their capacity to make program-related investments in the form of guarantees to CDFIs that are participants in capital markets. This could provide credit enhancement to a CDFI's debt issuance that carries a low rating and enable a CDFI to sell a bond deal in the capital markets at a lower cost of capital than if that CDFI had relied on its own public rating. This strategy would also fill an important deficit in guarantees for CDFIs. Many states only provide state guarantees (or other forms of state credit enhancement) to local governments and do not extend such forms of credit enhancement to CDFIs.

Conclusion

In recent years, state and local governments have been encouraged by the federal government to incorporate equity principles while deploying federal funds in LMI communities across the country. Yet the challenges and barriers that inhibit CDFIs from participating more fully in public finance ecosystems remain—and they are highly varied and often context-specific. Participants at the convening acknowledged that solutions must reflect awareness of the nuances and bespoke nature of public finance resources, as well as the diversity that exists across CDFIs, reflecting their varying organizational histories, capacities, and experiences. Participants also recognized that multiple parties, including government actors at all levels (federal, state, and local), intermediary organizations, and foundations, have roles to play in creating opportunities across different parts of the public finance ecosystem for CDFIs to participate. At the convening, CDFI leaders said lessons can be learned from both longstanding programs and emerging efforts that are testing innovations in both the public finance and CDFI sectors; they stressed the importance of disseminating that knowledge, possibly through a centralized repository. Participants underscored the importance of using a context-specific lens when attempting to replicate successful strategies. And CDFI leaders at the convening widely agreed that changing the regulatory environment in ways that help CDFIs utilize public finance resources and subsidized finance strategies has great potential to drive more investment to communities with the greatest need.

Details for Robin Newberger and Heidi Reijm are available on their Chicago Fed online profiles (accessed by clicking their names in the byline). Lourdes Germán is the executive director of the Public Finance Initiative and serves on the faculty of the Harvard Graduate School of Design.

Notes

¹ For more on the FHLB system and FHLB membership, see the CRS Report for Congress No. R46499, dated August 27, 2020.

² See U.S. Government Accountability Office report No. GAO-15-352, dated April 2015.

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