



Community Development INVESTMENT REVIEW

www.frbsf.org/cdinvestments

Articles

Global Agricultural Value Chains: Sustainable Growth as a Means for Sustainable Development
Patricia Lee Devaney, Root Capital

International Housing Partnership Exchange
Thomas A. Bledsoe and Paul Weech, Housing Partnership Network

Catalyzing American Retail Investment in Community Development Finance:
What Can We Learn from Other SRI Success Stories?
Caroline Bressan and Eliza M. Erikson, Calvert Foundation

Unlocking Local Capital for Development: Shared Interest's Guarantee Fund for South Africa
Donna Katzin, Shared Interest and Robert Rosenbloom, Strategic Philanthropy Advisors, LLC

Translating Plain English: Can the Peterborough Social Impact Bond Construct Apply Stateside?
Drew von Glahn and Caroline Whistler, Third Sector Capital Partners

Learning Social Metrics from International Development
Paul Veldman, Columbia University

Commentary

The Latest Frontiers for Financial Inclusion: Using Mobile Phones to Reach the Unbanked
Tillman Bruett, UN Capital Development Fund

CRA Goes Global: A Good Idea in the United States Could Use a Makeover and a Bigger Audience
David A. Smith, Affordable Housing Institute

Why Latin America Urgently Needs CRA, and Why CRA Won't Work for Latin America
Tova Maria Solo

Using the Framework of the Community Reinvestment Act to Support Rural Communities in China
Prabal Chakrabarti, Federal Reserve Bank of Boston



Community Development Investment Review

Volume 7, Issue 1, 2011

FEDERAL RESERVE BANK OF SAN FRANCISCO

FEDERAL RESERVE BANK OF SAN FRANCISCO
101 MARKET STREET
SAN FRANCISCO, CA 94105
AU 10252



PRSRT STD
POSTAGE & FEES PAID
SAN FRANCISCO, CA
PERMIT NO. 752

Community Development INVESTMENT REVIEW

The Community Development Department of the Federal Reserve Bank of San Francisco created the Center for Community Development Investments to research and disseminate best practices in providing capital to low- and moderate-income communities. Part of this mission is accomplished by publishing the *Community Development Investment Review*. The *Review* brings together experts to write about various community development investment topics including:

Finance—new tools, techniques, or approaches that increase the volume, lower the cost, lower the risk, or in any way make investments in low-income communities more attractive;

Collaborations—ways in which different groups can pool resources and expertise to address the capital needs of low-income communities;

Public Policy—analysis of how government and public policy influence community development finance options;

Best Practices—showcase innovative projects, people, or institutions that are improving the investment opportunities in low-income areas.

The goal of the *Review* is to bridge the gap between theory and practice and to enlist as many viewpoints as possible—government, nonprofits, financial institutions, and beneficiaries. As a leading economist in the community development field describes it, the *Review* provides “ideas for people who get things done.” For submission guidelines and themes of upcoming issues, visit our website: www.frbsf.org/cdinvestments. You may also contact David Erickson, Federal Reserve Bank of San Francisco, 101 Market Street, Mailstop 215, San Francisco, California, 94105-1530. (415) 974-3467, David.Erickson@sf.frb.org.

Center for Community Development Investments
Federal Reserve Bank of San Francisco
www.frbsf.org/cdinvestments

Center Staff

Joy Hoffmann, FRBSF Group Vice President

Scott Turner, Vice President

John Olson, Senior Advisor

David Erickson, Center Manager

Ian Galloway, Investment Associate

Advisory Committee

Frank Altman, Community Reinvestment Fund

Nancy Andrews, Low Income Investment Fund

Jim Carr, National Community Reinvestment Coalition

Prabal Chakrabarti, Federal Reserve Bank of Boston

Catherine Dolan, Opportunity Finance Network

Andrew Kelman, Bank of America Securities

Judd Levy, New York State Housing Finance Agency

John Moon, Federal Reserve Board of Governors

Kirsten Moy, Aspen Institute

Mark Pinsky, Opportunity Finance Network

John Quigley, University of California, Berkeley

Lisa Richter, GPS Capital Partners, LLC

Benson Roberts, U.S. Department of the Treasury

Clifford N. Rosenthal, NFCDCU

Ruth Salzman, Russell Berrie Foundation

Ellen Seidman, Consultant

Bob Taylor, Wells Fargo CDC

Kerwin Tesdell, Community Development Venture Capital Alliance

Betsy Zeidman, Robert F. Kennedy Center for Justice and Human Rights

Community Development INVESTMENT REVIEW

Free subscriptions and additional copies are available upon request from the Community Development Department, Federal Reserve Bank of San Francisco, 101 Market Street, San Francisco, California 94105, or call (415) 974-3467.

Change-of-address and subscription cancellations should be sent directly to the Community Development Department. Please include the current mailing label as well as any new information.

The views expressed are not necessarily those of the Federal Reserve Bank of San Francisco or the Federal Reserve System. Material herein may be reprinted or abstracted as long as the *Community Development Investment Review* is credited.



Table of Contents

ARTICLES

Global Agricultural Value Chains: Sustainable Growth as a Means for Sustainable Development	2
<i>Patricia Lee Devaney, Root Capital</i>	
International Housing Partnership Exchange	12
<i>Thomas A. Bledsoe and Paul Weech, Housing Partnership Network</i>	
Catalyzing American Retail Investment in Community Development Finance: What Can We Learn from Other SRI Success Stories?	28
<i>Caroline Bressan and Eliza M. Erikson, Calvert Foundation</i>	
Unlocking Local Capital for Development: Shared Interest's Guarantee Fund for South Africa	42
<i>Donna Katzin, Shared Interest and Robert Rosenbloom, Strategic Philanthropy Advisors, LLC</i>	
Translating Plain English: Can the Peterborough Social Impact Bond Construct Apply Stateside?	58
<i>Drew von Glahn and Caroline Whistler, Third Sector Capital Partners</i>	
Learning Social Metrics from International Development	71
<i>Paul Veldman, Columbia University</i>	

COMMENTARY

The Latest Frontiers for Financial Inclusion: Using Mobile Phones to Reach the Unbanked	114
<i>Tillman Bruett, UN Capital Development Fund</i>	
CRA Goes Global: A Good Idea in the United States Could Use a Makeover and a Bigger Audience	119
<i>David A. Smith, Affordable Housing Institute</i>	
Why Latin America Urgently Needs CRA, and Why CRA Won't Work for Latin America	134
<i>Tova Maria Solo</i>	
Using the Framework of the Community Reinvestment Act to Support Rural Communities in China	141
<i>Prabal Chakrabarti, Federal Reserve Bank of Boston</i>	

Foreword

David J. Erickson

Federal Reserve Bank of San Francisco

March 2011

Low-income people in the U.S. and abroad face similar challenges: access to credit, housing, jobs, and critical services including health and education. And yet today, those who work on international economic development and community development hardly know each other. This issue of the *Review* is dedicated to a simple idea: innovative ideas to solve poverty should not stop at the national border. There are too many good ideas abroad that can help inform our practices domestically, and good ideas here that can be relevant to other countries.

This issue of the *Review* covers a host of ideas, including: innovating how we do small business finance (Root Capital); learning about affordable housing finance from Europe, Canada and Australia (Housing Partnership Network); overcoming regulatory barriers in the U.S. to help free up more impact capital as has been done in Europe (Calvert Foundation); using credit enhancements to promote bank lending in South Africa (Shared Interest and Strategic Philanthropy Advisors); finding ways to capitalize on the UK's innovative social impact bond concept for the U.S. (Third Sector Capital Partners); learning the best practices in measuring social metrics from around the world (Paul Veldman, Columbia University); using mobile phones to reach the unbanked (UN Capital Development Fund); thinking about how the Community Reinvestment Act (CRA) might go global (David Smith, Affordable Housing Institute); and considering how CRA might, or might not, work in Latin America (Tova Solo, formerly with the World Bank) and China (Prabal Chakrabarti, Federal Reserve Bank of Boston).

Economist Jeffrey Sachs, in his book *The End of Poverty*, states that “extreme poverty can be ended, not in the time of our grandchildren, but in our time.” If we are to live up to Sachs’ charge, it is essential that we share the best ideas we have from both the international and domestic antipoverty communities.



Global Agricultural Value Chains: Sustainable Growth as a Means for Sustainable Development

Patricia Lee Devaney

Root Capital

Agricultural businesses in developing countries offer an opportunity for market-based economic development that creates benefits throughout global value chains.¹ Supporting the stability and growth of such businesses fosters economic prosperity and job creation in places where poverty is endemic. Further, it addresses key economic and social issues that affect the everyday lives of people in the United States, including immigration, drug production, post-conflict reconstruction, and supply chain stability.

Seventy-five percent of the world's poor live in rural areas and depend on agriculture as their primary source of income. Given the World Bank's estimate that economic growth in the agricultural sector is twice as effective in reducing poverty as growth in other sectors of the economy, strengthening agricultural value chains may be among the most effective ways to address global poverty.²

Agricultural cooperatives and private enterprises represent farmer suppliers at the base of many global value chains. A growing number of these enterprises produce and process high-value crops such as premium coffee and cocoa, vegetables, and nuts that have a growing market in North America and Europe. However, despite having quality products with established markets, most of these enterprises lack the financing to invest in inputs such as seeds and fertilizer, purchase raw material, and build processing facilities, warehouses, or other value-adding infrastructure.

In the United States, a variety of government programs, many of which are driven by legislation such as the Community Reinvestment Act (CRA), addresses gaps in rural and other underserved financial markets directly or indirectly through private sector engagement. The U.S. farm credit system provided \$152 billion in financing to agricultural small businesses in 2009.³ Since the Community Development Financial Institutions (CDFI) Fund's inception in 1994, it has provided more than \$1 billion to community development organizations and financial institutions, while more than 1,000 CDFIs lend billions of dollars to underserved markets in the United States, including small and growing businesses

1 We define value chains as "the sequence of value-adding activities, from production to consumption, through processing and commercialization. Each segment of a chain has one or more backward and forward linkages," from C. Miller and L. Jones, *Agricultural Value Chain Finance* (Rome: Food and Agriculture Organization of the United Nations and Practical Action Publishing, 2010).

2 The World Bank, "World Development Report 2008" (Washington, DC: World Bank Group, 2007).

3 Farm Credit Administration, "2009 Annual Report on the Farm Credit System" (McLean, VA: Farm Credit Administration, 2010).

(SGBs). At fiscal year-end 2009, the Small Business Administration had a total loan portfolio outstanding balance of \$90.5 billion, and had guaranteed \$62 billion of loan principal for U.S. small businesses.⁴

By contrast, few such government programs exist at a meaningful scale in developing countries, and thus the financing needs of rural SGBs are largely unmet. Microfinance is increasingly addressing the financing needs for very small businesses clustered in urban centers from Lima to Nairobi to Dhaka. However, microfinance has primarily focused on the smallest enterprises that typically employ fewer than three people and are rarely part of the formal economy. It has yet to reach much beyond periurban and the most densely populated rural areas or to address the needs of businesses employing more than five people and requiring more than \$10,000 in credit.

Commercial banks, for their part, bump up against the same constraints as microfinance institutions when considering expansion into rural markets: high transaction costs to reach enterprises in far-flung areas. Add to that a lack of traditional collateral, real and perceived risks of agricultural lending, cultural and linguistic differences, and often limited managerial capacity, and it is no surprise that rural SGBs are excluded from the financial mainstream and even “alternative” financial markets.

Recent interest by both traditional economic development agencies and a new breed of “impact investors” suggests that support for agricultural businesses is on the rise. Although official development assistance for agriculture declined in both percentage (from 18 percent in 1979 to 3.4 percent in 2004) and absolute terms (from \$8 billion in 1984 to \$3.4 billion in 2004) in the last two decades of the twentieth century,⁵ volatile markets, extreme weather patterns, and resulting food crises have prompted a renewed focus on the sector from governments, philanthropy, and the private sector during the past five years.

The rise of impact investing—generating social or environmental benefits and financial returns—provides a new opportunity to address rural poverty with market-based solutions. In a recent study, J.P. Morgan Global Research and The Rockefeller Foundation described the impact investment market as an emerging asset class with invested capital need estimated to be \$400 billion to \$1 trillion over the next decade.⁶

Financing Agricultural Value Chains

Root Capital aspires to expand access to finance to enterprises operating in rural areas of developing countries—the rural “missing middle” between microfinance and corporate banking. As a social investment fund, Root Capital provides loans to rural SGBs that operate within global value chains but that lack access to credit to support and expand their opera-

4 U.S. Small Business Administration, “Summary of Performance and Financial Information, 2009 Fiscal Year” (Washington, DC: SBA, 2010).

5 World Bank, World Development Report 2008.

6 J.P. Morgan Global Research, The Rockefeller Foundation, and Global Impact Investing Network, “Impact Investments: An Emerging Asset Class” (New York: J.P. Morgan Global Research, November 29, 2010).

tions. Root Capital also builds the capacity of these businesses to absorb and manage credit through financial training. Ultimately, it aims to expand financial markets to rural enterprises as a means to improve rural livelihoods.

Root Capital's Clients

Root Capital works with rural SGBs that have little or no traditional collateral. These businesses—associations, cooperatives, and private enterprises aggregating several hundred or a few thousand smallholder farmers—source products from the base of the value chain. They consolidate the harvests of smallholder producers and negotiate competitive prices on international markets. Beyond economic benefits in the form of stable market access, many rural SGBs offer agricultural extension services to boost productivity and help farmers adapt to changing weather conditions. They also often offer social services such as health care, education, and they build physical infrastructure (roads, community centers, water treatment facilities) in the remote areas in which they operate, areas that public services infrequently reach.

Those rural enterprises that supply products to international buyers sign forward purchase contracts several months in advance of the harvest. They can therefore offer a more consistent, reliable, and generally higher price to their farmer suppliers than local middlemen. But the middlemen often out-compete the farmer enterprise on one important dimension: they are able to offer cash at the time of harvest. Most rural businesses, on the other hand, lack sufficient working capital to pay their suppliers until they ship the product and are paid months later by their buyers.

Farmers, for their part, lose out when they sell to the middlemen. Although they receive cash upfront to meet immediate household needs, they are often paid well below market prices. For agriculturalists struggling to feed their families or pay school fees today, waiting for payment for three months may not be an option. Smallholder farmers, like the enterprises they supply, are perennially cash constrained. Although rational for farmers living at the poverty line, when farmers sell to middlemen instead of to the local enterprises, it weakens SGBs which serve an important role as a source of both income and social services benefiting producers and their families in the long-term.

With financing, rural SGBs can pay their farmer members or suppliers competitive prices at the time of the harvest. Producer enterprises can then fulfill their contracts with international buyers, strengthening the long-term viability of the enterprise itself.

Root Capital's Model

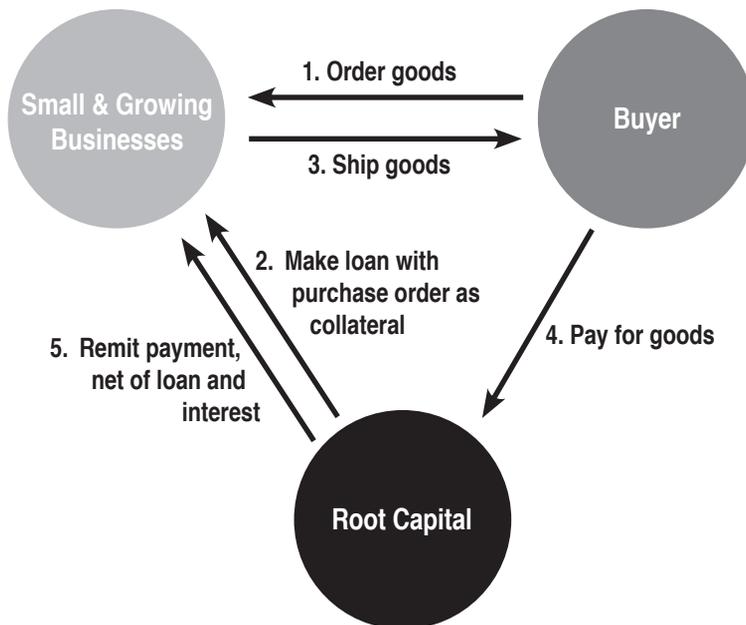
Ninety percent of Root Capital's portfolio is made up of short-term (typically five to nine months) trade credit loans to address the cash flow gap between the time an SGB purchases raw goods from its farmer suppliers and when the business receives payment from its buyers several months later. Pre-harvest loans to SGBs to lend to individual farmers to purchase seeds and other inputs represent a growing portion of Root Capital's portfolio.

The remaining 10 percent of Root Capital's lending is for longer-term capital expenditures that enable enterprises to offer value-added services, lower production costs, and raise product quality. UROCAL, a 115-member banana producer cooperative in Ecuador, has used Root Capital's loan to purchase water-efficient drip irrigation systems for growing bananas. COCLA, a coffee cooperative in Peru, borrowed Root Capital funds to build a warehouse for its spin-off business that processes and sells enriched, pelletized animal feed in local markets.

Root Capital has also expanded into new industries with particularly high social impact for both producers and consumers at the base of the economic pyramid. For example, in 2010, it provided its first loans to enterprises that produce high-yield, drought-resistant seeds to farmers. It also recently began financing businesses that manufacture ready-to-use therapeutic foods aimed at addressing severe acute malnutrition in refugee camps throughout the Horn of Africa.

Root Capital typically employs a form of value chain finance, depicted in Figure 1, whereby the main security is signed purchase agreements between SGBs and their buyers, primarily in North America and Europe. The purchase contract replaces the need for traditional collateral as it represents a discrete, future revenue stream pledged to repay the loan. When the product is shipped, the buyer pays Root Capital directly. Root Capital then recovers its principal and interest and remits the remainder of the payment to its SGB client.

Figure 1. Root Capital's Value Chain Finance Model



As of year-end 2010, Root Capital had disbursed a cumulative total of more than \$250 million in credit to 320 businesses, while maintaining a 99 percent repayment rate. Between 2007 and 2010, total loan disbursements grew at a compound annual growth rate (CAGR) of 42 percent. Its loans range from \$25,000 to \$2 million (in 2010, the median loan was \$250,000). The SGBs Root Capital finances provide market access and employment that improve incomes and livelihoods for more than 450,000 rural producer households.

What's at Stake?

Root Capital strengthens the operations of its borrower enterprises by enabling them to purchase more product from their smallholder suppliers, thus increasing supplier loyalty, fulfilling purchase contracts with buyers, and subsequently increasing their revenues. In and of itself, enterprise growth has value in rural communities because of the ripple effect of successful businesses. They hire more people, use and create more ancillary services (such as transportation, agricultural supplies, and labor), and attract financial and other support services to their communities.

Most important, where specialty crops match growing market demand, successful rural enterprises offer high-value export opportunities to marginalized producers whose markets would otherwise be limited to their immediate vicinity or, at best, national or regional markets that may offer significantly lower prices than export markets. By supporting these grassroots enterprises, Root Capital enables them to link small-scale and otherwise disaggregated producers to well-paying international markets.

Root Capital's market-based approach to reducing rural poverty carries benefits beyond the farming communities of its borrowers. Because borders are porous for money, people, and drugs, the impact of strong rural economies reverberates internationally. The United States, in particular, is affected by rural development in remote locations around the world because of the dependence of many U.S.-based businesses on global value chains, immigration to the United States from impoverished rural areas in Latin America, the incidence of drug production in rural communities, and the threat of continued instability in post-conflict environments.

Global Value Chains

The U.S. economy is only as strong as the weakest link in the value chains that stock its stores, clothe its residents, and fuel its cars. Although Root Capital's social mission guides the organization to improve the lives of small-scale producers, international buyers benefit from a more reliable supply chains brought about by third-party financing in two fundamental ways:

1. **Supply chain stability.** Access to capital enables SGBs to purchase greater volumes from their smallholder suppliers, and therefore more reliably meet the volume demands of their buyers. As suppliers prove their reliability, the time buyers must

spend with them—and likewise the cost of maintaining the relationship—declines over time. Further, because financing enables SGB managers to plan ahead and make appropriate capital investments, product quality is often enhanced by access to reliable sources of capital.

2. Lower sourcing costs. The increased volumes that buyers purchase from existing suppliers as a result of Root Capital’s financing reduce their sourcing costs as they no longer must develop relationships with as many new supplier enterprises. Further, with third-party financiers such as Root Capital financing capital expenditures, SGBs may realize increased operating efficiencies, lower energy and water use, and reduced transportation costs, which in turn can lower the total sourcing cost to the buyer.

Root Capital has applied this value chain finance model with 125 U.S. buyers, ranging from specialty importers, such as Equal Exchange and Sustainable Harvest, to large global buyers, including General Mills, Green Mountain Coffee Roasters, Pier 1 Imports, Starbucks Coffee Company, The Body Shop, The Home Depot, and Whole Foods Market.

Migration

Rural poverty frequently compels people to migrate, either to find new employment permanently or to round out volatile agricultural income with seasonal employment when yields or prices are low. Whether pulled by better employment opportunities or pushed by economic hardship, farmers migrate when their existing income prospects are low and expected income at their destination is perceived to be high.⁷ Developing-country farmers migrate to other rural areas, regional urban centers, or abroad to manage the risks inherent in agriculture and their other rural-based activities.⁸

Smallholder farmer income is especially volatile because of risks such as weather shocks affecting yields, erratic supply affecting price, and a variety of other factors. Because the incomes of most smallholder producers lag those of their urban counterparts even in “good” years, a bad year—characterized by drought, a hurricane, or low international prices for their goods—can be economically devastating to both individual households and local economies.

In 2001, international coffee prices plummeted to lows below \$0.50 per pound (2010 prices are high at greater than \$1.80 per pound)⁹ owing in part to overproduction in Brazil and Vietnam. The economic destruction that befell coffee communities with no safety nets to protect them from the price spiral drove hundreds of thousands of farmers from their land to seek employment as seasonal laborers or for longer-term non-agricultural jobs. In a particularly tragic illustration of the desperation of coffee farmers operating as

7 The World Bank, “World Development Report 2008.”

8 International Fund for Agricultural Development, “Rural Poverty Report 2011.”

9 International Coffee Organization, “ICO Indicator Prices 1998 – 2010” (London: International Coffee Organization, 2010), available at <http://dev.ico.org/prices/p2.htm>, Twin Trading Ltd, TwinCafé Bulletin. (London: Twin Trading, August 5, 2010).

“price takers” in a volatile export commodity market, 14 migrants from Mexico’s coffee-producing state of Veracruz died in the Arizona desert after abandoning their farms to find work in the United States.¹⁰

More stable and higher incomes in rural areas lead to the types of quality of life improvements that discourage migration. Rural enterprises, often the institutional backbone of rural communities untouched by municipal services, foster income and other social improvements, and give farmers and their families incentive to stay on their land. The enterprises that Root Capital supports offer their farmers fair prices, a consistent export market, and social services—stability in an otherwise unstable environment.

Many of Root Capital’s clients, particularly in Mexico and Central America, are directly affected by migration of their suppliers. One client, 21 de Septiembre, a coffee cooperative in Oaxaca, Mexico, witnessed high migration following a coffee price collapse in the early to mid-1990s. Migration trends have continued. Currently, two-thirds of 21 de Septiembre’s members who migrate go to the United States as temporary agricultural field workers or for permanent jobs in construction or food services. Because most of the migrants are traditionally young men, the average age of 21 de Septiembre’s members is approximately 55 years.

The flight of this demographic strains the family, as women, who now account for 45 percent of 21 de Septiembre’s remaining farmer members, are left with the triple responsibilities of farming the land, managing the cooperative, and caring for their families. Although many of the migrants send remittances to their families, amounts have dropped off significantly since the 2008 economic crisis, magnifying the daily stresses of both the migrants and the families they leave behind. With the goal of encouraging farmers to stay on their land, the cooperative has launched a number of training and scholarship programs aimed at local youth, as well as coffee plant renovation projects.

Drug Production

On the eastern slopes of the Andes in Peru, Colombia, and Bolivia, coca, the raw ingredient for cocaine, competes for land with coffee, cocoa, and other legal crops. Although fighting narco-terrorism is the mandate of governments, supporting organizations that can offer an economic rationale to plant, harvest, and sell productive crops is very much in line with Root Capital’s mission. Particularly in Latin America, rural SGBs offer the economic stability and unified voice that farmers often need to resist pressure to produce illicit drugs.

For example, Root Capital client Cooperativa Agraria Cafetalera Pangoa (Pangoa), is a Fair Trade and organic-certified coffee cooperative located in Peru’s Junín region. Peru accounts for a high percentage (39 percent and growing) of global cocaine production, second only to Colombia (at 48 percent and shrinking).¹¹ The Junín region is one of the four main

10 M. Wallengren, “Coffee Crisis Sends Mexico Producers to Death In Arizona,” Dow Jones Newswires, May 29, 2001.

11 United Nations Office on Drugs and Crime, “UN World Drug Report 2010” (Vienna: UN Office on Drugs and Crime, 2010).

coca producing regions of Peru and is considered a “red zone” for its concentration of drug production and trafficking.

During the 1980s, Pangoa’s coffee farmers were caught in the middle of the terrorist activities of the Shining Path movement, which was funded largely by the coca trade. Hundreds disappeared or were murdered, and thousands more abandoned their land. Pangoa all but collapsed under relentless attacks by the Shining Path against its farming communities. The violence was so rampant that locals referred to the main road to the town of San Martin de Pangoa, where Pangoa’s office and warehouse are located, as “el camino donde la vida no vale nada” (the road where life isn’t worth anything).

Although most farmer cooperatives in the area disbanded, Pangoa lost the majority of its members, but remained operational owing mainly to its strong leadership. The days of the Shining Path guerrillas in the 1990s have been replaced by an era of private militias and ongoing drug-related violence today.¹² Amid this upheaval, Pangoa continues to purchase coffee, and more recently cocoa, from its 200 farmer members and sponsors projects in reforestation, women’s disease screenings, other health programs, and education. By linking its members to international markets that pay premium prices for its specialty coffee, Pangoa offers its farmer members economic alternatives to coca production.

*Post-Conflict Reconstruction*¹³

Economic development plays an important role in post-conflict settings, as economic reconstruction is linked to stronger, longer-lasting peace building efforts. Forty percent of armed conflicts that end in a negotiated settlement revert to violence within 10 years.¹⁴ Economies that can absorb former combatants into other activities and improve the material lives of everyday citizens diminish wide-scale support for violence. Because the majority of people in most post-conflict countries live in rural areas, agriculture plays an important role in such situations. Further, although the industrial base takes time to rebuild, the agricultural sector can rapidly absorb large amounts of labor and rebuild individual livelihoods.

Although investment can help stabilize post-conflict economies, foreign private investment is sluggish to enter such markets for obvious reasons of risk. With a prudent approach to risk combined with an understanding of the social implications of successful reconstruction, Root Capital has worked in post-conflict societies since its earliest days. In fact, its entry point into Africa is very much a story of post-conflict reconstruction. In 2004, one of Root Capital’s international buyer partners approached the organization to finance their coffee suppliers in Rwanda. Beyond offering a quality product to a ready market, cooperatives in Rwanda were playing an important role in rebuilding relationships between Hutus and

12 S. Romero, “Coca Production Makes a Comeback in Peru,” *New York Times*. June 13, 2010.

13 Thanks to Nate Schaffran, Root Capital’s Africa Regional Director, for his contributions to this section.

14 P. Collier, A. Hoeffler, and D. Rohner. “Beyond Greed and Grievance: Feasibility and Civil War.” Working Paper 2006-10. (Oxford, UK: Oxford University, Department of Economics, Centre for the Study of African Economics, 2006).

Tutsis. The simple act of coming together with a common economic goal began to repair some of the social fabric of the countryside. In 2010, Root Capital provided \$2.75 million in loans to nine such businesses in Rwanda.

More recently, in December 2010, Root Capital provided a loan to Gulu Agricultural Development Company (GADC), a cotton ginner and exporter based in northern Uganda. Gulu District is recovering from nearly 25 years of armed conflict that left the north as the poorest region in Uganda, with a poverty rate of 61 percent (twice Uganda's national poverty level). The United Nations World Food Programme estimates that nearly 1.4 million people in the region were made homeless by the fighting, most taking shelter in internal refugee camps.

