Community Reinvestment Act Banks as Pioneer Investors in Pay for Success Financing

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Pay for Success (PFS) financing, sometimes known as social impact bonds (SIBs) or social innovation financing, has attracted much attention because it offers the promise of governments paying only for successful programs while increasing funding for prevention programs by accessing capital markets. To understand the emerging PFS investment landscape and determine the structures and investors that are most likely to attract incremental capital, we spoke with more than ninety investors and other stakeholders as part of an eight-month research project.¹ Our aim was to highlight distinct investor concerns, preferences, and insights that inform the systems, structures, and sequence critical to building a healthy and sustainable market for PFS financing. During our research, Community Reinvestment Act (CRA) financial institutions emerged as potential early investors in this new market. While philanthropy is expected to fund early PFS financings, CRA capital could prove to be the best bridge to other commercial investors. This article addresses how PFS financing can fit into CRA portfolios and outline some of the opportunities and challenges of executing PFS arrangements within CRA-regulated financial institutions.

Bridging Philanthropy and the Capital Markets

The CRA requires depository institutions to help meet the credit needs of the communities in which they operate, including low- and moderate-income (LMI) neighborhoods, in ways that are consistent with safe and sound operations. Banking regulators evaluate the banks’ performance in meeting these goals.² For most US banks, CRA regulatory considerations are a major force driving the execution of their community and economic development strategies. In 2011, US financial institutions made $209 billion in CRA-related loans including $47 billion of community development lending.³ CRA banks often work through community development financial institutions, community development corporations, and other intermediaries to realize their community development goals. As mission-driven financial institutions that provide financial products and services to people and communities


underserved by traditional financial institutions, these intermediaries can also play an important role in the development of the PFS financing market.

While PFS financing is expected to emerge across a range of programs, early transactions that would qualify for CRA credit will most likely involve the provision of community services to LMI individuals in the form of community facilities. These are defined as “facilities that promote community development by providing community services for LMI individuals such as youth programs, homeless centers, soup kitchens, health care facilities, battered women’s centers, and alcohol and drug recovery centers.” The first transactions in the United States are expected to specifically address issues such as prison recidivism, juvenile detention, and chronic homelessness.

Opportunities and Challenges

During our conversations, CRA banks highlighted several new opportunities and risks facing the expansion of PFS financing.

Outcome Performance Risk

PFS financing will require CRA banks to underwrite the performance risk of nonprofits. Performance risk encompasses risks related both to the intervention model itself and to the challenges that come specifically with scaling up the intervention to serve more people or to serve them more comprehensively. For example, a specific evidence-based intervention that focuses on changing the behavior of formerly incarcerated juveniles would need to be consistently operated and expanded. Underwriting a social service intervention based on social science research is difficult and will require the banks to assess new risks. “This is new work for the banks” was a common theme at a recent meeting of CRA financial institutions to discuss PFS opportunities. In addition, PFS financing is subject to the same investment committee standards for safety and soundness as other bank investments.

Certain interventions have a track record of success at a specific scale. Evaluating an investment within the context of this track record should reduce some of the intervention model risk. Outcome performance risk should generally decline as track records for PFS financing—and for particular interventions—grow. The participation of an intermediary organization (or active direct investor) to source deals and manage relationships throughout the life of the financing arrangement will help to ensure that only qualified service providers are selected, reasonable benchmarks are set, and communication among stakeholders is clear.

Government Counterparty Risk

No precedent exists to optimize the government’s payment obligation in PFS financing. Political and appropriations risk can arise given the multiyear contingent obligations of the government. The contracts underlying PFS financing are not standard government procure-

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ment contracts and will require the government to create new templates and procedures. Investors will want to be sure that their financial commitments are not jeopardized through changes of administrations and are not susceptible to political whims. Investors will most likely demand some type of escrow account to ensure that the government pays its obligations. A concern often raised by investors was whether it would be possible to pay private investors enough to attract commercial capital without triggering political issues. Some investors fear public backlash against what the public could perceive as the government paying a premium for “outsourcing” social programs.

Government counterparty risk needs to be clarified early in the negotiations and, ideally, be removed as a risk factor. Counterparty risk can be significantly mitigated through legislative or executive action to secure the long-term contingent liability to investors. Governments must be willing to commit to structuring their liability in a way that eliminates this risk as much as possible. For example, in July 2012, the Massachusetts legislature created a $50 million Social Innovation Financing Trust Fund with the full faith and credit of the state to cover its potential obligations in pending PFS transactions. As PFS financing proliferates, standard contractual templates will also develop.

**Transaction Pipeline, Allocations, and Liquidity**

Bank investors voiced concerns that dedicating resources to developing PFS capacity will not be met with deal flow large enough to justify the resources allocated. A select set of appropriate issue areas and a limited number of successful interventions within those areas may narrow the market of viable service providers. Nevertheless, PFS financing for some individual interventions could serve enough people and generate sufficient cost savings to create a market large enough to attract investors.

PFS financing presents a clear allocation challenge. For most investors, the decision to allocate to an investment bucket is made before specific investment products are selected. Because PFS financing is an instrument that shares both debt and equity features, deciding where to bucket it in a portfolio will be problematic. Many investors were also not comfortable with the prospect of being locked into an illiquid multiyear PFS position. A sustainable investor market for PFS financing will require a set of successfully executed deals to provide adequate data to price the risk and to standardize elements of a PFS transaction where possible.

