CDFI COMMUNITY INVESTMENT INITIATIVE

How to increase Socially Responsible Investment in CDFIs

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A CALL TO ACTION

Individual investors are speaking loud and clear to the investment industry: they want their money to support their values. They want to play a direct and tangible role in creating a world with more human opportunity and better environmental quality.

Socially Responsible Investing (SRI) is the result of this demand. Investors can now screen their investments to meet their definition of good impact. In addition, investors can join forces as shareholder advocates for social causes at the corporate level.

The young SRI industry is challenged, however, to connect investors with impact in their own backyards. Commercial platforms simply do not offer the community investments that many clients seek. There are few choices for an investor who wants to help the poor in her own state, or one who wants to improve water quality in his own watershed.

Meanwhile, local communities need investment capital for just these types of projects within the thriving Community Development Financial Institutions (CDFI) sector. CDFIs manage $30 billion in local community investment. Employing a unique triple-bottom-line business model, CDFIs are variously structured as banks, credit unions or loan funds. Their capital pools finance local housing, small businesses, and community facilities across the country. They can offer investments that target water quality in Puget Sound, sustainable forestry in West Virginia, or minority business development in Mississippi. Yet they have not attracted social investors in large numbers.

CDFIs began exploring the disconnect with social investors in 2010.[1] They learned that many social investors and investment professionals don't even know about the potential to invest in CDFIs. They also found that many in the SRI world perceive CDFI investments to be inconvenient, illiquid, low-return, risky and non-standard compared to mainstream securities.

The good news is that both CDFIs and the investment industry are motivated to improve the situation. For instance, fee-based wealth mangers are researching CDFIs and investing in them for their high-net-worth clients. Mutual funds are incorporating CDFIs into their portfolios. And CDFIs are structuring securities to sell directly to investors. As is common in early innovation, these efforts are promising but they are fragmented, uneven and uncoordinated.

This is an opportunity for CDFIs to take the lead in the dynamic and young field of SRI community investing. Building on the innovations catalogued in this report, CDFIs can work directly with the SRI sector to improve CDFI investment vehicles. Paying careful attention to the SRI customer's profile and investing habits, CDFIs can establsh an effective SRI marketing presence. This report details specific actions that are needed in both these areas.

Increasing social investment in CDFIs will force CDFIs to address several presesing industry issues. One is the adequacy of equity (non-borrowed) capital for CDFIs in the years to come. Another is the need for standardization of financial and impact reporting practices. Finally, working on SRI funding is sure to surface policy proposals that will help CDFI and the SRI sector to stimulate investment.

All of these actions are recommended here. The first step is for CDFIs to join forces. The easy work to court SRI capital has been carried out by individual CDFIs. The next steps will require a cohesive national presence, with CDFIs working together at a scale that can interact effectively with global securities insitutions.

[1] *Connecting CDFIs to the Socially Responsible Investor Community,* 2010, Rosalie Cates and Chris Larson.

INTRODUCTION

The CDFI Community Investment Initiative

In 2010 a group of CDFIs called the Triple Bottom Line Collaborative was funded by the Ford Foundation to complete the report *Connecting CDFIs to the Socially Responsible Investor Community.* By querying investors, fund managers, advisors, and other SRI participants, the CDFIs identified seven barriers that currently limit investments in CDFIs:

- Low awareness among investors and their advisors of CDFIs – their work, their impact, and the difference between CDFI loan funds and depositories;
- Lack of electronic handling;
- Low rate of return on CDFI investments;
- Unappealing investment term;
- Lack of liquidity;
- Perceived risk;
- Use of unfamiliar, non-security investment vehicles.

To follow up on this information, 11 CDFIs and community development organizations formed the CDFI Community Investment Initiative (CCII). CCII's members (listed on Page 14) collectively manage over $2 billion in impact investing capital. Most of them already accept investment from individuals, or from investment funds or wealth managers. They have found, however, that their efforts as single CDFIs cannot overcome the barriers identified in the 2010 report. They formed CCII to identify and initiate the actions that CDFIs can take to overcome barriers and forge a strong pipeline between CDFIs and impact investors.

