US SIF FOUNDATION

Options & Innovations in Community Investing

A Report from the Field

US SIF Foundation thanks Citi Foundation for its generous support in making this report possible.

About the Publisher

US SIF Foundation, a nonprofit 501(c)(3) organization, supports the educational and research activities of US SIF: The Forum for Sustainable and Responsible Investment (US SIF). US SIF is the US membership association for professionals, firms, institutions and organizations engaged in sustainable and responsible investing (SRI). US SIF and its members advance investment practices that consider environmental, social and corporate governance criteria to generate long-term competitive financial returns and positive societal impact. US SIF's members include investment management and advisory firms, mutual fund companies, research firms, financial planners and advisors, broker-dealers, banks, credit unions, community development organizations, non-profit associations, and pension funds, foundations and other asset owners.

About the Author

Rosalie Sheehy Cates is a consultant to the community investment field. She focuses on connecting responsible investors with affordable housing and community development enterprises. Since 1980 Rosalie has worked in farming, sustainable agriculture advocacy, microlending and as president of a small business/New Markets Tax Credit fund in Montana.

DISCLAIMER

Table of Contents

Introduction

Community investment helps build more vibrant neighborhoods and fosters economic growth by directing capital from investors and lenders to communities that are underserved by traditional financial services. In the United States and around the world, community investing organizations provide financial services to low-income individuals and supply capital for small businesses and vital community services, such as affordable housing, child care and healthcare. In addition to supplying badly needed capital in underserved areas, community investing institutions often provide important services, such as education, mentoring and technical support. Community investments also build relationships between families, nonprofits, small businesses and conventional financial institutions and markets.

US SIF: The Forum for Sustainable and Responsible Investment has promoted the concept and practice of community investing as a sustainable investment opportunity for more than a decade. In the early days of this investor education effort, community investment opportunities were limited to community bank and credit union deposits, and a handful of non-profit and bond fund offerings.

Since that time, community investing has grown and evolved. The early pioneers have improved their products, and they have been joined by new providers with a wider array of products. Awareness and interest of some community investing options has grown. Americans shared a sobering financial experience in recent years that heightened their awareness of the fragile economic status of low- and moderate-income households and communities, and revealed larger numbers of people needing help. The financial crisis also fostered some distrust of the large financial institutions whose risky practices helped drive the crisis. These developments have increased the motivation of many investors to direct their investments to community-based institutions and initiatives.

At the same time that community investing offerings have grown, US SIF Foundation, as well as other researchers[1] have documented that investors, including sustainable investors, have found challenges in their efforts to place assets in community investing.

1. **Low awareness of community investment options:** Many investors, advisors and money managers are not aware of the potential to make investments that will benefit lower-income communities.

2. **Low returns or perception of low returns:** While some community investments achieve market and above rates of return, some have low returns that essentially subsidize the work of investees in poor or hard-to-serve markets.

3. **Perception of high risk:** While community investing institutions mitigate the risks that keep their customers out of conventional capital markets, potential investors in these institutions' products perceive an inherent risk in the markets generally served by community investments.

1. Cates, R. and Larson, C. (2010), Connecting CDFIs and Socially Responsible Investors (Report for the CDFI Triple Bottom Line Collaborative, a working group funded by the Ford Foundation).

4. **Non-standard investment vehicles:** For many investors and advisors, community investments that involve limited partnerships or unregulated promissory notes present real barriers of regulatory compliance and due diligence.

5. **Manual processing and reporting:** Modern investing transactions occur on electronic platforms that include automated reporting systems. Some community investments, in contrast, are transacted using paper, mail and spreadsheets; these investments are time-consuming to process.

6. **Limited liquidity:** Many community investments need to hold funds for at least 12 months, another point of friction in today's investment atmosphere which allows investors to "point and click" to change their allocations at almost any time.

7. **Low or no advisor income:** There is little way to pay advisors for their time in placing many community investments, which prevents the practice from becoming truly market-based.

This report examines these challenges, but also the innovations and growing number of options in community investing. It assesses the extent to which financial professionals—retail advisors, wealth and institutional advisors and fund managers—are including community investing in the options they offer clients, and the kinds of investments—by asset class—that different types of investors can access. Thus, this report is intended as a resource for a wide array of investors and investment professionals.

All of the information here is "fresh from the field." It is based on interviews with over 50 investment sector professionals, primarily US SIF members. They include investment advisors, fund managers, impact consultants and advocates. Some actively place community investments, while some do not see any fit for their client base or funds under management. Therefore, this report covers what is working and what needs to be improved in order to advance community investing.

This report has three sections:

1. A brief explanation of community investing and a description of available community investment products organized by standard asset classes.

2. Current practices in community investment organized by three professional investment roles: retail advisors, institutional and high net worth advisors, and money managers.

3. Key issues that will influence the future of community investing.

US SIF's role is to stimulate dialogue, encourage new thinking, and facilitate relationships that lead to innovations in community investment products and practice. US SIF offers this report in support of those goals, and hopes that this research helps move sustainable and responsible investing forward in communities in the United States and abroad.

Community Investing Defined

Community investing puts money at risk or on deposit, with the expectation of repayment with a financial return, for the purpose of helping poor and underserved people and places. Community investments are not gifts or philanthropy. Both return of capital and return on capital are expected, although some investments have concessionary rates of return.

Community investment's benefits generally flow to people of low income who lack access to the financial resources necessary for a dignified standard of living. Community investment may also be place-based, targeting investment to cities, neighborhoods or rural areas in which underserved people live, and where they may lack basic services such as quality grocery stores, child care or health services.

Some of the activities that community investors fund or enable in the United States and abroad are:

- Job creation
- Business start-up and growth
- Provision of services such as nutrition, child care and training
- Safe and affordable housing
- Community facilities
- Charter schools
- Physical infrastructure
- Community wealth creation

In addition to social goals, many community investors add environmental sustainability to their goals for communities. This leads to additional community investing activities such as:

- Transit oriented development
- Green building
- Clean technology business development
- Sustainable agriculture and local food systems, including the eradication of food "deserts"

Community is in the eye of the beholder to some extent, and community investment likewise tends to be user-defined. Increasingly, community investment encompasses investments that are simply "local" and allow people to put their money to work in their own back yards. This is widening community investment from its traditional focus on poor and under-served people toward consideration of the health of the community as a whole.

