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Fitch: CDFI Ratings Reflect Strong Asset Quality and Solid Financial Profiles

Fitch Ratings-Chicago/New York/San Francisco-14 December 2022: The demand for affordable housing and community development lending is stronger than ever, with housing affordability at its weakest level in decades, according to Fitch Ratings. Given the worsening macroeconomic environment forecast for 2023, demand for the affordable housing and community development loans offered by community development financial institutions (CDFIs) is expected to rise. At the same time, rising unemployment and declining incomes could potentially lead to higher delinquency and default rates among CDFIs' borrowers.

In Fitch's view, however, CDFIs are well positioned to face these headwinds, given the strong asset quality of their loan portfolios, their solid financial profiles, and the effective oversight provided by their underwriting and servicing teams. It is these factors that support the high to medium investment-grade ratings currently assigned to CDFIs.

Fitch's existing ratings on CDFIs are currently in the 'A' and 'AA' categories and are assigned in accordance with Fitch's Public Sector, Revenue-Supported Entities Rating Criteria. The approach to assigning CDFI ratings under the Revenue-Supported Entities Criteria is in many ways similar to, yet distinct from, the approach to rating U.S. housing finance agencies under Fitch's U.S. Housing Finance Agency General Obligation Rating Criteria. By utilizing the Revenue-Supported Entities Criteria, Fitch acknowledges the similarities between CDFIs and other entities that provide essential public or social services, including social housing providers, public housing authorities, social service providers and charitable institutions. At the same time, the Revenue-Supported Entities Criteria provide enough flexibility such that Fitch is able to tailor its analysis to the unique characteristics of each CDFI.

As part of its rating analysis for CDFIs, Fitch assesses three key rating drivers (KRDs): revenue defensibility, operating risk and financial profile. Under the revenue defensibility KRD, Fitch assesses a CDFI's exposure to revenue disruption by evaluating the asset quality of its loan portfolio, including loan performance, portfolio composition, and the availability of collateral and reserves to offset loan losses. Under the revenue defensibility KRD, Fitch also assesses a CDFI's market position and the demand characteristics that influence revenue volatility. When assessing operating risk, Fitch considers the CDFI's risk profile, operating profitability, and its reliance on potentially volatile funding sources. With respect to financial profile, the CDFI's level of financial flexibility and the quality and stability of its financial resources are assessed through various leverage, capital base and liquidity metrics. Notably, Fitch evaluates each CDFI's loan portfolio individually and incorporates historical loan performance into the rating analysis, rather than relying on models or standard default and loss assumptions.

Generally speaking, CDFIs tend to exhibit stronger or midrange credit characteristics, including solid demand, low loan delinquencies and losses, conservative risk management and strong financial profiles. While loan performance may deteriorate next year given Fitch's expectations for a mild recession beginning in 2Q23, loan losses are expected to remain well within Fitch's stressed rating assumptions. As such, rating changes are not anticipated, and CDFIs remain well positioned to respond given their solid financial profiles. Notably, Fitch's risk analysis for CDFIs is forward-looking, with the aim of achieving ratings stability through economic cycles. Rating changes are therefore intended to reflect shifts in fundamentals for the CDFI or the sector, rather than cyclical or transitory changes in credit quality.

As the CDFI industry continues to evolve, Fitch is committed to ensuring that its rating opinions and criteria reflect the true nature of credit risks in this industry. In fact, Fitch reviews all of its criteria no less than once a year, providing ample opportunities to update the criteria to reflect current trends and market developments and/or incorporate any new risks identified in the sector.

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