Design of CCII's research

CCII focused closely on the seven investment barriers that investment advisors and money managers described in 2010. Once again they reached directly out to the investment industry with three lines of inquiry:

1. Is it feasible for individual CDFIs to offer securities on electronic investment platforms?
2. What existing securities are used to funnel investment into CDFIs despite the seven investment barriers, and can they be expanded?
3. Are there other security vehicles that aren't currently used by CDFIs, but could be?

CCII talked to Registered Investment Advisors, fee-base wealth managers, mutual fund managers, broker dealers, alternative investment managers, foundation representatives, CDFIs, First Affirmative Financial Network leaders and members, government agencies, Federal Reserve banks, individual investors, attorneys and many people loosely identified with the social investing "movement."

As the interviews proceeded, many issues arose that were outside the narrow scope of security vehicles. They involved marketing, public policy, and CDFI business models. CCII incorporated this information into the final recommendations made in this report.

FINDINGS

1. Individual CDFIs won't offer electronically-handled securities in the near term

It is not likely that CDFIs can offer securities on conventional (electronic) investment platforms in the near future. CCII modeled the process of structuring a securities offering, then obtaining registrations, a CUSIP[2] identifier, distribution and custody (See Figure 2). Each of these steps entails a cost, and CDFI investments do not have adequate margin to cover all these costs. Nor are CDFIs likely to attract service providers for each of these functions at the modest CDFI capital scale. Given these facts, it does not appear feasible for individual CDFIs to offer electronically-handled securities, as long as the CDFI business model is based on investor capital priced at 4% or less.

This is an important finding that should signal all stakeholders that retail electronic trading is not a solution that is within reach for CDFIs at this time.

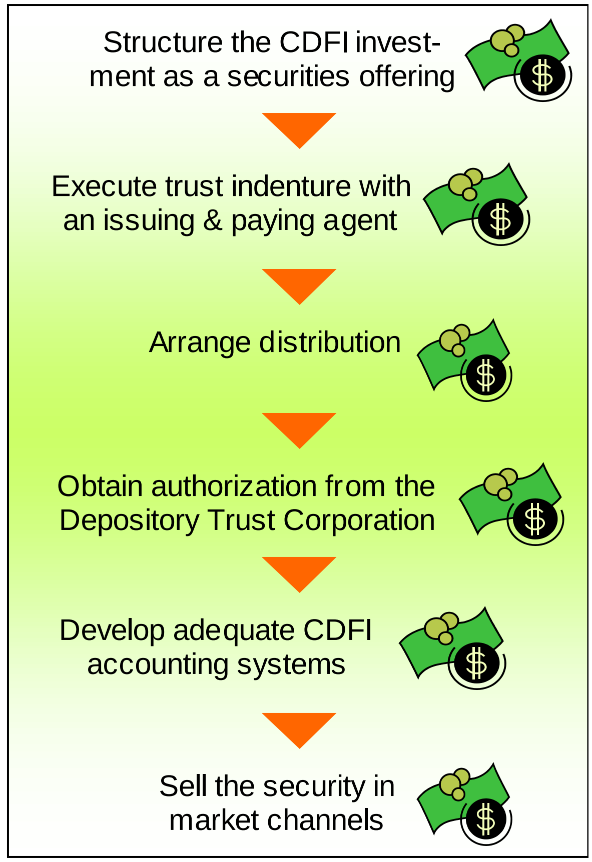

Figure 1: Each step in structuring a security for electronic handling incurs a cost.

2. Some conventional securities hold promise to expand CDFI investment

There are a number of existing investment vehicles that either are already being used to place funds in CDFIs, or show promise to be adapted for use by CDFIs. Each promising category is described here.