Two years ago, farmers in Gulu District began returning to their farms where they faced the challenge of reconstructing their lives as subsistence farmers. Although cotton had once been the economic mainstay of the region, it had been defunct for a decade as a result of the conflict. In 2009, GADC rehabilitated the cotton production infrastructure and began trading on a limited scale. The following year, Root Capital and its colleague organization, the Acumen Fund, together extended financing to GADC. GADC is emerging as an anchor of the region's economic revival, providing 30,000 farmers with access to seeds, agricultural training, and a secure market.

Conclusion

The most promising economic development programs are those that are sustainable. That is, they are able to pay for themselves, are embedded in existing systems, and fill a market need while generating a variety of public goods. Root Capital offers a sustainable approach to rural economic development by strengthening enterprises that link smallholder farmers to global value chains.

By addressing the financing needs of rural SGBs, Root Capital's approach improves livelihoods of the smallholder farmers who supply agricultural products to small and growing businesses. Beyond direct economic development in communities at the base of the economic pyramid, filling this market gap benefits actors further up global agricultural supply chains, including international buyers, retailers, and their consumers. At the same time, building rural economies through sustainable products stabilizes communities and improves their resiliency to external shocks.

While Root Capital focuses on rural enterprises in developing countries primarily as an economic development solution, its model can apply to other geographies including the United States, in industries beyond agriculture. There may be particular opportunity for community-focused financial institutions (CDFIs or CRA-motivated banks) that aim to expand beyond traditional asset-backed lending by offering additional financial products that reach underserved markets without compromising their risk profiles.

Cash-flow based lending that replaces traditional collateral with stable purchase contracts could be used to finance a variety of U.S. businesses—from small family farms to urban manufacturers—that hold purchase orders from buyers but face short-term liquidity constraints.

Further, banks that want to deepen their relationships with corporate clients that source products from small businesses may consider financing the enterprises throughout those value chains. A value chain finance strategy both facilitates banks' business development by identifying new clients that meet the sourcing standards of their existing clients, and mitigates risk by stabilizing supply chains and enabling banks to gain deeper knowledge of specific industries.

Fundamentally, Root Capital's approach is predicated on trust, transparency, and a deep understanding of agricultural production cycles and the risks inherent to rural markets, such as drought and changing commodity prices. Establishing banking relationships that respond to the specific needs of underserved markets—whether internationally or in the United States, rural or urban—requires products and repayment terms appropriate to sector-specific realities and risks. Such customization requires investing in understanding the detailed needs of each sector, an investment that can open up large, underserved markets with strong growth potential and that can spark economic and social improvements in local communities.

Patricia Lee Devaney, *Root Capital's Director of Knowledge & Impact, oversees the social and environmental impact assessment of the lending portfolio to inform organizational strategy and operations. Ms. Devaney also leads Root Capital's efforts to document and disseminate its experiences in agricultural value chain finance with the ultimate goal of attracting other financial institutions to this market and expanding access to financial services for underserved rural populations. To learn more about Root Capital, please visit www.rootcapital.org.*

International Housing Partnership Exchange

Thomas A. Bledsoe and Paul Weech

Housing Partnership Network

It started off feeling more like anthropological fieldwork than an exchange of ideas and practices among nonprofit housing leaders from the United States and Europe. At first contact, the gulf between our worlds seemed as large as the ocean we had just crossed. Our British hosts described their efforts to house “rough sleepers” and “key workers.” They talked about combating the “residualization” of tenants and the need to “increase turnover” in their properties. But after hours of stimulating discussion—adjusting for some of these language idiosyncrasies and the need to translate English to English—the U.S. nonprofit leaders realized we share a common mission and business approach with our British and Dutch cousins.

The U.S. nonprofit leaders and the European nonprofit leaders alike discovered that nonprofit housing organizations, no matter how different the policy environment, all share the mission of addressing the needs of homeless families and low-income workers. Regardless of our different locations, we are similarly charged with reducing concentrations of poverty, revitalizing communities, and generating earned income to sustain and grow nonprofit companies. As a result, a powerful bond emerged among this group of 30 nonprofit leaders from the United States, the Netherlands, and England, based on the transformative power of social enterprise and peer exchange.

In this article, we trace the evolution of this international exchange and offer insights gained from the continuing collaboration. We propose a transformative social enterprise framework that reflects the proven models of leading-edge nonprofits in the United States and Europe with advanced housing systems and nonprofit infrastructure.

Our central thesis is that both the affordable housing and community development industries, and the policy paradigm in which they operate, are at a historic inflection point in the United States. Building on the growth and evolution of these sectors, nonprofit organizations are now positioned to take the lead in tackling the nation’s most pressing community development challenges. The trend toward greater government and private-sector reliance on productive, nonprofit social enterprises is occurring in both the United States and Europe. Through international exchanges and collaboration, we can share and advance the best practices and policies from both continents that enhance our social impact and business performance. The result will be a system that encourages entrepreneurial nonprofits at a scale large enough to deliver integrative customer services, produce and operate sustainable communities, and foster economic revitalization.

European Scale and American Ingenuity

In April 2003, with generous support from the MacArthur Foundation, the Housing Partnership Network (Network) sponsored a study visit by a dozen CEOs from leading housing nonprofits in the United States to meet with their peers in the Netherlands and Great Britain. The Network is a business alliance of 96 top-performing nonprofit housing developers, owners, lenders, and housing counselors. Many of the international contacts were the result of the groundwork laid by Network founder Bob Whittlesey. His long-established ties to these European groups formed the basis of our exchange. After years of prodding anyone who would listen that U.S. housing nonprofits could learn a great deal from European housing associations, Bob's insistence finally stimulated the group's curiosity. We took the plunge and headed off to Europe. Our delegation included more than half of the Network's board of directors at that time. Leaders of many of the nation's top nonprofit housing developers attended, including BRIDGE Housing in California, CommonBond Communities in the Twin Cities, ACTION Housing in Pittsburgh, and the Community Preservation Development Corporation in Washington, DC.

We expected to be impressed by the scope and sophistication of the British and Dutch housing nonprofits. Our research showed that these organizations enjoyed a much larger share of the housing markets and benefited from national policy support. Instead, we were dazzled. We met housing associations in England that managed more than 30,000 apartments and were rapidly expanding as a result of a government policy to transfer that country's public housing stock to nonprofit ownership. Dutch housing associations had an even more central market position, with more than 75 percent of the nation's rental housing and 35 percent of the entire housing stock under nonprofit management. We encountered many business and social innovations. For example, the Orbit Housing Group, formed from the merger of several housing associations and public housing stock transfers in the Midlands and Southeastern regions of England, used a centralized back office to bring efficiency and scale to its nonprofit group members without their losing local control and community connections. Dutch housing associations in Amsterdam and Tilburg such as WonenBreda operate state-of-the-art, mixed-income communities that are models for smart design, sustainability, and inclusion. The innovative Dutch Housing Guarantee Fund (WSW), a not-for-profit foundation independent of the government, provides credit enhancements to more than 90 percent of the housing associations in country.

The greater strength and impact of the nonprofit housing sector in Europe was clear. The U.S. nonprofit leaders credited this success to the strong national policy and funding as well as an enterprise-level focus on real estate financing and housing management. The European approach contrasts sharply with the American "project-by-project," "transaction-by-transaction" approach. From what we saw in Great Britain and the Netherlands, an enterprise level focus results in a more scalable and better capitalized business model that is highly focused on efficient, quality management and resident satisfaction.

British nonprofits have a longer history of development and ownership than their U.S. counterparts. The sector grew rapidly when the national government (starting with Margaret Thatcher and the Conservatives, and expanding under Labor) shifted the responsibility for ownership and revitalization (“regeneration” as they call it) of former government-owned housing (known as “council public housing”) to existing and new housing associations. Government policy in the United Kingdom has always organized funding and regulation around the nonprofit sponsor rather than individual developments (“estates” to use British parlance).

Similarly, a national policy decision to convert all existing housing association development financing to organization-level equity capital is behind the dramatic scale and sophistication of the Dutch nonprofit field. In return for a strengthened balance sheet, nonprofits agreed to forgo future public subsidies and to fund new development with private financing leveraged by their new corporate equity.

American portfolios, in contrast, are smaller and rely on many separate, unconnected financial sources—each project with subsidies layered on top of one another, each project managed in a silo separate from the others—which makes it more difficult to leverage asset and portfolio growth. Nevertheless, the large U.S. nonprofits on the trip were surprised to learn that their annual level of housing production and preservation is comparable to their European peers. Europeans were also keenly interested in our members’ private sector, entrepreneurial partnerships and the Network’s collaborative business ventures, notably our members’ mutually-owned, captive insurance company.

Most important, the American visitors and the European hosts established a foundation of trust and candid dialogue that sets the stage for what we hope will be a long and fruitful friendship. The participants identified shared challenges, opportunities for collaboration, and common perspectives that will make ongoing exchanges highly productive and beneficial. The trip also stimulated new ideas about how nonprofits in America could be better capitalized to achieve greater scale, sustainability, and impact. The journey and the exchange reinforced the value of the Network’s social enterprise approach and its unique model as a peer-based business collaborative.

Staying in Touch: London, Stockholm, and Washington

In the days and months following the 2003 visit, we remained in touch with various European practitioners. A delegation from the Network visited London in 2004 to negotiate a reinsurance agreement between our insurance company and several Lloyds of London insurance syndicates. During this trip, we reconnected with our British colleagues and also began to explore a potential collaboration between English housing associations and the Network’s insurance company, the Housing Partnership Insurance Exchange or HPIEx.

A Network representative attended a meeting in Stockholm in 2005 of the European REX Group (Research and Exchange), a self-selected network of large housing associations, including some of our British and Dutch counterparts, as well as organizations from several other European countries. The interaction with the REX Group further influenced the evolu-

tion and depth of the Network's approach to peer exchange as a way to strengthen both the Network and its individual members. In 2006, chief executives from six associations in the REX Group visited the United States to tour properties and engage in informal discussions with four Network members in the Washington, DC, area. Following on the goodwill generated by that trip, the Network and a counterpart association in Britain, the National Housing Federation, agreed to host an in-depth, three-day, bilateral exchange in April 2007 in the United States.

The 2007 exchange brought together 40 leaders of the premier housing nonprofits in the United States and England. Significantly, the top governmental officials in the United Kingdom who oversee regulation and funding for housing (the Department of Communities and Local Government) also attended the event. The entire group met on Capitol Hill with Representative Maxine Waters, the chair of the Subcommittee on Housing and Community Opportunity. They also met with key housing staff from the offices of Senator Christopher Dodd of Connecticut and Congressman Barney Frank of Massachusetts. There was a strong camaraderie among the policy leaders and practitioners and recognition of the mutual value in further learning and exchange among the two affordable housing systems.

The British partners were eager to learn about the American public/private partnership models, our strategies to engage the business community, and our entrepreneurial ventures to finance and insure affordable housing on a pooled basis. The U.S. delegates explored the United Kingdom's approach to investing public resources directly in the nonprofit enterprise to support a broad portfolio of properties. They also explored innovative Dutch and British initiatives to create benchmarks and measure customer service, and the United Kingdom's stock transfer of public housing to nonprofit ownership.

American nonprofits were enthusiastic to learn about KVH, a performance benchmarking system pioneered by Dutch housing associations and expanded on by British nonprofits through HouseMark and QHS (Quality Housing System). Through a member-owned cooperative that establishes best-in-class metrics, KVH has created a rigorous system that has consistently raised the bar on performance. This model influenced the development of StrengthMatters, a new performance benchmarking initiative that collects and compares data on financial and operational performance of U.S. nonprofits. The British in turn were very interested in the real time, web-based technology being developed by the Network for our benchmarking system. One important area of contrast in the benchmarking systems is that the Europeans pay much greater attention to the quality of property management and tenant relations. Resident satisfaction with service delivery is the principal yardstick that the European nonprofits use to measure the quality of their products and organizations. In contrast, the American nonprofit housing provider, while often providing services to residents, tends to place more emphasis on development financing and the affordability of tenant rents.

The group participating in the exchange identified three areas for potential joint collaboration going forward and agreed to host a follow-up exchange in 2008. They were: 1) respective strategies for providing resident services (what the British called "non-landlord

activities”); 2) branding: how the industry could more effectively communicate the impacts of its work beyond housing creation and management; and 3) self-regulation and self-certification models, along the lines of those deployed by other industry groups.

The Portfolio Approach: Enterprise Investing in Action

The follow-up reciprocal exchange to the 2007 meeting took place in London in April, 2008. Leaders from 15 Network members met with the chief executives of 11 British housing associations. Additional participants from the United States included leaders of the MacArthur Foundation and Stewards of Affordable Housing for the Future. The U.K. participants included the National Housing Federation and the director general for housing and planning at the Department of Communities and Local Government. In addition, the president of PowerHousing Australia, a recently formed Australian group modeled after the Network, joined as a special guest.

Discussion over the three days focused on policy, business, and market issues that affect both countries' affordable housing sectors. It was fascinating to gain the perspectives of British and American housing leaders about the negative effects of the U.S. subprime mortgage crisis in both the United States and Great Britain. Performance metrics and certification were key areas for discussion, with a presentation of QHS, Britain's customer satisfaction certification system. The group also explored in some depth asset management, property management, and resident services practices.

An eye-opening experience (for the Americans) was a visit to the Gallions Housing Association in South London and seeing the advantages in the British structure when policy allows the housing association to manage at a portfolio or enterprise level versus managing exclusively at a project level. The highlight was a centralized customer call center with state-of-the-art technology that dramatically improves response time for tenant services at significantly lower cost. The call center demonstrated how operating as an enterprise in the British system allowed for significant economies of scale and better service. Another major theme throughout the three days of meetings was sustainable development and sustainable operations. The British housing groups have made great strides in green building, and the government has set out very aggressive goals for zero carbon development over the next 10 years. This topic has become one of the keystones on which the participants will base future international exchanges.

The British housing associations were, on the whole, astounded by the complexity and cost of the U.S. system. After hearing how individual properties each have legally segregated property management cost centers, checking accounts, project reserves, and annual audits, the British nonprofit leaders expressed bewilderment at how U.S. nonprofits could afford to operate in such an inefficient manner. One U.K. CEO tellingly said that he would be out of business if he had to operate in such a rigid system that did not better leverage the economies of scale within its businesses and distribute risks across its property portfolios.

A key outcome of the 2007 London Exchange was the commitment to formalize the collaboration through the creation of the International Housing Exchange Partnership. The participants agreed to expand the exchange to a select group of high-performing Canadian nonprofits and to hold the next meeting of the group in Toronto. The group also adopted protocols for the Exchange and created trilateral working groups in three key areas: business excellence and benchmarking; resident services; and sustainable development and operations. There is likely future interest in engaging around how to better serve aging seniors while maintaining independence.

Scaled Social Enterprises in Canada

The fourth face-to-face international exchange took place in Toronto, May 13, 2009, with the global economic meltdown as a backdrop. Leaders from 60 of the foremost nonprofit housing organizations from the United Kingdom, Canada, and the United States (plus a guest group from Australia) met to advance the previously agreed on agenda, as well as to address the impact and challenges from, and solutions to, the financial crisis at the community and organizational levels.

Key themes were the importance of repositioning social housing as critical infrastructure, the significant opportunities to spearhead community revitalization through housing initiatives, and the need to realign housing policies to create incentives for more efficient capitalization and performance. Although all participants were concerned about the prospects for obtaining much needed capital during the next several years, they also agreed that opportunity waited if leading nonprofits could adapt in new ways and apply their extensive experience to the problems at hand. The international housing leaders agreed that, in this time of enormous change and challenge, new approaches were needed to leverage the experiences of nonprofits in all three countries. The goal was to create more nimble and sustainable enterprises that maximize the ability to generate value and results for the field's partners in the private sector, government, and community. Social housing needed new policy support and capital that would allow us to operate at greater scale and impact.

The exchange featured a site visit with the Toronto Community Housing Corporation (TCHC). TCHC is the largest social housing provider in Canada and the second largest in North America with a combined portfolio serving 58,500 households. It was forged from a merger of three entities: a nonprofit developer, a cooperative housing organization, and Toronto's public housing agency. The newly constituted nonprofit has the capacity to oversee a revitalization of Toronto's most distressed public housing development into a mixed-income community using only its net worth and private financing. Derek Ballantyne, the then-CEO of TCHP, who actively participated in the exchange, remarked it was the first time he had engaged with nonprofit leaders with whom he shared a common sense of mission and business philosophy.

Comparing the Housing Systems: Financing Transactions or Enterprises?

A 2010 study by the Affordable Housing Institute compares the history, performance, and direction of the large nonprofit housing organizations in the United States and England.¹ Its analysis and conclusions track very closely with the experience and insights gained in the international exchange. Significantly, of the eight production-focused American nonprofits featured in the report, all were Network member organizations.

In the United Kingdom, and to a lesser degree in Canada, housing associations are asset-backed organizations that receive grant support from the government under a regulatory framework focused on long-term strength, production, and resident satisfaction. The grants are provided directly to the nonprofit sponsor to support the equity needs of a multiyear pipeline and production strategy. This allows the nonprofit to use its strong balance sheet, rather than a mortgage on the new development, to raise financing from private sources on favorable terms. This portfolio level approach creates a more robust platform to finance and develop housing and provides more certainty, flexibility, and sustainability for the enterprise. At the same time, the organizations derive the bulk of their income from property operations, which fosters a continuous focus on management excellence and long-term improvement. The reliance on management income from a portfolio of properties provides incentives to streamline operations and enhance customer service. Though efficient and scalable, a challenge for the more uniform British system is to encourage more innovation and experimentation and to build deeper partnerships with communities and the private sector. A second key issue for the British portfolio model is a comparative lack of information and focus on individual property-level performance. This can limit their ability to make informed asset management decisions and resource allocations among properties in their portfolio.

The affordable housing ecosystem in the United States has evolved significantly over the last 30 years with the emergence of a new breed of nonprofit enterprise that includes a large but distinct group of scaled – high-performing, high-capacity – developers and owners and an equally robust group of large community development financial institutions (CDFIs). As noted above, the Network is an alliance of the top-performing nonprofit housing developers, owners, lenders, and housing counselors, and the member organizations are among the nations’ largest producers and financers of affordable housing. Collectively, Network members have developed and/or financed more than 750,000 affordable homes and apartments, and it has provided homeownership and foreclosure prevention counseling to more than 600,000 families.²

Despite its collective and individual achievements, the Network has not achieved the scale or social market share of our colleagues in Britain and the Netherlands. Stated simply,

1 Raymond Christman, Gaynor Asquith, and David Smith, *Mission Entrepreneurial Entities: Essential Actors in Affordable Housing Delivery* (Washington, DC: Affordable Housing Institute, 2010).

2 See Neil Mayer and Kenneth Tempkin, “Housing Partnerships: The Work of Large-Scale Regional Nonprofits in Affordable Housing” (Washington, DC: Urban Institute, 2007), available at www.urban.org/publications/411454.html

we operate in a policy and funding environment in the United States that is generally not conducive to the growth and sustainability of these organizations. Ironically, the social entrepreneurship and ingenuity that is the key to our members' success is not fostered and reinforced by our housing policy system. Typical good business practices that lead to greater scale and specialization are not always encouraged or rewarded under current U.S. housing policy.

In the United States, in contrast to Europe, nonprofit development organizations (like their for-profit competitors) obtain project-specific subsidies and investments from a wide range of tax incentives and subsidy programs. Successful organizations become highly skilled at assembling resources from local, state, and federal governments and negotiating project-based financing agreements with a multiple private financial institutions and investors. This creates an entrepreneurial, partnership-based culture, but also a very complex business environment that demands that organizations be light on their feet and highly responsive to the market in order to thrive. The almost exclusively project-level orientation of this financing system also ensures that organizations maintain a strong focus on the performance of individual properties.

The counterpoint, however, is that this system produces a weaker business model for nonprofits within the U.S. system, and significantly reduces the scale of impact. The rigidly delineated real estate projects common in affordable housing finance make it difficult to efficiently manage operations, raise capital, and fuel growth and innovation. Nonprofits cannot use excess cash derived from operating efficiencies in one project to cover shortfalls or expand services in another. The business model also relies on a robust production pipeline with fees from new projects – and fundraising – supporting the organization. In turbulent times when new development is difficult, the limited revenue from operations can threaten organizational sustainability. It also restricts capacity to invest in new initiatives when partners call on nonprofits as the go-to organizations to address critical challenges, such as foreclosure prevention and neighborhood stabilization, energy retrofitting, and transit-oriented development.³

Social Enterprise at the Crossroads

The midpoint on the continuum between American social entrepreneurship and the British asset-backed organization is a form of social enterprise that draws on the strengths of both approaches. It builds on the success and best practices of high performing organizations in the United States and reflects the next stage in their natural evolution. Guided by insights from our international exchange and in collaboration with our partners, we are advancing a third generation business model for the sector that is capable of transformative and scaled impact.

3 For a cogent analysis of the strengths and challenges facing U.S. housing social enterprises, see David Smith, *More than Just Real Estate: Investing in Housing Enterprises and the Whole Delivery System* (Boston: Recap Real Estate Advisors; August 2010).

The independent New Orleans-based Gulf Coast Housing Partnership (GCHP), which the Network created in 2006 to address the housing needs following Hurricane Katrina, incorporates some of these important features. With a strong corporate balance sheet, GCHP has leveraged \$25 million of private financing at the enterprise level to quickly respond to development needs and opportunities in the region. Forging partnerships with the public sector, the business community, foundations, and other local nonprofits, GCHP has already built or rehabilitated more than 1,500 affordable homes valued in excess of \$200 million. It is a hybrid organization that operates as a housing developer and is also certified as a community development financial institution because of its balance sheet and enterprise level financing programs.

Meta-Trends Shaping the Policy and Business Environment

In the wake of the meltdown in the financial services and the housing markets, policymakers are rethinking the nature of the public support to the housing sector in general, and the future constructs of the housing finance system, specifically. The public debate has already raised fundamental questions around the contours of the federal government's role in housing finance and the need to revisit the imbalance in policy support for homeownership versus rental housing. The major challenges facing the housing sector, and the policy changes taking place to address these challenges, are not unique to the United States. Affordable housing as practiced across the developed world is facing changes in the capital markets and the structure of the financial services sector, responding to a greater awareness by the body politic of the need for sustainable development and a reduced carbon footprint, and reacting to the press to shrink public budgets and better rationalize spending and subsidies. Significant budget constraints confronting all levels of government will put a greater premium on proven performers and documented impact. Bank consolidation, credit concerns, and enhanced regulation are driving financial institutions to focus on the scale and performance of the banks' nonprofit counterparties. Add to this a new understanding of the role of metropolitan regions as engines for innovation and economic growth that will likely lead to policies that take the metropolitan economy into consideration. Institutions that can operate across an entire metropolitan region level are part of the answer.

Our own experiences, as well as the lessons learned from our international exchange, suggest these trends will reinforce the value and need for high-performing regional nonprofit enterprises that combine social mission, sound business practices, and significant capacity. This, then, is an opportune time to advance a policy agenda to improve and rationalize the delivery system for affordable housing and community development by strengthening these enterprises. We have developed a set of nine major recommendations and initiatives for consideration by U.S. policymakers, funders, and investors that can transform the productivity and business model of our sector.

Policy Recommendations: Transforming the Nonprofit Business Model

1. Increase the focus on the quality of the delivery system and value chain dynamics.

Governments at all levels should become more rigorous in their approach to the caliber and capacity of the institutions that compose the affordable housing delivery systems. Policymakers should begin to differentiate the roles played by the various participants in the affordable housing delivery system using sound management and performance criteria and focusing on the participants' production and management role in the overall value chain. We believe the high-capacity nonprofit sector will stand out for its relative capacity and impact in any objective analysis. As governments grow more confident of the metrics for assessing their counterparties' organizational strengths, they can and should consciously begin to expand the participation of the stronger entities in those instances where their partners have reached measurable levels of success. Federal, state, and local agencies administering public programs should then increasingly incorporate these regional, partnership-oriented nonprofits as key institutions in the delivery system because of their mission alignment, effective management, and role as strong counterparties. The successful British strategy of devolving public or council housing to a higher capacity and more cost-effective network of strong nonprofit housing associations is an approach that might be worth exploring in United States.

2. Change the relationship between the government and the nonprofit social enterprises.

Government and financial institutions could reframe their relationships with high-capacity nonprofit social enterprises. Typically, governmental and financial institutions treat housing development nonprofits as agents. Despite the high value, combined assets, and risk profiles of real estate businesses, U.S. financial and government systems view the individual project partnerships—rather than the sponsors, owners, and managers—as the principal counterparty. The British system funds, regulates, and evaluates housing developers and owners on the basis of their organizational and portfolio performance. The U.S. Department of Treasury and private investors took a similar approach in underwriting, investing, and regulating CDFIs as principals (not agents) and integrated business enterprises. The U.S. Department of Housing and Urban Development could signal a change in its primary focus from the individual housing project to the enterprise and the enterprise's overall portfolio by creating a single point of contact for the entity in the Department. The new relationship could potentially move toward a single master contract with specific performance measures and outcomes agreed to by the social enterprise, with increased flexibility provided by the government. There are many other examples of changes that the federal government, cities, and state housing finance agencies could make to place the capabilities, performance, and sustainability of the principal nonprofit sponsor at the center of attention.

3. Encourage and support enterprise-level finance.

One manifestation of an enterprise-level orientation would be the ability of an organization to replace project-based financing with portfolio-level financing or enterprise-level financing. Among the possibilities to consider are a line of credit secured by a pool of properties with cross-collateralization for credit enhancement. The distribution of default risks and losses against a large portfolio would allow the lender to offer more flexible and lower-cost terms on the financing package. Managers could deploy those resources across a portfolio those component assets that most need them, making for a healthier portfolio, and securing more robust collateral. A sophisticated, well-managed organization might also further lower its borrowing costs with a financing package that allows the entity to substitute assets in and out of the pool of collateralized obligations. A key advantage of the British and Dutch approach to enterprise-level finance is the increased focus and support it provides for efficient management operations and service quality for residents.

4. Encourage and support enterprise-level development and operations.

The government could foster a more powerful and reliable program delivery system if it could devise mechanisms that encourage and reinforce the management of these high-performing nonprofits as enterprises. Fundamentally, this could require a shift in approach from a rule-based control system to a program delivery system based more on outcomes, with the government and the nonprofit engaged in a flexible, contractual partnership. The government could test this approach by giving its nonprofit partners greater freedom at the enterprise and portfolio level in exchange for a greater accountability for meeting program performance, outcome, and impact standards. Most notably, under this proposed new system, in addition to allowing the aggregation of resources at a portfolio level, the U.S. Department of Housing and Urban Development could allow organizations to shift residual receipts (unused resources associated with a property that are not available for distribution) from properties with excess resources to the enterprise level where they could strengthen the overall balance sheet or reinforce other properties in the inventory with relevant needs. Operational activities, such as accounting, budgeting, reporting, compliance, and contract administration, could also be consolidated and streamlined. In portfolios with multiple properties with budget-based rents, enterprises might be able to trade lower rents or agree to predictable restraints on future rent increases on individual properties in exchange for the flexibility to move financing to a portfolio level or move resources from one property to another.

5. Allow nonprofits to take advantage of earnings to build sufficient liquidity and equity capital as social enterprises.

Like any well-run small business, successful nonprofit developers and owners require liquidity and working capital to operate and expand their enterprises. This is particularly important for the affordable housing industry given the capital-intensive nature of housing

development, the breadth of the field's real estate portfolios and management operations, and the often-extended reimbursement and payment schedules of government partners. Too often, however, governments expect nonprofits to manage without sufficient earned income or fees to support operations. As examples, Department of Housing and Urban Development program rules, as well as the underwriting guidelines used by local governments and state housing finance agencies, often prohibit or limit nonprofits from taking cash flow from their individual projects. Current policies often limit the distributions of cash flow from individual properties to the enterprise level, even under circumstances in which a for-profit owner could distribute funds to investors for their private use. This should be changed. At the margin, these current rules arguably create a disincentive to fully realize savings given that the benefits of aggressive asset management cannot accrue to the parent ownership entity. A new "pay for performance" philosophy would allow high-performing nonprofits to benefit from strong management and cost controls. The new resources would allow nonprofit organizations move their operations to a sustainable place and to expand their missions.