**Objective Performance Targets**

Investors universally stressed that social outcome goals need to be clear, objective, measurable, and nondebatable. The evaluation process must be transparent and clear to all parties before a transaction can be completed. The triggering events themselves were not the problem; rather, investors were concerned about the potentially nebulous nature of social-impact outcome triggers.
Structuring Opportunities

Most CRA bankers see bank participation in the first demonstration projects as critical to building the capacity to underwrite PFS financings and build a sustainable market. While early transactions may require close to full credit enhancement for commercial investors to participate, commercial investors will need some level of outcome performance risk participation to build their capacity to assume more outcome performance risk and position themselves to participate in more deals in the future.

As PFS financing develops a track record, the amount of credit enhancement will likely decrease. Structures with more level repayment schedules could also have lower credit enhancement requirements. Some institutions would not be willing to take any principal risk in an early transaction but would consider some variability in the yield-based outcomes. Other investors thought that some portion of the principal repayment could be contingent on the successful achievement of outcomes. Banks were also generally of the view that any intermediary should assume some level of outcome performance risk.

Various structures such as principal floors, credit enhancements, senior/subordinated tranching, and variable payouts can be used to modify how PFS financing agreements allocate risk. Other creative structuring suggestions that we heard from investors included building in call or put options to provide exit opportunities, having the public sector post underused assets (e.g., undeveloped property) as collateral, sharing risk and upside incentives across all stakeholders (public sector, investors, intermediary, and service provider), and adjusting repayment terms to smooth out risk.

Clear Regulatory Signals

Favorable treatment of PFS financing by CRA regulators will be a key issue for engaging banks although the ability of specific institutions to get CRA credit will vary. To receive CRA credit from bank regulators, a bank’s investment must connect directly to LMI communities in the bank’s market area. Given the multiple layers of bank regulators, CRA strategies and compliance vary significantly across institutions.

Banks would like to have their CRA regulators signal that PFS financing would earn CRA credit before committing time and resources to specific transactions. Complex PFS financing transactions will also need to compete with more straightforward community development lending transactions that would offer the same CRA credit to a bank. Given that wholesale banks that do not operate branches in specific markets have somewhat more flexibility in their CRA evaluations than their retail banking counterparts do, wholesale banks may be more likely participants in early PFS financing arrangements.

New York City SIB for Incarcerated Youth as Possible Model

In the New York City SIB, credit enhancement from Bloomberg Philanthropies enabled Goldman Sachs to advance a loan to MDRC, the intermediary managing the program serving incarcerated youth. The credit enhancement covers 75 percent of the loan, with Goldman
Sachs assuming 25 percent of the performance risk related to the program’s outcome of reduced recidivism. The loan to MDRC was structured by the Goldman Sachs Urban Investment Group and will be made from Goldman Sachs Bank. It is not structured as a program-related investment or foundation grant. Goldman expects to receive CRA credit for the transaction although it is a relatively small portion of Goldman’s overall CRA portfolio. Goldman’s underwriting analysis for the loan included the following:

- Examination of the evidence base of the intervention as supported by previous studies;
- Assessment of the program partners’ capacity to ramp up the program while maintaining the quality of the intervention; and
- Review of the underlying contracts.

The New York City deal demonstrates commercial interest in the PFS financing market. In early deals, it is clear that large collateral or loan guarantees from third parties such as philanthropies will make payoff structures more palatable for commercial investors while still ensuring that they assume some outcome performance risk. However, as the market grows, participation of philanthropic entities as guarantors may not prove scalable. Familiarity with deal structures and evaluation methods, supportive political environments, and longer track records for interventions should contribute to commercial investors’ gradually assuming more performance risk with lower levels of guarantees.

**Moving the Market Forward**

Investors stressed that outcome performance goals need to be clear, objective, measurable, and nondebatable and that government counterparty risk needs to be addressed early in the negotiation. Credit enhancement will also play a major role in bringing commercial investors to the table by providing external collateral or supporting senior positions in capital structures. Creative risk sharing—not risk transfer—will be necessary to address investor concerns about performance risk, illiquidity, and deal flow. However, unless investors ultimately assume significant outcome performance risk, PFS financing may simply cannibalize philanthropic and public funding and fail to increase the capital available to fund the needed interventions.

CRA banks can benefit from viewing PFS financing as a market opportunity to build expertise in the evaluation of social service performance risk. Bank participation in early transactions will require strong institutional leadership as well as a team to structure, negotiate, close, and monitor transactions.

Finally, PFS financing can be an important opportunity for CRA banks to reframe community and economic development to include a broad range of social services. PFS financing provides CRA banks with the opportunity to expand the reach of community and economic development beyond asset-based strategies and to develop methodologies to underwrite outcome risks that can leverage existing community development finance practices.
Steven Godeke advises foundations, corporations and individuals on the integration of their investment and philanthropic goals—creating and executing impact investment strategies across asset classes and program areas. Mr. Godeke also teaches at New York University’s Stern School of Business where he created an impact investing course. Prior to establishing his own firm, Godeke Consulting, he worked in corporate and project finance with Deutsche Bank. Mr. Godeke attended Purdue University, studied as a Fulbright Scholar at the University of Cologne and earned an MPA from Harvard University.