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New Approaches in Social Investing

Issues of wealth, power, race, and class keep bubbling to the surface. If the bubbling makes dramatic television, it may even appear on the evening news. Recent hurricanes highlighted the impoverished conditions many live under along the Gulf of Mexico and challenged Americans to question domestic policies and economic structures. But the issues don't go away after the hurricanes and tornadoes. We need lasting change, and to get there, we need more individual investors willing to consider "social investing."

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Illustrations: Kirk Lyttle

Many organizations have sprung up over the past few decades dedicated to bridging the gap between the rich and poor. Community development corporations and community development financial institutions (CDCs/CDFIs) never stop striving to help people and places left out of the economic mainstream.[1] Their biggest challenge: finding new sources of funds. Many see a potential source of funds in individuals with high or even modest net worth who are concerned about the viability of local communities.

CDCs and CDFIs are not just looking for handouts. They are looking for investors who expect a financial return. After all, a loan for affordable housing or for an immigrant's start-up business gets paid back with interest.

Background

In the mid-1990s, working with Co-op America (http://www.coopamerica.org/), socially conscious asset managers came together as the Social Investment Forum (SIF). Their goal was to plan for the greatest challenges of the 21st century, which they identified as the growing gap between rich and poor, and the degradation of the natural environment that sustains human settlements. Today, as the wealth gap widens (a mere one percent of U.S. households hold 50 percent of the wealth), investment in community development is increasingly critical.

Managers in the socially responsible investment field traditionally promoted investments in companies that improved health or avoided pollution or treated workers well. But in 2001, the SIF established the "1% or More in Community Campaign," which aimed to invest as much as $15 billion in community development initiatives by 2005. Despite progress, that goal has not been met. So far, socially conscious mutual funds and others have invested $1.8 billion in community development, mostly by taking out certificates of deposit in regulated community development banks and credit unions.

Perhaps it is time for managers of socially responsible investment (SRI) funds to revisit their gatekeeper role. CDCs/CDFIs are uniquely situated to meet both the social and the financial goals of asset managers' clients, and more of that group might be interested if managers provided information about the industry. Just as they would for any investment, they would need to explain both the risks and potential benefits.

Community Development Comes of Age

Today community development groups have 40 years of experience investing in livable and healthy communities. They comprise 4,000 entities across rural and urban America. And they have been learning to measure their accomplishments in ways investors can understand.

National Community Capital Association's most recent CDFI survey reported that a mere 143 community development financial institutions had aggregate assets of $3.7 billion, employed more than 2,200 people, and financed nearly $9 billion worth of social-impact projects.[2] The sources of funding were telling. Banks contributed 53.7 percent; foundations, 15 percent; government, 13 percent; and individuals, only 3 percent.

The industry is ripe for investment. The challenge is how to get the word out. If CDCs and CDFIs can make their value clearer, they might, for example, engage investors through the recently passed $15 billion federal program that encourages private investment in underserved communities, New Markets Tax Credit.[3]

However, explaining the value of the industry is not always easy. The world of community development financing is complicated (it can involve, for example, venture-capital investing, commercial real estate, charter school support, shopping mall development in poor urban areas, cooperatively owned ventures, and housing projects). Traditional sources of funding consider CDCs and CDFIs unconventional, and potential investors often have trouble seeing them as an asset class. That is something the industry must overcome.

Sources of Capital

CDCs and CDFIs grapple with challenges that, although they exist in other sectors, are a bigger struggle for groups devoted to creating economic opportunities in areas the private market has left behind. The following are among those challenges.

Liquidity, or Access to Capital

CDCs and CDFIs require flexible grants, loans, and equity to support the underlying value of their mission. They depend to some extent on subsidy, as do other groups favored by the U.S. tax code—agribusiness, highway departments, homeowners deducting mortgage interest, and so on.

Leverage of Private Capital

CDCs/CDFIs have proven their ability to leverage and manage large sums of private-sector capital—that is, to expand the reach of the dollars they get from government or foundations with large private-sector loans and investments that can be paid back over time. Today's challenge is to access more of that private capital.

Suitable Regulations

Many CDCs/CDFIs rely on partnerships and joint ventures with banks to finance a project, so community-investment regulation of banking institutions—and potentially of credit unions and insurance companies—is critical. The Community Reinvestment Act has been of great value. Future modifications to regulations could give individuals an incentive to invest in the CDC/CDFI industry.

Impact

CDCs/CDFIs need operating efficiencies combined with high social impact. Like any business, they require skilled staff to manage and make investments, measure performance, market the organization's products and services, and create a sustainable, mission-driven enterprise.