The Recipients of Community Investing

Recipients of community investment can be for-profit or non-profit entities. In the United States, three big categories of investees are Community Development Financial Institutions (CDFIs), affordable housing developers, and microfinance funds with domestic or international portfolios.

CDFIs are private financial institutions devoted to the needs of the poor, racial and ethnic minorities and other people with limited access to financial resources. CDFIs finance small businesses, microenterprises, nonprofit organizations, commercial real estate and affordable housing. Community development banks and credit unions also provide access to affordable credit and opportunities to build wealth through savings. CDFIs can be international, national, regional or strictly local. The chart below shows the variety of CDFI legal structures.

CDFI Structures

	For profit?	Regulated?
Banks	yes	yes
Credit unions	no	yes
Loan funds	usually no	no
Venture capital funds	yes	by securities laws

Most CDFIs are certified by the US Treasury Department, and most banks supported by community investments are CDFIs. However, some banks and credit unions with a commitment to serving low-and middle-income communities do not go through the CDFI certification process. In this report, all of these depositories are included in references to CDFI banks and credit unions.

Affordable housing developers consist of for-profit and non-profit companies that build housing, schools and community facilities that serve lower-income people. Some affordable housing developers are also CDFIs. Affordable housing organizations have access to a variety of tax credits and government loan programs that subsidize the housing and can also enhance returns for investors.

Microfinance organizations make small loans to help very small businesses, especially in the poorest parts of the world. They are organized as both for-profit and non-profit entities, and there are a number of intermediaries that pool investor funds and re-lend them to microfinance organizations. In addition there are international or internationally focused organizations that provide loan guarantees and technical assistance to microfinance organizations and to businesses, affordable housing providers, smallholder farmers and agricultural cooperatives.

Along with these three traditional community investees, new investees are emerging. Individual businesses use community investor funds to achieve impacts such as job creation, clean technology deployment or community revitalization. A diverse array of limited liability partnerships (LLPs) uses community investment to finance their work in sustainable land

2. Organizations such as the National Community Investment Fund and the National Federation of Community Development Credit Unions maintain databases that identify both certified and uncertified banks and credit unions for community investment.

management, local food systems, small business development, affordable housing preservation and green technologies.

Community Investing Products

The chart below lists the products available to community investors today, organized by asset class, and indicating whether the product is most suited to retail investors, accredited individuals or institutions. In this report, the term "retail investors" refers to individual investors who are generally unaccredited and invest relatively small amounts. The term "accredited individual investors" refers to people who meet certain wealth standards and whom regulators consider financially sophisticated, with less need for the protection provided by certain government filings on the part of their advisors. The term "institutions" refers to organizations investing large sums and subject to fewer regulatory protections, such as investment companies, insurance companies, mutual funds, religious organizations, pensions and trusts.

Community Investment Options by Asset Class & Investor Type

		Most suited for		
Asset Class	**Products**	**Retail**	**Accredited Individuals**	**Institutions**
Cash	• Deposits and CDs in a CDFI bank or credit union, or a similar institution	•	•	•
Fixed Income	• Calvert Foundation Notes	•	•	•
	• Direct loan to a CDFI loan fund or other loan fund*		•	•
	• SRI mutual funds with strong CI component	•	•	•
	• Government bonds or bond funds for housing and other activities in Community Reinvestment Act geographies	•	•	•
	• Investment in international micro or small business finance entity		•	•
Private equities, real estate & other alternative investments	• Debt or equity investment in a private company		•	
	• Equity investment in community development venture capital fund		•	•
	• Equity investment in special-purpose real estate development fund		•	•
	• Equity investment in special-purpose timber, farmland or conservation entity		•	•
Public equities	Heron/State Street Global Advisors Index strategy			•
Hedge Funds	No product, though a few funds consider community factors			
Commodities	No product			

** Though most advisors and fund managers consider CDFI loan funds and other loan funds as part of the fixed-income asset allocation, custodians hold them as alternative investments. Most advisors consider these investments restricted to accredited investors, but state filings may or may not contain this restriction, and many loan funds accept investment from non-accredited individuals who invest directly.*

Below are brief descriptions of these community investment products.

Bank and credit union deposits

A very common community investment practice is to place cash on deposit in CDFI banks and credit unions, or in a community bank as defined by the investor. These deposits are easy for investors and advisors to use because they are standard vehicles, pay market rates and carry federal deposit insurance. A program called Certificate of Deposit Account Registry Service (CDARS) is often used to create one large cash deposit that is placed in multiple banks in amounts that qualify for federal deposit insurance. A similar product for credit union deposits is offered by the National Federation of Community Development Credit Unions.

Calvert Foundation Notes

The Calvert Foundation is a CDFI that offers a security that pools investor funds and lends them to a diversified group of CDFIs, affordable housing developers and international microfinance organizations. Calvert Foundation Notes are processed electronically and are widely distributed through conventional investment platforms, making them extremely popular as a community investment vehicle in all investor classes.

Loans to CDFI or other loan funds

A growing number of CDFI and non-CDFI loan funds and affordable housing developers accept direct investment. The investment is generally executed as a promissory note providing term debt to the organization. Typically the notes are offered under a non-profit exemption from registration at the state level. The notes are generally unsecured and pay 0-4 percent interest. None of these notes are currently distributed through conventional investment industry channels, and sales are usually made directly by the CDFI. In some instances Calvert Foundation's subsidiary Community Investment Partners helps the CDFI to develop the note and performs some "back office" functions for the CDFI and its investors. See more about CDFI and other loan funds later in this report.

Mutual funds and separately managed accounts

Some mutual funds and separately managed accounts include community development investments as part of the mix of investments that they manage for investors. In that case the fund manager will be purchasing any of the instruments included in this community investment list. Community investment is more typically seen in fixed-income funds, because this asset class includes more product choices for fund managers. Several specific funds that emphasize community investment are described later in this report.