6. Provide growth equity capital to expand social enterprises.

The shortage of equity capital is perhaps the major barrier to expansion. The value and impact of targeted, performance-based investments at the enterprise level have been demonstrated by the Treasury Department's successful CDFI equity program that has helped to scale up and encourage private financing for loan funds. The government could similarly increase the production of high-capacity nonprofit development organizations through direct equity-like investments in these enterprises or in joint ventures and collaborations controlled by nonprofit networks. The Network has proposed a new program administered by the Department of Housing and Urban Development to demonstrate impact investing strategies. In addition, if Congress authorizes a new permanent source of equity for the Capital Magnet Fund within the upcoming rewrite of the rules for housing finance, it could also provide a new important resource to scale up the sector. Foundations and social investors can demonstrate the effectiveness of impact investment strategies in housing social enterprises through funding initiatives with major intermediaries and networks that are closely aligned with the high-producing nonprofit sector.

7. Create incentives for private-sector investments and pooled debt and equity facilities.

By strengthening their liquidity and their balance sheets, nonprofit developers will be better positioned to fulfill a third capital need: mezzanine debt financing for real estate development and acquisition. Mezzanine debt is a hybrid of debt and equity financing. It is advantageous because it is treated like equity on a company's balance sheet and may make it easier to obtain standard bank financing. Nonprofits need patient, private financing to acquire, reposition, and preserve properties, including those that could be converted from market rate housing to long-term affordable housing in many markets. Federal regulators can

encourage banks to address this need by providing investment and lending credit in revised Community Reinvestment Act (CRA) regulations for capital provided directly to nonprofit developers, CDFIs, and financial intermediaries. British and Dutch nonprofits have used their strong balance sheets to obtain lower-cost corporate financing from banks to finance their development pipelines. The European nonprofits' ability to obtain favorable financing has been enhanced by investment ratings that housing associations receive for their corporate entities from credit agencies such as Moody's and Standard and Poor's. Despite their financial and management sophistication, American nonprofits face significant obstacles in raising corporate-level debt owing to limited unrestricted net assets and earned income. To strengthen their competitive positions, it may make sense even for the strongest nonprofits to collaborate on pooled strategies and Real Estate Investment Trust (REIT)-like structures to raise preferred financing and pursue acquisition opportunities. A \$1 billion facility for best-in-class developers financed privately from financial institutions, social investors, and foundations could finance as many as 80,000 homes.

8. Promote nonprofit transparency and performance through self regulation.

Like their counterparts in other professional industries, the best-in-class housing and community development nonprofits should take the lead in developing performance standards and data collection systems that improve transparency, productivity, and outcome measurement. As the sector grows in scale and sophistication, this infrastructure and standardization will be critical for establishing an asset class of organizations that can receive enterprise-level investment. The Housing Partnership Network, NeighborWorks America, and the Stewards for Affordable Housing for the Future have made a significant progress toward this goal through the Strength Matters collaborative.⁴ With support from major foundations and financial institutions, the Strength Matters collaborative has developed standardized best practices on financial management and created a data warehouse to collect and compare information on operational and financing performance. The British nonprofit experience of using quality measurement systems to drive continuous improvement and customer satisfaction through a rigorous certification process is instructive. Self-regulation using transparent metrics and verifiable data could be a better alternative to the top-down government regulation as a way to guide the growth and evolution of the housing delivery system in the United States towards a social enterprise rather than project finance model.

9. Achieve scale and innovation through collaboration and networks.

A byproduct of the growth and maturation of the community development sector in the United States is the emergence of collaborative networks. In fact, one of the distinguishing features and assets of the U.S. "system" that has emerged through our discussion with Euro-

⁴ For more information on the Strength Matters™ collaborative and to download papers on best financial practices visit their website at www.strengthmatters.net/.

pean colleagues is the entrepreneurial networks and intermediaries that drive bottom-up innovation and experimentation. A study prepared by the Aspen Institute in cooperation with the Community Development Offices of the Federal Reserve System showed how practitioner networks like the Network and Strength Matters could play a critical role in helping systems innovate and evolve to higher levels of performance and impact.⁵ These networks can partner with government and the private sector to test new products and then bring them to scale. An encouraging example of this public/private partnership is a recent agreement announced by Department of Housing and Urban Development Secretary Shaun Donovan between the department and the National Community Stabilization Trust (NCST) to operate a National First Look program. First Look gives communities preferred access to foreclosed properties to spur neighborhood revitalization.⁶ Many of the proposed recommendations in this paper, such as an equity investment program for high-capacity nonprofits, a \$1 billion REIT-like fund, and a portfolio finance and management initiative, could best be piloted and implemented through practitioner networks, or what Secretary Donovan calls, “third sector partnerships.”

Leveraging Innovation from around the World

The policy inflection point available now provides a historic opportunity to reshape housing and community development activity for years to come. Affordable housing is uniquely positioned to connect with other key sectors such as transportation, energy, workforce development, health care, and education to promote sustainable and equitable communities. Social enterprises, such as housing partnerships in the United States and housing associations in Europe, are innovative engines that not only produce and renovate badly needed affordable homes and communities, but do so in a manner that coordinates with economic and human development strategies to achieve more ambitious social outcomes.

The Network’s international peer exchanges have served to underscore the potential effectiveness of a different delivery system model for the United States, one that is based on nonprofit housing organizations of a certain scale. Yet, our current policy framework makes it very difficult for nonprofit housing organizations to operate effectively and grow as self-sustaining and scalable social enterprises. The policy proposals outlined here incorporate insights and models from leading European practitioners, but the core ideas and approaches have also emerged through the leadership and experiences of successful nonprofit organizations in the United States who thrive within the current policy framework. These policy

5 Kristen Moy and Gregory Ratliff, “New Pathways to Scale for Community Development Finance” (Washington, DC: Aspen Institute; 2004), available at www.aspeninstitute.org/publications/new-pathways-scale-community-development-finance-paper-published-profitwise-news-and-view

6 Shaun Donovan, “Prepared Remarks of Secretary Shaun Donovan at the Federal Reserve Board Reo Summit: “Vacant Property, Strategies for Neighborhood Stabilization” (Washington, DC: Federal Reserve Board of Governors, September 1, 2010) available at http://portal.hud.gov/portal/page/portal/HUD/press/speeches_remarks_statements/2010/Speech_09012010

recommendations have been shaped by our experience about what works in communities around the country and, despite best intentions, what has not worked.

The Network's international collaboration has also been recognized for its innovative approach to peer-based exchange, learning, and cooperation among nonprofit leaders. In June 2009, the Center for Strategic and International Studies (CSIS), in collaboration with the White House and the Eurasia Foundation, invited the Network to participate in a "Civil Society Summit" of Russian and America nonprofit leaders organized in Moscow alongside the Presidential Summit. In this exchange, we learned firsthand about the challenges Russia faces on a range of critical issues, from housing and community development to education, the environment, media, and human rights. Perhaps the most striking observation was the limited and nascent nature of the civil society sector. The dearth of nonprofit institutions that can partner with government and business to tackle their pressing needs, and the lack of a collaborative culture and trust among these sectors, are two of the biggest barriers facing Russia. The development challenges in Russia served to make us appreciate the power and important role of the social enterprise sector in the United States. Despite obstacles, U.S. nonprofit housing and community development institutions have evolved in ways few would have predicted 30 years ago.

International collaboration is helping inform and accelerate the nonprofit sector's growth. The most recent exchange among nonprofit leaders from the United States, Britain, Canada, and Australia took place in Berlin, Germany in October 2010. Forty-five leaders met at the British Embassy there to discuss strategies to help their respective organizations adapt to the momentous changes underfoot in the policy and business environment. Given the forum's focus on sustainable development, Germany was chosen as the host country so participants could see firsthand innovations leading the way in energy retrofitting and green technologies. The conference underscored the imperative to evolve business and organizational strategies to be more effective partners with government, the private sector, and civil society.

The event took place against the backdrop of the British government's historic announcement of major policy changes to promote the "Big Society." Housing associations in the United Kingdom will see their funding cut for new homes development, but they gain much more flexibility in how they operate to achieve production outcomes within a more private-market context. Faced with similar budget constraints but continued need for affordable housing and neighborhood stabilization, the participants discussed ways to integrate the British portfolio and enterprise level grant-driven models with American entrepreneurship and asset-specific strategies. This synthesis framework would enable a greater market orientation while maintaining a strong mission focus and it would balance operational risk and financial return. The approach was particularly relevant to the U.S. participants who are exploring options to acquire overleveraged, private-market rental housing and convert it to long-term affordable apartments serving low- and moderate-income families.

Given the rapidly shifting policy and economic landscape, the international exchange

remains a vital resource for nonprofit executives and policymakers in managing change and driving innovation. From the journey so far, we expect new learning and practices to emerge that will raise the bar on performance of the affordable housing and community development industry in the United States, Canada, and Europe.

Thomas A. Bledsoe is the President and Chief executive officer of the Housing Partnership Network and its affiliated companies. He became the first full-time president of the Housing Partnership Network in 1998. Under his leadership, the Network has become the leading voice for the high-capacity, partnership-based nonprofits in the affordable housing industry and has launched innovative social enterprises that strengthen the performance and scale of the sector. Previously, he served as President of the Metropolitan Boston Housing Partnership, Deputy Secretary of the cabinet level Executive Office of Communities and Development in Massachusetts, and as the first Director of the Mayor's Office of Neighborhood Services in Boston. Mr. Bledsoe graduated magna cum laude with a Bachelor's degree from Wesleyan University in Connecticut and received his Masters Degree from the John F. Kennedy School of Government at Harvard. He lives in Newton, MA with his wife and four daughters.

Paul Weech is the senior vice president for policy at the Housing Partnership Network and at the Stewards of Affordable Housing for the Future. Immediately prior to joining the Network, Mr. Weech worked as a consultant to a diverse client base through Innovative Housing Strategies, LLC. Previously, Mr. Weech served at Fannie Mae in various affordable housing and public policy leadership positions, culminating in a role as the vice president for Mission Strategy and Execution in the Business Strategy Group. He has also served as the chief of staff at the United States Small Business Administration, as the staff director for the Subcommittee on Housing and Community Development for the U.S. Senate Committee on Banking, Housing, and Urban Affairs, and as a senior analyst for Housing and Credit for the U.S. Senate Committee on Budget. Mr. Weech received a master of public policy degree from the Ford School for Public Policy Studies at the University of Michigan in 1981 and a bachelor of arts in political science from Duke University in 1978. He serves on the boards of the National Low Income Housing Coalition, the National Housing Conference, and the Bollinger Foundation.

Catalyzing American Retail Investment in Community Development Finance: What Can We Learn From other SRI Success Stories?

Caroline Bressan and Eliza M. Erikson

Calvert Foundation

Overview

When Calvert Social Investment Foundation launched its current programs in 1995, with the mission of helping to end poverty through investment, we began our first foray into investing in microfinance. Through our increasing involvement in the international impact investing industry, we have seen a true scaling of targeted investments to the microfinance sector. Impact investing can be broadly defined as investments made to solve social or environmental problems while still generating a financial return.¹ The impact investing community in the United States grew to \$30 billion in 2009.² Impact investors have proven their commitment to microfinance even in times of economic crisis. This is evident in the ability of microfinance investment funds to raise more than \$1 billion in new funds from a range of capital market sources in 2009 despite the ongoing effects of the global financial crisis.³ We believe the Community Development Financial Institution (CDFI) industry is poised to be a catalyst for comparable capital in the United States. CDFIs are “mission-driven financial institutions that provide financial products and services to people and communities underserved by traditional financial institutions.”⁴ They include regulated depository institutions, such as credit unions and banks, as well as unregulated loan funds.

Calvert Foundation has worked actively in the U.S. “socially responsible investing” (SRI) industry since our inception. SRI is an umbrella term that refers to responsible methods of investment including screening, shareholder advocacy, and impact investing.⁵ With the desire to have a deeper impact, Calvert Group—an investment management company—joined with several traditional endowed foundations to establish Calvert Foundation by allocating a portion of its mutual fund assets, along with foundation financing. These funds help finance underserved communities through “impact investments” in CDFIs, affordable housing, and microfinance. Owing to its early relationship with an SRI mutual fund, Calvert Foundation has always been focused on the power of the retail investor. Raising retail investment

1 The GIIN, www.thegiin.org/cgi-bin/iowa/home/index.html.

2 2009/10 Socially Responsible Investing Trends in the United States, SIF.

3 July 2010 State of Microfinance Investment, The MicroRate 2010 MIV Survey.

4 CDFI Fact Sheet, CDFI Coalition, http://cdfi.org/uploads/other/CDFI_Fact_Sheet.pdf.

5 “Socially Responsible Investing: Top 10 Frequently Asked Questions and Answers,” Social Investment Forum.

can offer upwards of \$60 billion in programmatically unrestricted capital, a loyal long-term investor base, and favorable terms of investment. Recent studies have pointed to a significant amount of untapped investor demand for impact investment that, with education and the further development of appropriate sales channels, could be significant. Calvert Foundation believes that one way to scale impact investing in the United States is by developing financial advisor and broker relationships to reach everyday people, the true retail investors.

In the 15 years since we began actively investing, Calvert Foundation's unique business model has created a number of opportunities for cross-learning and growth within the organization. Over the years, we have become more adept at understanding our retail investors and reflecting their demand in our portfolio of investments. The impact investing community will continue to be integral in channeling funding toward socially oriented organizations. Witness what has transpired in Western Europe. Favorable tax and regulatory environments have unlocked the wallets of Dutch, British, and Swiss citizens, to name a few, and have vaulted socially responsible investments to € trillion (\$6.87 trillion) across 19 European countries.⁶ Calvert Foundation believes that these mainstream markets truly are the key to scaling community development finance in the United States.

For this reason, Calvert Foundation pays close attention to the shifting winds of investor demand. Retail investors are not a homogeneous group, and over the past seven years, investors have become increasingly interested in making an impact internationally with their investments. Even though modern microfinance began in the 1970s, it wasn't until 2004 that it started to catch the attention of the retail investor. In the fall of 2004, the United Nations announced that 2005 would be the International Year of Microcredit. The following year, the Nobel Peace Prize was awarded to Muhammad Yunus, a micro-finance pioneer, for his work with the Grameen Bank. To respond to this growing interest, in 2007 Calvert Foundation partnered with MicroPlace, a brokerage firm and online platform where retail investors could target their money toward international microfinance institutions. Although Calvert Foundation had been investing in microfinance since its launch in 1995, MicroPlace offered the ability to involve a much broader audience in microfinance and impact investing. Specifically, it gave access to those who could not meet the original purchase minimum of \$1,000, many of these being younger investors. Since the launch of MicroPlace in 2007, Calvert Foundation has attracted more than 5,000 new retail investors through the platform with an average investment size of just under \$300.

There was also a significant increase in microfinance funding by the private sector in 2007. This jump was the result of the successful development of new financing mechanisms to scale investments, such as responsibly managed, collateralized debt-obligations, or retail investment products, and pension fund allocations. Much of this growth was financed by European asset managers dedicated to microfinance and impact investment. In advance of this scaling, the microfinance industry had to make itself more investment ready. This

6 European SRI Study 2010, EUROSIF Executive Summary.

included adopting new strategies to improve the industry's transparency, organization, and responsiveness.

Our experience in microfinance has confirmed our belief that gaining access to capital markets, and specifically the retail investor segment, is the key to expanding social impact. These markets offer the consistent and significant streams of unrestricted funding needed to reach our developmental goals. While growth is important, equally crucial is ensuring such industry growth is achieved responsibly. This includes ensuring a high level of transparency, promoting strong industry associations and collectively responding to issues that arise. The CDFI industry is approaching a crossroads where it has the opportunity to grow substantially if it can capitalize on the opportunities presented and prepare itself to absorb significant growth.

Investor Demand: U.S. Market Potential

Forms of socially responsible investing have existed in the United States since the 1960s, but it has only been in the last 10 years that the idea has really begun to take off. The 2010 Report on Socially Responsible Investing Trends in the United States reports that sustainable and social managed investments (mutual funds and separate accounts) grew to more than \$3 trillion at the end of 2009, even as the overall markets contracted. Of this \$3 trillion, \$30 billion was targeted to community development financing or impact investments.⁷ Impact investments differ from other socially responsible investments in that socially responsible investments generally use screening methods to avoid investing in publicly traded companies with questionable practices while impact investments involve financing private companies and non-profits to generate and effectively measure social, environmental and financial returns. Although impact investments funded by U.S. investors have grown by \$5 billion since the last survey in 2007, there still remains a significant gap between the potential investor demand for this type of social finance and the actual amounts funded, as evidenced by the findings in a recent "Money for Good" report by Hope Consulting. It is up to the impact investment industry to reduce the barriers of entry for these potential social investors in order to reach the scale and impact that is possible.

In its recent "Money for Good" report, Hope Consulting surveyed more than 4,000 individuals on the market opportunity for impact investments in the United States.⁸ The results are extremely encouraging, pointing to a potential \$120 billion in investor capital that could be targeted to impact investments. Half of this estimated market would come from smaller-sized investments (less than \$25,000) from both nonaccredited and accredited investors. A strong case can therefore be made for developing more retail impact investing products that would allow the everyday investor to target his or her money to community development.

7 2010 Report on Socially Responsible Investing Trends in the United States, Social Investment Forum Foundation.

8 May 2010, Money for Good: The US Market for Impact Investments and Charitable Gifts from Individual Donors and Investors, Hope Consulting.

The survey also found that while only 12 percent of Americans have made an impact investment in the past, an additional 48 percent were interested but said they wanted to know more about the industry before investing. The primary issue raised was the relative immaturity of the market and the associated risk. To those surveyed, a guarantee on principal and low risk were six times more important than a high return. This desire matches well with the low risk, low volatility, and low return that CDFIs seek for investors. It also represents an almost unlimited market for CDFIs' favorable unrestricted, low-rate, long-term financing.

While the market potential is huge, the field still lacks sufficient distribution channels to match demand with the supply of impact investments. One reason for this is that many people discover new investments through their financial advisor. Approximately 45 percent of respondents to the Hope Consulting survey said they would be willing to make an impact investment through their current financial advisor or broker. This suggests that a crucial step in expanding impact investing through retail investors will be educating the advisors and brokers on the industry and convincing them to offer impact investment options on their platforms. With education, there is also the opportunity for large financial institutions such as Fidelity or Vanguard to structure and sell impact investments.

The SRI Market: The United States and Europe

The SRI market in the United States has achieved substantial growth in the last decade to just over \$3 trillion outstanding in 2009.⁹ While the SRI industry in the United States has achieved a certain level of success, significant work remains in the areas of educating the public on the SRI philosophy and working with financial advisors, brokers, and regulators to expand the sales channels available to interested investors.

The European SRI industry has also expanded at an impressive rate, more than doubling the size of the U.S. market with €5 trillion (\$7.1 trillion) outstanding in 2009, up from just under €2.7 trillion (\$4 trillion) in 2007.¹⁰ Owing to regulations involving pension fund SRI management, institutional investors have driven the growth in the European SRI market. Institutional investors represented 92 percent of total assets under management in 2009. These institutional investors include public pension funds, reserve funds, universities, and insurance companies, among others.¹¹ In addition, since 2008, the portion of retail investors active in SRI has increased in almost all countries, according to European Social Investment Forum's (EuroSIF) 2010 market study. In particular, Austria, Belgium, France, and Germany have all seen notable increases in their retail SRI market. In Switzerland, retail investors represent the majority of the €23 billion (\$31.6 billion) market, with 55.4 percent of all socially responsible investments.¹²

Microfinance is also assuming a prominent role in the SRI strategy in Europe. The

9 2010 Report on Socially Responsible Investing Trends in the United States, Social Investment Forum Foundation.

10 European SRI Study 2010, EUROSIF Executive Summary.

11 Ibid.

12 European SRI Study 2010, EUROSIF p. 51.

amount of European SRI funds targeted to microfinance investment in 2009 was an estimated €1 billion (\$1.4 billion). EuroSIF predicts that microfinance will continue to be of significant interest to SRI investors over the next few years, signaling the continued demand for microfinance-focused investment funds.¹³

How have the Europeans expanded their market so significantly? One important factor is the progressive regulation in Europe that encourages responsible investing. However, where local legislators failed to enact SRI legislation, many European financial institutions have taken it upon themselves to update their practices and invest in a socially responsible and transparent way.

The Case for Regulation

According to the EuroSIF 2010 European market study, at least eight countries in Europe have specific national SRI regulations in place pertaining to their pension systems. These eight include the United Kingdom (passed in 2000), Germany (2001), Sweden (2001), France (2001), Belgium (2004), Norway (2004), Austria (2005) and Italy (2005). Elsewhere, regulations on environmental, social, and governance (ESG) reporting for companies (France in 2001; Denmark in 2008) provide a good basis for similar developments in SRI.

The principal motivation for these regulations is the desire to enhance consumer protection, to strengthen SRI investments, and enhance transparency in financial institutions handling the public's money. The British SRI disclosure regulation, enacted in July 2000, is largely accepted as the first of its kind in Europe.¹⁴ The regulation requires that the statement of investment principles for private and public occupational pension trustees include the extent to which social, environmental, or ethical considerations are taken into account when selecting investments. Germany has passed similar legislation in its 2001 Pension Reform law requiring pension funds to report annually to their members on SRI policies. Compliance with these regulations requires little additional effort, but the impact is significant: it creates a greater level of transparency and accountability between the retail investor and the pension fund manager. Overall, these regulations have elevated the profile of SRI in Europe, helping to familiarize the public with the concept and thereby increasing the market of interested investors.

Although regulation has spurred the growth of the SRI industry in several countries, others, such as The Netherlands, have seen growth without specific SRI laws. The Netherlands does, however, have a special tax credit—1.3 percent of the average amount invested during the year in recognized socially responsible investments. The maximum exempt amount per taxpayer is €55,145 (\$75,780), proving the tax credit to be truly focused on the Dutch retail investor.¹⁵ This tax credit has resulted in socially and environmentally worth-

13 European SRI Study 2010, EUROSIF p. 17.

14 2000-2010 Celebrating ten years of responsible investment disclosure by UK Occupational Pension Funds, UK Sustainable Investment and Finance (UKSIF) June 2010.

15 Dutch Tax Administration (Belastingdiens) www.belastingdienst.nl/variabel/buitenland/en/private_taxpayers/private_taxpayers-40.html#P661_57865.

while projects that would otherwise not have had access to finance.¹⁶ Dutch pension funds have also become very active in SRI, sparked by a 2007 documentary that revealed questionable pension fund investments into high polluting companies. The scandal that followed encouraged many large pension funds to draft and implement their own SRI policies and, in combination with the favorable tax credit, this has made The Netherlands one of the most active SRI markets in Europe.

The legal framework for SRI in the United States is less supportive than in Europe. The laws, and perhaps more importantly, the practices that govern everyday retail investment contain significant barriers to increasing impact investments in the United States. The 1933 Securities Act was the first major federal legislation regulating the offer and sale of securities. It divides the investing public into accredited and non-accredited investors and defines rules for serving each type of investor group. Accredited investors include most institutional investors with total assets in excess of \$5 million, or an individual whose household net worth exceeds \$1 million. Accredited investors are permitted by law to participate in securities such as hedge funds, limited partnerships, and angel investor networks that are not registered federally with the Securities and Exchange Commission or with the state securities regulators. Everyday retail investors are only allowed to invest in securities that are registered and in full compliance with federal and state regulators. It requires a fair amount of infrastructure and financial resources to register, and therefore, most impact-investing intermediaries have not expended the effort, choosing instead to focus solely on the accredited investor market. That said, 75 percent of American investment capital is located in the retail segment, and according to the Hope Consulting report, there is \$60 billion of retail demand for impact investments. Therefore, unleashing significant amounts of capital will require tapping this segment.¹⁷

The United States has no federal regulations pertaining to SRI; however, there has been some progress at the state level. At least 17 state governments offer their employees the option to invest their retirement money in SRI funds (socially screened stocks and bonds).¹⁸ The U.S. Social Investment Forum has also recently introduced the Employees Responsible Investment Act, which proposes granting federal employees the option of selecting an SRI fund for their retirement account allocations. This bill would be the first federal legislation pertaining to SRI and, if approved, would give an SRI option to more than four million current or retired federal employees, whose funds totaled \$244.4 billion in 2009.

16 Impact Investing: A Framework for Policy Design and Analysis, The Initiative for Responsible Investment at Harvard University, January 2011, p. 60.

17 May 2010, Money for Good: The US Market for Impact Investments and Charitable Gifts from Individual Donors and Investors, Hope Consulting.

18 September 21, 2010, Social Investment Forum Applauds Introduction of Bill Allowing Federal Employees to Select SRI Retirement Option, SIF Press Release.

Looking to the Future

Although the regulatory environment has not enabled the U.S. industry's growth, traditional financial institutions can be proactive in advance of any favorable legislation, as was demonstrated in the Netherlands. To date, SRI advocates have experienced resistance from certain mainstream financial institutions to incorporating SRI practices into their policies due to varying interpretations of the definitions of fiduciary responsibility. Some managers argue that SRI could potentially lead to a lower financial return which they see as a violation of their fiduciary duties to investors.¹⁹ Similar resistance was also evident in the United Kingdom in 2000, prior to the regulation requiring pension funds to disclose environmental, social, and governance. At that time, it was common to hear pension funds claim that legal constraints prevented responsible investing. Now it is widely accepted in the United Kingdom that long-term, responsible investment is integral to fiduciary duties. With new studies showing an expansive potential impact-investing market in the United States, the SRI industry should create an enabling environment for these new entrants to the market.²⁰

One area worth attention is the tax treatment of such investments. The success of the Dutch SRI tax credit could be a model for a campaign to introduce a similar SRI tax credit in the United States. Today, there are no tax benefits or federal insurance for impact investments in the United States. Another target could be raising investor awareness of how retirement funds are allocated and pushing for greater transparency in pension fund reporting. The main driver of the SRI industry's growth in Europe has been through pension funds. In certain countries, such as the United Kingdom, France, and The Netherlands, trade unions have been granted increased say in how their pensions are managed. Thanks to this increased agency, unions have chosen to allocate some of their retirement funds to SRIs. The recent financial crisis in the United States may have increased interest among everyday investors to direct their assets to low volatility, fixed income options with impact. These are just the options that social lenders such as MFIs and CDFIs are best positioned to provide to the investing public.

Finally, the U.S. SRI industry could push for more engagement and investor activism. Engagement is defined as "a long-term process of dialogue with companies which seeks to influence company behavior in relation to their social, ethical and environmental practices."²¹ Engagement has become a common practice in the United Kingdom, with £830.1 billion (\$1.34 trillion) of assets managed through engagement mandates.²² Investors have several tools to ensure they are heard, including writing letters to senior management, filing resolutions at General Assembly meetings, voting, and, ultimately, divesting. Until then, tradi-

19 Derwall, J., Koedijk, K. & J. T. Horst (2010) "A Table of Value-Driven and Profit-Seeking Social Investors", July 13 2010.

20 May 2010, Money for Good: The US Market for Impact Investments and Charitable Gifts from Individual Donors and Investors, Hope Consulting.

21 European SRI Study 2010, EUROSIF, p. 60.

22 European SRI Study 2010, EUROSIF, p. 53.

tional asset managers will only provide the services when their clients demand it. We have significant work to do in the United States to raise investor awareness and encourage investors to communicate their desire for SRI to their asset managers.

Impact Results based on Environment

Pension Fund Involvement

Even without new regulations, pension funds can issue their own SRI guidelines. TIAA-CREF is perhaps the most obvious example of a U.S.-based pension fund that has been proactive in adopting SRI policies. TIAA-CREF is a Fortune 100 financial services company and the leading example of how socially responsible investing can be done by pension funds. It was founded through the Carnegie Foundation in 1918 to provide pensions for professors, and the fund is committed to its nonprofit heritage and mission to serve those who “serve the greater good” by investing in a socially responsible manner. As of March 31, 2010, the company had more than \$426 billion in assets under management, all of which had been evaluated through some type of SRI screen. TIAA-CREF has been an impact investor since 1985 and launched its first socially screened portfolio in 1990. The fund offers a spectrum of SRI investments. TIAA-CREF management sees social investments as a critical component of their fiduciary responsibility to investors. TIAA-CREF has also dedicated \$100 million to a four-year global microfinance investment program, further demonstrating the microfinance industry’s success in attracting mainstream investments.