- **Wealth managers:** Well known firms that specialize in triple bottom line portfolio services include Trillium Asset Management, Loring Wolcott & Coolidge, and Veris Wealth Partners. Firms like these actively invest in individual CDFIs on behalf of their high-net-worth clients. Two firms alone hold over $35 million in CDFI investment. There is no standardization of investment practices among wealth management firms, as illustrated below:

  Underwriting the CDFI: Each wealth management firm has its own unique method of underwriting CDFIs, and none specifies an overt underwriting standard for financial performance or impact. Some firms maintain a list of CDFIs with whom they work; others seem to underwrite at clients' requests.

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[2]The Committee on Uniform Securities Procedure assigns an identification number to all stocks and registered bonds.

Investment vehicles: All of the firms accept non-standard investment instruments and are willing to execute simple promissory notes between their clients and CDFIs.

Rate of return, term, risk: Current CDFI pricing, term and risk are acceptable to the clients of fee-based wealth managers.

Custody of the investment: Custody arrangements are different at each firm interviewed. One firm uses Schwab, one custodies CDFIs in-house, and another has no formal custody. Schwab has become actively resistant to holding CDFI debt instruments. Schwab's new policies caused one wealth management firm to set minimum CDFI investments at $50,000 per single CDFI.

Electronic handling: Investments are manually purchased, but all of the firms have devised methods to include CDFI investments in electronic client reports. The systems for generating electronic reports vary widely from firm to firm and depend in part on the custody arrangement. However, in actuality most systems are heavily manual. This is a high cost area with complex compliance factors.

Marketing and awareness: Wealth managers are "high-touch" service providers and are very responsive to client requests. At the time of this scan they were responding to high demand for investments that would help local farmers, but they lacked a convenient point of contact to find CDFIs that could meet this demand.

CDFIs can work with fee-based wealth managers to expand CDFI investment from their high-net-worth clients. Wealth management is a very private, tailored service, and CDFIs will have to respect strict marketing boundaries in working with wealth managers. Important steps might include: 1) standardize CDFI offerings and reporting in order to reduce the costs that wealth managers incur to place and service CDFI investments; 2) advocate for custody houses to handle CDFI investments; 3) improve and increase CDFI marketing to wealth managers, especially to match CDFIs with "boutique" impact requests made by high-net-worth investors.

- Mutual Funds: CDFIs would benefit from attracting even a fraction of the investments made by multi-billion dollar SRI mutual funds such as Pax World, Praxis, or Domini. Mutual fund investment in CDFIs is limited right now, but it has begun in at least two mutuals. Some of the issues include:

  Investment vehicles: One mutual fund can execute simple promissory notes with CDFIs. The other went to great lengths to structure a compliant security offering.

Just two fee-based wealth management firms have invested over $35 million in CDFIs. These firms will accept simple promissory notes, and their clients are comfortable with CDFI terms and rate of return.

Rate of return: Mutual funds can accept relatively low rates of return from CDFIs because they blend a small number of CDFI investments within a much larger overall investment corpus. However, market returns are very low at September, 2011, and rate sensitivity will likely increase for mutual funds if the market rises.

Securities compliance: Mutual fund managers operate under the rules of the 1940 Securities Act, which requires daily pricing of mutual fund holding. The 1940 Act also dictates the type of securities offerings that mutual funds can buy. Fund managers have engineered compliance solutions, but so far their efforts are hand-crafted, and replication for many CDFIs will be expensive. The significant finding here, however, is that the mutual fund managers are willing to collaborate with CDFIs to work on 1940 Act compliance solutions.

In the mutual fund market, CDFIs can work with fund managers who either already buy CDFI debt, or want to. These CDFI customers are actively working to solve securities issues and expand CDFI holdings. CDFIs can join this effort, providing much-needed direction and assistance from the CDFI sector. Then the practices can be proposed to additional mutual funds.

- Alternative Investments: People in the securities world tend to think of high-return hedge funds or private equity funds when they think of alternative investments. However, new companies are springing up to offer SRI products using the alternative investment category. This could allow CDFIs to offer products to mainstream investment advisors in this product category.

