

CRA Modernization and Impact Investments

John Moon

Federal Reserve Board of Governors

Bank regulators are currently reviewing public comment on the Community Reinvestment Act (CRA) to determine what regulatory changes, if any, might be made to this law that has served as a pillar in the community development field. In its first iteration, the CRA addressed the fundamental challenge of inputs – simply getting capital and financial services into low- and moderate-income (LMI) areas. In its second iteration after several major changes, the CRA focused on how to better measure activities that improve communities. In what may be its third iteration, the CRA must focus on measuring outcomes and impact; in other words, to what degree has CRA-motivated lending and investing successfully improved communities?

CRA-motivated banks and the rapidly growing social impact investments field have overlapping and complementary objectives and challenges. On one hand, this nascent social impact investments movement faces similar challenges that the early community development movement faced, such as creating intermediaries, building a supportive ecosystem, establishing a track record, and creating the right assessment tools. On the other hand, the social impact investments movement is on the cusp of becoming a standard bearer through the sheer size of its potential investment activities (estimated to be \$500 billion within the next ten years), its intellectual and innovative vibrancy, and the growing professionalism of this field. The potential challenge and opportunity for the community development industry will be to realign itself to tap these new funding sources by adapting to shifting investor expectations for impact-based outcomes. Similarly, the CRA must also adapt to this potential funding shift within the community development industry.

CRA History

A lack of lending in LMI communities stemmed largely from discriminatory practices and the perception of excessive investment risk in these areas. In the mid-1930s, banks identified geographic regions as high-risk and, as a matter of bank policy, did not lend in those “red-lined” regions. In 1961, the “Report on Housing” by the U.S. Commission on Civil Rights documented bank practices of requiring higher down payments and rapid amortization schedules for African Americans, in addition to blanket refusals to lend in certain areas. The Community Reinvestment Act was passed in 1977 in response to worsening economic conditions in urban areas, and to redress lending practices whereby financial institutions

accepted deposits from households in their local communities but did not lend or invest in those very communities.¹

Congress instituted a quid pro quo for access to the Federal Reserve discount window and FDIC insurance by requiring financial institutions to provide services and capital to underserved markets. In its 30-year history, the CRA has achieved its goal of increasing capital access to LMI and underserved communities. According to some studies, the changes made in the mid-1990s to make CRA more transparent coincided with an increase in annual lending commitments from \$1.6 billion in 1990 to \$103 billion in 1999.² According to a study by Harvard's Joint Center for Housing, the CRA expanded access to residential mortgages for lower-income borrowers.³ Another study concluded that the CRA has been effective in helping to overcome market failures and reduce discrimination at a relatively low cost.⁴

Although the CRA is a critical regulatory tool in promoting the flow of capital to LMI areas and in supporting the community development industry, the CRA has not kept pace with the significant changes within the financial services industry. Bank consolidation and the growing dominance of national banks along with the impact of technology have made the notion of serving local markets where banks take deposits seem outmoded. With the growth of securitization, non-CRA-regulated financial institutions were able to penetrate LMI communities with lending products. In 1990, non-CRA-regulated institutions originated 17 percent of mortgage lending. By 1993, at its peak, non-CRA-regulated institutions originated 40 percent of mortgages. Many industry observers suggest that these non-CRA-regulated institutions maintained a competitive advantage over CRA-regulated banks in originating loans, many of which were subprime, to LMI individuals because of the relative lack of supervisory scrutiny. At the same time, the emergence of other non-CRA-regulated, non-bank financial service products such as pay-day loans, check cashing services, remittances, and other potentially predatory products also proliferated in LMI communities. As a result, the challenge for the community development field has changed since CRA was enacted from one of access to credit to the availability of fair and quality credit.

The Rapid Growth of Social Impact Investing

The rapid growth of social impact investing, with its emphasis on delivering impact, is

- 1 The CRA affirms the obligation of federally insured depository institutions to help meet the credit needs of their communities, including LMI areas, in which they are chartered. To enforce the statute, the four federal regulatory agencies examine banking institutions for CRA compliance, and take this information into consideration when approving applications for new bank branches or for mergers or acquisitions.
- 2 National Community Reinvestment Coalition CRA Commitments (Washington, DC: NCRC, September 2007). Available at www.community-wealth.org/_pdfs/articles-publications/cdfis/report-silver-brown.pdf.
- 3 William Apgar and Mark Duda, "The Twenty-Fifth Anniversary of the Community Reinvestment Act: Past Accomplishments and Future Regulatory Challenges" *FRBNY Economic Policy Review*, 9 (June 2003): 169-91. Available at <http://www.newyorkfed.org/research/epr/03v09n2/0306apga.pdf>
- 4 Michael S. Barr, "Credit Where It Counts: The Community Reinvestment Act and Its Critics," *New York University Law Review* 80 (May 2005): 513-652. Available at <http://www.law.nyu.edu/journals/lawreview/issues/vol80/no2/NYU202.pdf>

poised to be an evolutionary step in providing capital to intermediaries and firms that spur social innovation. A recent Monitor Group report states, “using profit-seeking investment to generate social and environmental good is moving from a periphery of activist investors to the core of mainstream financial institution,” with a potential market size of \$500 billion within the next decade.⁵ Socially motivated investors (retail and institutional) are actively seeking to invest in funds and enterprises that tackle social challenges such as early childhood education, environmental sustainability, workforce development, and a range of other activities that create social value. These investors expect some balance between financial and social return, or what is often referred to as “double bottom line” returns.