The Retail Impact Investors

Microfinance-focused asset managers and funds started to gain popularity in the early 2000s as a result of the positive SRI regulatory environments in Europe and the increased focus on microfinance as a tool for development. Although there is a visible contingent of U.S.-based microfinance funds, the European market remains much larger to date. These funds structure and manage billions of dollars in debt and equity investments through a wide range of financial products, including direct financing, structured funds, and collateralized debt obligations. ResponsAbility, a Swiss social investment company, is one of the fairly few European impact investment managers that targets retail investors and that has reached a particular level of scale, with assets under management of \$889 million in 2009. A group of well-established Swiss financial institutions (including Credit Suisse) founded ResponsAbility in 2003, and today it manages funds with a minimum investment amount of \$1,000. This product may not be sold to an unaccredited U.S. investor owing to the barriers of registration required under the United States Security Act of 1933.

ResponsAbility has worked in a similar retail investor market as Calvert Foundation, although it has been able to scale to twice the size in a shorter period of time as a result of the enabling European market. In 2004, ResponsAbility became the first microfinance fund in Switzerland to be authorized by the Swiss Federal Banking Commission for public sale

on the Swiss stock exchange. A huge accomplishment, it gave ResponsAbility unfettered access to the Swiss retail market as its product could be purchased through any broker. The Swiss stock exchange also took part in the United Nation's International Year on Microcredit, further emphasizing the importance of social investment and microfinance in the mainstream Swiss financial market. The ResponsAbility Global Microfinance Fund aims for a return just above money market rates and has a conservative strategy to make it more attractive to retail investors.

ResponsAbility has been able to capitalize on the enabling environment, diversify its product offering, and has used the existing sales channels to achieve impressive growth since its inception. In the United States, in contrast, the road to growth in impact investments similar to ResponsAbility has been longer owing to regulatory barriers and a smaller SRI market. Although Calvert Foundation, for example, is a peer of ResponsAbility in many ways, it operates within a stricter financial regulatory system. Given this environment, Calvert Foundation and its subsidiary has achieved a notable size with about \$500 million in assets under management in 2010. Nevertheless, it has not reached the same level of scale as its European counterparts, even though the foundation was incorporated five years before European retail microfinance funds were formed. While a number of other factors affected its growth trajectory, the regulatory barriers and a less socially inclined financial industry made it more difficult to gain access to the American retail investor. Calvert Foundation issues Community Investment Notes, which are senior, general recourse obligations that pay investors a traditionally below-market fixed interest rate. In Calvert Foundation's experience, retail investors are not only willing to accept this below-market rate to achieve positive social impact, but they are also committed for the long term, investing up to 10 years and renewing at an average rate above 80 percent during the U.S. financial crisis.

Originally, the Note was paper-based and could only be purchased directly from the Foundation for a minimum investment size of \$1,000. In 2004, Calvert Foundation entered into an agreement with InCapital, a fixed-income securities distributor, to help distribute the notes through the Depository Trust Company (DTC). This allowed investors to hold the note electronically in a brokerage account with all their other investments. In 2007, Calvert Foundation gained access to another retail channel when it became an initial issuer to offer retail securities on MicroPlace, an eBay subsidiary and online broker in microfinance investments. Through MicroPlace, Calvert Foundation was able to lower its minimum investment amount to \$20.

While both the DTC and MicroPlace channels significantly increased Calvert Foundation's access to the retail investor, neither partnership could compete with the enabling regulatory environment in Europe and strong financial industry support, as was the case with ResponsAbility. To be able to sell the note, Calvert Foundation must register separately with each state securities regulator every year in lieu of an even more cumbersome process of registering nationally with the SEC. This is a significant barrier for new entrants looking to access the retail impact investor. Traditional financial outlets have also needed continued

education on SRI, as the concept is not as widely accepted as it is in Europe. Calvert Foundation has worked diligently for 15 years to develop relationships with brokers and financial advisors on a case by case basis, but the general accessibility of the Calvert Foundation Note still falls short of what is available in Europe.

Investment Readiness and Vehicles in the CDFI Sector

Although the microfinance industry has grown rapidly with the development of new financing mechanisms, the CDFI industry has also seen innovative financing solutions although very few, other than through Calvert Foundation, have targeted retail impact investors on a national scale. The Community Reinvestment Fund (CRF) is a national CDFI that purchases and warehouses community development loans and transfers them to an affiliated off-balance sheet or with a third-party investor, which then sells ownership interests to institutional investors. As of February 2010, CRF serviced \$515 million of managed assets while its total on-balance sheet assets were just under \$103 million in 2009.

Over time, as CRF gained experience in the institutional capital market, they began to use a variety of structured financing techniques and instruments to finance their loan purchases. These include the sale of asset-backed debt securities for economic development loans, New Market Tax Credit incentives for commercial and facilities loans, and direct placement of pooled loans with private institutional investors for affordable housing loans. These innovative structures have permitted CRF to grow considerably. However, many CDFIs are not-for-profit 501(c)3 companies, which are prohibited from accepting equity unless they transform into or create a subsidiary for-profit entity. Although there have been innovations in equity-like products offered to nonprofit CDFIs, the scale of these products (existing or promised) remains inadequate. When nonprofits are only able to take on debt financing or grants, it limits the CDFI industry's ability to grow. Once a nonprofit CDFI has reached a certain level of leverage, it is limited in its ability to grow unless it can devise some type of off-balance sheet structure, as is the case with CRF.

Explaining Success

Demand: How to Become "Investment Ready"

Although the external regulatory environment is clearly crucial to scaling capital market investment in the U.S. community development arena, there are also steps the industry can take to make *itself* more attractive to the everyday investor. Over the past few years, the microfinance industry has successfully established itself as a transparent, organized, and responsive industry—all things mainstream investors look for when making their money management decisions.

The Microfinance Information Exchange (MIX) was founded in 2002 to promote transparency in the microfinance industry by providing objective financial and social data on microfinance providers. The MIX is a free website that solicits audited financial information

along with portfolio and social impact data from microfinance institutions worldwide. The data are fully available to anyone accessing the website. MIX staff verify the submitted data to ensure accuracy. After just eight years, the MIX lists 1,400 microfinance institutions and offers data comparisons between MFIs by region, country, and legal structure. This allows potential investors to analyze and compare an institution's relative performance against its peers and industry benchmarks. MIX has introduced a higher level of transparency to the industry and in doing so has given microfinance more credibility in the eyes of investors.

While the MIX has greatly leveled the information playing field for small microfinance institutions, LuxFlag is bringing a new level of transparency to the investment vehicles that place their capital with the MFIs. Since its founding in July 2006, LuxFlag has promoted new investment in microfinance through the issuing of its "LuxFlag Label." This label certifies that microfinance investment vehicles actually do invest in microfinance and comply with certain governance criteria, including publishing regular financial reports, segregating the functions of custody and management of assets, and applying the principle of risk diversification. LuxFlag therefore increases the credibility of the certified investment vehicles in the eyes of potential investors and ensures a certain level of oversight in operations. Only European microfinance investment vehicles have been assigned the label to date, and these organizations in turn benefit from a special listing on the Finesti database, a subsidiary of the Luxembourg Stock Exchange. This is another example of greater transparency opening up new funding opportunities for organizations.

One of the primary founders of MIX is the Consultative Group to Assist the Poor (CGAP). CGAP was formed in 1995 to help create permanent financial services to the poor on a large scale. Today, CGAP has become a thought leader in the microfinance industry, publishing focus notes, technical guides, white papers, consensus guidelines and blogs, all promoting and discussing best practices in the industry. Not only do they keep the different industry constituents informed, but they also actively educate governments and policy-makers on the appropriate and enabling regulatory frameworks for financial inclusion. In this way, the microfinance industry has a champion who can work with legislators and central banks globally to make microfinance more manageable from a legal standpoint.

The microfinance industry has also proven responsive to industry-wide issues that have surfaced recently, such as client and consumer protection. A recent example of this is the "SMART Campaign," launched in late 2008 by CGAP and ACCION International's Center for Financial Inclusion in response to the global financial crisis and calls for a greater focus on consumer protection. The international microfinance community rallied around this campaign, which asked organizations at every level of the financing chain that signed on to agree to implement the six principles of consumer protection into their internal processes. These principles included ensuring transparent pricing to clients, ethical loan collections and staff behavior, privacy of client data, and avoidance of over-indebtedness. To date, the SMART Campaign claims strong support from industry players across the board: 349 MFIs, 62 networks and associations, 95 supporting organizations, and 101 investors and donors

have all signed on to comply with the principles of client protection.²³ This demonstrated responsiveness to serious industry issues gives further comfort to investors that their money will be properly managed through any problems that arise.

Significant challenges of course remain in microfinance, and the industry could learn lessons from the CDFI sector. In particular, the CDFI industry has been grappling with outcome-based impact reporting requirements to its funders for many years. Impact measurement standards have become more developed in the U.S. market, where in many ways, CDFIs have a more varied impact story, creating housing, education, health care, and jobs, all areas that need to be measured. The microfinance industry as a whole is currently tackling how and to what extent to report on social impact or social performance.

Next Steps

How to “Unlock” the Impact Investing Market

The current mindset of the American investor offers new opportunities for the CDFI industry to grow by raising investments with favorable terms from the retail markets. In Calvert Foundation’s experience, the best approach to expanding the retail market is to create and market vehicles that can meet the internal demands of the financial services firms. Every year since the implementation of our sales channel through the Depository Trust Company, the Calvert Foundation has seen a quantum leap of investment through the platform: from \$19 million in 2008, to \$36 million in 2009, to \$45 million in 2010. In 15 years of marketing and selling through investment advisory firms, Calvert Foundation has found that meeting the specific demands of interested clients means working within the entrenched U.S. distribution system for investment products and with the gatekeepers who sell and monitor them. At one brokerage firm, approval for our Note product came from the Taxable Fixed Income Trading and Legal department, while at another firm, the private bank in conjunction with the estate planning group made the decision. Ultimately, overcoming these hurdles has been the key to the Calvert Foundation’s 10 year average growth rate of 22 percent per year. Although significant challenges, costs, and uncertainty remain in creating an impact investment product targeted to retail individual investors, Calvert Foundation believes that this target market is the lynchpin to appreciably increasing the flow of American capital to disadvantaged communities. The potential funding amount not only substantial, it is also attractively structured as potentially long-term and unrestricted, resulting in an beneficial source of capital for many social enterprises.

Why Would a CDFI Want to Gain Access to the Capital Markets?

Although the premise that CDFIs should access capital markets might be a given for some, others may be asking what the benefits are of accessing private capital, particularly in

²³ www.smartcampaign.org/about-the-campaign/campaign-endorsers.

the retail segment. After all, CDFIs have been successfully raising capital through Community Reinvestment Act (CRA) funds from banks, foundations, and government support for decades. As the SRI movement grows in the United States, more retail investors will be looking for outlets where they can earn a reasonable yield on their capital, with low volatility, and also have a social impact. This retail capital can enable an industry such as microfinance or community development finance to reach a scale that would otherwise be impossible when relying on traditional capital sources for social organizations.

The potential impact of such growth on underserved U.S. communities is an extremely important consideration. Once a track record has been established, not only are the amounts invested larger, but the terms are often more favorable as well. In Calvert Foundation's experience, retail investors are willing to accept a lower rate of return (between 0 and 2 percent) at a longer term (up to ten years) for the trade-off of a stable investment that provides social and financial return. It should also be stressed again that these investments are generally unrestricted, allowing greater flexibility in their allocation. This type of capital should be very attractive to CDFIs that often must manage restricted funding sources based on product or region. Lastly, retail investments, in our experience, have had a high rate of renewal, averaging above 80 percent during the financial crisis between 2008 and 2010, and over 90 percent since inception. This proves that they can be counted on as a long-term source of financing.

Significant work remains to prepare the CDFI industry for this type of investment. As in the case of CGAP in microfinance, although CDFIs do have existing networks, the industry needs a strong voice that is representative of all industry players to champion its causes. It has become a standard for microfinance institutions looking to grow to transform themselves into regulated entities. However, mission drift is a serious concern in many of these transformations. This risk has been mitigated in the past by a group of microfinance-focused social investors who use an engagement strategy to keep the organization in line with its mission. Should more CDFIs choose to incorporate as for-profits or create for-profit subsidiaries allowing them to accept equity, similar structures could be designed. If CDFIs choose not to change their legal structures, the industry will need to innovate once again, at a larger scale, in order to expand its impact. Without such a shift in structure or new financial innovation, the growth of the CDFI industry could be limited due to capital adequacy minimum requirements.

The future for impact investing in the United States looks very promising. The domestic impact investing community can learn from the European example and begin to lobby for changes in financial regulations to encourage more transparency from financial institutions. In doing so, a more enabling regulatory environment will increase public awareness and allow organizations such as Calvert Foundation to truly go to scale. New channels must also be developed to include pension funds, brokers, and financial advisors in the socially responsible investing movement. Now more than ever, in the context of economic downturn and post-financial crisis, Americans are looking for ways to allocate their assets safely and responsibly while also having a positive impact on their struggling communities. These retail investors can offer favorable terms of investment to CDFIs. Amid high unemployment, the

growth of the CDFI industry that directly spurs the creation of new small businesses becomes ever more valuable. The microfinance industry's experience with the capital markets also offers key lessons. Should the CDFI industry be able to capitalize on this moment in history and ready itself by promoting greater transparency, strengthening its industry associations, and being prepared to act with a unified voice should any criticisms surface in the future, the opportunity for scaling their social impact is boundless.

Caroline Bressan is an Investment Officer on Calvert Foundation's International Investments Team. She joined Calvert Foundation in 2007 to assist in the launch of the MicroPlace platform. Today, she manages the Latin American investments of Calvert Foundation's \$70 million international portfolio, specifically focusing on microfinance, Fair Trade and Base of the Pyramid investments. Caroline previously worked in Bolivia with Pro Mujer designing a business education program for clients. She received her Bachelor's in Business Administration and Latin American Studies from the University of Michigan.

Eliza M. Erikson is the Chief Lending Officer of Calvert Foundation. She is responsible for the management and growth of Calvert Foundation's \$190 million portfolio of debt and equity investments to community financial intermediaries and social enterprises in the U.S. and around the world. Previously, Eliza managed Calvert Foundation's international portfolio. Prior to joining Calvert Foundation, she worked with the Corporation for Enterprise Development and the US Agency for International Development, providing management consulting and investment services to development finance institutions in the US, Latin America, South Asia and North Africa. Eliza earned a Masters in Public Policy with concentrations in finance and program evaluation from the John F. Kennedy School of Government at Harvard University, as well as an A.B. in Politics from Princeton University.

Unlocking Local Capital for Development: Shared Interest's Guarantee Fund for South Africa

Donna Katzin, Shared Interest

Robert Rosenbloom, Strategic Philanthropy Advisors, LLC

Introduction

As the world grapples with growing income disparities that leave more than three billion of the planet's people in poverty, and as the current recession shrinks the pool of public and private resources available to remedy the situation, investors and policymakers across the globe are seeking high-impact, cost-effective strategies and tools to reduce the cavernous income and wealth gap and create bridges out of poverty.¹

South Africa is a stark case in point. In 1994, when the country replaced apartheid with majority rule and elected Nelson Mandela president, South Africa was one of the most unequal nations on earth, with the preponderance of the country's wealth concentrated in the hands of 9 percent of the population.² Eighty-four percent of that wealth was deposited in the country's four major banks, which by and large did not extend credit or most other banking services to blacks, who made up 80 percent of the population.³

That year, after the country transferred political power, but left economic power concentrated in the same minority hands, Shared Interest was launched to provide U.S. investors with a catalytic vehicle to help reverse apartheid's legacy of institutionalized race-based inequality. In creating a model that would respond to South Africa's particular conditions and needs, Shared Interest established a guarantee fund that moved highly capitalized South African banks to lend to community development financial institutions (CDFIs), cooperatives, and emerging enterprises that, in turn, have supplied credit, affordable homes, and jobs to more than one million low-income black (including mixed race) South Africans. In the process, it has forged a model applicable and replicable far beyond South Africa.

1 The World Bank Development Indicators for 2008 report that almost half of the world's population, more than 3 billion people, live on less than \$2.50 a day.

2 Crait Schwabe, "Fact Sheet: Poverty in South Africa," South Africa: Human Sciences Research Council, Pretoria, July 26, 2004.

3 T.T. Mboweni, South African Reserve Bank; DI 900; "Banking Council Annual Report, 1999" cit. in, Penelope Hawkins, "South Africa's Financial Sector Ten Years On: The Performance of the Financial Sector Since Democracy," Cape Town: Development Policy Research Unit, School of Economics, University of Capetown, 2003: 16.

How Shared Interest Works

Shared Interest's fund guarantees South African bank loans to low-income black entrepreneurs, cooperatives, and the CDFIs (including microfinance institutions) that serve their communities.

Individuals and institutions (ranging from foundations to religious orders) currently invest between \$3,000 and \$1.5 million in Shared Interest for between three and five years, earning a rate of return that closely tracks that of U.S. Treasury notes. (Through an arrangement with MicroPlace, retail investors in most states can also lend as little as \$20 online.) Shared Interest invests the funds it borrows from its investors in quality debt securities, primarily U.S. government Notes, which it deposits in a U.S. bank. The bank in turn uses these securities to back letters of credit to mainstream South African financial institutions. The letters of credit secure loans to South Africa's black entrepreneurial poor through CDFIs, cooperatives, and their own small and growing businesses. Through Shared Interest, U.S. investors become the functional cosigners for emerging entrepreneurs who would otherwise be considered "unbankable."

But they are doing much more. Because Shared Interest guarantees no more than 75 percent of any bank loan (and often covers less), it moves financial institutions to begin to underwrite and take their own risk in the majority market. Having brokered and guaranteed these new relationships, Shared Interest's objective over time is to reduce its coverage and ultimately withdraw from particular transactions, leaving banks and their new borrowers working together, as a matter of ordinary business.

As Shared Interest puts the securities it purchases to work, it manages default risk through its South African partner organization, the Thembani International Guarantee Fund, which it established with RAFAD, a Swiss nongovernmental organization (NGO), in 1995.⁴ Thembani's wholly South African staff readies credit-worthy CDFIs, co-ops, and emerging enterprises to prepare their paperwork, apply for, and then negotiate what is usually their first commercial loan. With the added value of the guarantees it can provide, Thembani is also able to serve as a facilitator for its clients, brokering loans, and encouraging banks to lend at more favorable rates and terms than they would otherwise. Historically, Thembani has been able to lower interest rates to 1.5 percent above or below prime—the banks' rate for their best customers.

Once the loan proposals are submitted, Thembani frequently confers with the banks during the underwriting process and assists the borrowers in complying with the banks' and Thembani's reporting and other monitoring requirements once the loans are made. Finally, Thembani also serves as a trainer for bank lending officers, either by assisting them on a case-by-case basis throughout the transaction or, more recently, conducting classes to help them to better understand how to lend prudently to sectors they have previously shunned.

4 RAFAD (Recherches et Applications du Financement Alternatif au Développement) created the International Guarantee Fund in 1996. Since that time, the fund has managed RAFAD's guarantee portfolio, composed of 22 guarantees totaling 1,679,844 CHF in 2009.

Them bani also regularly monitors the risk of the outstanding guarantees and reports quarterly to its Credit Committee and to Shared Interest on the risk of the portfolio. This enables Shared Interest to assess the level of reserves to set aside in its Guarantee Loss Reserve Fund (GLRF) (built with its own net assets and donor capital) to protect its investors' capital from potential loss. Shared Interest's additional layer of subordinated debt and other credit enhancements includes a \$3 million facility from the Overseas Private Investment Corporation (OPIC) to cushion lenders' capital from loss in the event that defaults on guaranteed loans in South Africa cause South African banks to call on Shared Interest's underlying securities and deplete its GLRF. Them bani's Credit Committee, which approves new initiatives, can only authorize the issuance of guarantees if sufficient reserves are available to cover any projected risk. (Shared Interest representatives must approve the guarantee issued with its capital.) Shared Interest pays Them bani to place and negotiate the guarantees and to provide the necessary technical support and monitoring.

At the same time as Them bani's hands-on assistance and the GLRF help to mitigate the risk that South African borrowers will default on their loans, the guarantee fund itself reduces currency risk. Shared Interest borrows in dollars, reinvests investors' funds in dollar-denominated securities, and uses these securities to back letters of credit issued in South African rand. It does not re-lend its funds to institutions operating in other currencies. Shared Interest only incurs currency risk in the event that loan defaults result in calls on its guarantees in South Africa. Should the rand appreciate against the dollar after the guarantee is issued, Shared Interest must supply more dollars than originally anticipated to cover the call. Shared Interest protects against such possibilities by using no more than 75 percent of its guarantee capital at any one time. Moreover, it invests its GLRF in rand-denominated securities so that the value of its reserves will rise and fall with the value of its guarantees.

Additional Models

Shared Interest's is not the only loan guarantee fund. In the United States, one of the oldest and best known models providing opportunities for retail investors is ACCION International's Bridge Fund, which extends facilities to institutions in the ACCION network.⁵ Other development institutions, such as Grameen Foundation, use guarantees to enhance leverage and reduce credit risk for their own subsidiaries and network members.

Other models include large portfolio guarantees (such as those by USAID, which help to secure portfolios of loans issued by particular banks). They also include multi-country funds, such as the International Guarantee Fund (FIG), which manages the guarantee portfolio of the Swiss NGO RAFAD and operates with capital largely supplied by its member institutions in different countries.

5 ACCION reported in 2005 that its Bridge Fund borrowed from socially responsible investors who made loans beginning at \$2,000 to ACCION at below market rates – and used these funds backed local currency loans from commercial banks to nonprofit microfinance institutions. Maria Otero, "The Power of Microfinance: The Experience of ACCION International," ACCION International, 2005: 7.

Another guarantee model, pioneered by MicroCredit Enterprises (MCE), uses pledges of investors' assets (without actually borrowing them) as guarantees to back loans issued by US banks to MCE which, in turn, lends the money to MFIs around the world (www.mcenterprises.org). In the event of a call, investors pay their proportional share of their losses to MCE as tax-deductible contributions.

The increasing international interest in guarantees reflects growing recognition that, when properly financed, managed, and supported by local know-how, such vehicles play an important and unique role in development finance. Leveraging local resources, guarantees can boost the sustainability and scale of CDFIs and emerging enterprises, mitigate risk, and link new borrowers to their own countries' commercial capital.

Multisector Approach

Numerous guarantee funds and other development finance vehicles specialize in one sector, such as microfinance or Small and Medium Enterprises (SMEs), also referred to as "small and growing businesses" (SGBs). However, from the outset, Shared Interest noted that apartheid created deep craters of poverty in a number of ways, ranging from forcibly relocating black families to the country's least productive land or ethnically designated "homelands," to concentrating industry in white areas, forcing rural blacks in search of jobs to migrate to townships on the outskirts of cities. In response, Shared Interest—recognizing that South Africa's diverse communities were already implementing a broad spectrum of effective strategies to create wealth and jobs, sustainable rural livelihoods and affordable housing—decided to support and learn from them by taking a multisector approach.

Microfinance institutions, small black-owned enterprises (which were illegal outside of the "homelands" during apartheid), and new black-owned cooperatives face a common barrier: access to capital and the capacity to put it to productive use. Cognizant of South Africa's numerous development needs and approaches, Shared Interest and Them bani together devised different development strategies to address poverty in rural, periurban, and urban areas. The partner organizations work to continue to unlock capital for low-income communities in three main sectors: microfinance, rural SGBs, and affordable housing. They also work with innovative institutions to bridge boundaries between sectors.

For example, two of Shared Interest's microfinance institution (MFI) beneficiaries make credit available for low-cost housing. The first, Kuyasa, promotes individual and group saving and lending to enable low-income (primarily township) families to build, expand, or improve their homes. The second MFI, Norufin, issues loans for housing construction and improvement to the residents of traditional communities that, by law, cannot put up communally owned land as collateral. Banks otherwise unwilling to lend to such rural homeowners have extended credit to the CDFI, which lends to current and future homeowners, with a Shared Interest guarantee.

Impact

By the end of 2010, the 41 guarantees that Shared Interest has issued have benefited 1,994,546 low-income, black South Africans. The finances have reached residents in each of the country's nine provinces. The financial leverage achieved by Shared Interest's guarantee model has helped millions more. Since its inception, Shared Interest guarantees have enabled more than 99,699 economically disenfranchised South Africans to launch or expand small and microenterprises; 120,223 to build or improve affordable homes; and 1,774,381 to obtain jobs.⁶ Shared Interest's guarantees have ranged in size from \$18,124 to \$1,516,320. Their leverage has varied from a \$17,189, guarantee resulting in loans of \$32,740 to a \$711,631 guarantee unlocking \$66,000,000 in credit.

Together, Shared Interest's guarantees, totaling \$14,938,657, have leveraged \$94,504,524 in loans to organizations benefiting South Africa's entrepreneurial poor. That is, every dollar of guarantees issued has directly unlocked more than six dollars in credit. Moreover—and of particular interest today—during its 17 years of operation, Shared Interest has repaid all investors requesting repayment 100 percent of their principal and interest on time. Only six calls on its guarantees have been made as a result of full or partial borrower defaults in South Africa. However, owing to Shared Interest's risk mitigation and guarantee loss reserves, no investor has lost a penny of interest or principal.

Examples

Several exemplars showcase the benefits of guarantees as a catalyst for development. The Small Enterprise Foundation (SEF), one of South Africa's premiere microfinance institutions, is one. An early Shared Interest's client, SEF mobilizes savings and extends microloans (often beginning at less than \$100 each) to women in groups of five who use them to launch or expand tiny businesses in the provinces of Limpopo, Mpumalanga, Gauteng and the Eastern Cape. During the early 2000s, SEF was unable to obtain a loan from Standard Bank, where it had kept its accounts for 12 years, or any other commercial bank. Seeking to diversify its sources of capital and scale up, SEF obtained a series of guarantees from Shared Interest. Over a six-year period, SEF used \$1,854,397 in guarantees to unlock \$2,601,752 in commercial credit from the Amalgamated Banks of South Africa (ABSA), one of the country's largest, and Teba (now renamed U-Bank), a second-tier bank that is half-owned by South Africa's National Union of Mineworkers. This leverage helped SEF expand from 22,110 clients to 68,578, while maintaining its borrowers' 99 percent repayment rate.

Most important, the loans to SEF built the physical capital of rural communities; enhanced social capital by helping to strengthen the survival, social cohesion, and organization of these communities; and empowered women to protect their rights and enhance

⁶ These jobs include both permanent jobs created by enterprises and temporary jobs related to housing construction. The South African government estimates that the construction of each new house creates an average of 15 jobs.

their families' well-being. A study of eight SEF village centers found that "among direct programme recipients, [the] 12 month experience of physical and/or sexual abuse was reduced by 55 percent."⁷

Shared Interest issued another guarantee to Siboshwa, a sugarcane cooperative in eastern Mpumalanga, three miles from the Mozambican border. Siboshwa's workers were forcibly removed from an area declared a "black spot" during apartheid, and trucked to inhospitable, undeveloped land, before the authorities shot their cattle. After apartheid, the democratically elected government gave Siboshwa initial financing and helped them form a cooperative, while TechnoServe provided technical assistance in growing cane, managing the business, and securing markets. Shared Interest provided an \$80,496 guarantee, which unlocked a \$107,328 loan from ABSA. This enabled the cooperative to expand its acres under cultivation, increase its yield, and prepare it for financial sustainability.

Key Features

The power of the guarantee model created by Shared Interest is enhanced by several factors, including its ability to leverage local capital, strengthen the capacity of local CDFIs and small black-owned enterprises, and alter banking practices and attitudes. We consider each of those factors below.

Leveraging Local Capital

In the wake of the 2008 global recession and the G-20's call for nations to reduce deficits by 50 percent by 2013, the role has only grown for development strategies that do not sink governments deeper into debt or exacerbate cross-border exposure.⁸ Since the 1980s, many nations' debt traps have undermined their development efforts, as creditors such as the IMF and the World Bank have imposed rigorous "structural adjustment" (and "enhanced structural adjustment") and mandated austerity measures in exchange for debt forgiveness and/or access to future international investment. As a result, there is a growing interest in strategies that avoid ongoing dependency on overseas investors and markets, and instead elicit local private-sector participation to mobilize local capital for development.

