FUTURE OF COMMUNITY DEVELOPMENT:
How CDFIs Can Best Ride the Impact Investing Wave

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Think of the community development finance industry as a small boat with an outboard motor. For four decades, pioneering leaders have helped to build this boat, take it out of port, and chart new waters. This boat has served as a lifeline, bringing essential resources to previously cut-off communities. But you don't have to be a soothsayer to see that this boating life is unlikely to continue. Even if the economy and the capital markets stabilize, three fundamental forces will prevent us continuing with business as usual:

- **Our boat may still be solid, but we are running out of fuel:** With the 30-year wave of retail bank consolidation largely behind us, there are fewer institutions remaining for which Community Reinvestment Act (CRA) credit represent a major

driver of institutional community development investments.[1] Looking ahead, as regulators remain focused on the safety and soundness of the banking system, CRA will likely diminish in importance there as well.

- **Our investees are running out of fuel too:** Many of our borrowers have relied on direct or indirect government reimbursements and subsidies to repay our investments. These government reimbursements are eroding and unlikely to recover soon. Therefore, even if we can mobilize capital to lend, it's not clear that our traditional borrowers will be in a solid position to pay us back.

- **We have not been building everything the communities need:** Crucially, safe housing and adequate facilities are increasingly recognized as insufficient to create the just and vibrant communities we aspire to support. These communities also need health care, educational opportunities, viable social service agencies, and decent job opportunities. Many community development finance institutions have worked on these issues, but our individual successes have not combined effectively to support neighborhoods with sufficient durability to withstand the current "perfect storm" of high unemployment, frozen credit, and declining real estate values.

None of these realities threaten to sink our sector in the short term. But they will become increasingly undeniable and problematic in the next decade. We should work together to find more fuel that works in our current engines. We should also look to the horizon for other boats out there, and entirely new ways to navigate these waters.

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1 The Community Reinvestment Act of 1977 is intended to encourage depository institutions to help meet the credit needs of the communities in which they operate, including low- and moderate-income neighborhoods, consistent with safe and sound operations. It was enacted by the Congress in 1977 (12 USC 2901) and is implemented by Regulation BB (12 CFR 228). The regulation was substantially revised in May 1995 and updated again in August 2005. More information is available at http://federalreserve.gov/communitydev/cra_about.htm.

The emerging impact investing industry looms on the horizon and has been coming into clearer view in the past few years. Is it a lifeline, bringing the promise of new supplies to allow us to continue our current operations? Is it an oceangoing vessel that we can climb aboard to sail more deeply into the multitrillion dollar mainstream capital markets? Or is it a Spanish galleon on the sixteenth-century South American shore, poised to disrupt the world we have so carefully cultivated?

Leaving these metaphorical waters behind, this essay considers sources of impact investing capital and what it will take to tap them. But even if impact investing flourishes, it may not prove a lifeline to all existing community finance intermediaries. The organizations that flourish in an impact investing world must provide value in new ways to new partners, and they must create new disciplines and practices. Ultimately, impact investing's greatest contribution may not be what it does or does not bring to community finance, but rather that it could prompt us to reexamine why we do what we do and to reaffirm "community development" as the organizing force of community development finance.

THE PROMISE OF IMPACT INVESTING

Impact investments seek to generate a "blended value" of both financial and social return. This concept is not new. In Europe, seventeenth-century Quaker communities aligned investments with spiritual practice, capitalizing worker-owned communities and community housing schemes. In the United States, private companies were the original "community development" investors, building housing and facilities for workers, and taking stewardship in the cultural development of their towns. And certainly any American reading a book like this one on community development finance has likely made or supported impact investments through a community development financial institution (CDFI) or socially responsible investment account.

But the rather simple idea that for-profit investment is both a morally legitimate and economically effective way to

address social and environmental challenges is making its way out of the niche in which it has grown up. Its emergence is fomenting demand for private capital and talent to be put to work. Increasingly, influential capital owners and capital markets participants are developing creative mechanisms to tap this demand.