Electronic handling and rate of return are the issues for CDFIs in the alternative investment category. As explained earlier in this report, CDFI pricing is too low to carry the costs of electronic handling, which is standard for the companies developing new SRI alternative investments. In addition CDFI returns do not meet customer expectations in this securities class. Despite these financial hurdles, alternative investment is a match for CDFIs in many ways, and alternative investment managers are interested in the impact story that CDFIs bring to investors.

CDFIs can collaborate with the alternative investment sector to solve specific CDFI securities barriers and push for CDFI products to be included in this market.

- Local SRI solicitation: Many CDFIs directly solicit individual investors as part of their ongoing fundraising programs. For example, New Hampshire Community Loan Fund raises $3 million in new debt annually.

Practices among these CDFIs vary widely, both in product offerings and sales strategies. Some CDFIs offer

SRI mutual funds are investing in CDFIs. They are sensitive to liquidity and rate of return, but they overcome these issues by holding CDFIs as a small portion of much larger portfolios.

structured exempt securities, usually in partnership with Calvert Foundation; others simply offer "investment" as an option to donors. Some CDFIs offer self-directed Individual Retirement Accounts (IRAs).

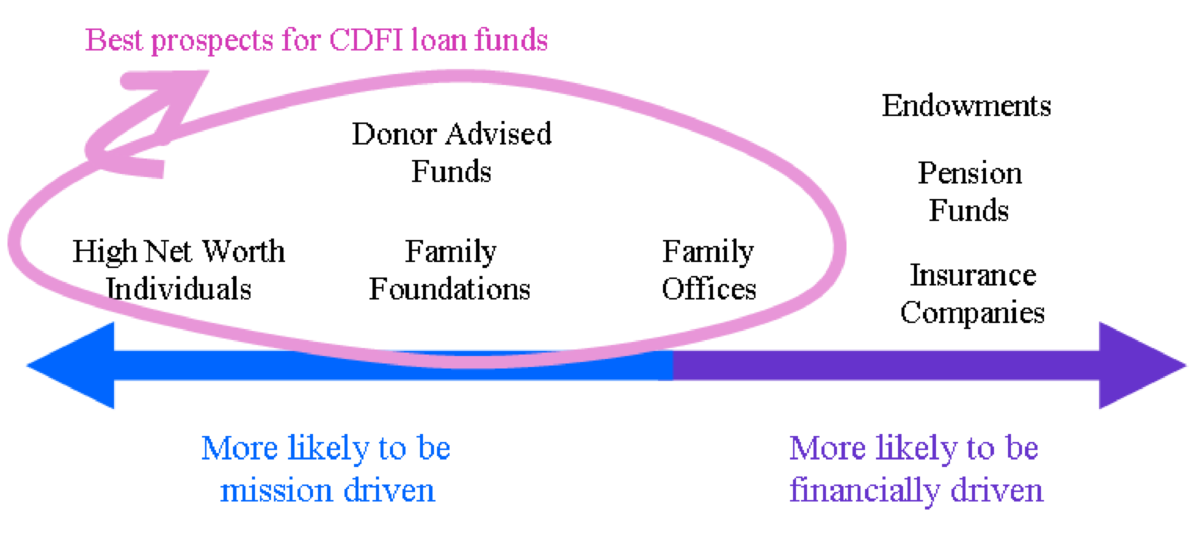
The most typical marketing is direct to local friends of the CDFI. Some CDFIs also market to local investment advisors, but for the most part traction with these professionals is limited.

There are at least three issues to address if more CDFIs want to directly solicit investors. 1) CDFIs are in jeopardy of violating securities law without careful structuring of their investor programs. The CDFI sector should produce reliable legal guidance in this area. 2) CDFIs also need guidance to help them understand how to work with local investment advisors, wealth managers, Calvert Foundation, and other entities in the investment sector. 3) CDFIs need marketing tailored to individual investors. Scattered expertise in all of these areas exists within the CDFI network, but the information is inconsistent and hard to find.

- Impact Investing: Impact investing is not a precise term, but usually refers to mission-enhanced investing by institutions, such as insurance companies, retirement funds and foundations. Recently the term is being used to encompass socially responsible investing, and to include individual investors. Impact investors are often segmented based on their desire for financial return versus mission impact, as illustrated in Figure 2.