Bond funds

Another fairly common community investment vehicle is a community development bond fund, structured either as a mutual fund or a separately managed account. These funds bundle government-backed affordable housing, business financing and municipal bonds. The securities were first developed to facilitate investments in low-income census tracts—investments that banks are required to make under the Community Reinvestment Act (CRA).[3] They have grown in popularity with non-bank investors who like the combination of impact, return and security these bonds offer. These bond funds are often referred to as "CRA bonds" or "social bonds."

3. Under the Community Reinvestment Act, the US government periodically assesses US depository institutions insured under the Federal Deposit Insurance Corporation on the extent to which they are helping to meet the credit needs of the communities in which they operate, including low-and moderate-income neighborhoods.

International microfinance organizations

Microfinance investments can be made as debt or equity, and either directly to microfinance organizations or through intermediaries that pool funds to invest in a diversified group of microfinance funds. The funds might work throughout the world or in a specific region. For example, US-based Shared Interest, which is registered or exempt in 35 states, provides access to credit and technical support to low-income black South African communities and enterprises. Returns on microfinance debt investments are similar to those offered by CDFI loan funds in the United States, while equity returns can be higher. The online brokerage firm MicroPlace offers a number of security issuers and accepts very small microfinance investments directly from individuals in any investor class.

Private companies

Some accredited investors invest directly in individual companies. By placing either debt or equity, such investors can realize financial returns as well as impacts such as job creation, community revitalization, provision of vital community services (such as a grocery stores in “food deserts”), or deployment of green technology.

Community development venture capital

CDFI-certified venture capital funds pool investor money to make equity investments in private operating companies that yield high financial returns while accomplishing community development goals such as job creation for the poor and revitalization of marginal neighborhoods. These investments are executed as limited partner equity agreements.

Special purpose real estate, timber, farmland or conservation funds

These alternative investments are generally Limited Liability Partnerships (LLPs) organized for a particular, time-limited purpose. They frequently involve real estate projects such as redevelopment of a blighted area, transit oriented development and various kinds of affordable housing. This type of real estate activity is starting to be called Responsible Property Investing.

The LLP form is also sometimes used to structure some international microfinance funds, local community development funds and conservation funds that acquire sensitive lands for conservation easement protection. Other special purpose funds are organized as timber investment management organizations (TIMOs) or real estate investment trusts (REITs). To the extent that these funds meet community investment objectives—for instance, sustainable forest management that preserves jobs in a rural area—they are considered community investments.

Public equities

The State Street Global Advisors Community Investing Index is the only public equity (stock) community investing strategy currently available. It contains companies screened for community investment criteria by the F.B. Heron Foundation, and is available to institutional investors and as a strategy.

Hedge funds and commodities

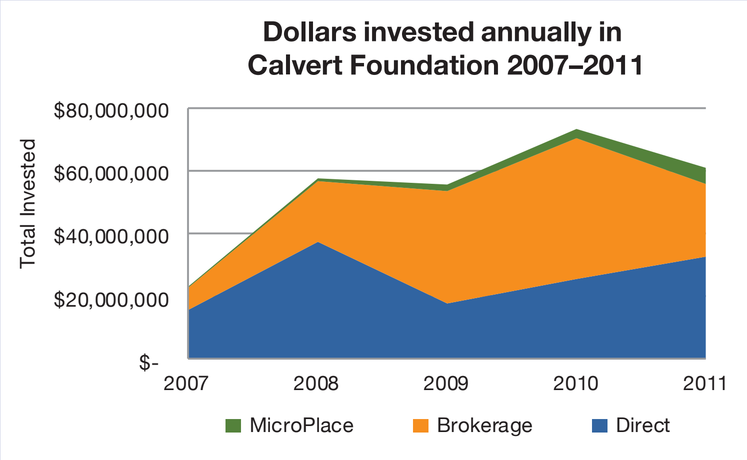
At present there are no vehicles that apply community investment objectives in the hedge fund or commodity asset classifications.

Calvert Foundation Notes

Calvert Foundation Notes are part of nearly every active community investor's toolkit.

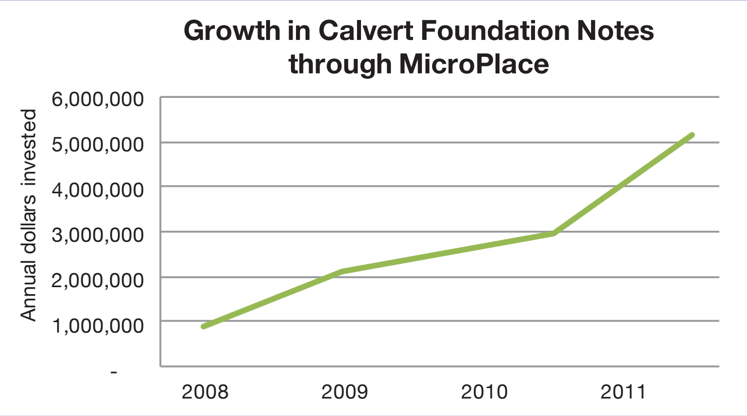
Starting in 2001, Calvert Foundation made herculean efforts to bring a more standard security product to the community investment sector. It achieved registration in all 50 states, a trust indenture, electronic DTCC[4] handling with a CUSIP[5] number, and distribution on multiple conventional brokerage platforms.

Calvert Foundation lends the proceeds from the Note sales to CDFIs, affordable housing organizations, microfinance institutions and other social enterprises, providing flexible and patient financing for a broad array of mission-focused enterprises. The entire principal is lent out and as loans are repaid, the capital is lent out again.



Calvert Foundation's Notes hit an all-time high of $73 million in new investments in 2010. This was the peak of a two-year surge in which the foundation's brokerage channel more than doubled, to $45 million in sales in 2010. In 2011, the foundation lowered its rate of return to investors, responding to a record low interest rate environment and shifts in demand for its lending. That slowed new Note sales to $61 million. At the close of 2011, Calvert Foundation's total fund stood at $215 million.