The stakes are enormous. Even with the successes of the CDFI sector, we still leave $999 in the U.S. capital markets untapped for every $1 we have mobilized directly for socially motivated finance. Impact investing offers potential to unlock a portion of the other 99.9 percent. Obviously, most of that money is locked away in vaults unlikely to be opened for impact investments. It will remain beyond our reach. But even a small share of that treasure could transform the capital available to community development finance.

CDFIs are poised to be an important partner for impact investors, bringing their decades of knowledge in financing the organizations that tackle social issues. We bring to the table structuring expertise, as well as a pipeline of high-quality, high-social-impact investments. And the "complete capital" approach we will explain later in this article outlines a structure by which we can bring together these players and their capital, which to-date have approached social problem-solving separately.

WHERE WILL WE FIND THE MONEY?

Today the U.S. capital market is valued in the tens of trillions of dollars. This is an eye-catching number, but it is still more of an abstraction than a concrete market. Instead of one "market," this capital sits in discrete pools with varying relevance for community finance investors. Most of this capital is not poised to flow into impact investments. But four areas are particularly interesting to explore.

Private Foundations

Given that they are formally constituted (and tax privileged) to contribute to social good, private foundations are an obvious

place to start. Pioneers such as the John D. and Catherine T. MacArthur and Ford Foundations helped fund some of the early models of community development finance. But historically the private foundation sector as a whole has focused only a tiny portion of its grant-making budgets on program-related investments (PRIs).[2]

The impact investing movement is spurring rapid growth of PRIs from this tiny base. More important, perhaps, it is galvanizing attention on the approximately $590 billion in total endowment assets these foundations currently hold.[3] The twin forces of wealth concentration and the aging baby boom generation are set to precipitate a second great era of private foundation capitalization in the coming decade. If we are able to unlock even 5 percent for impact investment, this could provide nearly $30 billion, an amount equal to the balance sheets of all CDFIs today.

Private Banks and Family Offices

Private banks and family offices represent a potential sweet spot for impact investing. Their clients typically hold tens of millions of dollars in their accounts and can influence directly where their money goes. Various private banks are beginning to build impact investing products. These are funds-of-funds channeling money into emerging market impact fund managers and even platforms for direct investment into CDFIs such as the Calvert Foundation. Family offices are also making direct investments in deals as well as through intermediaries.

Donor-Advised Funds

Donor-advised funds—another opportunity for impact investing—are investment vehicles that give their owners immediate tax write-offs for future charitable donations. While

2 PRIs are investments that further the mission of the foundation and also earn a return. According to the IRS, "To be program-related, the investments must significantly further the foundation's exempt activities. They must be investments that would not have been made except for their relationship to the exempt purposes." A PRI may count as part of the 5 percent of assets that a foundation must deploy every year. More information is available at http://irs.gov/charities/foundations/article/0,,id=137793,00.html.

3 Foundation Center. Aggregate Fiscal Data by Foundation Type, 2009, FCStats, available at www.foundationcenter.org/findfunders/statistics/pdf/01_found_fin_data/2009/02_09.pdf.

they await donation placement, funds reside in profit-seeking investments. Major investment firms have mobilized billions of dollars into this increasingly popular product. With the capital pre-allocated to charity, these tools could be particularly well poised for impact investing. In one pioneering example, the Schwab Charitable Fund used donor-advised fund assets as a guarantee to secure a cheaper loan for the Grameen Foundation. This approach could be replicated widely for community development finance. Community foundations are also waking up to the opportunity to enhance impact and marketing by putting their clients' donor-advised assets to work in the local community.

The Person on the Street

So where does that leave the "regular investor?" Impact investing has until now largely been inaccessible to them. But that is starting to change. The economic crisis and backlash against large banks have led many to explore community banks and credit unions. Internet-enabled peer-to-peer lending platforms are also emerging and challenging regulatory practice. With Kiva.org, a website that enables the public to make very small loans globally for socially valuable purposes, now making investments in the United States, and Calvert Foundation working through MicroPlace, which offers a similar way to make small, online investments to help alleviate poverty, retail investors can make U.S. impact investments over the internet for as little as $20.