Shared Interest's guarantee fund leverages local capital in several ways. First, it encourages mainstream South African financial institutions to extend credit to clients previously considered unbankable and to lend at least 33 percent more than the amount of the guarantee. (Over the years, guarantees have ranged from 19 percent to 75 percent, resulting in the extension of local loans at 1.3 to 6 times their value.) Second, CDFIs that receive commercial bank loans in turn lend the funds they borrow to previously neglected black clients. Small

7 Paul M. Pronyk et al., "Effect of a Structural Intervention for the Prevention of Intimate Partner Violence and HIV in Rural South Africa: Results of a Cluster Randomized Trial," *The Lancet*, 2006 Dec 2; 368(9551):1973-83.

8 In Toronto in 2010, the G-20 countries called for halving deficits by 2013, implying the possibility of imposing national austerity measures.

business borrowers may secure loans with less than 12-month terms, enabling community lenders like CDFIs to deploy the same funds more than once a year by relending the principal when loans are repaid. Many microfinance institutions make use of four-month repayment periods, which allows the institutions to recycle the funds to those businesses three times a year. The result is that local partners' capital and institutional support revolves funds and multiplies the value of the guarantees up to 12 times for microfinance institutions over a three-year period. (The bank lends 1.3 times the amount guaranteed, which revolves three times a year over a three-year period.)

Strengthening the Financial Skills of CDFIs and Emerging Black Enterprises

Shared Interest's guarantees enable CDFIs and emerging enterprises to receive, use, and repay loans they need to grow, reach more clients, achieve economies of scale, and become increasingly sustainable. Thembani's guidance and technical support throughout the process build skills in using financial tools such as guarantees for commercial expansion loans and help to enhance efficiencies and lessen dependency on grants.

When guarantee beneficiaries require assistance related to their particular industries, technologies, and markets, Thembani and Shared Interest often partner with specialized service providers. In the Western Cape, for example, Thembani worked closely with Stellenbosch University's aquaculture department to assist the Hands-On Fish Farming Cooperative (HOFFC). With the university's innovative trout farming methods and feed, and Shared Interest's guarantees, HOFFC enabled black farmworkers to launch a successful trout farming cooperative consisting of 35 projects on the white-owned farms where they live and work. In Mpumalanga Province, Thembani has partnered with TechnoServe to enhance the agricultural and management expertise of two sugar cane cooperatives that were able to borrow working capital with the help of Shared Interest guarantees.

The guarantees are designed to move borrowers to access commercial loans without guarantees. After utilizing Shared Interest guarantees for six years, growing and strengthening its balance sheet, SEF obtained its first unsecured loan from Standard Bank (the bank with which it has maintained an account for 18 years). After only one guarantee, the Siboshwa sugar cane cooperative was able to obtain a loan from TSB, the local sugar industry's largest financier, without a guarantee.

Finally, guarantees can be instrumental in bolstering financial intermediaries that build both social and financial capital. Guarantees to MFIs that use group or "solidarity" loans for development, for example, help to strengthen support systems that mobilize community members to back one another's loans and benefit their communities in additional ways. This system has enabled Tropical Mushrooms, a mushroom farming business in North West Province, to double its growing area, boost annual sales from R5.9 to R10.0 million, increase its workforce from 65 to 105, and create jobs to employ and encourage the careers of local youth.

Altering Banking Practices and Attitudes

More than unlocking credit for impoverished people and helping them build strong CDFIs, Shared Interest set out to promote institutional and attitudinal change to redress historical inequities in the banking system. It is far too soon to declare success with an effort that may take more than a generation. Nonetheless, the fact that Shared Interest has issued 41 guarantees and moved at least some bankers to lend to clients previously considered unbankable demonstrates the potential of the approach. Moreover, an evaluation conducted by the New School for Social Research in 2005 found that banks using Shared Interest guarantees demonstrated increased willingness to lend to emerging entrepreneurs and, over time, to consider taking a greater share of the risk.⁹

While the financial risk coverage serves as a catalyst for credit, Them bani's hands-on technical support fosters new capacity and policies. By sharing its own due diligence with mainstream financial institutions, Them bani assists the lenders in underwriting loans to the new market. In addition, during the fall of 2009, ABSA hired Them bani staff to help train 150 of its loan officers.

Such support continues throughout the life of the guarantee, particularly if credit issues arise that the bank and its guarantors must address together. When several small businesses encountered difficulties during the recession of 2008 and 2009, Them bani collaborated with the banks to avert liquidation and work out solutions to business challenges, including providing specialized consultants and identifying potential equity partners.

Challenges

Shared Interest's guarantee model faces several significant challenges to its success and growth. We outline the most prominent below.

Legacies of Apartheid Banking

Two key features of banking during the apartheid era continue to challenge South African financial institutions seeking to serve the majority market, even with internationally provided guarantees. The country's international financial isolation in the 1980s and 1990s curtailed bankers' interactions with international markets, and reduced their familiarity with mechanisms such as international letters of credit.¹⁰ Meanwhile, deeply rooted discriminatory lending practices entrenched during colonial rule and perfected during apartheid shaped

9 Frank Brunetti et al., "An Evaluation of the Them bani International Guarantee Fund" (New York: The New School, Graduate Program in International Affairs, September 2005).

10 Banks' relationships with international markets were curtailed by financial sanctions and overseas banks' refusals to roll over their loans. Chase Manhattan's decision in 1985 not to renew its loan to South Africa led other international banks to follow suit. This left the country unable to repay its mountain of short-term debt, and moved the government to declare a moratorium on further repayments pending negotiations with international creditor banks. The move sharply reduced the flow of international credit to South Africa and further isolated the country's banks.

underwriting criteria, credit policies, and attitudes. Black entrepreneurs and communities were typically not perceived as “credit-worthy,” particularly when they lacked traditional forms of collateral difficult for impoverished families to obtain, and had no formal borrowing histories, creating a vicious cycle of exclusion from credit.

Apartheid practices and perspectives further limited experience with community lending, which continues to undermine mainstream lenders’ capacity to serve the low-income black majority. During the last five years, for example, Shared Interest has found that even banks with decades of experience lending to white-owned sugarcane cooperatives are reluctant to lend to black-owned sugarcane cooperatives, even those with solid financial records. Similarly, the banks are much faster to foreclose on black farmers in trouble than on similarly situated white farmers, who are more likely to be given time to work things out. By shutting down black-owned businesses, this disturbing pattern undoes the potential for positive community outcomes. Worse, it establishes negative precedents and expectations that black-owned businesses are likely to fail and are unworthy of credit.

Borrowers’ Reluctance and Limited Capacity to Use Commercial Credit

A second challenge to continued growth is the fact that access to commercial credit is new for many in South Africa, and elsewhere. South Africa’s CDFIs, cooperatives, and emerging enterprises have had little experience with formal-sector financial institutions, and are often reluctant and unprepared to seek commercial credit on their own. They require Thembani’s technical and often moral support in applying for and negotiating loans from banks that have rejected them in the past—if they have the courage and opportunity to approach them at all.

Meanwhile, many of the newer emerging enterprises and agricultural cooperatives that have sought Shared Interest’s assistance have required extensive work with technical partners to prepare them to put commercial credit to work. The HOFFC, for example, would not be bankable today without the strong technical support of the University of Stellenbosch’s aquaculture department. Similarly, the Siboshwa cooperative would have been unable to launch or manage its profitable sugarcane business without TechnoServe’s expertise in crop production, management, and marketing. This inexperience and continued reliance on outside advice can place significant demand on supporting organizations. It elevates the time and expense of providing these services, which are critical for bringing banks and emerging entrepreneurs and communities together to “make the market.” This means that at least during the short- and medium-term, intermediaries like Shared Interest and Thembani that provide technical assistance to new market entrants are unlikely to be able to cover the cost of their non-financial services with revenues earned from their guarantee funds. As a result, for the foreseeable future, they are likely to require fees from those clients who can afford them pay for them—and subsidies for those who cannot.

Sustainability and Scale

To succeed and grow, development finance organizations such as Shared Interest require a firm foundation of “equity” or net assets. Yet building this equity is not easy if the institution is not well capitalized at the outset and must scale up loan by loan, grant by grant. For these organizations, long-term and major support is often needed to ensure their staying power and anchor their growth.¹¹ Yet such support is often very difficult to find. With limited equity or net assets, such organizations may experience difficulty in obtaining loans from larger and more mainstream investors which, in turn, is an important step toward protecting the funds they borrow and increasing their scale of operations.

Building the guarantee portfolio is further challenged by the interest Shared Interest is able to pay its lenders. The rates are capped by the gross interest the organization earns on its investments in high-quality but low-return securities (particularly in the current market). Consequently, it is not yet possible for Shared Interest to pay investors an entirely risk-adjusted return. Moreover, the lack of a market for Shared Interest notes presents an obstacle for those mainstream investors seeking enhanced liquidity, and a constraint on the organization’s potential growth.

Replicability

Going to scale with any successful venture can be difficult. As Shared Interest prepares to scale up and extend its work to other countries in Southern Africa, it confronts several obstacles. The first is that guarantees presuppose a sufficiently developed banking system that is capable of extending loans and working with international letters of credit. Unfortunately, a number of countries in the region still lack such a robust system. This means that guarantees for developmental domestic bank lending may take more time and work to establish, and are likely to be less supported by sound credit policies and lending practices.

The second obstacle is the frequent lack of a political and regulatory environment conducive to these kinds of development initiatives. South Africa is moving in the direction of fostering such an environment. Even though it lacks legislation resembling the U.S. Community Reinvestment Act, South Africa has made reducing inequality a priority and has established a series of industry-specific black economic empowerment charters, including the Financial Sector Charter (FSC). The FSC sets benchmarks for banks and a reporting system to hold them publicly accountable. Although momentum for the FSC progress has slowed during the past two years, it has had a significant impact by ensuring that the industry sets, and in most cases exceeds, transformation benchmarks, including lending to low-income black South Africans.¹² Although this is not a prerequisite for moving mainstream banks to lend

11 Nonprofit Finance Fund, “NFF Capital Partners 2009 Portfolio Performance Report” (New York: Nonprofit Finance Fund, 2010).

12 Banking Association of South Africa, Financial Sector Charter 2008 Annual Report on the Transformation of the Financial Sector of South Africa (Marshalltown: Banking Association of South Africa, January 1, 2010).

to the majority market, and its impact has varied within the context of other political pressures, it has provided strong incentives that do not exist in many other emerging economies. Without even these legal measures, there may be less incentive for banks in other countries to overcome their own barriers and inertia, and to extend credit to underserved communities.

Myopia about Microfinance

The buzz surrounding microfinance risks diverting attention from its original aims. Recently, the discovery by international capital markets that microfinance can be extremely lucrative has created both momentum and confusion. It has also contributed to over-concentration, escalating interest rates and defaults in some markets. While impressive microfinance returns have driven \$30 billion into the sector, they have also blurred the boundaries of a field whose original focus was developmental. In some countries, South Africa included, the term “microfinance” now applies to institutions such as “reckless lenders,” “payday lenders” and “loan sharks” that the government is attempting to regulate in the interest of consumers. Such inclusive terminology has blurred the perceptual lines between the categories and their basic purposes.

Moreover, by focusing investment on the more profitable microfinance institutions—primarily those top-tier MFIs already operating at substantial scale and equipped to connect to capital markets—the field is contributing to its own concentration in a subset of MFIs that compete with each other in some saturated markets, as numerous investors compete to invest in the same established MFIs. Such concentration exerts pressures on MFIs to raise their interest rates and grow quickly to meet the return expectations of investors. In the process they fuel client over-indebtedness and, in countries like India, have contributed to a backlash of consumers refusing to repay their loans.

At the same time, such top-tier MFI investment concentration is failing to support the growth of smaller and younger developmental MFIs that need capital to mature and enhance their self-sufficiency.¹³ Failing to seed the next generation of MFIs is short-sighted on the part of the investment community. Investors totally driven by profit are failing to expand the field to serve the estimated 270 million impoverished people still waiting for credit, as well as to meet MFI investors’ own need for new investment opportunities.¹⁴ The trend challenges Shared Interest to distinguish its own work with smaller institutions and its particular developmental impact in order to compete with investments offering higher financial returns.

13 In discussing Microfinance Investment Vehicles (MIVs), Reille and Sansanikone report that “The MIV market is concentrated in many respects. The top 10 MIVs account for 67 percent of the aggregate portfolio. A quarter of MIV investments are concentrated in just 10 MFIs. That said, MIV funds are invested in a larger pool of MFIs than IFIs are. In terms of instruments, MIVs are primarily invested in fixed income, of which 70 percent is hard currency. Recently, mainstream financial structures, such as securitizations, collateralized debt obligations, and credit wraps, are being adopted for microfinance investors. Finally, there is regional concentration, with 81 percent of MIVs in Eastern Europe, Central Asia, and Latin America.” From Xavier Reille and Ousa Sananikone, “Microfinance Investment Vehicles” Washington DC: CGAP Brief, April 2007.

14 In 2008, CGAP reported \$30 billion of international investment in microfinance, out of an estimated \$300 billion in funding needed to extend financial services to the planet’s unbanked poor. See Joan Trant, “Microfinance Investing with an Impact” (New York City: International Association of Microfinance Investors, 2009).

Government Policy

Policy tools that spur international lending to combat poverty are scarce. In the United States, several policy initiatives create incentives for domestic financial institutions to supply loans and grants to low-income communities. The Community Reinvestment Act (CRA), where enforced, can penalize those that do not do so. Further, the Obama administration recently approved the largest funding allocation to the CDFI Fund in its history. The fund channels government grants directly to CDFIs. However, in the international arena, no legislation provides incentives for the private sector and nonprofit financial intermediaries to combat global poverty by advancing international community lending.¹⁵ With the exception of grants through USAID, and OPIC, U.S. policy has yet to reward bank and corporate support for organizations that unlock private-sector finance for low-income communities overseas, in the way that CRA-motivated banks and CDFIs are doing at home. While U.S. policymakers articulate commitments to reducing poverty, and stabilizing and building markets overseas, their available remedies are also constrained by the volume of tax-levy dollars available to donate to international development initiatives. In this context, the government could do more to mobilize and reward private-sector loans and contributions to intermediaries fostering public-private partnerships and investment in disadvantaged communities overseas. This would be a cost-effective tool to enhance the success and leverage the results of its other international development strategies.

Lessons Learned

We can mine Shared Interest's 17 years of experience for a variety of lessons for making capital more accessible to low-income people and the small and micro-enterprises they establish and run. The first lesson is the most humbling: there is no silver bullet for eradicating poverty. Unlocking the power and potential of marginalized communities will require multiple strategies and partnerships. Shared Interest's work with MFIs, cooperatives, and other emerging enterprises has helped to leverage financial and human capital for a range of complementary approaches to combating poverty. Nonetheless, many other public- and private-sector initiatives are required to reverse centuries of exploitation and build a more equitable economy.

Mobilizing Local Capital

Despite the enormity of the task, eradicating poverty is not impossible, and mobilizing local capital lies at the heart of one of the most promising strategies for doing so. Numerous

15 In President Obama's inauguration speech, he underscored that the United States "can no longer afford indifference to the suffering outside our borders." See "President Barack Obama's Inaugural Address," (The White House, January 21, 2009, available at www.WhiteHouse.gov.) Moreover, his administration has allocated \$246.75 million during 2010 alone to the CDFI Fund. "Statement by CDFI Fund Director Gambrell on President's Signing of the FY 2010 Appropriations Bill," U.S. Department of the Treasury, Dec. 17, 2009.

international agencies will, and must, continue to invest their own funds, often in their own currencies, in development across the globe. However, it is also essential that emerging communities and nations themselves raise local capital and invest it in their own development. Clearly, guarantee funds are one mechanism to mobilize local currency resources for these purposes. The guarantees also reduce currency risk to both local beneficiaries and international investors. As noted, Shared Interest and Them bani plan to secure capital to back guarantees from South African investors, a move that will further leverage U.S. resources and enable Them bani to finance its own guarantees. The devastating lessons of dependency, distorted development, and structural adjustment have been driven home again. The recent international financial debacle planted a new red flag signaling the dangers of the kind of development that “giveth and taketh away.”

Local Partners

Local partners are another local resource that is critical to sustained success. Indeed, an important lesson that Shared Interest has learned in the process of seeding development is the invaluable role that these local partners play in a range of functions. Shared Interest’s ability to place quality guarantees, monitor and mitigate risk, measure impact, and build the skills and relationships of beneficiaries and banks would not be possible without a strong local partner. In this case, Them bani ensures that Shared Interest’s investors’ capital achieves its intended purpose with a minimum of risk, while building the field of development finance in South Africa. As Them bani collaborates in turn with additional technical assistance and mentoring organizations in South Africa, it further roots the work in local knowledge and institutions, and helps local institutions learn from each other’s experiences. These mechanisms are essential not only to implementation and mitigating risk, but to ensuring that development becomes a tool of the communities it seeks to serve.

Social Capital

The elusive, but critical “social capital” is yet another element in the sustained success of development efforts.¹⁶ Social capital takes its name from financial capital, and its importance is on par with that of finance. But it is neither quantifiable like money nor measurable like poverty. Social capital is the glue that binds communities together—the networks that connect ideas and people; the trust that springs from working together; the nonmonetary aspects that make life easier for community members and increase their collective ability to accomplish their own goals. Indeed, building social capital is as important as leveraging financial capital. Shared Interest’s most successful partners have not only developed strong

16 Harvard University professor Robert Putnam, one of the scholars best known for his pioneering work on social capital, defines the concept as “features of social organizations, such as networks, norms, and trust, that facilitate action and cooperation for mutual benefit.” Robert D. Putnam, “The Prosperous Community: Social Capital and Public Life,” *The American Prospect*, Vol. 4, No.13, March 21, 1993, pp. 35-36.

management systems and delivery models, and enhanced their scale, but have also enhanced their clients' skills, social support systems, organization, and a belief in themselves. Ultimately social capital can not only magnify the impact of development finance strategies such as group microfinance and loans for cooperatives, but also complement them with other strategies that enhance their beneficiaries' ability to meet their basic needs. SEF clients, for example, have mobilized through their savings-and-borrowing village centers to reduce violence against women and other behavior that had threatened their safety and health, and to make community clinics more responsive to their members. In so doing they enhanced their communities' interrelated physical and economic survival and well-being.

Systems Change: More Than Moving Money

Financial models that use a systems approach can be particularly effective catalysts for social change. By impacting the behavior of major institutions (such as banks) and their relationships to other market participants (such as emerging entrepreneurs), development finance institutions can achieve far greater and more enduring results than those they could produce with their own resources and episodic interventions alone. Guarantee funds with a hands-on catalytic and capacity-building component can have a profound impact on private-sector institutions and practices. Specifically they can help emerging nations mobilize their own institutions and resources to lay the foundations for increasingly equitable development on an ongoing basis. While it is much too early to declare “victory” in moving banks to lend to low-income communities, Shared Interest has demonstrated the credit-worthiness of many of its guarantee beneficiaries, and begun to move some bankers and banks to extend credit to borrowers they would have previously considered “unbankable.”

Appeal of the Model

What makes stakeholders invest in tools like guarantees? What is the appeal to investors of models such as Shared Interest's? In reality, a number of factors motivate stakeholders, some tangible, some less so. Banks that use the guarantees in South Africa, for example, have enhanced their reputations as institutions contributing to “broad-based black economic empowerment” (BBBEE), a goal of the South African government and those who elected it. Loans to low-income black borrowers enhance a lending institution's “scorecard,” the instrument that measures its social performance according to the standards of the country's Financial Sector Charter. In this context, Shared Interest and Them bani help move banks to issue loans that benefit both their balance sheets and their public profile.¹⁷

As banks move beyond their traditional comfort zones, they benefit from a low-risk introduction to a significant new market—the majority of the population. Through Shared

17 South African banks have received more than a nudge in this direction by the Financial Sector Charter. While the charter does not carry penalties like those of the U.S. Community Reinvestment Act, it does demand disclosure and creates an environment of public and governmental expectations, even without sanctions.

Interest's guarantees and Thembani's technical support, they not only mitigate their risk, they also enhance their understanding of the black, low-income market, as well as their skills in underwriting and monitoring loans to CDFIs and emerging entrepreneurs.

Shared Interest's investors, in turn, are motivated by the high social return on their investment. Many are driven by their commitment to help South Africans build an equitable economy after apartheid. Others value the financial leverage of the guarantee model and its ability to mobilize local capital for the country's unbanked majority, and particularly its women. While financial returns have tended to be lower than those of corporate and government fixed-income securities (with the exception of years such as 2009 and 2010, when U.S. government Treasury and Agency interest rates plummeted), they are commensurate with those of many other community investments.

In addition, investing in Shared Interest (and other CDFIs) provides a hedge against movements of a market with which it is only tangentially correlated. Because Shared Interest's operations do not depend on mainstream financial markets, the organization provides an opportunity for portfolio diversification. At the same time, it strengthens the most powerful economy on the African continent—an engine for growth badly needed as U.S. and European economies falter.¹⁸

Shared Interest's investors and donors, in addition to placing high priority on the social return on their contributions, are compelled by the knowledge that they are building an increasingly sustainable institution that is enhancing the capacity of South African entrepreneurs, families, and communities to support themselves. They are further motivated to support Shared Interest's strategy to alter South Africa's financial ecosystem—by moving banks to lend to their country's own majority market—ultimately without the support of guarantees. Finally they support Shared Interest's current strategy to expand its operations to reach the next 500,000 black South Africans, and to ensure its own sustainability and that of Thembani for the long haul.

Conclusion

Although South Africa is exceptional, in many ways it is not an exception. Discriminatory lending practices are not unique to South Africa. They have been entrenched across the globe, leaving diverse and exploited populations struggling to direct their own development. Such lending practices are more the norm than the exception. South Africa is like many other countries with histories of colonial rule, economic exploitation and institutionalized racial discrimination, only more so.

18 In June, McKinsey & Company issued a report entitled "Lions on the Move," which marked Africa's compound annual growth in real GDP for 2008 at 4.9 percent. This is higher than the rates for developed economies (2.0 percent), all countries reporting such data (3.0 percent), Latin America (4.0 percent), and Central and Eastern Europe (4.8 percent). It follows Emerging Asia (8.3 percent) and the Middle East (5.2 percent). Celia W. Dugger, "Report Offers Optimistic View of Africa's Economies," *New York Times*, June 24, 2010, p. A8.

Guarantees have an important role to play in building a new financial ecosystem that reduces economic disparities, roots development finance in emerging communities, and moves them forward on their own developmental paths, while providing a role for international partners without creating detrimental dependency. As Shared Interest works to further test and develop its model, and explores opportunities to extend its work beyond South Africa, it is looking to other countries in Southern Africa. With sufficient public and private support at home and abroad, its model can be replicated well beyond the region.

Donna Katzin is the founding and current executive director of Shared Interest, and previous director of the South Africa and International Justice Programs for the Interfaith Center on Corporate Responsibility (ICCR), where she focused on investor campaigns to isolate apartheid, and to promote responsible lending. She has a master's degree in community organization and planning and a doctorate in human services education and development.

Robert Rosenbloom is a principal and co-founder of Strategic Philanthropy Advisors, LLC where he specializes in working with donors who want to develop philanthropic programs that focus on increasing assets and income of low-income people domestically and internationally. Previously he directed the national and international community development programs at the JPMorgan Chase Foundation. A former Peace Corps Volunteer, Rosenbloom has a Ph.D. in Political Science from Stanford.

Translating Plain English: Can the Peterborough Social Impact Bond Construct Apply Stateside?

Drew von Glahn and Caroline Whistler

Third Sector Capital Partners

In September 2010, the United Kingdom government partnered with Social Finance, Ltd. to break new ground in financing for the nonprofit sector with its pilot program to reduce recidivism in the Peterborough prison. Dubbed the “Social Impact Bond,” or SIB for short, the instrument links private capital to the success of social programs. As announced by the British government at the time:

[The] SIB pilot is the first scheme in the world that has used new funding from investors outside government to reduce reoffending with offenders. Investors will only receive returns on their investment from the Ministry of Justice if they reduce reoffending by a set amount.¹

The SIB uses private sector capital to fund social programs that have proven to be successful. As constructed, the government agrees to repay the investors if the program succeeds in achieving agreed upon outcomes. In only stipulating desired results, the government grants investors and service providers independence to design, implement and manage the program execution.

So why do we care? By tapping the private sector, the SIB offers a unique opportunity to expand the available capital for the social sector. In their 2010 report, Hope Consulting’s research estimated that there is over \$120 billion in untapped interest in impact investing by individuals in the U.S.² And in paying for programs that have documented successful outcomes, the government sector uses its limited capital resources much more efficiently. For example, today, in the U.S. taxpayers expend over \$6 billion annually to incarcerate youths, with no measurable benefit in improving the lives of these young individuals.³ Imagine if a portion of these monies could be redirected towards programs that have proven, through scientific studies to reduce the likelihood of re-offending, putting the individuals onto a path for a more productive life. SIBs have the potential to do just that. As a result, SIBs not only expand the capital available to the social sector but in these fiscally challenged times, allow the government sector to more effectively manage taxpayer dollars.

1 “Minister Launches Social Impact Bond Pilot.” Press Release. London: Ministry of Finance, September 10, 2010.

2 Hope Neighbor, “Money for Good: The US Market for Impact Investments and Charitable Gifts from Individual Donors and Investors.” Hope Consulting. San Francisco: May 2010.

3 “The Cost of Confinement: Why Good Juvenile Justice Policies Make Good Fiscal Sense.” Justice Policy Institute. Washington, D.C: May 2009.

There are several factors that make this funding construct intriguing. In structuring the bonds, “social impact” becomes a proxy for traditional financial outcomes such as net profit. Private investors initially fund the bonds, and the U.K. government only repays the bondholders if targeted outcomes are achieved. As a result, the private sector underwrites the performance risk, alleviating the government’s exposure to commit resources to programs that differ from existing approaches. By applying external and rigorous analytics to audit the intervention, the government and investors can independently verify the program’s outcomes.

Compared with traditional social program funding, SIBs shift performance risk to the private sector. Investors, who have assumed this risk, have the opportunity for a return on their capital and the ability to redeploy that capital. If the Peterborough program is successful, the fiscal cost of incarceration can be reduced, for example, generating savings for the U.K. government and taxpayers. Programs that succeed will attract additional capital, allowing replication throughout the country. Failed programs will eventually lose funding as capital is redirected to more effective programs.

A key distinction from philanthropic grants is the use of evidence-based social metrics as a means to replicate the financial metrics that are applied in the traditional capital markets (such as Net Profit and Earnings Before Interest, Tax, Depreciation and Amortization [EBITDA]). Such social metrics permit an evaluation of the underlying performance of social programs, allowing capital to flow to those organizations with successful outcomes.

In light of this innovative demonstration of SIBs, this paper explores several questions:

- What is the U.K. Social Impact Bond? What does it offer the social sector?
- How can SIBs be constructed in order to balance the priorities of the government, investor and service provider, and in doing so, redefine traditional relationships between these players?
- Can this construct apply to the United States, and if so, what must we consider to maximize its value?

Ultimately, we believe that SIBs can be applied effectively in the United States. Given SIB’s singular focus on outcomes, the construct can accelerate a transformation toward *funding what works* and help drive an expansion of capital for the social sector.

The Peterborough SIB

Working with a group of social service agencies, philanthropic organizations, and Social Finance, Ltd., the U.K. government developed a pilot program to reduce re-offending by convicts. The program works with a target population at the Peterborough Prison, north of London. To fund the program, charities raised £5.00 million (roughly \$8 million). The parties agreed to performance metrics, with a goal to reduce recidivism within the pilot population by 7.5 percent. To isolate a direct causal effect of the intervention, control groups were established at 30 other similar prisons.