The Calvert Foundation is focused on retooling its products for CDFIs, housing organizations and microfinance borrowers. In 2010 it launched a $200 million off-balance-sheet partnership with Citigroup, resulting in record high volume of CDFI financing. Calvert Foundation is also broadening the types of financing it provides to community development customers with the investment capital raised through Notes.



A small but notable part of Calvert Foundation's program growth occurred through MicroPlace, an online portal or retail microfinance investment that accepts $20 minimum investments. The chart below shows the steady growth of this sales channel, which now includes 4,000 investors.

4. The Depository Trust and Clearing Corporation and its subsidiaries provide clearing, settlement and information services for equities, corporate and municipal bonds, government and mortgage-backed securities, money market instruments and over-the-counter derivatives. The DTCC says on its website that in 2010, it settled nearly US$1.66 quadrillion in securities transactions.

5. The Securities and Exchange Commission notes that:
CUSIP stands for Committee on Uniform Securities Identification Procedures. A CUSIP number identifies most securities, including: stocks of all registered U.S. and Canadian companies, and U.S. government and municipal bonds. The CUSIP system—owned by the American Bankers Association and operated by Standard & Poor's—facilitates the clearing and settlement process of securities.

Alternative Investments

Alternative investments are growing rapidly as community investment vehicles, though they are still a small piece of the community investing universe. Included in this category are several asset classes: private equity, hedge funds and real estate projects or funds. Usually requiring fairly sophisticated underwriting, alternatives are generally restricted to accredited individuals and institutions. The selling point for alternatives is the range of choices they offer in both impact and rate of return.

Overall, this category grew its community investing assets under management by about 7 percent from 2010 to 2011, according to research the Tellus Institute conducted for US SIF Foundation.[6] Tellus tracks alternative assets screened for environmental, social and governance (ESG) factors, and isolates those that include a focus on economic development, affordable housing, and access to credit for low income people.

Within community-focused alternatives, private equity assets grew the most, growing 41 percent to reach $800 million by 2011. Much of that total is invested in community development venture capital funds. Real estate was the slowest-growing community alternative, adding 4 percent in additional assets from 2010–2011.

Community investors have many ways to customize their impact when they work with alternative investments. For instance, an investor could address climate change as a limited partner in a real estate fund that develops transit-oriented housing. Another climate change choice would be a fund that finances energy-efficient retooling of truck fleets. Investors can achieve place-based impact through a real estate fund that redevelops a commercial district or builds affordable housing in a particular city or region. All of these vehicles typically offer strong market-competitive rates of return.

Private equity or debt investments in individual businesses usually promise market-competitive returns, and allow investors to support job creation, green outcomes and community revitalization fueled by the business. Alternative investors can also support promising companies as equity partners to Community Development Venture Capital Funds, which offer market-competitive equity returns.

Debt placed with business loan funds operated by CDFIs and other organizations will often meet investor desire for place-based impact or services to low-income people. Returns are usually concessionary if considered as risk-adjusted. Though many advisors and fund managers consider CDFI loan funds and other loan funds as part of the fixed-income asset allocation, custodians hold them as alternative investments, and usually consider them restricted to accredited investors.

6. US SIF Foundation. *Sustainability Trends in US Alternative Investments.* 2011.

This section describes what some US SIF members and other investors do to create and place community investment products. It is organized by three main roles in the investment industry:

- Retail advisors—including all types of advisors who serve unaccredited investors.
- Advisors to high-net-worth and institutional investors—including all types of advisors who serve accredited investors

Taken together these two roles are the sales force for community investment. They are joined by the professionals who provide product:

- Money managers—including all who manage collective investment schemes such as mutual funds, separately managed accounts and investment companies.

There are other financial industry roles of critical importance to community investment. These include custodians, distributors and international asset management companies. Their roles, however, are behind the scenes and often involve the "plumbing" that makes it possible—or not—for advisors and money managers to offer community investment at reasonable fees and on conventional electronic securities platforms.

Advisors to Retail Investors

INTRODUCTION

"When you help your clients get involved in community investing, even if you're not paid, it just locks you to the client. They just love it. It's a great way to create client loyalty."

Retail Registered Investment Advisors (RIAs) often operate within a very limited range of community investment options. One reason is that many retail clients are unaccredited. That makes them ineligible for investments that regulators and advisors consider risky and therefore inappropriate for unsophisticated investors. For practical purposes, that limits the investment options of unaccredited investors to publically traded securities and insured deposits. Their community investing will occur in the handful of cash and fixed income products on the market.

Even if a retail advisor works with accredited investors, the community investment options may be limited by the firm through which he or she is licensed. That firm is responsible for securities compliance, and will determine whether community investment products are offered, based on the compliance department's judgment of the best interests of the client base. Most wire houses and many RIA firms do not authorize even the most standard community investment products (community bank deposits and bond funds). They balk at the perceived risk, custody issues and handling costs. Or they may have their own proprietary products and not wish to bring in community investments from outside the company.

Independent advisors and smaller retail shops have more product latitude and can adopt community investing into their standard

"Achieving community investment is up to the advisor. Advisors who anticipate some problem are making a big mistake. At higher levels they might hesitate—but 1 or 2 percent [of the total portfolio] is a low number."

practices. Some advisors affiliate with First Affirmative Financial Network, which employs a standard platform that includes community investment allocations. However retail advisors navigate these choices, their community investment activities will nearly always be confined to the cash and fixed income classes.

Despite these limitations, some large wire house advisors and many small-shop advisors routinely achieve 1–3 percent of assets under management in community investment. The highest practice-wide allocation among retail advisors participating in this report was 12 percent, admittedly an outlier, but undertaken by a very enthusiastic community investing advocate.

All of the above assumes the investor places funds using an advisor. Retail investors can independently place community investing directly, working with a local CDFI bank, credit union or loan fund, or affordable housing developer, or using an online microfinance site. Some advisors actively encourage this practice. Please note that not all domestic and international non-profits offer their products in every state.