POTENTIAL BARRIERS TO TAPPING NEW CAPITAL

Together, these are not the largest pools of the capital markets (those are assets managed by pension funds and insurance companies). However, they add up to a capital pool far deeper than we have mobilized to date for community finance. As businesses begin to develop products and services for impact investors, and more deals demonstrate the viability of this approach, impact investing could take off.

Yet impact investors operate in an inhospitable set of systems. Chief among them is a regulatory and policy system built on the twin assumptions that only charity and government can address

social issues and that the only purpose of investment is to make money. Relatively small changes to existing policy mandates and structures could make a significant positive difference. The Treasury Department's ongoing review of decades-old guidance for PRIs could stimulate more private foundation impact investments. The Small Business Administration's creation of a $500 million impact investing mandate for Small Business Investment Corporations is yet another promising development.

Government can also build on impact investing momentum with bolder action. As the premise of impact investing is to unlock private capital for social purpose, it would be self-defeating to demand substantial public money to make this work. Government, however, can seed the industry with risk-taking capital and by offering coordination to a highly fragmented market. The United Kingdom's launch last year of a $1 billion impact investment wholesale bank, Big Society Capital, with investment from major banks, is one model. Government can also play a coordinating and legitimizing role, as the White House has done in bringing together states, cities, and potential investors in Social Impact Bonds.

WHAT DOES MOMENTUM AROUND IMPACT INVESTING MEAN FOR THE CDFI INDUSTRY?

CDFIs were making impact investments long before the current buzz about them surfaced. As such, they should be well poised to reap the benefits of these increased private capital flows. Yet there is a real danger that CDFIs will be left on the sideline as impact investing takes off. To understand why, and what we can do about it, we first must recognize that the new wave of impact investing creates fundamentally different strategic dynamics for intermediaries. To navigate successfully, CDFIs must orient themselves to new clients with new demands, using new practices.

The fundamental differences between the new approach and the old are the source of capital and its motivation. CDFIs have largely been capitalized by government and by retail banks seeking to fulfill CRA mandates. Impact investors are increasingly

mobilized through private capital pools seeking to meet private social motivations. The CRA bankers sought intermediaries that could provide the most efficient conversion of capital into reliable CRA credit. The private impact investors are seeking intermediaries that can most effectively convert capital into compelling social solutions. These motivations may seem similar but have important, distinct implications. Successful intermediaries in this new world will offer their lenders and investors:

- **Sector diversification:** Although the efficiency imperative of CRA bankers has led most CRA capital to flow to capital-intensive real estate deals (the easiest way to put the most capital to work), the social imperative of impact investors will require greater diversification. Impact investors want to affect health care, education, social services, and the arts, not just housing.

- **National capacity to invest locally:** To serve private investors with strong local ties, intermediaries will need to put capital to work in local communities. The aggregators of impact investing assets in private banks and national donor-advised funds, however, will seek the efficiency gains from working with national-scale partners. They will look to work with intermediaries who can offer local investment expertise and capabilities across a national or at least regional footprint. Few existing intermediaries have the products, practices, and presence to pull this off.

- **Off-balance-sheet capabilities (and beyond):** The new client will focus on connecting capital to specific projects. Growing the balance sheet of an intermediary to make general investments will not be as compelling. Therefore, successful intermediaries will be nimble in setting up off-balance-sheet vehicles to pool capital for specific projects with tailored underwriting standards. Going one step further, some impact investors will keep their assets on book and seek advisors and deal brokers who can advise on direct transactions. Depending on how

we respond, this is either a disintermediation threat or a new business opportunity.

- **Enhanced capabilities to measure and report our impact:** The new impact investor will want to know how CDFIs manage our social impact beyond our ability to comply with government mandates. Especially as we move toward the retail investor, communicating our social impact in ways that resonate with laypeople rather than insiders will be crucial. We will need to come to terms with "marketing" and find an appropriate balance between simplicity and substance in our impact measurement.