The greatest of the above challenges is the first. CDCs and CDFIs need a continuous supply of capital, particularly "patient" capital—capital from investors who do not need an immediate return. Historically, private individuals have not invested in community development because it is difficult for one person acting alone to do the necessary research. Through a vehicle called Community Investment Notes, the Calvert Foundation of Bethesda, Maryland, has perhaps come closest to tapping the wealth of individuals in an organized, underwriting way.[4]

But, admittedly, many otherwise willing investors have trouble assessing which CDCs and CDFIs are best for them. Some just stick to the regulated financial institutions, such as Shore Bank in Chicago and Self-Help Credit Union in Durham, North Carolina, which use the common, federally insured certificate of deposit for capital.

But the unregulated majority also offer good investments. Major CDCs/CDFIs in which individuals have successfully invested include Enterprise Corporation of the Delta in Jackson, Mississippi; New Hampshire Community Loan Fund; Boston Community Capital; and Coastal Enterprises, Inc., in Maine. Some even have for-profit subsidiaries with traditional venture-capital investment options that support their mission.

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Other funding comes through national intermediaries such as the Local Initiative Support Corporation (LISC), Enterprise Foundation, and National Community Capital, which aggregate private and public capital and deliver it wholesale to CDCs and CDFIs.

Current Capacity

The community development industry now has a far greater capacity and sophistication than most people realize. Not only have CDCs and CDFIs invested tens of billions of dollars, but they are professionally managed, they have strong boards, financial systems, and annual audits—and they do major projects. Coastal Enterprises, for one, has directly invested and leveraged more than $1.1 billion. Its capital has been used for 1.8 million acres of sustainably managed working forests, 160 fisheries enterprises along the coast of Maine, and financing for 120 child-care centers and hundreds of affordable rental and ownership housing units. The list goes on. In the process it has generated thousands of jobs in businesses large and small.

But as CDCs and CDFIs continue to grow, explaining to potential investors what they do and how well they do it has had to move beyond the heartwarming anecdote to more precise measures. The CDFI Rating and Assessment System (CARS), for example, both takes into account the industry's unique characteristics and applies standard criteria for assessing weaknesses and strengths.[5] From an investor's point of view, there are indeed strengths. Besides management experience, the industry has assets like real estate, having often taken first-lien positions on properties.

One way to open up the capital markets for this untapped class might be to give CDCs and CDFIs "nonbank" borrowing status under the Federal Home Loan Bank system. A second avenue could be raising socially directed venture-capital funds. A third option is utilizing charitable, tax-exempt-bond-financing sources. The possibilities are endless.

The Three-Legged Stool

If we think of the history of the socially responsible investing movement as a three-legged stool, the first leg represents the corporate social responsibility movement (CSR) that came out of the 1960s turbulence. Its aim was and still is to align capital and business behavior with social values. Through stockholder action and public education, the movement holds large corporations and those who invest in them accountable for their effects on society—workplace practices, minority hiring, human rights, and environmental stewardship.

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The second leg is the behavior of a new generation of businesses that voluntarily include environmental stewardship as part of their focus—for example, Microsoft, Starbucks, Ben & Jerry's, and Stonyfield Yogurt.

The third leg is community development. Capital markets are adjusting to the first two legs fairly well, but will they adjust to a CDC/CDFI asset class? The markets are not yet very receptive, still tending to describe such investments as junk bonds. But unlike many corporations with higher ratings, CDCs and CDFIs support social and economic justice for communities and thus provide a lasting value.

Community development groups may not yet be a recognized asset class for investment purposes, but they are definitely an asset to society. The industry has come a long way. We hope that before another 40 years pass, we will be able to bring some of the billions of dollars of private social investments into supporting the economic sustainability of low- and moderate-income people and the places where they live. We need to keep capital flowing into building and rebuilding the lives of marginalized people and communities.

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Endnotes

1 Throughout this article I refer to the CDC/CDFI industry as virtually the same in terms of their history and overall mission. The CDCs of the 1960s set the stage for community development entities such as housing-development corporations, community development credit unions, community development banks, microenterprise funds, and CDFIs.

2 The Corporate Data Project, managed by National Community Capital Association, is sponsored by the CDFI Fund and several private foundations. The annual publication is based on a sample survey of CDFIs active in a variety of financing initiatives, including housing, small business, community facilities, and venture capital. See http://www.communitycapital.org/.

3 For more information on the New Markets Tax Credit, visit the web site of the CDFI Fund http://www.cdfifund.gov/; or the web site of the NMTC Coalition, the national community development advocate for legislation, program impact, and reauthorization, www.newmarketstaxcreditcoalition.org.

4 Investors purchase notes that go into a Calvert Foundation revolving loan fund and ultimately to CDCs/CDFIs. Funds are used by borrowers for a variety of purposes, including small-business loans and microloans, community facilities, and affordable housing. The notes are not the same as a mutual fund, are not FDIC insured, and are not related to Calvert Group's sponsored investment products.

5 It uses CAMEL (capital adequacy, asset quality, management, earnings, and liquidity), an internationally accepted way of assessing a bank's strengths and weaknesses. The CARS method also includes a rating for impact and how much the organization engages in policy.