STANDARD PRODUCTS AND PRACTICE

Cash

- Certificates of Deposits in insured CDFI or community banks and credit unions

"Once I explain community investment, every client wants it."

Fixed Income

- Calvert Foundation Notes
- Community development bond funds such as Community Capital Management or RBC Access Capital Community Investment Fund. (Several mutual funds have included community investments; see Advanced Practices under the Fund Manager section of this report.)

INNOVATIONS AND ADVANCED PRACTICE

Set a community investment goal: Retail advisors with the strongest commitment to community investment have an overt goal to place at least 1 percent of all client portfolios in community investment, and they simply default this portion of cash and fixed income to the standard products listed above. This report found both independent and wire house advisors who made routine allocations of up to 3 percent of client portfolios to community investment.

"This year I was completing my year-end review of portfolios, looking at the allocation to community investing of 2 percent, and I thought, why not 3 percent?"

Proactive client intake and counseling: The advisors with the best record make community investment a routine topic with their clients. Their intake forms introduce the topic as an investment option. This prompts a conversation in the meetings to set up the client's investment strategy. In some cases the advisor suggest a default community investment allocation. If the concept is unfamiliar, these proactive methods open a conversation on community investment, its benefits and the low risk of the standard products. The topic is discussed again in regular portfolio review meetings.

Community Development Bank and Credit Union Deposits

A nearly universal community investing practice is to deposit cash in community development banks and credit unions. Investors and fund managers like the market-rate return and the federally insured investment, as well as the impact: their dollars provide banking to low-income people and neighborhoods.

These deposits have certainly surged in the past two years (2010-2011), according to Saurabh Narain, the Chief Executive of National Community Investment Fund (NCIF). NCIF makes equity investments in community development banks and credit unions, and advises several sustainable and responsible investors on placing deposits.

Narain says that growing distrust of Wall Street has motivated the transfer of cash into local, mission-oriented banks and credit unions. He cautions, however, that there are constraints to the growth of these popular community investing vehicles.

One challenge is that regulators limit the amount of brokered deposits a bank or credit union can accept from channels such as the popular CDARS program or the Nominee Deposit program of the National Federation of Community Development Credit Unions. The regulators consider these deposits "hot" money that could leave the bank's balance sheet in search of the best interest rates.

A second limitation is equity. Depositories use equity to leverage a multiple of deposits that they accept. Equity is very difficult to raise, and is the limiting factor in the growth of community investment Certificates of Deposit.

NCIF is working to build awareness that community development banks cannot realistically offer high impact to investors on the strength of risk-free, market-yield, fully liquid deposits. Narain suggests that SRI and mainstream investors focus on investing equity into CDFI depositories since that will have more impact than deposits.

High Net Worth and Institutional Investors

INTRODUCTION

Included in this category of investors are wealthy individuals, foundations, religious institutions and family offices. All of these investors are accredited. Because regulators consider them sophisticated, their advisors have wide latitude to work with virtually any legal security vehicle. This opens up many community investment vehicles—direct loans to CDFI loan funds, private equities, real estate and other alternative investments—that are not available as advised products for retail investors.

"Two of our largest donor advised funds have almost everything in Calvert Notes. In those funds they said 'it's not for market-rate return—it's all for mission in our donor advised funds."

Besides being accredited, individuals in this investor group generally have significant assets, and they often have expansive impact goals. Their risk tolerance might be greater than that of retail investors. Factors like these make high net worth and institutional investors more likely to innovate in the community investment sector.

In this investor class, advisors are generally paid a percentage of assets under management. Within limits, these fees allow advisors to go the extra mile to customize portfolios that will meet each investor's particular impact goals. Therefore advisors in this category often take substantial time to structure one-off or complicated deals, to underwrite unconventional investments, and to deal with non-automated payment and reporting systems.

All of these factors lead many US SIF members to believe the strongest potential to advance the scope of community investing will occur among high net worth and institutional investors.

STANDARD PRODUCTS AND PRACTICE

Cash

- Certificates of Deposits in insured CDFI banks and credit unions or in local banks the investor chooses for impact. CDARS can accept one deposit and break it into insurable amounts at numerous banks, and the National Federation of Community Development Credit Unions offers a similar product for credit union deposits.

"Community investing is difficult.... Custody is the hardest part.Æ

Fixed Income

- Calvert Foundation Notes
- Community development bond funds such as Community Capital Management or RBC Access Capital Community Investment Fund. (Several mutual funds have included community investments; see Advanced Practices under the Fund Manager section of this chapter.)
- Loans to non-depository CDFI loan funds: It is not unusual for advisors to place loans in CDFIs or buy notes offered by CDFI loan funds. Custody can be a complex issue (see sidebar on custody issues on p. 17). They require the advisor to complete due diligence/underwriting of the CDFI, and to process non-automated paperwork. Some advisors do not manage CDFI loan investments, but refer clients on how to make these investments directly.

INNOVATIONS AND ADVANCED PRACTICE

"It's OK for accredited investors to lead the way on community investing. It's a building process, and it's realistic for them to participate."

"This is a flexible operating environment. Everything we deal with is an exception. We are culturally attuned to doing community investment."

Private equity, real estate and other alternative investments

- **Responsible property investment (RPI):** Investors become limited partners in a real estate development project or a fund that involves multiple projects. The projects might address various impacts: affordable housing, green building, transit oriented development, charter school finance or conservation real estate.

- **Special purpose funds:** Accredited investors and institutions can participate in virtually any legal fund structure that meets their impact goals, and many innovative funds have responded. A few examples show the diversity of fund size and impact targeting that are available:

  Contact Fund is a private investment fund focused on high-impact community development in New York City. It raises capital by selling notes to individual investors, emphasizing liquidity, financial returns and creation of "social capital." The Fund makes early-stage, short-term loans to community development organizations and social enterprises.

  Portfolio 21 offers Local Economies Income Fund (LEIF), a private fixed income fund. LEIF layers three community investing vehicles into the fund: 1) bond offerings in the Pacific Northwest and northern California that support positive projects, 2) community bank CDs, and 3) private loans, made with banks and secured by real property, to businesses that are engaged in building sustainable local economies.