The mission appeal of CDFIs appears to create an opportunity to attract funds from impact investor groups. However, nearly all insitutional funds are managed to Employment Retirement Income Security Act (ERISA) standards, which demand that investment managers maximize financial returns on investments. Only CDFI venture capital funds have been able to meet this return standard

Conventional CDFI loan funds cannot meet ERISA's return standard. But they may be able to capitalize on the interest in impact investing to convince small foundations, family offices and donor advised funds,to invest as part of their



The spectrum of "Impact Investors"

philanthropy portfolios.

Some larger CDFIs can also explore a relatively new role: structuring and managing special purpose funds. (Technically these are classifies as alternative investments.) With their ability to attract philanthropic or government funds as first-loss funds, CDFIs may be able to "stack" sources so they can offer a compelling rate of return to institutional investors.

Niether of these opportunities was carefully examined in this scan but both merit further work.

CDFIs can continue to build relationships in the impact investing movement., and to explore specific impact investing tie-ins and products..

- CDFI bonds: The US Treasury just received authority to guarantee bonds issued by CDFIs. When offered, this conventional, electronic, competitive retail investment product will be welcomed by the social investment industry.

  There are a number of issues to address as US Treasury and CDFIs work to structure and issue the industry's first bonds. Most important is whether the bonds will funnel capital at an acceptable cost to CDFIs and whether any but the largest CDFIs will have capacity to participate.

  CDFIs can energetically pursue issuance of bonds, address questions of cost and scale, and explore forming pools to jointly issue bonds that reach smaller CDFIs.

- What else? The opportunities to expand CDFI investment in the conventional securities sector that are presented here are the result of a rapid scan only. There is an opportunity to find other and perhaps better investment approaches, through more research, and more collaboration with the securities industry.

  Many of the professionals intereviewed for this report are willing to work more on product development. They also suggested the conversation be extended to include influential and important third party administrators, clearing platforms and professionals in other parts of the securities system.

  CDFIs can continue to identify and develop securities-compliant CDFI investment products, in collaboration with existing and new allies in the investment industry.

3. *CDFIs can help the SRI industry solve the community investing puzzle*

Socially responsible investing has three components: screening portfolios to create desired investor impact; advocacy campaigns that give investors a voice in corporate boardrooms; and placing investment in investors' own communities (See Figure 3). The SRI sector has been innovative and successful in creating products and services in screened investments and corporate advocacy. They report frustration, however, in the area of

Figure 3.   Three Core Elements of SRI

community investment.

CDFIs have 30 years of experience in community investing. CCII represents CDFIs with $2 billion under management in community impact investments. They have proven debt and equity products that get funds to local businesses, non-profits and housing developers. They have effective risk management systems. They have deep local knowledge and active networks. These are important community investing assets, and they can be the basis of an aligned business and mission partnership with the SRI sector.

Professionals in the SRI sector are very interested in CDFIs. However, they are not familiar with the CDFI business model and have very limited understanding of the logistics of delivering effective financing for mission in U.S. communities. This limits their understanding of potential CDFI investment products.

At the same time, CDFIs have much to learn about the securities industry. They are not familiar with the industry structure and its regulations. CDFIs will increase their effectiveness by knowing who does what, and why, in the industry. It is especially important for CDFIs to become conversant with the securities laws that dictate the framework for investment innovations.

CDFIs can form mutually beneficial working partnerships with the SRI industry. Concrete partnership opportunities include:

- **Forming a mutual fund working group to model and test new ways to increase investment from mutual funds.**
- **Working with high-net-worth wealth managers to better fit the CDFI offering, marketing and reporting to those clients.**
- **Convening design innovators who can help CDFIs and SRI representatives to re-think community investment models.**

4. CDFIs can create a much more effective marketing presence with social investors

CDFIs have marketing challenges in the SRI sector: lack of awareness, an unclear message, and a confusing presence. CCII noted these issues:

- Many SRI investors and advisors are simply unaware of CDFIs. Those that do know the term "CDFI" may only know of CDFI banks and credit unions. There is low awareness of the existence of CDFI loan and venture funds that work with affordable housing and business financing.
- CDFIs frame their marketing message around social justice, civil rights and poverty. The message has not translated particularly well in the social

CDFIs need a new message that better translates social justice, civil rights, and poverty alleviation for SRI customers. CDFIs also need to communicate their positive environmental work.

investment industry, and it has not communicated the environmental work of CDFIs.