Figure 1 illustrates the basic concept of the Peterborough pilot. The six-year SIB pilot program will prepare approximately 3,000 short-term prisoners for their lives post-release and will work with them to prevent a return to a life of crime. If these services are successful and re-offending drops by more than 7.5 percent within six years, investors receive a pre-determined payment representing a share of the cost savings for the government. Should the rate be achieved, the first payout to the bond investors would occur in June 2013. The payout to investors increases as the re-offending rate declines, with investors' return capped at 13 percent.⁴

Figure 1. Basic SIB Mechanics



** Benchmarked through longitudinal study to baseline and comparative populations*

One of the key successes of the Social Finance (SF) construct in the United Kingdom is the move to expand beyond traditional government performance-based contracting. As cited in their August 2009 paper, *Social Impact Bonds: Rethinking Finance for Social Outcomes*, SF makes the following comparison:

Outcome payments are made annually in arrears in proportion to the outcomes achieved according to a pre-agreed metric of success (e.g. the proportion of prison leavers that reoffend within 12 months of release). The value of the outcome payments, linked to the corresponding cost savings to Government, is agreed at the beginning of the contract period. To disincentivise 'cherry picking' of the easiest to work with individuals from the target population, outcome payments may increase with successive percentage point improvements in the target outcome in recognition of the increasing marginal cost (and benefit) of each incremental improvement.⁵

4 Emily Bolton, "Social Impact Bonds: Unlocking Investments in Rehabilitation." Social Finance, Ltd. London: September 2010.

5 Social Finance, Ltd., "Social Impact Bonds: Rethinking Finance for Social Outcomes." August 2009.

With this approach, the bonds have potential returns of 2.5 percent to 13 percent. The return rates increase in step with the improvements in recidivism. The rates reflect the desire to provide an acceptable rate of return, while recognizing the government's desire to recapture a material portion of the fiscal savings that such a program can provide.

Where to From Here?

The Peterborough pilot took two years to formulate. Although this may be an intimidating timeframe, it is not surprising considering the myriad players and factors. Breaking new ground requires new language; redefining and realigning long-held relationships. The critical question is, what makes a program a good candidate for the SIB concept? Answering such a question uncovers the standards for replication.

We offer five factors that made the Peterborough program a good candidate for the SIB concept:

1. **It had a definable and relevant impact metric.** In this case, the starting metric was the current Peterborough Prison recidivism rate for short-term male inmates. This rate had already been measured and was easily compared against peer prisons. As the government stated, the program's targeted outcome is "*...to prevent a return to a life of crime*" – a highly relevant social agenda.

2. **There was a targetable audience for an intervention program.** Interventions map cleanly into "whole prison" populations. The ability to track the performance of this population against peer prisons gives all parties confidence in the outcome metrics. This overcomes issues related to potential "creaming" of the easy-to-serve prisoners.

3. **Investors could be confident in its impact.** Interventions used at Peterborough already exist and have been evaluated with promising results. For bond investors to put money at risk, there must be existing evidence demonstrating efficacy of the program.

4. **A cost-benefit ratio could be defined.** By targeting recidivism, the bondholders selected an outcome that directly relates to potential savings. For the government, reducing recidivism directly generates savings through lower prison operating costs and ultimately, the closing of prisons. Therefore, evaluators can directly measure the fiscal savings relative to the cost of the programs.

5. **There are cashable benefits.** Prison budgets benefit directly from lower recidivism rate (variable costs and, at scale, ability to close prisons). By lowering the costs of serving this population, the government saves money. Thus, the government can (a) use a portion of the savings to repay the bond holders, (b) address fiscal issues (lower taxes or reduce budget deficits); and/or (c) redirect public resources to other impact-oriented social programs.

The Peterborough pilot offers a good template for replication in the United States. There are differences in tax regimen, the legal system, and the state role in funding and administering many social benefits. These factors must be considered in designing an SIB for the U.S. market. None of these differences, however, have limited the cross-fertilization of other financial products over the years. It will take work, and one should not assume that developing the first SIBs in the United States would take any less time than the Peterborough experience.

What It Will Take to Make SIBs Work in the United States

One of the most important criteria of a social impact bond is that it *creates incentive for social impact*. Within the SIB construct, investors who back programs with positive social impact are rewarded, accelerating a mind-shift from traditional philanthropy to *funding-what-works*. Low performers will eventually lose funding as investors seek to direct capital toward building greater evidence of impact.

In “Making the Case for Social Metrics and Impact Investing,” Margot Bradenberg of the Rockefeller Foundation correctly states that for the sector to grow, impact finance needs to move toward standardized and trustworthy metrics.⁶ SIB’s use of metrics based upon measurable outcomes addresses her concerns. Distinguishing low- from high-impact social programs (or as Bradenberg calls it “distinguishing apples from oranges”) is possible because SIB calls for ongoing “embedded” evaluation systems as opposed to episodic “snapshots” of historical performance. A single shared impact metric, such as reduced recidivism, is used to judge performance, allowing multiple programs to collaborate to achieve impact. Again following on Bradenberg’s concerns for the sector, by taking such a standardized approach, SIBs seek to avoid the complexities, costs, and expert staffing that would limit the development of social impact financings.

Although government contracts with multiple programs could prove bureaucratically complex and confusing, SIBs actually reduce bureaucracy as providers contract with an intermediary nongovernmental agency instead of the government. The intermediary then acts as the sole interface to government, reporting on impact metrics and facilitating distribution of government savings. By taking the government out of a direct relationship with providers, SIBs transfer the risk of low performance to the private investors and require government payouts only when interventions reduce taxpayer burden.

On a positive note, the current administration appears receptive to a concept similar to social impact bonds. The most recent budget proposal allocates \$100 million for **“pay for success” programs**, or initiatives that mirror the U.K. construct.⁷ For the remainder of this paper, these terms will be used interchangeably in support of the transition of the SIB concept to the US.

Finally, tapping into private finance provides a foundation for social impact bonds or pay for success programs to develop a performance-driven social capital market in the United States. With experience and the development of a track record, bond risk should decline, further expanding the appetite for the bonds.

6 Margot Bradenberg, “Making the Case for Social Metrics and Impact Investing.” Federal Reserve Bank of San Francisco: *Community Development Investment Review*, vol. 6, no. 1, 2010.

7 David Leonhardt, “For Federal Programs, A Taste of Market Discipline.” *The New York Times*. New York: 8 February 2011.

A Cornerstone on which to Develop SIBs, or “Pay for Success” Programs in the U.S.

While the UK’s Peterborough program has set the template for SIBs, the concept is not new to the U.S. At the America Forward’s annual meeting, The Gathering, the basic framework for a SIB construct was laid out by George Overholser. In a speech at the 2007 Gathering, he discussed the need for “social investments with measurable returns.”⁸ Overholser also framed a government guarantee mechanism based on rigorous adherence to programs that have documented impact, and has now founded Third Sector Capital Partners as an intermediary focused on implementing rigorous pay for success programs in the US.

Several arrangements that resemble SIBs have already been designed and implemented in the United States. Program Related Investments (PRIs) were established in the late 1960s and have allowed the social sector to attract over \$3.7 billion in just the last twenty years.⁹ Under PRIs, the U.S. social sector has become accustomed to structuring social programs that provide financial returns. However, the investor return for PRIs is typically based on noncontingent payments. A key differentiator with SIBs is that program related investments do not stipulate measurable social outcome metrics, rather the investment’s primary purpose must be to advance the foundation’s charitable objectives. In addition, the PRI is designed to attract philanthropic dollars, not private-sector capital.

Government pay-for-performance contracts have established contingency based payments. Although pay-for-performance contracts drive the necessary accountability, the arrangements have not been developed to attract private-sector capital. In addition, these contracts traditionally stipulate the program design, rather than leave implementation to the investors and service providers as is the case with SIBs.

There have also been efforts to use private-sector capital to pre-fund services for the government. Legal contracts, however, must adhere to a strong and clear definition of outcomes if this is to work. Without clarity among parties, and contracts that document the relationships, the ability to ensure investor returns is limited.

Targeting Pay for Success Program Applications in the U.S.

An American Pay for Success program will not solve all the capital needs of the social sector. At a developmental stage, it is best to apply SIBs to certain sectors, which share specific characteristics. We at Third Sector Capital Partners believe that the criteria for an appropriate investment candidate at this time include:

Fit with Issue-Area Priorities: As the bonds unite private investors or philanthropists with government entities, alignment with issue areas is critical. Sectors such as education and workforce development are two areas in which local and federal governments have a vested

8 George Overholser, “Envisioning a \$1 Billion Social Investment Fund.” Presented at America Forward’s “Gathering of Leaders”. Miami: February 2007.

9 Lawrence, Stephen. “Doing Good with Financial Assets: An Updated Look at Program-related Investments”. Excerpt from the PRI Director, 3rd Edition. Foundation Center: 2010. http://foundationcenter.org/gainknowledge/research/pdf/pri_directory_excerpt.pdf.

interest in both increasing social outcomes and the efficiency of public funds spent. Strong government benefits will help attract public sector partners.

Likelihood of Achieving the Social Impact Goal: For investors to take the risk on a SIB, they must be convinced of its potential success. Likelihood of success is determined in part by the proposed investment’s track record of impact compared with counterfactuals, as well as the *quality of evidence* of social outcomes. For the bond design, similar rigor must be brought to impact measurement, including large sample sizes and a strong system of data capture. An area with social impact potential is Multi-systemic therapy, which offers a promising track record of redirecting high-risk youth. With more than 30 years of research and top tier evidence of positive results, juvenile redirection offers great potential for a pay for success program.¹⁰

Attractive Proposition to Government: Any bond prospect must have fiscal benefits and social outcomes to be an attractive proposition to government. For example, one promising sector for a pay for success program is healthcare, particularly senior home care. Investing in successful senior programs could generate much-desired savings for Medicare and Medicaid, particularly as the population ages. Such tangible benefits will allow government agencies to commit to definitive, ratified, and binding contracts with intermediaries and ensure a fully committed source of public payments throughout the full investment timeframe. Jeff Liebman provides an exceptional analysis of government challenges and incentives working with the social impact bond construct in his recent paper titled “Social Impact Bonds: A Promising New Financing Model to Accelerate Social Innovation and Improve Government Performance” published by the Center for American Progress.

Financial Characteristics: As private investors bear the most financial risk, it is important to develop deals with compelling benefit-to-cost ratios. Targeting a 3:1 benefit-cost ratio could generate an internal rate of return for the investor of 10 percent, and simultaneously provide fiscal savings. Investors must be convinced that the savings generated to government are “cashable”—that there is a specific government entity enjoying the fiscal savings and, hence, is willing and able to make payments to investors if the underlying programs achieve the agreed upon outcomes.

Prospects for Replication: Early deals will require a significant amount of collaboration and legal preparation, and each deal should be capable of being replicated in similar situations throughout the country. For example, a \$5 million deal in a quality pre-kindergarten program that successfully reduces special education needs would either receive a new bond investment to expand the program as part of a commitment to funding what works or be replicated by other providers and investors across the country.

For the SIB to gain traction in the United States, Third Sector Capital Partners believes it makes sense to focus on issues that best lend themselves to the above criteria. These would include: early education, recidivism, senior healthcare, high school completion,

10 Jon Baron, “Social programs that work: Multisystemic therapy for juvenile offender.” Coalition for Evidenced-Based Policy. Washington, DC: 2010 Available: http://evidencebasedprograms.org/wordpress/?page_id=120.

individuals with disabilities, and workforce engagement. Although the application of pay for success programs are not restricted to these areas, finding the right criteria “match” between evidence-based social programs, government, and investor priorities will be challenging. We believe these areas have the greatest potential to yield successful bonds, the most important criterion we need to build confidence in a broader SIB market.

Challenges and Considerations for SIBs/Pay for Success Programs

A 2009 Monitor report titled *Investing for Social & Environmental Impact: A Design for Catalyzing an Emerging Industry* by Jessica Frieriech and Katherine Fulton forewarns that one of the sector’s greatest risks is “sloppy execution.”¹¹ It is imperative that as the SIB concept develops in the United States, the intermediaries involved in early stages set benchmarks for quality design. This does not mean deals are highly customized, but rather, designed to have impact *and* be replicated.

There are several challenges in implementing and scaling up SIBs, including:

Data Integrity: This is not unique to the SIB. It has been raised in many journals and reports, including in Ben Thornley and Colby Daily’s lead article of volume 6, issue 1 of the *Community Development Investment Review*. Appropriately, they state “The very practice of nonfinancial performance metrics holds the promise of building scale in community impact investing.”¹² They cite the benefits that the “traditional” investment sector has gained from using quality metrics. In particular, they highlight the Global Investment Performance Standards’ axioms to ensure quality metrics:

- Longitudinal data to reflect performance over time
- Comparison to a baseline and external benchmarks
- Independent third-party verification
- Disclosure of calculation methodologies and definitions
- Timely release and update of information

When assessing social impact, it is particularly important to establish valid counterfactuals, often via a control and experimental group in evaluations. The Peterborough pilot has incorporated these benchmarks and methodologies. It will be imperative that SIB constructs in the United States apply the same standards for evaluation.

The data collection and verification process will be demanding. Costs are still unclear for accessing and analyzing the necessary outcome metrics. However, analysts have made great strides in harnessing the data that is generated as a byproduct of running government programs. For example, organizations such as the Justice Research Center have developed an expertise in

11 Jessica Freireich and Katherine Fulton, “Investing for Social and Environmental Impact: A Design for Catalyzing An Emerging Industry. (Boston: Monitor Institute, January 30, 2009).

12 Ben Thornley and Colby Daily, “Building Scale in Community Impact Investing through Nonfinancial Performance Measurements.” Federal Reserve Bank of San Francisco: *Community Development Investment Review*, vol. 6, no. 1, 2010.

working with multiple government juvenile justice department databases. With this capability, it becomes easier to apply statistical data analysis and measure the efficacy of programs.

Sufficient Returns: The success of attracting investors will in part be driven by the potential returns. In the Peterborough pilot, the returns are targeted at 2.5 to 13 percent. However, not all programs that drive social change will have high returns. It is hoped that as the sector scales, investors will diversify their portfolios, allowing the growth of pay for success programs that have quality social outcomes with lower yields.

Redesign of Government Contracting: Combining multi-year contingency-based contracts with payouts to third-party investors conflicts with many existing state and federal funding requirements. In addition, state government contracts have historically focused on process and oversight. In the SIB construct, the contracts will focus on outcomes and less on process, leaving execution to the providers. The legal and legislative work necessary to generate an acceptable SIB contract will most likely be significant.

Establishing an Intermediary: Like any nascent innovation, there needs to be the appropriate coordination and oversight of the process. The integration of the social, financial, and legal issues is complex and, as evidenced in the United Kingdom, takes time to resolve. In the traditional capital markets, banks play a key role in intermediating, particularly for new financial innovations. In the pay for success program marketplace, intermediary organizations will need to develop to coordinate among the government, service providers, and investors. At Third Sector Capital Partners, we believe that these intermediaries will provide two key functions. The first will be to design, structure, negotiate, and execute on the bond construct. In this phase, they will play a role in arranging the investor capital, either through managing a fund directly, or acting as placement agent on the bonds. Post closing of the financing, an intermediary will be required to provide oversight for the program, ensuring independent verification of outcomes is obtained, and to arrange for capital flows between the various parties following the agreed upon terms. To accomplish the structuring and arrangement of the bonds, a new breed of organizations will need to develop, bringing together the skills to appropriately represent each of the players.

Recognizing the challenges and addressing them head-on are critical. The adaptation and application of SIBs in the United States will not be easy. It will require a disciplined process, focused on the details and sensitive to the changes that it is asking of each party from the “traditional” way of doing business.

A Vision for Transforming the Social Capital Infrastructure in the United States

In their report, “Human Services Finance for the 21st Century,” Deloitte and Touche argued that “by rethinking traditional grant making . . . investment banking could infuse capital into the nonprofit sector, while bringing inherent lending rules and accountability.”¹³

13 “Human Services for the 21st Century: A Blueprint for Building Stronger Children and Families”. Deloitte Development, 2009.

As a general statement, the United States is considered very receptive to innovation in the financial markets—and scaling the application of new financial instruments to a higher level. There is no reason that this could not be the case for SIBs. The flow chart on the opposite page illustrates a potential construct of a U.S. pay for success program.

SIBs could easily follow the development stages of other financial products, namely: (1) proof of concept; (2) expansion and replication; (3) structural variance; and (4) the development of impact measurements and legal construct standards. The first, proof of concept, will require replication of the U.K. experience with several transactions here in the United States. These will be highly vetted and documented programs. Being “first-to-market,” these pay for success programs will be customized to meet their unique characteristics. That said, one must be mindful to ensure that every attempt at creating standards for future transactions be considered.

Expansion and replication, the second phase, should see the beginning of investor returns on the first transactions. These successes will allow the market to perceive the value and benefits of the bonds. Initial investors will have the opportunity to recycle their returns into new programs funded through the proceeds of maturing earlier bonds. Secondary markets begin to provide rapid takeout and recycling as investors sell partially mature bonds to other investors for a premium.

At this point, structural variants should develop. Tapping specific pockets of capital, new investors will be able to select among risk categories, allowing for new social impact service models to develop. Tax incentives and philanthropic layers of “first loss” make bonds attractive to retail channels.

Finally, impact measurements and legal construct standards take hold as documentation and use of outcome metrics become widely accepted. A growing perception of combined social and financial success should develop, igniting a virtuous cycle that results in hundreds of SIB issuances. The number of issuances (and varieties) becomes large enough to support comprehensive ratings agencies, central payment clearinghouses, impact metric specialist firms, and other supporting infrastructure.

Before scoffing at the audacity of such a development, consider the now ubiquitous bank loan market. Prior to 1990, the market for lending to U.S. corporations shared many of the same characteristics that appear to constrain the pay for success program opportunity:

- All transactions were “one-offs” with no market transparency.
- They were heavily documented with highly customized performance commitments.
- There was no standardized documentation;
- Covenants restricted the ability to assign loans among potential investors; the loans remained with the bank that originally extended credit to the corporate borrower.
- No marketplace existed to trade bank loans.
- The system required credit “experts” to interpret and track performance—whole departments of specialists analyzing an issuer’s performance and adherence to agreed upon performance metrics.

Beginning in the late 1980s, banks instituted a process of creating a marketplace for loans. This required a major change in how financings were structured, one that sought standardization in performance metrics and associated contracts between the parties. By 2007, the U.S. syndicated bank loan market had grown at a rate that exceeded the country's rate of growth in gross domestic product over the same period. Today, through mutual funds, even retail investors can invest in these types of debt instruments.

Experts would agree that the increase in transparency, the standardization of performance metrics, and embedding this culture in the finance world has expanded the availability of capital for the global economy. There is no reason that such a disciplined approach to SIBs couldn't expand the capital available for the social sector.

Returning to the U.K. experience and expectations, Social Finance Ltd, one of the key partners in the Peterborough pilot, estimates the potential of SIB financing in the United Kingdom:

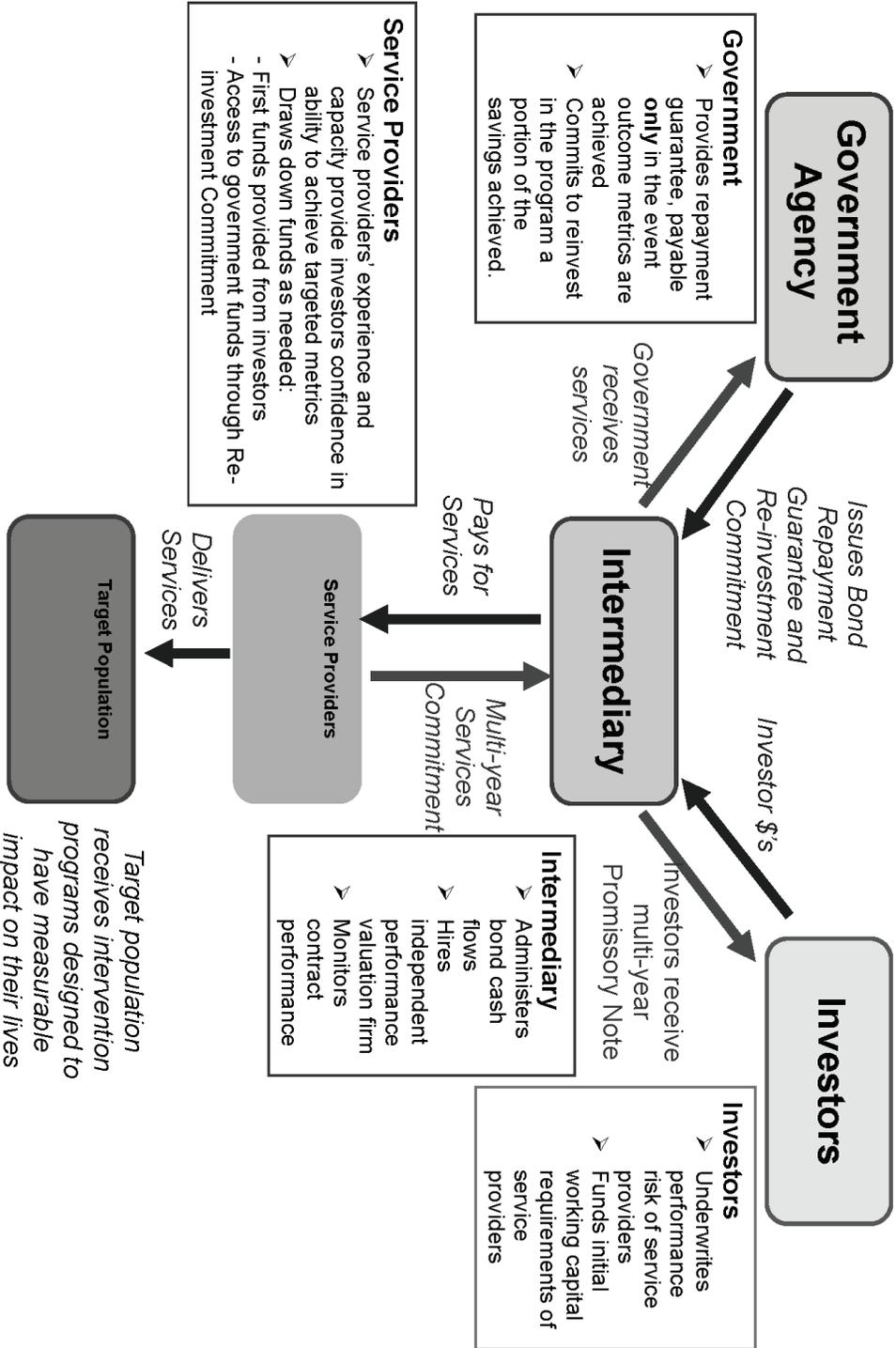
If just 5% of charity investment assets, 0.5% of institutionally managed assets and 5% of retail investments in U.K. ISAs were attracted to social investment this would unlock more than £10 billion of new finance for social projects.¹⁴

Just applying the percentages for the first two categories above to the larger US economy would equate to \$73 billion in capital available for programs that drive social impact.¹⁵ Given the challenges of today's funding environment for the nonprofit sector, the multiple benefits of SIB, and the opportunity to access new pools of capital, the social impact sector should feel compelled to investigate the development and application of the social impact bond here in the United States.

¹⁴ Emily Bolton, "Social Impact Bonds," September 2010.

¹⁵ Numbers calculated from "Foundations Today Series: Highlights of Foundation Yearbook." Foundation Center: October 2010. http://foundationcenter.org/gainknowledge/research/pdf/fy2010_highlights.pdf and Reid, Collins, Holden, Steenstra. A Review of Trends and Activities in the Investment Company Industry. Investment Company Fact Book, 50th edition. Investment Company Institute: 2010.

Figure 2. Potential U.S. SIB Construct



Drew von Glahn is Managing Director and Co-Founder of Third Sector Capital Partners a nonprofit firm, which has a mission to expand the capital availability for social enterprises. Third Sector's team develops, structures and funds initiatives that have measurable social impact. Working with government agencies, service providers and philanthropists, Third Sector is actively involved in developing the application and marketplace of Social Impact Bonds here in the United States. Previously, Mr. von Glahn was the CEO of the social venture subsidiary of the Alliance for Families and Children. Prior to spearheading FEI, Drew spent over twenty years in finance, working for such global financial firms as Credit Suisse and the predecessor firms to JP Morgan Chase. He has extensive experience in structuring debt financings, having arranged over \$30 billion in issuances, across different products and different markets. His areas of expertise include corporate and public finance, capital markets, new venture equity investing and strategic business advisory. Mr. von Glahn graduated from the Boston College Carroll School of Management with degrees in Economics and Accounting.

Caroline Whistler joined Third Sector Capital Partners after completing a Fulbright Fellowship in Brazil researching nonprofit sustainability. Previously she worked at NFF Capital Partners, where she structured growth capital campaigns for nonprofits. NFF Capital Partners is a leader in applying growth metrics and accountability to equity-like financing for high performing nonprofits. The programs on which Caroline worked helped raise \$320 million for such nonprofits as Project Health, Stand for Children and Year Up. Prior to NFF, Caroline conducted nonprofit analysis, market research and a study of sustainability for a foundation at Community Wealth Ventures, a social enterprise consulting firm. Caroline was a Robertson Scholar at Duke University where she graduated Phi Beta Kappa with a B.A. in Political Science and African Studies.

Learning Social Metrics from International Development

Paul Veldman

Columbia University

The goal of community development should be to improve the lives of as many disadvantaged people as possible with a minimum amount of resources. The field can achieve this goal by identifying those community development projects that are both efficient and have significant social impacts, and then scaling up. However, without effective evaluations, it is impossible to gauge progress. Effective evaluations include randomized experiments and well-designed observational studies, both of which can measure the impact to society. This article analyzes the best evaluation methods in international development, including examples of evaluation toolkits, with the aim of helping community development practitioners apply the methods to projects in the United States. The article also includes steps and recommendations to increase the quantity and quality of evaluations for community development projects.

Introduction

In many respects, the U.S. community development field lags the international development community in the number and precision of evaluations methods used to measure social impacts. Evaluations are costly in both time and resources, and they can divert social enterprises from delivering valuable services or goods to clients. However, sound evaluations result in information that can help guide more effective development projects while using funds more efficiently. Furthermore, when the results are publicly shared, the entire development community benefits. In the long run, quality evaluations will result in more development goals being achieved for less money.

With high “opportunity costs,” evaluation research becomes a balance between collecting valuable information to improve operations and delivering goods and services to a target population. In contrast, in the for-profit arena, the market often automatically generates the information needed for an industry to evaluate its operations and make the decisions that allow it to operate more efficiently. Although some market indicators can be used to improve the efficiency of development projects, these projects are usually implemented precisely to address the breakdown of information that results from market failures.

In the United States, several programs and policies support antipoverty and community development programs, including the Community Reinvestment Act of 1977 (CRA). CRA redresses the market failure of inadequate access to capital in low-income areas. The CRA requires regulated financial institutions in the United States to meet the credit needs of

the local communities where they do business. The CRA investments are often funded in conjunction with nonprofits and federal, state, and local governments.

CRA investments have allocated billions of dollars to community development projects across the United States. However, the social impact of these investments is rarely evaluated. Those evaluations that have been done are generally so poorly executed that it is difficult to assess whether the goals of the program are being addressed, let alone achieved. Declaring that an investment has allowed a school to build new classrooms reveals nothing about whether school attendance has increased, test scores have increased, or graduation rates have improved. Even if the goals are met, a proper evaluation is still needed to determine whether other, less-expensive and more efficient interventions would have achieved the same outcomes. Rigorous evaluation also reveals the reason why a certain project or policy succeeded or failed, which is valuable information for future development practitioners.

To date, evaluations in U.S. development projects have been underfunded, for a variety of reasons. Many government departments and institutions, for example, do not require them. Evaluations are technically complex and can raise questions of data accuracy and bias in reporting. Further, it is difficult to standardize evaluations, which reduces the ability of third parties to understand and use the data. Evaluations can also be politically damaging, particularly if the results are negative. Methodologically, quality data are often unavailable;¹ it is sometimes difficult to account for externalities; and selection biases in funding can confound results. Finally, there is a general lack of consideration for long-term analysis, and there are few incentives to develop new tools needed for evaluations.²

A further problem with evaluations is that practitioners want rapid feedback, both to make managerial decisions and to appease donors. However, researchers often need much more time to collect and analyze data. It can sometimes take years before certain social impacts from a program can be measured. This “myopia bias”—the tendency for short-term impacts to be more readily studied than long-term impacts—inevitably leads to the funding of development projects that provide short-term results, which are often less effective.³

In addition, the market does not accurately value the public benefits—positive externalities—of evaluations. Practitioners would benefit from more data because they could design more effective development projects when using the results from the evaluation of other projects. This added value is often not considered sufficiently important to incur the costs for the evaluation. Also, evaluation research is underfunded because development impacts are difficult to identify and measure. Most development projects have spillover effects that

1 Judy L. Baker, *Evaluating the Impact of Development Projects on Poverty: Handbook for Practitioners* (Washington, DC: LCSPR/PRMPO, The World Bank, 2000). See also Lisa A. Hagerman and Janneke Ratcliffe, “Increasing Access to Capital: Could Better Measurement of Social and Environmental Outcomes Entice More Institutional Investment Capital into Underserved Communities,” *Federal Reserve Bank of San Francisco, Community Development Investment Review*, vol. 6, Issue 1, (2010).