  Other special purpose funds include CDFI venture capital funds, timber investment management organizations (TIMOs) and "Slow Money" farm loan funds.

- Direct equity investment: Funding a local private company can put money to work locally, a strong emerging desire among impact investors, and may assist poor and underserved people or offer sustainability impacts.

- Targeted affordable housing or small business financing bonds: In addition to their "off the shelf" CRA-qualified affordable housing bonds, both Community Capital Management and Access Capital will bundle government-backed affordable housing bonds to meet specific geographic impact targets. This service is generally for separately managed accounts.

"Interest in community investing is continuously strong. It is one of the things clients like the most in their whole portfolio of SRI investment."

Public equities

- As part of a portfolio-wide focus on fighting poverty, San Mateo County's United Way devised a "local" public equity strategy. Reasoning that Bay Area companies provide jobs in the organization's geography of interest, its managers devised an equity purchasing strategy limited to companies in Bloomberg's Bay Area Index. Only the largest metropolitan areas will have their own Bloomberg Index, and the organization's managers acknowledge that the effect on poverty is not direct. They believe, however, that the local equities held by the United Way are are better suited to the United Way's anti-poverty mission.

- Institutional investors can purchase equities screened for good community investment practice through the State Street Global Advisors US Community Investment Index (USCII) or a community investing strategy based on it. Originally developed by the F.B. Heron Foundation, the index includes more than 300 large- and mid-cap companies in diverse sectors. They are screened for strong engagement with economically underserved populations. The USCII works with Heron to evaluate the companies using three main factors: strategic alignment, workforce development and wealth creation, and community engagement and corporate philanthropy.

"I think a lot of people don't know they can have impact and earn a competitive return on their cash."

Other promising efforts

- **Advocacy and innovation on CDFI custody issues:** With nearly $20 million in CDFI and other direct investments custodied at Charles Schwab, Trillium Asset Management's entire community investment philosophy was threatened when the investment house announced in 2009 that it would no longer hold these alternative securities. Trillium's management engaged in two years of negotiations that eventually resulted in Charles Schwab continuing to custody CDFI securities. However, new custodial requirements and minimums have added to the transaction cost.

  Faced with similar custody complications from Bank of America in the tightening regulatory environment of the past few years, Loring Wolcott Coolidge restructured as a non-depository bank under New Hampshire law. The structure allows LWC to directly custody investments when necessary, particularly for clients of its Sustainability Group, a special LWC division that advises some impact investors. With no custody issues to worry about, the group can continue its practice of pursuing all prudent community investing options that fit client portfolios.

The High Cost of High Touch

Custody, regulatory compliance and manual processing combine to create high costs for registered investments advisors (RIAs) who place client money with non-profit loan funds.

Most RIAs are prohibited from performing custodial functions. They use outside custody banks that perform, and take compliance responsibility for, highly regulated functions including holding securities, reporting their value and maintaining investment accounts. They receive payments from the investee and keep accounting records. Custodians essentially control what RIAs sell or don't sell, and how they sell it, because they must approve both the individual security as well as the documentation of the sale.

The regulatory compliance process starts with the extensive permissions and signed disclosure documents that give an RIA authority to act on a client's behalf. Sometimes RIAs must also obtain additional permissions and disclosures for an individual's investment transactions.

While most securities are ordered, purchased, settled and serviced through automated electronic processes, notes to loan funds require manual processing. These steps are:

1. The RIA sends or wires payment to the loan fund along with the proposed investment terms.
2. The loan fund mails back a signed promissory note for the RIA countersignature. At that point it is a negotiable security that the RIA can hold only for a reasonable processing time.
3. The RIA sends the note to the custodian, which books the investment into the investor's account and sets its value (at par, or face value).
4. The physical note is sent to the Deposit Trust Corporation for storage.
5. Over the term of the investment, the loan fund sends interest payments to the custodian.

Until 2009, custodians credited payments to the investor's account for the loan fund investment, and provided periodic accounting statements to both the client and the RIA. This changed when regulators increased their scrutiny of alternative investments. Charles Schwab, a major custodian, responded by refusing to accept loan fund notes. Although the custodian eventually agreed to continue to custody, and receive payments from these investments, it no longer credits client account statements with the payment amounts. It is now up to the RIA to service the actual accounting, even though the custodian receives the funds.

Process issues like these chew up enormous amounts of staff time for RIA firms. They involve continually increasing paperwork, legal disclosures and client education. The result is higher transaction and opportunity costs, which creates perceptions of community investing as inefficient. One RIA firm responded to custody issues by reorganizing itself as a non-depository bank that is legally allowed to custody its clients' investments. Another large RIA firm helps clients invest in loan funds, but stays out of the purchase chain. As a courtesy it tracks the performance of these investments for clients, but does not count them as assets under management on which clients' fees are paid.

A small firm or stand-alone advisor working on a commercial advisor platform simply has no access to any of these custodial alternatives. At best these advisors can, within their comfort levels and the rules of their firms, encourage clients to explore making their own direct investments in CDFIs and other loan funds.

Fund Managers

INTRODUCTION

Fund managers oversee collective investment vehicles such as investment companies, mutual funds, hedge funds and separately managed accounts. Many fund managers also advise clients, an activity that is separate, from a regulatory point of view, and is covered in other parts of this report.

Fund managers are themselves investors, choosing from the same set of products in cash, fixed-income, equities and alternatives that are described earlier for accredited and institutional investors. These investments are bundled into a fund, a strategy or a separately managed account, and are in turn offered as product to clients of the fund or to investment advisors.

Fund managers typically specialize within a narrow asset class or management strategy. That specialization may preclude significant community investment. For instance, an actively managed equity fund has virtually no community investment product options.

Cash and fixed-income fund managers have the most ability to get involved in community investment, simply allocating a portion of their investment to Calvert Foundation Notes or housing bonds. Some have also made direct purchase of notes from individual CDFI loan funds, but it is very difficult to meet the legal requirement that they mark these notes with a Net Asset Value (NAV) on a daily basis.