- Affordable housing has very limited awareness with social investors.

- CDFIs are often perceived to be small, risky, unsophisticated or highly associated with the government.

- CDFIs have a sporadic and inconsistent presence at key SRI industry events.

It is very important for CDFIs to unify behind an effective national marketing presence that gives the SRI industry a clear "front door" to CDFIs. CDFIs can join forces in two areas. 1) CDFIs should create a cohesive and powerful story that is specifically framed for social investors. This messaging can be used by individual CDFIs in local markets, as well as in national efforts. 2) CDFIs need a game plan to establish and maintain key strategic relationships in the investment industry. These relationships will open investment channels and foster collaboration on product innovations and policy.

5. CDFIs have a significant equity issue

The idea of raising large amounts of new debt capital from social investors raises a basic—and critical – question of business model sustainability for CDFIs: Do CDFIs have enough equity to take on more debt? The current CDFI business model includes a capital pool made up of 25-50% equity, with the remainder of capital borrowed from investors who receive returns of 0-4%. The capital is lent out to businesses, affordable housing development, and other community projects. Tremendous community benefits accrue, and the lending generates interest revenue. This revenue typically covers interest payments to investors as well as most of the organization's lending costs. Any shortfall is made up with fundraising, or other revenues in the CDFI.

The federal government is main source of the equity that CDFIs have built on their balance sheets. It is also the main source of operating grants that help cover loan operations. Banks and foundations are also important funders. In recent years some CDFIs have also covered costs and/or generated retained earnings through New Markets Tax Credit fees.

If CDFIs ramp up the debt side of their balance sheets with new SRI funds, the business model demands that equity be ramped up proportionately. In many loan funds, additional operating funds will also have to be raised to cover the full costs of lending. Will banks, foundations and the government step up with more of both these types of funding? At a certain level CDFIs might ask whether it is realistic to portray CDFI debt as an "investment" when grants must be raised from other sources to support the overall business model.

One answer to these questions is that CDFIs should not be going to SRI for more debt, but for capital in a form that will truly build CDFI impact and sustainability. That form is equity.

Another answer is that CDFIs should seek new ways to deliver local financing with reduced costs and better margins. Many CDFI managers are deeply engaged in this effort, which will make CDFI investment more viable for SRI. But the CDFI business

Ramping up the debt side of CDFI balance sheets with new SRI funds will require CDFIs to raise more equity, and more operating capital.

model is not going to change overnight, and it is unlikely that CDFIs can lend to the poor and underserved without some form of subsidy.

CDFIs need to look frankly at the sustainability of their business model, and be very careful to plan for equity and operating grants as they take on new SRI funds.

6. Reporting is important to SRI

The SRI sector is very attentive to data, and very oriented to impact certifications and ratings. This is likely to emerge as an issue because CDFIs do not employ consistent, standard formats for their financial and mission impact data. This makes it difficult for social investors to develop efficient underwriting and reporting systems, and to compare and evaluate the claims made by various CDFIs.

Diversity in organizations is a treasured value among CDFIs, but it will be frustrating to investors if this diversity in data persists. This scan does not cover the current state of practice in CDFI impact reporting, ratings or certifications. It simply notes that the issue is already arising with CDFI investors, and will become more noticeable as CDFIs attract more attention in the SRI sector.

A number of entities in both the CDFI and SRI worlds are addressing financial and impact reporting. Because reporting is important to social investors, CDFIs will likely need to embrace the data formats accepted by investors as new SRI channels are developed.