2 Martin Ravallion, “Evaluation in the Practice of Development,” (New York: World Bank, March 2008). *The World Bank Research Observer*, vol. 24, no. 1 (February 2009)

3 *Ibid.*

affect the surrounding community. These effects are often unintended and not measured. More focused development projects, with well-defined beneficiaries, are more likely to be thoroughly evaluated. The evaluation field is further complicated by the tendency of development practitioners to disguise advocacy information as evaluation research. They often only highlight successful projects and ignore failures for the purpose of attracting donors.⁴

However, attitudes are changing. Nonprofits, government agencies, foundations, and social entrepreneurs are realizing the benefits of evaluation and the need to address obstacles to evaluation. The various groups have developed several cost-effective evaluation methods and toolkits, some more rigorous than others. This paper discusses five methods of effective evaluation: randomized evaluation, observational evaluation, cost-benefit analysis, citizen participation, and process evaluation. Before discussing these methods in more detail, I discuss several aspects that all well designed evaluations share.

Best Practices of Evaluation Methods

Evaluation research provides greater value when it demonstrates causality. Causality is the relationship of an intervention to a change in a society, where the change in society is a consequence of the intervention. In other words, the intervention is directly responsible for the change. It is isolating this causality that is difficult, if not impossible, and usually expensive. Isolating causality requires controlling for a large number of variables, which is difficult when analyzing a community or society.

A development project creates a chain of events, referred to as the “results hierarchy.”⁵ Each part of the chain can be evaluated to provide information on the effects of the project. The sequence of the hierarchy is:⁶

1. Inputs—the resources employed to implement activities.
2. Activities—the actions taken by an organization.
3. Outputs—the direct and early results of the activities.
4. Outcomes—the intermediate observable and measureable changes that serve as progress toward an impact for the target population.
5. Impacts—the ultimate sustainable changes sometimes attributed to an action or combination of actions.

Evaluation research is designed to measure these various factors. The challenge is that researchers must collect enough data and control for enough variables to demonstrate the causality of a project. Furthermore, the value of the research is enhanced if the findings can be applied to other projects and policies. However, as the focus of a development project

4 Ibid.

5 Fay Twersky, Amy Ratcliffe, Jodi Nelson, Phillip Setel, and Lance Potter, “A Guide to Actionable Measurement” (Seattle: Bill and Melinda Gates Foundation, 2010).

6 Ibid.

narrows in order to control for variables and to generate more accurate evaluation research, the less applicable the project intervention is for development projects in other communities.

The five methodologies we review here share five components that are necessary to address in a thorough evaluation: time horizon, sample size, transparency, third-party evaluation, and counterfactuals. These are of special importance because they are the components that are most often ignored or not properly incorporated into evaluations.

Time Horizon. An evaluation should be adjusted for the appropriate timeline of a project. Ideally, the evaluation methodology also should include periodic monitoring that will provide updated information about the social impacts of a project. Designing the timeframe poses problems as some projects can take years or even decades for the social impact to reach the point where it can be measured. For example, the evaluation of a project that improves a community's drinking water will have a much shorter timeframe than an early childhood development program.

Sample Size. The Social Development Family of the World Bank analyzed 60 evaluations of community-driven development (CDD) projects. The majority of the evaluations, the assessment found, suffered from limited scale, meaning that the evaluations lacked the sample size necessary to generate statistically significant results.⁷ A mathematical formula that uses population size and variance should be used to determine a sample size that is sufficiently large for the analyses to be sensitive enough to detect statistically significant results.

Transparency. Transparency includes not only disclosing the results of the evaluation but also clearly describing the methodology used to collect and analyze the data. This includes explaining the rationale behind all assumptions made, equations used, social indicators measured, sample population selected, time period analyzed, counterfactuals used, and so forth. Transparency is a key component to any thorough evaluation. First, it allows other development practitioners to identify which interventions did and did not work, and often why. Second, it allows the data and analysis to be verified. Third, it allows evaluations to be accurately replicated when applied to other similar projects. Fourth, transparency provides the opportunity for practitioners to identify flaws in an evaluation and to improve later implementations.

Third-Party Evaluation. A third-party evaluation increases validity. It helps ensure that the data are accurately collected and not influenced by any conflicting interest of the organization being evaluated. However, third-party evaluations are usually more expensive. A less costly option is to have a third party audit a self-conducted evaluation of an organization.

Counterfactuals. To isolate the impact of a development project, it is necessary to estimate the counterfactual; that is, what change, if any, would have occurred if the project were never implemented. For example, presume the income of an individual participating in a

7 Paul Wassenich and Katherine Whiteside, "CDD Impact Assessments Study: Optimizing Evaluation Design Under Constraints" (New York: Social Development Family, World Bank, February 2004).

microfinancing program increases. Is this increase because of the microfinancing program or factors in the community, such as a newly constructed road linking the community to new markets? To identify the counterfactual, it is necessary to “net out” the effect of the intervention from other variables. This is accomplished by comparing control groups (those that do not participate in the intervention) with treatment groups (those that do participate in the intervention).⁸ Although counterfactuals are necessary to estimate the true impact of a development project, they are often ignored. Setting up, monitoring, and evaluating counterfactuals requires time and resources that could otherwise be used for delivering services or goods.⁹ In addition, donors and investors typically prefer that their funds be allocated to operational activities and not to analyzing counterfactuals that do not directly benefit the clients or beneficiaries. Additionally, it could be unethical to withhold a program to the counterfactual if resources are available.

The world of international development evaluations is a complex one, and as with many complex topics, an extensive spectrum of tools has been developed to shed light on the subject. This is not surprising when considering that evaluations must control for a seemingly infinite number of variables, in thousand of locations around the world, and do so with varying budgets. I have categorized these evaluation tools into the five types of evaluations noted above with the aim of helping the field better understand how they work, what they can tell us, when they should be used, and how difficult and costly they are to implement.

I begin with the most rigorous technique, randomized evaluations. Starting with the “gold standard” will be helpful in understanding the other categories of evaluation if this method proves too costly or logistically infeasible. Randomized evaluations are important because they isolate causality.

Overview of Evaluation Tools Used Internationally

Randomized Evaluations

In this method, researchers randomly assign participants (the sample) to a treatment group or a control. The treatment group receives the intervention and the average impacts are compared with those in the control group. This method bypasses several weaknesses of other methods. If the sample size is large enough, the attributes of the sample will represent the attributes of the entire population. In other words, what is true for the sample size is most likely true for the entire population. In addition, when individuals are randomly assigned to two groups of sufficient size, they are considered statistically identical to the larger population and to each other. This provides an ideal counterfactual, as one group known (treatment group) receives development interventions and the other group (control group) does not. All other variables are controlled for, meaning they will have equal influence on the outcomes

⁸ Baker, Evaluating the Impact of Development Projects on Poverty.

⁹ Claire Brown, “Developing an Effective-Efficient Assessment Template for Social Enterprises” (forthcoming, early manuscript provided to the author, June 2010).

and thereby the effects of the intervention are isolated. The impact is then determined by measuring the differences in outcomes between the control group and the treatment group for a period of time after an intervention.

In the international development field academic organizations such as Massachusetts Institute of Technology's Abdul Latif Jameel Poverty Action Lab (J-PAL), and University of California, Berkeley's, Center for the Evaluation of Global Action (CEGA) lead the field in using randomized testing. In addition, other organizations, such as the Bill and Melinda Gates Foundation and the William and Flora Hewlett Foundation, are realizing the importance of randomized evaluations and are allocating more resources to such evaluations.

A widely cited success in randomized evaluation is CEGA's Primary School Deworming Project (PSDP). The PSDP evaluated school-based mass treatment with deworming drugs in Kenya. The evaluation phased in the program in three stages at three sets of randomly selected primary schools. The evaluation found that the program reduced absenteeism and increased school performance in treatment schools by 25 percent, and the program was much cheaper than alternative methods for boosting school participation, such as purchasing new textbooks.¹⁰ The program also had sizable "spillover" effects. The health and school participation improved for children who were not taking part in the experiment in both the treatment schools and neighboring schools owing to fewer instances of worms being transferred among students.¹¹ In this example, not only can randomization accurately show program impacts, but also it can reveal seemingly unlikely solutions to difficult problems. This opens doors for creative development solutions to be tested.

Randomization has its limits, however. First, this method can be costly. It can also require modification to the implementation plan, and sometimes these adjustments are deemed unacceptable. Third, some programs are so idiosyncratic that conducting a randomized evaluation would not generate useful, widely applicable information. Fourth, some programs and sectors do not have a large enough control population or a large enough sample size.¹² Finally, it might be unethical or politically infeasible to deny a program to a control group.¹³

Randomized evaluations must be specifically designed for each development project, and therefore there are no existing general toolkits that can be applied to every randomized evaluation. However, J-PAL provides an abundance of material and information describing randomized evaluation methodology and best practices, including information on planning, implementing, obtaining results, and how to draw policy conclusions from randomized evaluations.¹⁴

10 David Leonhardt, "Making Economics Relevant Again," *New York Times*, February 20, 2008.

11 Edward Miguel and Michael Kremer, "Worms: Identifying Impacts on Education and Health in the Presence of Treatment Externalities," *Econometrica*, 72 (1) (January, 2004).

12 Franck S. Wiebe, Millennium Challenge Corporation, "Working Paper: Aid Effectiveness: Putting Results at the Forefront" (Washington, DC: Millennium Challenge Corporation, October 27, 2008).

13 Abdul Latif Jameel Poverty Action Lab, "When is Randomizing (Not) Appropriate?" (Cambridge, MA: Massachusetts Institute of Technology, 2010), available at www.povertyactionlab.org/methodology/when/when-randomization-not-appropriate.

14 Abdul Latif Jameel Poverty Action Lab, "Methodology: Overview" (Cambridge, MA: Massachusetts Institute of Technology, n.d.), available at www.povertyactionlab.org/methodology.

Randomization is the most accurate way to create a counterfactual but other methods are available. These methods of creating a comparison group can provide useful insight, but they rely more on assumptions. It is usually impossible, and always difficult, to ensure that all the assumptions are true, and it is these assumptions that usually cause debate about a project's claimed social impact.¹⁵

Observational Evaluations

If proving causality is not feasible, the next best thing is to illustrate correlation between a particular action and a set of outcomes.¹⁶ This is what observational evaluations can provide. Observational evaluations can illustrate, for example, that distributing mosquito nets is highly correlated with fewer malaria cases. It is still not known how much the mosquito nets contributed (or if it even did) to the reduction of malaria given that other variables could simultaneously be influencing the malaria rate. However, the higher the correlation, the more likely it is that the mosquito nets are having an impact. What must then be decided is if the correlation is high enough to justify spending resources to distribute mosquito nets. This can only be determined by conducting a cost-benefit analysis (see below).

There are three main types of observational evaluations, also referred to as quasi-experimental evaluations. The simplest compares the same group before and after an intervention, also referred to as pre-post evaluation. This method requires the assumption that the intervention was the only factor (or at least the major factor) influencing any changes in the measured outcomes over time.

A second method uses a cross-sectional approach and compares the treatment group with a similar group that exists elsewhere and that is not created through randomization.¹⁷ This approach can be further divided into what is called either simple difference or differences in differences. Simple difference is the measure of difference after the intervention is implemented between those who receive an intervention and those who do not. This requires the assumption that nonparticipants are identical to participants except for the intervention, and that both groups were equally likely to receive the intervention before it was implemented. Differences in differences measures the improvement over time of those who received an intervention relative to those who did not. The assumption of this method is that if the program did not exist, the two groups would have identical trajectories over the specified period.¹⁸

As mentioned above, these nonrandomized evaluations cannot provide proof of causality, but they can provide evidence of correlation between an intervention and a change in a social outcome. To revisit the example used above, supplying mosquito nets to a community could be correlated with a decline in malaria cases, but this could be attributed to other variables

15 Abdul Latif Jameel Poverty Action Lab, "When is Randomizing (Not) Appropriate?"

16 Examples of observational evaluations can be found in Appendix A.

17 Paul Brest and Hal Harvey, "Money Well Spent: A Strategic Plan for Smart Philanthropy" (New York: Bloomberg Press, 2008).

18 Abdul Latif Jameel Poverty Action Lab, "When is Randomizing (Not) Appropriate?"

that are not accounted for in the evaluation, such as a decline in the mosquito population. However, observational evaluations do provide useful information and can illustrate if an organization is heading in the right direction with its interventions. Correlation combined with one's knowledge of how the world works, perhaps gained from more thorough evaluations of similar interventions, can at least hint strongly at causation.¹⁹

Observational evaluation methods rely heavily on the collection of baseline data. Baseline data allow for the comparison of social indicators before and after a development project is implemented. This provides additional information about how a project has affected a target population. However, comparing baseline data with results after the project's implementation does not necessarily provide an accurate measure of the project effect owing to confounding variables that can influence the target population. A counterfactual would be needed to eliminate or reduce the possibility that other variables may be affecting a target population. Nevertheless, baseline data are valuable in comparisons, particularly between various development projects that target populations with different characteristics or that live in other geographic locations.

Baseline data provide information on the level of education, infrastructure, income, and other factors, all of which are necessary for designing an effective development project. A given development project might have been successful with one target population, but the results could be very different in a community with other characteristics. The more baseline data collected, the better the understanding of how various development projects affect different populations. Again, this data collection takes time and money, and the feasibility of collecting the data must be considered in the design of the evaluation.

There is another category of observational evaluations that includes a subset of models that rely on regression analysis to determine correlation between interventions and outcomes. Regression analysis includes techniques for modeling and analyzing the correlation of one or more variables (independent variables) with a specific outcome (dependent variable). This type of analysis provides insight on how the value of the dependent variable changes on average when any of the independent variables are varied. The independent variables can be further categorized as control variables and noncontrol variables. The control variables are included to isolate the noncontrol variables' correlation with the dependent variable and to exclude their impacts from the measured changes in the dependent variable. The inclusion of control variables assists in isolating the correlation and influence of an independent variable of interest relative to the dependent variable.

For example, with a sufficiently large sample size, a regression equation could be calculated where the dependent variable is the number of malaria cases and the independent variables are the number of mosquito nets distributed, average rain fall for the year, community population, and average level of education. The average rainfall is used to control for the number of mosquitoes that exist which is largely based on amount of rainfall, population size controls for the ease of malaria to be transmitted from one person to another, and the

19 Brest and Harvey, "Money Well Spent."

level of education is used as a proxy for the level of understanding of how malaria is transmitted. Creating such a regression equation allows an evaluator to say something similar to “on average, a distribution of 100 additional mosquito nets is associated with a decrease of 50 malaria cases a year, holding the average rainfall, population size, and level of education constant.” The larger the sample size and the more relevant the controlling variables added to the equations are, the greater the accuracy of the correlation will be between the dependent variable (number of malaria cases) and the independent variable of interest (number of mosquito nets distributed). However, as with all observational evaluations, regression analysis does not prove causality, but it can illustrate high levels of correlation that suggest causality.

Regression analysis can be extremely technical and be used in a variety of ways. Some of the subcategories of regression analysis used to analyze development work include multivariate regression, regression discontinuity design, statistical matching, and instrumental variables (see Table 1).

Multivariate regression compares individuals who receive treatment against those who do not, and other factors that might explain differences in the outcomes are accounted for with control variables. This method requires that information for both participants and nonparticipants be collected before and after the intervention.

Regression discontinuity design ranks individuals on the basis of specific measurable criteria. A cut-off is created that determines whether an individual is eligible to participate in a program or not. The comparison group is composed of individuals who are close to the cut-off point, but who fall on the “wrong” side of that cut-off and therefore do not receive the program. The experiment group consists of those who were close to the cut-off point, but who fall on the “right” side. This allows for criteria variables to be very similar between the participants and nonparticipants, and therefore these variables are somewhat controlled.

Statistical matching uses regression analysis to compare individuals in the treatment group with similar individuals in the control group. This is achieved by either matching participants from each group who have exactly the same selected characteristics, or who have a mix of characteristics that predict that they would be as likely to participate in the program.

Instrumental variables analysis uses an almost random factor (instrumental variable) that is uncorrelated with the outcomes other than the fact that it predicts an individual’s participation. The control group is composed of individuals who, because of this close to random factor, are predicted not to participate (and possibly as a result) do not participate. For example a researcher may attempt to estimate the effect of smoking on health from observational data by using the tax rate on tobacco products as an instrument variable for smoking in a health regression. If a tobacco tax only affects health because it affects smoking (holding the other variables in the model constant), correlation between a tobacco tax and health is evidence that smoking causes changes in health.²⁰

20 Jonathan Gruber and Botond Koszegi, “Tax Incidence When Individuals Are Time-Inconsistent: The Case of Cigarette Excise Taxes” *Journal of Public Economics*, 88 (nos. 9-10) (August 2004): 1959-1987.

Table 1. *Experimental Evaluation Methods*

Methodology	Description	Who is in the Comparison Group?	Required Assumptions	Required Data
Pre-Post	Measure how program participants improved (or changed) over time.	Program participants themselves—before participating in the program	The program was the only factor influencing any changes over time.	Before and after data for program participants.
Simple Difference	Measure difference between program participants and non-participants after the program is completed.	Individuals who didn't participate in the program (for any reason), but for whom data were collected after the program.	Non-participants are identical to participants except for program participation, and were equally likely to enter program before it started.	After data for program participants and non-participants.
Differences in Differences	Measure improvement (change) over time of program participants relative to the improvement (change) of non-participants.	Individuals who didn't participate in the program (for any reason), but for whom data were collected both before and after the program.	If the program didn't exist, the two groups would have had identical trajectories over this period.	Before and after data for both participants and non-participants.
Multivariate Regression	Individuals who received treatment are compared with those who did not, and other factors that might explain differences in the outcomes are “controlled” for.	Individuals who didn't participate in the program (for any reason), but for whom data were collected both before and after the program. In this case data is not comprised of just indicators of outcomes, but other “explanatory” variables as well.	The factors that were <i>excluded</i> (because they are unobservable and/or have not been measured) do not bias results because they are either uncorrelated with the outcome or do not differ between participants and non-participants.	Outcomes as well as “control variables” for both participants and non-participants.
Statistical Matching	Individuals in control group are compared to similar individuals in experimental group.	Exact matching: For each participant, at least one non-participant who is identical on <i>selected characteristics</i> . <u>Propensity score matching</u> : non-participants who have a mix of characteristics which predict that they would be as likely to participate as participants.	The factors that were <i>excluded</i> (because they are unobservable and/or have not been measured) do not bias results because they are either uncorrelated with the outcome <u>or</u> do not differ between participants and non-participants.	Outcomes as well as “variables for matching” for both participants and non-participants.

Quasi-Experimental Methods

	Regression Discontinuity Design	Individuals who are close to the cutoff, but fall on the “wrong” side of that cutoff, and therefore do not get the program.	After controlling for the criteria (and other measures of choice), the remaining differences between individuals directly below and directly above the cutoff score are not statistically significant and will not bias the results. A necessary but sufficient requirement for this is that the cutoff criteria are strictly adhered to.	Outcomes as well as measures on criteria (and any other controls).
	Instrumental Variables	Individuals who, because of this close to random factor, are predicted not to participate and (possible as a result) did not participate.	If it weren’t for the instrumental variable’s ability to predict participation, this “instrument” would otherwise have no effect on, or be uncorrelated with, the outcome.	Outcomes, the “instrument,” and other control variables
Experimental Method	Randomized Evaluation	Participants are randomly assigned to the control groups.	Randomization “worked.” That is, the two groups are statistically identical (on observed and unobserved factors).	Outcome data for control and experimental groups. Control variables can help absorb variance and improve “power.”

Source: Abdul Latif Jameel Poverty Action Lab, available at [www.povertyactionlab.org/sites/default/files/documents/Experimental percent20Methodology percent20Table.pdf](http://www.povertyactionlab.org/sites/default/files/documents/Experimental%20Methodology%20Table.pdf).

Appendix A describes a number of internationally used toolkits that are used to measure observational data from development projects. These examples provide creative and useful techniques that could be adapted to measuring domestic community development projects.

Cost-Benefit Analysis

Although cost-benefit analysis is not mutually exclusive from randomized and observational evaluations, it stands as its own category as well.²¹ Both randomized and observational evaluations should include some sort of a cost-benefit analysis because it answers the question “what development impact does \$1 of spending achieve?” It is only when this question is answered that the efficiency of a development program can be understood, and can, consequently be gauged against other development projects.

It is very difficult to quantify social impacts in monetary terms, mainly because these determinations are often subjective. This subjectivity can result in debates over the accuracy of measurements. Cost-effectiveness analysis can make this process clearer. This method divides the impact of a program (e.g., the increase in the number of students attending school) by the cost of the project. However, it is still difficult to compare different projects that are addressing various aspects of development.²² For example, which is more valuable to society, 50 job placements or one more high school graduate?²³

In a study prepared for the Bill and Melinda Gates Foundation, analysts compared eight integrated cost approaches to measuring or estimating social value. In reviewing these different methods Paul Brest, President of the William and Flora Hewlett Foundation, stated that, in essence, all the methods are about expected return:

$$\text{Expected Return} = \frac{(\text{Outcome or Benefit} \times \text{Probability of Success})}{\text{Cost}}$$

As the study notes, the above simplification is useful, but each of the methodologies (REDF SROI, Robin Hood Foundation Benefit-Cost Ratio, Acumen Fund BANCO Ratio, Hewlett Foundation Expected Return, Center for High Impact Philanthropy Cost per Impact, and Foundation Investment Bubble Chart) answers the following questions differently:²⁴

- How are the outcomes or benefits estimated?
- How are the costs calculated?

21 Examples of cost-benefit analysis can be found in Appendix B.

22 Abdul Latif Jameel Poverty Action Lab, “When Cost-Benefit/Effectiveness/Comparison Analysis” (Cambridge, MA: Massachusetts Institute of Technology, n.d.), available at www.povertyactionlab.org/methodology/what-evaluation/cost-benefit/effectiveness/comparison-analyses.

23 Michael M. Weinstein, “Measuring Success: How Robin Hood Estimates the Impact of Grants” (New York: Robin Hood Foundation, November 12, 2007).

24 Melinda T. Tuan, “Measuring and/or Estimating Social Value Creation: Insights Into Eight Integrated Cost Approaches” (Seattle: Bill and Melinda Gates Foundation, December 15, 2008).

- How are uncertainties and partial attribution of result accounted for?
- How are the outcomes or benefits translated into natural units or monetized?

These cost-benefit evaluations attempt to create a counterfactual by estimating what would have happened to the beneficiaries of a program if they did not receive the program. For example, in estimating the cost-benefit of a job training program, the cost of the program is the dominator, and the number of beneficiaries who achieved job placement (the numerator) are multiplied by the their expected lifetime income, minus the average income they would have received if they had not received the job training. However, unlike randomized evaluations, this method does not consider the possibility that some beneficiaries could have become employed without the training. This issue can be somewhat addressed by subtracting an estimated percentage of the beneficiaries who would likely found a job without the training. However, as with many aspects of cost-benefit analysis for social impacts, this introduces assumptions that are vulnerable to credibility questions.

These cost-benefit evaluations also must make assumptions in order to estimate the present value of future benefits. The social impact of a program on a beneficiary should be estimated over his or her lifetime. However, estimating this amount can be difficult because the dollar value of a benefit received in the future is less than the dollar value of a benefit received today. This is because people in general prefer to receive something now as opposed to in the future and therefore, future costs and benefits must be discounted to present value. In financial terms this is referred to as the “discount rate.” However, there is no agreed upon method of estimating the discount rate for the many different social impacts.²⁵

Another assumption is applying a dollar value to the outcomes of social programs. This is referred to as the “shadow price.” Sometimes the shadow price is relatively easy to estimate; for example, the expected lifetime increase of attaining a job can be calculated by multiplying the average salary increase from the job placement by the average number of years that individual will most likely work. However, some impacts are more difficult to estimate. For example, there is no market value for the cost of crime to a victim. Similarly, value judgments must often be made. For example, is it better to save or improve the life of a 30-year-old as opposed to a 70-year-old?²⁶

Yet another aspect of social impacts to consider is that of interdependencies—when the outcomes of one or a series of interventions are dependent on other interventions. Interdependencies have an important influence on social impacts, yet they are very difficult to measure. For example, the increase in income levels from a microfinance program is also dependent on the level of infrastructure improvements, such as new roads. The success of an intervention will depend on many factors that are not addressed by the intervention. The number and influence of these interdependencies increases as the timeframe of the projected benefits increases.²⁷

25 Weinstein, “Measuring Success.”

26 Tuan, “Measuring and/or Estimating Social Value Creation.”

27 Ibid.

Even with all the above-mentioned assumptions and susceptibility for debate, cost-benefit analysis is useful and important tool for social impact evaluations. As Paul Brest, *Measuring and/or Estimating Social Value Creation: Insight Into Eight Integrated Cost Approaches*, explains, “You’re putting in a lot of incredibly speculative numbers, but ‘doing the numbers’ presses program officers to test their intuitions, and that’s likely to sharpen them.”²⁸ For cost-benefit analysis to be understood and used, it is important that the assumptions are clearly explained.

Appendix B provides six summaries of cost-benefit analysis methods used by leading non-profits and foundations. Each of the examples has their own method to address the difficulty of measuring and monetizing the social impacts from development interventions.

Citizen Participation

Yet another category of international development evaluation tools is evaluations that focus on citizen participation. These methods rely on the citizens, who ultimately are the beneficiaries of the development projects, to act as the evaluators. Asking citizens how development projects have affected them or which aspect of their lives they would like to improve can reduce the time and resources spent trying to answer these particular questions.

Several methods provide citizens with a greater opportunity to express their opinions on how public funds should be allocated. Two methods that have received international attention are participatory budgeting and citizen report cards.

Participatory budgeting. Participatory budgeting (PB) is a democratic process in which citizens meet to decide how to allocate a portion of a municipal or public budget and to identify, discuss, and prioritize public spending projects. PB attempts to improve both the performance and accountability of a bureaucracy that is not effectively representing the people and is underperforming. PB creates opportunities for engaging, educating, and empowering citizens. Also, PB addresses corruption by including citizens in the budget process, which promotes transparency and increases the accountability of government agencies. PB programs have typically involved individuals with low incomes and low levels of formal education, and as a result PB offers individuals from historically marginalized and excluded groups the opportunity to determine how resources are allocated. This typically results in funding being allocated to infrastructure and services that are more relevant to the communities they serve.²⁹

The first full PB process was developed in Porto Alegre, Brazil, in 1989. The World Bank’s evaluation of the program concluded that the PB led to direct improvements of facilities such as sewer and water connections. The program also resulted in an increase in the number of citizens who were participating in the budgeting process over the 10-year period of the study. In addition, the percentage of the budget that was allocated to both

28 Paul Brest to Melinda Tuan, “Re: Hewlett Foundation’s Return Methodology” (April 24, 2008) as cited in Tuan, “Measuring and/or Estimating Social Value Creation.”

29 Anwar Shah, ed., *Public Governance and Accountability Series: Participatory Budgeting* (New York: World Bank, June 9, 2010).

health and education increased substantially, from single digits to greater than 70 percent. These successes led to more than 140 (about 2.5 percent) of the 5,571 municipalities in Brazil adopting PB programs.³⁰

PB is now practiced in countries around the world, including Canada, which has implemented PB for public housing, neighborhood groups, and public schools, and in the United States in Chicago.³¹

Citizen report cards. Citizen Report Cards (CRC), like PB, provide an opportunity for marginalized and excluded citizens to voice their opinion about their underserved and neglected communities. The CRC process begins with a survey sent to a random set of citizens in a particular community, asking them to rate various public services and facilities. CRC not only provides accountability for government spending, which leads to more transparency and less corruption, but it also strengthens civil society through increased citizen influence over political decisions. CRC were first implemented in Bangalore, India, in 1993. Analysis of the subsequent CRCs reveals a decrease in corruption and a substantial increase in citizen satisfaction for most government agencies.³²

Process Evaluations

A final method for performing evaluations focuses on measuring an organization's internal management systems, processes and procedures, and incentives.³³ This methodology focuses on evaluating inputs and processes as opposed to outcomes. The logic is that if stakeholders can identify key elements or processes within organizations that result in successful development projects, then those key elements can be evaluated instead of project outcomes.³⁴ Measuring such indicators is usually less costly and time-consuming than trying to measure a variety of outcomes. This process has led to various certification and scoring systems for organizations.