Of the many elements needed to build this marketplace, a key one is standards that measure social return so investors can gauge the relative impact of their investments. Indeed, several tools have been developed to measure social impact in recent years. Leading examples include the Rockefeller Foundation’s Impact Reporting and Investment Standards (IRIS) system that brings together social enterprises to develop a common framework to capture impact. Another is the Global Impact Investment Rating System, an international platform similar to the services provided by ratings agencies such as Standard and Poor’s and Morningstar. Within the community development field, the Opportunity Finance Network’s CDFI Assessment and Rating System, or CARS, and the National Community Investment Fund’s social performance metrics were developed to address the desire to track impact.

The CRA, however, continues to focus on bank actions, such as the number of mortgages closed in LMI areas or the number of small businesses funded, rather than the impact of these loans. Indeed, a common refrain at many of the recent public hearings on the CRA is that it overemphasizes activity tracking and does not adequately recognize or encourage activities that have significant community impact. Mark Willis, who once headed the community development and CRA departments at a large national bank, offered this critique:

While the addition of such qualitative criteria as innovation, complexity, responsiveness, and Performance Context were intended to allow for more nuanced judgments, the reality has been disappointing. Quantitative tests tend to dominate the exam process perhaps because examiners either lack the authority to give qualitative factors the appropriate weight or because they naturally gravitate toward quantifiable measures that are easier to defend.... The results have been that projects that have great community impact may not go forward simply because a bank will not receive credit sufficient to justify the effort required.⁶

5 Monitor Institute, “Investing for Social & Environmental Impact: A Design for Catalyzing an Emerging Industry” (San Francisco: Monitor Institute, 2009), 3.

6 Mark Willis, “It’s the Rating, Stupid: A Banker’s Perspective on the CRA.” In *Revisiting the CRA: Perspectives on the Future of the Community Reinvestment Act* (San Francisco: Federal Reserve Banks of Boston and San Francisco, February 2009).

The social impact investment movement is positioned to address this problem and influence how the community development industry might track its impact. Effective efforts to measure social impact for investors may be driven, in part, by the lure of significant new funding for the community development field. For example, the Calvert Foundation is raising funds from institutional and retail investors through the sale of its Community Investments Notes, with proceeds invested in Community Development Financial Institutions (CDFI) intermediaries. Through this channel, Calvert's managed assets have nearly doubled in just four years, in spite of the economic recession. These new impact investors seek measurable social impact and, to further tap these funds, the community development industry will need to develop a common framework to report impact to this new investor class.

As bank regulators contemplate potential changes to the CRA regulations, consideration should be given to how the CRA could align itself with this likely shift to impact-based measurement and reporting. It is beyond the scope of this paper to make specific detailed recommendations, but it is critical to bring stakeholders together to share ideas that may lead to potential breakthroughs. The following are some ideas about potential benefits and opportunities:

- Admittedly, creating a standard set of impact measurements is inherently difficult, but doing so could spur, or at least complement, the broader use of standard metrics by social impact investors. CRA could work hand-in-glove with the impact investing world, but this would require much more cooperation and coordination than currently exists. For example, CRA could require banks to use some aspects of evolving impact measures, such as IRIS, GIIN, CARS, etc. It might also provide carrots to "opt-in" to some of those measuring systems. Conversely, impact investors could use CRA data and ratings to help capture community impact. In other words, the two communities could place expectations on each other that would help bring their worlds together in action, a world they already share in terms of their goals of improving the lives of low-income individuals and communities.
- The benefit of this partnership cannot be overstated. The impact investment world could supercharge the role that foundations have traditionally played: as sources of capital for higher risk/higher reward strategies to solve problems of poverty and disinvestment. Banks, on the other hand, are not in the experimenting business (and for good reason); they are in the system building business. When concepts are proven by high risk capital, banks can enter the marketplace with their size, reach, expertise, and systems and make what seemed almost impossible (lending to charter schools, homeless shelters, innovative small businesses, green retrofits, community clinics) into something that is routine. Banks are uniquely positioned to provide the sheer size of investment necessary to make the comprehensive and systemic changes that struggling communities need. Identifying the right incentives via the CRA would be an important first step.

- Getting the incentives right so that the CRA can evolve to encourage innovation requires that these incentives are in line with those of the impact investment world. Right now, the focus on numbers (outputs) ranks the same as an investment in a targeted mortgage-backed security and a high-risk/high-reward investment in an innovative charter school experimenting with wrap-around services to keep low-income children reading at grade level. A new regime that captures outcomes would reward the latter more, and create incentives for banks to become better partners with the impact investing community that cares about these innovative strategies.

Conclusion

As CRA modernization is considered to better reflect the significant changes within the financial services sector, there should be equal consideration of the new landscape of the community development sector. The growth of social impact investments and their potential influence could begin to change how the community development sector acquires capital. Many promising innovations are already taking place, such as greater access to retail investors who are interested in placing capital into double-bottom-line investments. Of the various investment criteria that these new investors will require, social impact will be a key determinant, and organizations must be positioned to provide such reporting. In addition to the obvious benefit of bringing more money into community development finance, social metrics will also provide the necessary feedback for community developers to ensure that all investments in low-income communities are spent in the most efficient way. The CRA could be an important catalyst to forming this marketplace, or it could be a relic of a bygone era of community development investments.

John Moon is a senior community affairs analyst at the Federal Reserve Board of Governors, where he focuses on community development finance and investment matters.