Next Steps

CDFIs have a very realistic opportunity to increase their investor base among socially responsible investors. The findings reported here show that it won't be easy – relationships need to be strengthened, products massaged, and the story told. But CDFIs are not starting from scratch. Social investors want the impact that CDFIs have to offer and have showed willingness to invest in the CDFI price range.

To take advantage of this opportunity, CCII recommends that CDFIs join forces behind these immediate actions:

- **Create a legal guide and marketing framework to improve and expand local CDFI investment programs:** To raise capital directly from social investors at the local level, CDFIs need good legal guidance on structuring and selling investments, which are securities. In addition they need a basic understanding of the options they have for reaching individual investors, and a map of who does what in the commercial investment sector.

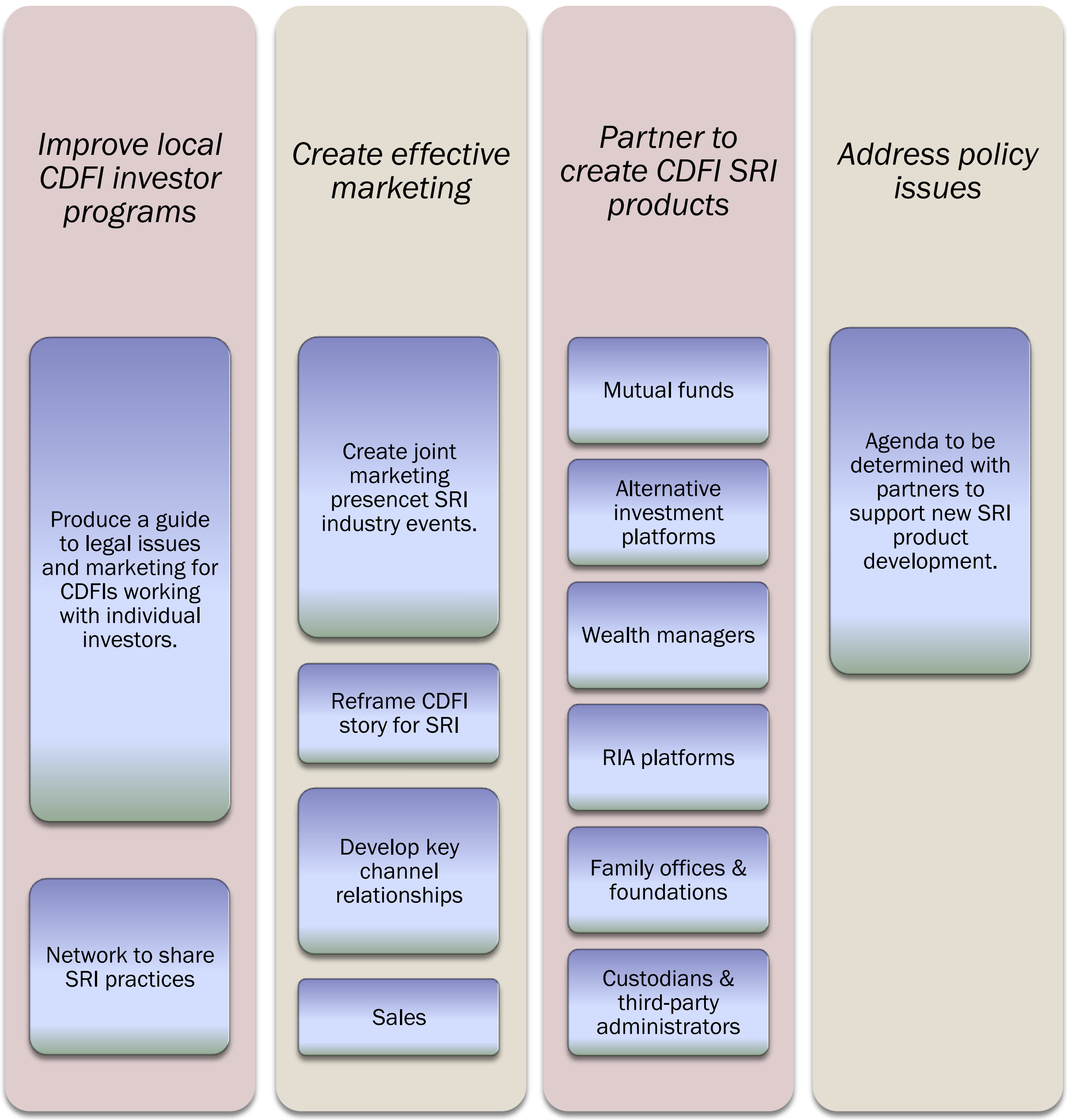
- **Market CDFIs effectively to investors and to the investing industry:** CDFIs can join forces to move beyond their current fragmented and disjointed presence in the investment industry. Positioning efforts would include developing a strong CDFI message that is specifically tailored for SRI; joint CDFI marketing; nurturing key channel relationships within the investment sector; and ongoing partnership with the investment sector to solve SRI community investment issues.

