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Can CDFIs help their communities while keeping investors satisfied?

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A community development bank in Arkadelphia, Ark., that raised nearly $35 million could be a model for a growing number of similar banks scrounging for capital to meet the needs of consumers and small businesses in struggling neighborhoods.

Central to the strategy of the $1.6 billion-asset Southern Bancorp is a heavy emphasis on returning capital to investors through regular dividends and a stock repurchase program.

"There's patient capital, but patient shouldn't mean permanent," CEO Darrin Williams said in an interview after the bank recently published a paper about its successful capital raise late last year.

"There aren't a lot of other CDFI banks I can point to who have done something similar to what Darrin and his team are doing," said Jennifer Vasiloff, chief external affairs officer at Opportunity Finance Network, which invested an undisclosed sum in Southern. "It's kind of exciting as a strategy."

CDFIs at a glance

Here are some key facts about community development financial institutions:

26: Years that Treasury's CDFI Fund has been in existence

$4 billion: Money distributed by the fund in that time

1,144: Number of CDFIs

19%: Growth in that number since 2015

147: Number of CDFIs that are banks

Source: Treasury Department

Designation as a community development financial institution allows banks, credit unions and nondepositories such as venture and loan funds to seek awards from the Treasury Department's CDFI Fund. Since its creation in 1994, the fund has distributed about $4 billion.

Charitable foundations and money-center banks have also emerged as a source of capital for CDFIs. Bank of America has contributed $1.6 billion to CDFI institutions, Sharon Miller, its head of small-business banking, said recently at a virtual Women in Banking conference held by American Banker.

Still, with more than 1,144 bank and nonbank CDFIs currently in operation —a 19% increase from 2015 — the amount of capital that flows from the industry's traditional benefactors is rarely enough to go around. Demand is only expected to grow given the disproportionate impact of the coronavirus pandemic on communities of color and efforts to address systemic financial inequities.

“To be a community development bank means you’ve really got to take one step further than even a high-performing and responsive community bank in my opinion,” said consultant George Surgeon, who was a longtime community development banker at Chicago-based ShoreBank and at Southern. “What that’s going to result in is your shareholder base and possibly your deposit base are going to have to live with slightly lower financial returns.”

Surgeon said he couldn’t recall any community development bank repurchasing a large amount stock or implementing a regular buyback.

OFN, a trade group representing CDFIs, saw enough promise to participate in Southern’s recent capital raise, with an eye toward positioning its strategy as a model for other community development banks.

“This is one of the few equity investments we’ve made,” Vasiloff said. “We made it to support the strategy and to test it out so that perhaps other CDFI depositories could learn from it. … Anything to broaden the investment base is good for the industry.”

Southern began reviewing its capital situationin 2016, three years after Williams arrived. The bank has been profitable throughout his tenure, but its capital structure had grown unwieldy. It included three issuances of trust-preferred securities and numerous classes of common and preferred stock, including an investment from the Treasury’s Troubled Asset Relief Program whose coupon was scheduled to jump from 2% to 9% in 2018.

After retiring the trust-preferred issuances, repaying the TARP money and streamlining the stock classes, Southern embarked on its capital campaign, which raised a total of $34.7 million when it concluded at the end of 2019.

Southern had actually set a target of $50 million for its capital raise. According to Surgeon who advised on both the restructuring and capital campaign, Southern may have been able to raise the full sum in a shorter time frame. However, it refused to seek money from hedge funds and other institutional sources.

“We did make it harder on ourselves in that we did not go public … and we stayed away from Wall Street investors,” Surgeon said. “We really tried to identify investors who would support what Southern was trying to do and could live with the financial returns that we thought realistically Southern could deliver. That was just a tougher go than we thought it would be.”

Even so, the dividends and buybacks that the company began in 2017 proved crucial to attracting investor support, according to Williams.

Southern used the capital to open two new branches in Glenwood and Mount Ida. It's also interested in merger-and-acquisition opportunities in Arkansas and Mississippi, though it will likely wait until after the COVID-19 pandemic subsides to seriously pursue deals.

"With the uncertainty surrounding asset quality, now may not be the best time," Williams said.

Like Vasiloff, Surgeon is hoping Southern's strategy emerges as a model for other community development banks.

"I certainly hope that's the case," he said.

Maureen Frank, CEO of the $155 million-asset Bank of New Haven in Connecticut, called the strategy "interesting," but she expressed some reservations about whether it would suit her bank.

"Our board is very adamant about remaining independent," Frank said. "When you look at a model such as Southern's, you have investors. You're somewhat beholden to them. I'm not sure our board would want to consider that."

Frank, however, stopped short of ruling it out.

"We may be amenable to looking at something like that if we were not able to secure capital via other means," she said.

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