Some CDFIs are already quite innovative and are working with these new capital sources to provide these capabilities. But few of us have strategically reoriented our work to thrive in this new world. Other innovators are not waiting for CDFIs to move. New firms are springing up to offer off-balance-sheet structuring and advice. Mainstream financial services institutions like JPMorgan Chase and MorganStanley have set up impact investing units, and new investment firms are offering donor-advised funds and other more widely available products. Many of the new entrants, however, lack the experience and skills required to make the best impact investments. The CDFI sector's decades of experience and community links enable us to provide powerful solutions for communities; we need to become the partner of choice for the new impact investors. Beyond these institutional-level responses, as a sector CDFIs must engage more fully in expanding the political and social acceptance of impact investing. Rather than narrowly lobbying government for subsidies and regulatory mandates, we need to advocate widely for the legitimacy and effectiveness of for-profit approaches. Recent history shows how failure to proactively address the skepticism most people have about investors can torpedo otherwise thriving industries. The Indian microfinance industry's inattention to proving its social value set it up for a disastrous backlash in 2010.

REINFORCING THE "COMMUNITY DEVELOPMENT" IN COMMUNITY DEVELOPMENT FINANCE

Some existing community finance institutions will likely build new services and approaches that enable them to tap into private impact investing capital as a new source of sustenance. Private impact investing could, however, be more than just a source of new capital to continue to do old things. Instead, it could spur the field to put investment in its appropriate place. Impact investing is a tool, not an end in itself. So is community finance. If you approach the world asking, "Where can I invest?" you will end up doing far less interesting work than if you ask, "What social challenges need addressing, and how can investing be one of the tools I use to address them?"

This may sound like mere semantics, but in our work at Nonprofit Finance Fund, this reframing has opened up great opportunities. In New York City in 2010, we set up a fund to provide working capital loans to frontline agencies such as soup kitchens and homeless shelters. They were too financially shaky to take on debt, however. If we were only looking for places to invest, we would have moved on to find other less risky borrowers, but because preserving New York's safety net was crucial, we structured a new initiative, the Community Resilience Fund. The fund aims to support up to 100 agencies seeking to transition to a more sustainable business model. This fund would not be possible without impact investors offering millions of dollars of loans. It also requires credit enhancement from city government and substantial grant support from private donors. No one piece would work alone. The most interesting impact investing in the next few years will involve similar collaboration, as impact investors work with governments and donors to tackle challenges that cannot be addressed with any one tool.

As poor communities continue to suffer the aftershocks of the economic crisis, more essential organizations will become riskier and riskier borrowers. If we want to make a difference in these organizations, we will have to work alongside philanthropic and government support, with each part made more powerful and

useful because of its complementarity. We call this approach "complete capital." Complete capital weaves together financial capital (grants and impact investments), intellectual capital (the ideas about what we need to do and how to do it), human capital (the ability to support organizations to implement bold strategies), and social capital (which allows collaboration among people and institutions that don't typically work together).

Complete capital approaches require those of us who seek to address fundamental social challenges in the field to reorient our work around development as the end goal, with investment as only one tool. Complete capital practitioners will need to become accustomed to working with different organizations. This sounds banal, but it will be difficult to pull off, especially as economic pressures spur an instinct to retreat into defending narrowly claimed territory for "our organization" or "our sector." CDFIs will need to develop enhanced cultures of innovation that build on but are not constrained by our historic experiences as primarily relatively conservative lenders. We will need new approaches to mitigating risk by mobilizing impact investing capital into mezzanine finance structures. We must better understand how grants can be used not just to mitigate the risk to investors *when* investments fail but also to reduce the likelihood that investments *will* fail with timely and efficient technical assistance to investees.

Many of the easy problems that can be solved with singular, siloed approaches are already being tackled. The increasingly complex and accelerating challenges that remain will require complete capital approaches to solve them. Impact investing capital from private sources will be an important part of these solutions. But they will not work alone. It will take collaborative, creative energy and problem-solving to deepen the community development impact of community development finance.

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