- **Partner with motivated members of the SRI investment industry to create better CDFI investment options:** The investment industry is actively exploring community investment products that provide an acceptable balance of impact, financial return, and risk. Many are eager to discuss possible products with CDFIs, such as mutual funds, alternative investment platforms, new custodial arrangements, and a family foundation product. No single CDFI has the scale to act alone on product development; the work requires joint CDFI action.

- **Pursue policy change:** Possible policy changes will arise as CDFIs work to structure investment vehicles within the highly technical, complex securities environment. These policy matters need careful attention. The US Social Investment Forum takes the lead on SRI community investing policy matters; CDFIs should join their work and create a CDFI-specific agenda as needed.

CCII members have committed to continue operating as an informal collaborative in order to work on these steps. Besides their own financial commitments, members are raising foundation funding and seeking contracts that will advance CDFIs in the SRI sector.

SUMMARY: CDFI COMMUNITY INVESTING LEADERSHIP AGENDA



PARTICIPANTS IN CCII

Ten CDFIs and NeighborWorks Rocky Mountain Region make up the CDFI Community Investment Initiative. They represent housing, business, venture capital and credit union services throughout the United States, with nearly $2 billion in impact assets under management.

Total community investment assets of CDFI Community Investment Initiative members

CDFI	Assets	Financing activity			Geography
		Housing	Business	Venture	
Coastal Enteprises	$ 788,700,000	✓	✓	✓	Maine & New England
Cooperative Fund of New England	$ 9,000,000	✓	✓		Northeastern States
Enterprise	$ 159,000,000	✓			United States
Enterprise Cascadia	$ 100,900,000		✓		Oregon, Washington
Hope Enterprise Corporation/Hope Credit Union	$ 197,859,000	✓	✓		Mississippi Delta States
Low Income Investment Fund	$ 293,300,000	✓			United States
Mountain Association for Community Economic Development	$ 21,000,000		✓		Kentucky
Natural Capital Investment Fund	$ 10,100,000		✓		West Virginia, North Carolina & Appalachia states
Neighborworks Rocky Mountain Region	$ 280,385,000	✓			Rocky Mountain States
New Hampshire Community Loan Fund	$ 79,700,000	✓	✓		New Hampshire
Pacific Community Ventures	$ 60,000,000			✓	California
TOTAL	**$ 1,999,944,000**				

Assets include all balance sheet assets and assets under management through subsidiaries such as New Markets Tax Credit and SBA 504 programs. The Neighborworks total includes only the CDFI members of the Rocky Mountain Neighborworks network. Community facilities may be included in housing fund activities.

Thank You

The entire social investment community was generous with time, ideas and enthusiasm for CCII and its goals. CCII thanks all those who responded to our requests for information, ideas and assistance. Consultant Chris Larson of Larson Ventures in Portland OR provided important support and strategic adjustments as the process unfolded. Author Marjorie Kelly of the Tellus Institute helped frame the early project thinking.

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Contact CCII

Your questions and comments are welcome. To learn more about any of the subjects in this report, please contact Rosalie Sheehy Cates at rosalie.sheehy.cates@gmail.com.