For these reasons, community investment is happening among fund managers, but nearly always as a unique and artisanal exercise. There is no standard practice that applies across the board. This section describes innovations and advanced community investment practices, mostly by cash and fixed-income managers, and also in a number of other innovative funds.

INNOVATIONS AND ADVANCED PRACTICE

Cash and fixed income

A number of sustainable and responsible mutual funds place a portion of cash and fixed income assets in community investment. The most common vehicles are Calvert Foundation Notes, CDs in CDFI banks and credit unions, and bond funds targeting affordable housing and community development.

Direct purchase of debt in CDFI loan funds

- Pax World Funds has a small portfolio of notes it has purchased directly from CDFI loan funds. Pax committed itself to the process of investigating and underwriting several community loan funds, and it devised a manual system to mark daily pricing on the notes as required by securities law.

"I don't really care about return from my community investment. We make our money on picking stocks—this is the cash and it just needs to be safe and liquid."

- Everence is a holding company whose subsidiary corporations offer insurance and financial services targeting Mennonite religious communities. Each corporation contributes a set amount of funding to community investment, which is pooled in the non-profit subsidiary, Everence Community Investment (ECI). ECI uses these funds in a diversified pool of community investments, targeting one portion at near-market returns (70 percent of the three-year US Treasuries average) and one portion below market (50 percent of the three-year US Treasuries average). Within these targets, ECI invests in international microfinance, CDs in CDFI banks and credit unions, and debt in CDFI loan funds. ECI also sponsors the One World Community Investment Program, a special offering of Calvert Foundation's Note. ECI is self-sufficient and requires no grants or operating subsidies from the Everence holding company.

Affordable housing and other community development bond funds
RBC Access Capital and Community Capital Management both provide mutual funds and separately managed accounts made up of government–backed bonds that support affordable housing, municipal projects, and some small business financing. For large enough investments, they can construct bond purchases that are customized to an investor's geographic or impact preference.

CDFI Loan Funds

CDFI loan funds are increasing their presence and sophistication in the community investment sector. Several funds now have formal offering memoranda and are registered (as exempt non-profits) to offer their notes in multiple states. Others operate more informally and reach out to investors as an extension of their local fundraising efforts. CDFIs generally offer returns of 2-4 percent and seek at least two-year terms. Because very few financial advisors can place investments in loan funds for their clients, CDFIs generally market their investments directly to investors.

The biggest single success story is probably the Stabilizing Urban Neighborhoods (SUN) fund launched by Boston Community Capital. The CDFI leveraged its strong existing ties to the Boston investment community plus extensive national publicity (CBS TV news, Huffington Post, New York Times) to raise $25 million from accredited individual investors. SUN notes pay 4.25 percent interest and mature in 2015. The fund buys failing mortgages from banks and refinances them for low-income home owners.

Most CDFI loan funds face a slower road, but results are encouraging: New Hampshire Community Loan Fund raises $2.6 to $4 million annually from individuals. Coastal Enterprises, Inc. of Maine has raised $2.25 million with its CEI Investment Notes along with $40 million in its venture capital funds. Enterprise Community Loan Fund's full-time, national investor liaison has raised $8.8 million.

CDFI loan funds hope that more mutual funds will follow the lead of Pax, Praxis and Portfolio 21. These mutual funds have invested in various business and affordable housing loan funds.

In addition, community development loans funds are benefiting from grants awarded from the "Create Jobs for USA" program that CDFI membership association Opportunity Finance Network has established with the national coffee chain, Starbucks. Starbucks has seeded the fund with an initial $5 million contribution and encourages and accepts small individual donations at company-owned stores.

CDFI loan funds, along with affordable housing organizations, are collaborating to increase their visibility and their capacity to work in the regulated securities sector. They are interested in attracting investments from community foundations and donor advised funds, and in better communicating the impact of community development finance for low-income people and communities across the United States.

In the wake of Occupy Wall Street and the meltdown of global financial markets, awareness of and demand for community investment in depository institutions is as high as it has ever been. This is evidenced by the "Move Your Money" campaign. The Credit Union National Association recently reported that 650,000 consumers opened credit union accounts and closed accounts with big banks in a single month—October 2011—resulting in 80 percent of its members experiencing member growth during the month.[7]

At the same time, interviews for this project confirmed that the barriers known prior to this study largely still exist. These are: the relatively low awareness of community investment options, a shortage of products, low returns or the perception of low returns, the perception of high risk, the manual processing and reporting required for non-standard investment vehicles, limited liquidity and the fact that community investing products generate low or no income for advisors. Additionally, interviews revealed an increasing concern about regulatory constraints.

It is not likely that the industry will develop a one-size-fits-all community investment product that addresses all existing and potential challenges. And while these barriers can hold back more widespread adoption of community investment practices, there continues to be innovation in this field that will continue to attract new investors.

Key issues that will influence the future of community investing are noted below.

Enhanced Product Diversity

The diversity of products is making community investing look more like an ecosystem, and while the increasing choice is welcome, it also increases the complexity of product selection, messaging and collaboration.

Community investment now spans several asset classes, and its practice varies widely by investor type. This report found targeted community investment innovations taking place in very specific niches in the market. CDFI loan funds, for instance, are developing sophistication in offering notes directly to local investors. Real estate developers are refining limited partnership structures for affordable housing funds. Mutual fund managers are innovating to purchase CDFI loan fund notes. The Calvert Foundation Note overcomes many of the barriers by offering a standard investment vehicle, electronic handling and advisor income.

At the same time, product offerings are clustered in the cash and fixed-income asset classes, particularly for non-accredited investors. Accredited investors and institutions have far more options than retail investors because their access to unregistered and non-standard investments opens up a much more diverse set of community investment products. Even the most standard products that offer market-comparable returns, such as bank CDs or Calvert Foundation Notes, are only available on a few advisor platforms.

7. Roberts, Ed. "Bank Customers Flee to CUs." American Banker. Nov. 3, 2011.

Some investors see great potential for community investment growth among high-wealth investors and institutions. After all, these investors have ample funds and the risk tolerance to innovate. Others advocate for the "democratization" of community investing, and continue to push for expansion in availability of retail products.

Both actions are needed. Growth in the number of accredited investors pursuing innovative community investment products in new asset classes will increase awareness and push new investment into communities with real needs. At the same time, everyday investors are an important market for community investment. Advocates within wire houses and RIA firms can push to make sure the basic cash and fixed-income products described in this report are available to their clients.

Increasing Awareness

To help raise awareness of community investment opportunities, many respondents called for wider dissemination of the community investment message, especially outside of sustainable and responsible investing networks. There was also interest in finding a consistent way to talk about this space as respondents felt that there was confusion spawned by the concurrent use of the terms "community investing," "sustainable and responsible investing," impact investing" and "mission investing."

Information needs are substantial, and many respondents called for a clearinghouse to help them stay abreast of community investment innovation. Any effort to centralize information, however, needs to take into account increasingly specific information demands from a diverse audience, and a very dynamic innovation culture.

Better Messaging about Returns

As higher-yield community investment products become more common, it will remain important to maintain and grow the traditional, lower-yield portion of community investing. These are typically the non-profit loan funds and affordable housing providers that often serve the poorest people and places. At 0-4 percent interest, investment in a CDFI loan fund is certainly priced below the risk-adjusted market rate of return for unsecured, unregistered investments. By definition this work will not offer market-rate returns. Yet community investors must continue to embrace and support the effort. It is not just an ethical obligation—it is a financial imperative. The economy needs new consumer groups, stronger financial infrastructure, new assets in the hands of community residents, and the political stability that comes from economic fairness in the system as a whole.

On the other hand, investments such as banks and credit union deposits and housing bonds offer market-comparable returns, and many of the emerging alternative investments can offer very competitive returns. Moreover, community development credit unions and banks, with their strong record in preserving principal, have appeal to many investors after the market gyrations of the last several years.

All of these rate-of-return factors call for a more nuanced message about rate of return. New messages can market the high social impact of community investment, with transparent information about the return choices that are becoming available. Today it is accurate to say that community investing is evolving a range of products along a spectrum of risk and return.

The goal should be to connect the right investors to the right community investment products at the rates of return that fit their needs. Clarity about return will ultimately move more money into communities.

Regulatory Requirements

Last, advisors and fund managers alike report that financial regulators are increasing their requirements for permissions, disclosures, audits and documentation of all kinds. The trend affects securities transactions across the board, and has a general stifling effect on adoption of new or unknown products, and on innovation in the community investment sphere. Non-standard or unregulated investments are often a red flag for regulation, increasing the difficulty of advisors and fund managers who try to meld instruments like CDFI loan notes into conventional portfolios.

Heightened regulation has caused higher minimum investment requirements for CDFI loan funds at some advisor firms, lower appetite for brokered deposits at banks and

RSF Social Finance

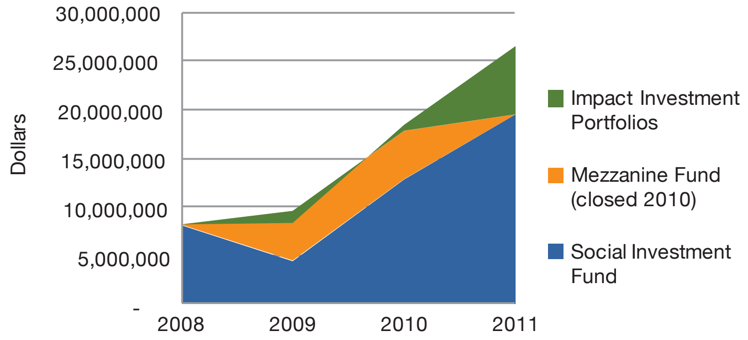
While most community investment advocates are seeking products and practices that work with financial markets, RSF Social Finance is taking the opposite tack. "We are bailing on the conventional system. We want to be as uncorrelated with Wall Street as possible. We are going off the grid," explains Don Shaffer, RSF's President and CEO.

RSF is a financial services organization whose foundation parent has non-profit and for-profit affiliates that offer giving, lending and investment strategies. RSF provides financing to values-driven social enterprises in three focus areas: Food and Agriculture, Education and the Arts, and Ecological Stewardship. Around each of these it creates an integrated program of grants, business loans, program related investments and limited conventional investments to address its goals.

This strategy garnered RSF a record-high $19.5 million in new investments for its core Social Investment Fund in 2011. That loan fund now manages $86 million, provided by 1,200 individual and organizational investors at amounts from $1,000 to over $2 million. The funds are lent to small businesses and non-profits in North America that further RSF's social or environmental program goals.

RSF also works with limited partner investors in a $10 million mezzanine fund (now closed), which provides growth financing to companies with impact. Finally, RSF manages $50 million in philanthropic funds. These are managed under three Impact Investment Portfolio choices, and they are used to meet donor goals through gifts and program related investments. The philanthropic funds under management grew by over $7 million in 2011.

Annual investment in RSF Social Finance Fund products



credit unions, and increased costs or outright inability to arrange custody of alternative community investments.

The implications for community investment advocates are: 1) all industry members need high levels of regulatory sophistication to operate in compliance, 2) new products have to bear significant regulatory cost, both as they are developed and later, during operation, and 3) the cost and complexity of meeting standards means that some community investments may never be feasible as offerings in the regulated investment sector.

At present, there is no universal community investment agenda in the area of regulation. The issues have to be dealt with by different investors, advisors or money managers as they encounter issues and particular rules. Furthermore, most community investors likely support the intent of the regulation even if the unintended consequence is to create hurdles to community investment.

Conclusion

The future of community investing will likely include further product development, a broader return horizon, a rich impact canvas, and a complicated regulatory environment. This increased complexity will require advisors and fund managers to create and communicate more nuanced messages around community investing. They will have to better match products and investors, and understand particular and specific market segments. They will have to know their stuff—and there will be much more to know.