One organization that has developed such an evaluation process is CGAP, with its SmartAid methodology.³⁵ Although SmartAid was developed for the micro-financing industry, its process can be applied to other sectors of development. As David Roodman of the Center for Global Development explains it:

30 Ibid.

31 In Canada see, "Participatory Budgeting – Working Together, Making a Difference" (Toronto: Toronto Community Housing, n.d.), available at http://www.torontohousing.ca/participatory_budgeting. In Chicago, PB is initiated in the city's 49th ward. See Alderman Joe Moor, 49th Ward Participatory Budgeting Initiative <http://www.ward49.com/participatory-budgeting/>, accessed July 27, 2010.

32 Suresh Balakrishnan and Sita Sekhar, "Holding the State to Account, Citizens Voice Through Report Cards in Bangalore" (Bangalore: Public Affairs Centre, February 2004).

33 Examples of process-based evaluation can be found in Appendix C.

34 World Economic Forum, "Philanthropy Measures Up," Global Leaders Tomorrow, Benchmarking Philanthropy Report, 2003.

35 CGAP is an independent policy and research center dedicated to advancing financial access for the world's poor. Housed at the World Bank, CGAP evaluates micro-financing institutions and provides market intelligence, promotes standards, develops innovative solutions, and offers advisory services.

How do you know a high-quality aid agency when you see one? Is it one that learns from past projects, or that rewards employees for subtle blend of results and risk-taking? Measuring such characteristics is hard, especially when the agencies being measured fund your budget. But that is exactly what CGAP has done, in the realm of aid for microfinance, using extensive surveys and interviews.³⁶

As a result of a peer review that analyzed the systems, procedures, and incentives of 17 of the most important microfinance donors, CGAP developed the SmartAid framework. The framework includes five measurable elements for evaluating micro-financing institutions (MFIs). The analysts selected nine weighted indicators to measure the five key elements and to assign organizations an overall score.

Another valuable aspect of this approach is that it allows an organization to determine where it has a comparative advantage in its field. Understanding which management and process elements an organization scores well in allows it to focus on its strengths and its comparative advantage. Similarly, such evaluations can provide insight into which organizations should forge partnerships. Forming a partnership with an organization that has complementary strengths can increase the overall effectiveness of the two organizations.³⁷

The United Nations Capital Development Fund (UNCDF) developed a similar evaluation that evaluates the processes as an indirect way to measure the outcomes of their programs.³⁸ One of the missions of UNCDF is to develop inclusive finance programs. To evaluate these programs, it has developed the “inclusive evaluation matrix.” The matrix asks a series of questions about the management, design, and process of a program. For example, questions include, “To what extent are the financial service program providing appropriate services and opportunities to women?” To measure this, the following indicators could be used 1) the number of women in senior management positions, including the board, and 2) percentage of active clients who are women. For each question, the matrix provides a list of indicators that can be used to answer the questions, methods on how to collect the data, and sources for finding the information.

Appendix C provides examples of process evaluation methodologies that are used by international organizations. Many of these methods are less costly than evaluating project impacts and therefore, many of these methods could be adopted by domestic community development organizations.

36 CGAP, “What Is Smart Aid?” (Washington, DC, CGAP, n.d.), available at <http://www.cgap.org/p/site/c/template.rc/1.11.7956/>, accessed August 9, 2010.

37 Brigit Helms and Alexia Latortue, “Aid Effectiveness Initiative: Microfinance Donor Peer Reviews, Elements of Donor Effectiveness in Microfinance: Policy Implications” (Washington, DC: CGAP, April 2004).

38 United Nations Development Programme, “Annex 3. Evaluation Terms of Reference Template and Quality Standards,” in *Handbook on Planning, Monitoring and Evaluating for Development Results* (New York: United Nations, 2009), available at www.undp.org/evaluation/handbook/Annex3.html#62.

Evaluation Infrastructure

The final category of evaluation, underlying all the above categories, includes tools that improve the infrastructure of evaluations knowledge. They improve the standardization of evaluation methodology, promote the use of evaluations, and distribute evaluation techniques and results. This category is extremely important because evaluations are only as valuable as their ability to be used to improve either current or future development projects, and this cannot happen if the information is not shared with other practitioners. In addition, practitioners must be able to easily understand this information, which means that the data must be standardized for impact development projects to be understood, replicated, or improved. Such standardization also leads to improved transparency and credibility, which in turn attracts more funding. Organizations and foundations are attempting to create standards for the evaluation and measurement of social impacts. These organizations are leading the way in creating the infrastructure that will allow for the effective dissemination of evaluation research.

One example of a group of organizations working to create evaluation research infrastructure is the Global Impact Investing Network (GIIN) and its “Impact Reporting and Investment Standards” (IRIS) initiative. GIIN is a network of nonprofits that include organizations such as the Rockefeller Foundation, Acumen Fund, and B Lab that are dedicated to increasing the effectiveness of impact investing.³⁹ Impact investments attempt to have positive social or environmental impacts while generating profit. IRIS is creating a common framework for defining, tracking, and reporting the performance of impact capital. As a recent report notes:

The IRIS initiative will build on these sector-specific efforts to create a common language that will allow comparison and communication across the breadth of organizations that have social or environmental impact as a primary driver. A common language for measuring and reporting performance forms a basis for enabling infrastructure and leads to transparency and credibility.⁴⁰

Currently the IRIS framework consists of hundreds of social indicators that are defined and categorized into five parts:

1. The social performance standards framework and description;
2. Descriptor Indicators that focus on the organization’s mission, products, and services and the target markets that the organization intends to affect;
3. Financial Indicators that are expected to be commonly reported for all organizations regardless of size or operational mode;

³⁹ For more information, see Global Impact Investing Network, <http://www.thegiin.org/cgi-bin/iowa/home/index.html>.

⁴⁰ The Rockefeller Foundation, Acumen Fund and B Lab, ‘Impact Reporting and Investment Standards’ website: <http://iris-standards.org/>.

4. Operations Indicators that are applied to organizations depending on their operational type and where in the production process they function; and
5. Sector-specific indicators:
 - agriculture and artisanal indicators
 - energy, environment and water indicators
 - education indicators
 - community development financial indicators
 - healthcare indicators
 - microfinance indicators

Similarly, an online database that is increasing the evaluation infrastructure is the “Tools and Resources for Assessing Social Impact” (TRASI), created by the Foundation Center. TRASI contains a comprehensive listing of 150 approaches to measuring and analyzing social impact for programs and investments. A range of organizations have contributed to the database, including social investors, foundations, NGOs, and microfinance institutions. These approaches range from off-the-shelf tools and concrete methodologies to generalized best practices. These approaches to measuring social impacts have been classified into 18 categories.⁴¹

Applying International Methodologies to Domestic Community Development

The above section demonstrated how various evaluation techniques used in international development have greatly enhanced the effectiveness of certain development projects. Unfortunately, evaluations are rarely done for domestic community development projects, and therefore the impacts of these projects are largely unknown. Using the examples from above, I suggest various ways international development evaluation methods could be adopted domestically to improve the cost-effectiveness of the billions of dollars that are spent each year on community development projects.

Financial institutions often fund community development projects in conjunction with nonprofits and federal, state, and local governments. These sources of funding can be categorized into five main groups:⁴²

Government: Federally, the U.S. Department of Treasury, through the Community Development Financial Institution (CDFI) Fund, channels financial support directly to the CDFIs that register with the fund in order to receive funding.

Depository Institutions: These include banks and credit unions that are created specifically for the purpose of working in markets underserved by traditional capital and federally insured commercial banks and savings institutions, which are motivated by CRA requirements.

41 The Foundation Center, “Tools and Resources for Assessing Social Impact” website at <http://trasi.foundationcenter.org>.

42 Ben Thornley and Colby Dailey, Building Scale in Community Impact Investing through Nonfinancial Performance Measurement,” Federal Reserve Bank of San Francisco, *Community Development Investment Review*, Volume 6, Issue 1, 2010.

Nondepository Institutions: These include institutions created specifically for the purpose of community investment, such as community development loan funds and community development venture capital funds registered with the CDFI Fund. They also include a diversity of pension funds, private insurers, financial advisors, and investment funds investing for financial and nonfinancial returns.

Philanthropic Organizations Making Investments: These include corporate, community, religious, and especially private foundations that invest in community development projects.

Individuals: Tens of thousands of individuals, including bank customers, mutual fund investors, and the world's wealthiest families, are a large contributor to community development projects.

A large portion of the money funneled to community development projects is motivated by the CRA.⁴³ Among the 998 institutions reporting CRA-motivated lending in 2007, 746 institutions invested \$63.8 billion.⁴⁴ None of these institutions are required to conduct evaluations of their investments.⁴⁵ For example, the single largest investor in community development projects in the United State, the CDFI Fund, requires only that CDFIs respond to a very narrow set of social impact survey questions. In any one year, just one-fifth of CDFIs are mandated to report community impacts.⁴⁶

As reported in their paper, *The Role of Nonfinancial Performance in Community Impact Investing*, Colby Dailey and Ben Thornley conducted a literature review, stakeholder interviews and examinations of 40 annual reports. They concluded that the reports lacked nonfinancial performance measurements in the field of community development. The nonfinancial returns were not widely measured nor widely disclosed. The review revealed significant differences and clear trends in the measurement and reporting of nonfinancial returns. The general observations they made were as follows:

- Most impact investors surveyed do not include nonfinancial performance in annual reports. The measures that are reported are usually published separately or only on the investor's website
- Although the CDFIs report on a very narrow set of survey questions, they report nonfinancial performance in the greatest depth compared to other community development practitioners, with measures of job creation, housing units and commercial/facilities spaces financed, number of individuals served, and minority group representation

43 Currently four federal regulators oversee the CRA: Federal Reserve Bank, Office of the Comptroller of the Currency, Federal Deposit Insurance Corporation, and the Office of Thrift Supervision. The latter will cease operation in the summer of 2011.

44 Federal Financial Institutions Examination Council, www.ffiec.gov, accessed July 21, 2010.

45 Ben Thornley and Colby Dailey, "Building Scale in Community Impact Investing through Nonfinancial Performance Measurement," Federal Reserve Bank of San Francisco, *Community Development Investment Review*, Volume 6, Issue 1, 2010.

46 *Ibid.*

- Banks, in particular, appear to use nonfinancial performance as a marketing and branding tool in annual reports, with stories and photographs but no accompanying analysis. All of the major banks sampled published separate corporate citizenship/corporate social responsibility (CSR) reports or reported on CRA lending volume on websites;
- Foundations, pension funds, and private equity managers were the least likely to report publicly on nonfinancial performance.
- Investment firms (fund/equity managers) generally highlight nonfinancial performance by describing screening and selection processes and the characteristics of underlying portfolio companies

The analysis also found that the most widely reported metrics were the volume of inputs invested for community impact (dollars of financing and capital); that anecdotal evidence of impact was typically presented as a supplement to quantitative performance measures; and that none of the investor annual reports reviewed benchmarked the nonfinancial performance data that was included.

Next I will use the template I created to look at how community development practices can be improved domestically.⁴⁷ The goal is to inspire innovation and to reveal potential opportunities for improving domestic evaluation practices. Specifically, I offer examples of how these methods can either be implemented for specific community development projects or incorporated into the existing institutional framework that is responsible for carrying out community development projects in the United States.

Randomized Evaluations

The scope of community development projects in the United States is large and diverse, but it is accepted that all could benefit from thorough evaluation. Affordable housing is a large sector of the community development field. Affordable housing typically refers to affordable rental housing for those of lesser means. Randomized evaluations could help uncover various impacts of stable and affordable housing on a family, which could improve the design of future affordable housing programs.

Recently, a *New York Times* article criticized the randomized evaluations of the affordable housing program Homebase as unethical and cruel.⁴⁸ However, there are usually more eligible candidates for affordable housing than available housing and funds. Therefore, a control group (those who did not receive housing) would exist irrespective of the randomized evaluations, eliminating ethical issues in randomly assigning eligible candidates to either receive affordable housing or not. This fact that there are more eligible candidates than funds

47 A more in-depth analysis of this topic can be found in Ben Thornley and Colby Dailey, "Building Scale in Community Impact Investing through Nonfinancial Performance Measurement," Federal Reserve Bank of San Francisco, Community Development Investment Review, Volume 6, Issue 1, 2010.

48 Cara Buckley, "To Test Housing Program, Some are Denied Aid," *New York Times*, December 8, 2010.

available provides an opportunity for a randomized evaluation as typically there are multiple treatment groups and a control group that can be evaluated and compared. A different community development intervention could be introduced to each treatment group to understand which aspects of affordable housing have the greatest impact on the tenants' livelihoods. Tenants who are selected would then be evaluated prior to moving into the housing and then re-evaluated periodically thereafter. These evaluations would measure social indicators such as housing conditions, health, employment, education, mobility, welfare receipt, delinquency, and so forth. These results would then be compared with the control group to reveal the impact of the program.

There have been very few randomized evaluations of community development projects. One example of such an evaluation is the Moving to Opportunity program. This on-going evaluation examined the short-term impacts of moving from high-poverty public housing to lower-poverty neighborhoods. Families that qualified received Section 8 housing vouchers through a random lottery. One group was required to move to low-income neighborhoods, a second group could use the vouchers to move anywhere, and a third group (the control) received no vouchers. The evaluators were able to determine whether moving to low-income neighborhoods caused changes to well-being relative to a control group.

The short-term results, which were measured five years after the treatment groups received the vouchers, showed that moving to low-poverty neighborhoods had significant positive impacts on personal safety, housing quality, mental health and obesity among adults, and staying in school, delinquency, and risky behavior among teenage girls. However, there was an apparent negative impact on boys' behavior and no significant effect on employment outcomes for adults or educational achievement for children. Only marginal improvements were found in the quality of schools attended.⁴⁹ These results are considered short-term impact and the effects of the program could change in the long-term.

A randomized evaluation such as this conducted for the HUD program rarely occurs for any community development project. Such randomized evaluations should be performed more frequently and continuously improved in order to clearly understand the effects of community development interventions and to determine any needed policy adjustments. It is not realistic to suggest that randomized evaluations should be performed on all, or even the majority, of community development projects. However, if they are performed on key projects, they can provide a tremendous amount of information for other projects and evaluations to build on.

Consider the deworming program in Kenya, for example. Without the proof of causality provided by the randomized evaluation, it would have been unlikely that developers would have considered allocating the majority of resources to a deworming program, as opposed

49 For interim results see Jeffrey Kling, Jeffrey B. Liebman, and Lawrence F. Katz. "Experimental Analysis of Neighborhood Effects," *Econometrica* 75(1) (2007): 83-119; and Jeffrey Kling, Jens Ludwig, and Lawrence F. Katz, "Neighborhood Effects on Crime for Female and Male Youth: Evidence from a Randomized Housing Voucher Experiment," *Quarterly Journal of Economics* 120(1) (2005): 87-130.

to additional teachers or materials, in order to increase school attendance. Randomized evaluations are needed to test our assumptions about what works and what does not work in community development, and, as the deworming example illustrates, to uncover seemingly unlikely solutions to achieve a development goal. In addition, randomized evaluations provide a solid base for other, less expensive evaluations, such as observational evaluations.

Community development practitioners should work together and select key projects for a randomized evaluation. These projects should be selected on their ability to allow for the testing of multiple interventions and assumptions and, at the same time, provide the most pertinent information for a large variety of community development practitioners. This way, a small number of randomized evaluations can provide a large amount of useful information to the community development field.

Observational Evaluations

As discussed above, randomized evaluations are not always feasible. Observational evaluations, however, might be a good second option. Hundreds of observational evaluations have been conducted on community development projects, largely performed by academic institutions. It is rare to find a community development policy or program that mandates an observational evaluation. One example is the U.S. Department of Education's "Promise Neighborhoods." The program is intended to significantly improve the educational and developmental outcomes of all children in the most distressed communities, including rural and tribal communities. The program aims to transform those communities by supporting comprehensive cradle-through-college-to-career programs.

Among 339 applicants, DOE only had funding for 20 distressed communities. An observational evaluation could provide valuable information on the effectiveness of the program. Data for each community that receives funding could be collected prior to receiving funding and periodically thereafter. This data could be compared among the 20 communities to see what interventions were implemented and which communities improved.⁵⁰

Although this would not demonstrate causality, it would provide useful information by revealing which interventions are most correlated with improvement in social indicators. There is a large spectrum of evaluations techniques that can be adapted to every type of community development project. It is just a matter of finding the right one that fits the specific characteristics and budget of a particular project.

If more government policies and community development projects required data collection and evaluation, the pool of data on these types of projects would grow. With better data, a greater number of, and more accurate, regression analyses could be conducted to reveal what works and what doesn't in community development. Paul Collier in *The Bottom Billion*, offers an example of how regression analyses using large databases has resulted in

⁵⁰ U.S. Department of Education, Promise Neighborhoods, <http://www.ed.gov/blog/2010/04/promise-neighborhoods/>, accessed July 27, 2010.

surprising and useful information. Collier used large databases from a number of sources, such as the U.N. and World Bank, to identify four main poverty traps for countries: 1) *conflict trap*—the more recently a country has experienced a civil war, the more likely it suffers from a lack of development; 2) *natural resource trap*—the more a country’s economy relies on one natural resource, the greater the likelihood of lacking development; 3) *landlocked trap*—landlocked countries are more likely to lack development; and 4) *bad government trap*—countries that have high corruption, patronage, and relatively high military spending are correlated with lack of development. This information is very helpful for development practitioners in designing new projects that address these poverty traps.⁵¹

Cost-Benefit Analysis

Government assessments of projects and programs rarely include a comprehensive cost-benefit analysis. Only about 12 percent of all the U.S. government regulations that had an impact assessment in 2007 included a cost-benefit analysis or a best estimate for total net benefits to society. This 12 percent does not include the many more regulations that had no impact assessment conducted.

Table 2. Summary of U.S. Regulatory Impact Analyses and EU Impact Assessments

<i>Scorecard item</i>	<i>Percent of analyses in U.S. study that include the scorecard item (n = 74)</i>	<i>Percent of analyses in European study that include the scorecard item (n = 70)</i>
<i>Estimation of total costs</i>		
Provided best estimate of total costs	65%	19%
Provided range of total costs	34%	13%
<i>Estimation of total benefits</i>		
Provided best estimate of total benefits	22%	13%
Provided range of total benefits	26%	3%
<i>Estimation of net benefits</i>		
Provided a best estimate of net benefits	12%	13%
Provided a range of net benefits	20%	4%

Notes: U.S. study figures taken from Hahn and Dudley (2007), based on regulatory impact analyses. European Study figures taken from Renda (2006), based on impact assessments. See text for details. Numbers are rounded to nearest percent.

An example of the tremendous amount of useful information a cost-benefit analysis of a community development program provides is a study on early care and education in the United States.⁵² This study used both randomized and observational evaluations and

51 Paul Collier, *The Bottom Billion*, Oxford University Press, 2007.

52 James Heckman, Rob Grunewald, and Arthur Reynolds, “The Dollars and Cents of Investing Early: Cost-Benefit Analysis in Early Care and Education, Zero to Three,” v26 n6 p10-17 July, 2006.

found that, compared with a control group who did not receive early child education, those who did were more likely to make significant gains in cognition, social-emotional development, to perform better in school, to have higher earnings in the workforce, and they were less likely to commit juvenile and adult crimes. The researchers also calculated the estimated economic benefit of the early care and education programs in increased earnings (and resulting tax revenues), public savings due to reduced crime, averted crime victim costs, and reduced need for rehabilitation and treatment. The range of the benefit to society was from \$3.78 per dollar invested to \$17.07 per dollar.⁵³ This type of analysis provides insight into which program should be further funded and expanded.⁵⁴

It is important that such cost-benefit analyses be encouraged, if not required, for projects implemented to fulfill CRA requirements and that standards are created and used. Standards—in this case that the assumptions (discussed above) for similar projects be calculated using the same methods—are important so that they may be accurately compared to one another. The greater the standardization, the easier it is to compare the benefits and costs of community development projects, even those that are quite dissimilar.

As mentioned above, randomized evaluation allowed development practitioners to illustrate that out of all the programs analyzed, the deworming program was the most effective program at increasing student attendance. In addition, a cost-benefit analysis was conducted and revealed the deworming program would cost on average \$3.50 per pupil per year. This was compared to the next most effective program, which cost approximately \$99 dollars per pupil per year. In addition, the evaluation estimated that the program cost only \$5 per Disability Adjusted Life Year (DALY)⁵⁵ saved. This is extremely low when compared to vaccinations that are considered one of the most cost effective ways to save DALYs at \$12 to \$17. With this information it is obvious that the more effective and cheaper deworming program is the one that should be scaled up.⁵⁶ Imagine how much money could be saved and how more effective community development projects would be if similar information could be obtained through evaluations.

Citizen Participation

Some have argued that participatory budgeting (PB) and community report cards (CRC) are not necessary in the United States because the democratic political system allows citizens to participate through elections. However, this is not always the case in high-poverty areas. A study conducted by the Federal Reserve System Community Affairs Offices found that local

53 This disparity in benefit-cost ratio is partially due to the varying time frames that were used to evaluate each program. The longer the time period was from implementation, the greater the benefits.

54 James Heckman, Rob Grunewald, and Arthur Reynolds, "The Dollars and Cents of Investing Early: Cost-Benefit Analysis in Early Care and Education, Zero to Three," v26 n6 p10-17 July, 2006.

55 The disability-adjusted life year (DALY) is a measure of overall disease burden, expressed as the number of years lost due to ill-health, disability or early death.

56 Edward Miguel and Michael Kremer, Worms: Identifying Impacts on Education and Health in the Presence of Treatment Externalities, *Econometrica*, Vol. 72, No. 1, January, 2004.

governments are not always leaders in alleviating poverty in low-income areas.⁵⁷ This suggests that locally elected governments in these low-income areas are not adequately addressing the community development needs of the citizens. This situation could be improved if the citizens had more say in where funds were allocated.

Currently, it is often the case in the community development field that organizations or government agencies identify the needs of low-income communities and then procure funding to address those needs. Yet often the organizations assessing the needs of a community are not located in the community and do not take the time to gather input from those living there. Consequently, they may not be in the best position to determine the needs of that community. This situation is further exacerbated when multiple government agencies, nonprofits, and foundations operate in the same area and all compete for limited resources.

PB and CRC could address these problems by providing citizens with the opportunity to identify and prioritize those aspects of their community they wish to improve. This would push competing organizations to collaborate and share funding in order to meet the needs of the community as determined by those living in it.

One argument against greater citizen participation in the decision-making process is that bureaucracies and the political processes are already slow-moving and that providing additional avenues for citizen participation will bog down the political processes even further. An additional argument is that the citizens in these low-income communities usually have low levels of education and therefore will make less-informed decisions than practitioners in the community development field. However, these obstacles are even more prevalent and extreme in low-income areas of developing countries, yet PB and CRC have succeeded in improving communities in these countries. As mentioned above, PB practices in Brazil resulted in greater infrastructure improvements and a larger percent of resources allocated to health and education services. CRC in India resulted in a decline in corruption and an increase in citizen satisfaction with public services.⁵⁸

PB and CRC should be performed prior to implementing a community development project to gain insights on whether the particular project is a priority for the community or if they would prefer to allocate funds to a different community project. The information gained from PB and CRC would reduce the number of failed projects that are implemented, but never properly supported or used by the local community. In addition, such information could be analyzed for correlations between certain types of communities and the types of project and improvements they prefer. This will assist community development practitioners in designing projects that more directly address the needs of the community.

57 The Federal Reserve System and Brookings Institute, "The Enduring Challenge of Concentrated Poverty in America: Case Studies from Communities Across the U.S.," <http://www.frbfsf.org/cpreport/>, 2006.

58 Anwar Shah, ed., *Public Governance and Accountability Series, Participatory Budgeting* (New York: World Bank, June 9, 2010). See also Balakrishnan and Sekhar, "Citizens Voice Through Report Cards in Bangalore."

Process Evaluations

A further suggestion is to create a rating or certification system for banks, based on the comprehensiveness of their evaluations of community development projects. The certification process could be modeled after the Fair Trade Certification system and might work alongside, or even replace, current CRA regulation.

The Federal Reserve System, Office of the Comptroller of the Currency, or the Federal Deposit Insurance Corporation could conduct the certification process, or it could be contracted out to a third party. Banks could earn certification by allocating a certain percentage of their investments to certified community development projects or programs, funds, or intermediaries, such as CDFIs or Community Development Corporations (CDCs).⁵⁹ These third parties would be certified through conducting thorough evaluations of their activities. Banks would seek certifications as they could be used as a marketing tool and as part of their public relations strategy. A bank could attract customers with a certification demonstrating the bank's commitment to community development. The Fair Trade Certification has already proved there is a large market for those who want to purchase goods or services from organizations that contribute to sustainable development or environmental protection (see Appendix C for more information about Fair Trade Certification). Similar certificates include LEED certification for green buildings. In addition to a certification system, an added incentive could be created for those banks that demonstrate effectiveness in their community development projects. A bank could satisfy its CRA requirements by investing in CRA-certified projects or CRA-certified intermediaries, for example.

As an alternative to a certification system, a ranking or scoring system could be developed to rank those banks that have the greatest community development impact. Such ranking would create competition among banks to attract more socially conscious customers. Similar ranking and scoring systems have been developed for companies and nonprofits that are involved in social impact work.

A certification system could save both the banks and the bank regulators time and resources. Currently banks employ CRA compliance staff who are responsible for collecting and analyzing data on the bank's operations in low-income areas in order to demonstrate compliance. If these employees were redirected to evaluating community investment projects working toward social impacts the bank is supporting, then the bank could receive certification or a ranking based on established criteria. Certified banks could be rewarded, for example, by being subjected to less frequent CRA reviews. This would allow the banks to reduce the number of CRA compliance officers employed. In addition, they could have their CRA requirements reduced (as suggested with a certification system) based on their ranking or score.

⁵⁹ Although there is no established legal definition of CDCs, they are characterized by their community-based leadership and their work primarily in housing production and/or job creation. This is what differentiates them from other types of nonprofit groups.

Bank regulators also invest resources in bank examiners who are responsible for assessing whether a bank is complying with CRA requirements. Currently, CRA compliance staff at banks are required to produce large amounts of documentation to demonstrate that the bank activities meet CRA requirements. Bank examiners then must examine this documentation to assess whether each investment complies with CRA requirements. This process is time-consuming and expensive. Alternatively, if a bank can simply show that it invested in a certified CDFI, then a bank regulator would not need to review the investment because the CDFIs, by definition, comply with federal CRA requirements. However, there are not always CDFIs available in a bank's area of operation. If more individual projects/programs, CDFI Funds, or intermediaries, such as CDFIs and CDCs, were certified as CRA compliant, banks could then choose to invest in such entities, thus reducing the costs of the bank's CRA officers and the bank regulators' CRA compliance monitoring costs.

It is true that by reducing CRA requirements for banks that demonstrate effective investments in community development projects, these banks might invest less community development money because the amount of funds they will be obligated to invest in community development projects would be reduced and redirected to more profitable investments. However, the incentive would allow banks to discover those projects that are most effective and to allocate all of CRA funds to projects that are proven to be successful rather than to many projects whose impacts are undetermined. In addition, the information and data from such evaluations could be disseminated to other banks, which could then invest in similar community development projects. These benefits would far outweigh the negative impact of having CRA requirements reduced for banks that demonstrate effective community development investing.

A CDFI Fund certification process currently exists through the Financial Assistance (FA) Awards and the Bank Enterprise Awards Program (BEA). Through the FA Awards, the CDFI Fund invests in certified CDFIs that have demonstrated financial and managerial capacity to provide financial products that will positively impact their communities. Similarly, the BEA supports FDIC-insured financial institutions that are dedicated to financing and supporting community and economic development activities.⁶⁰ These certification processes can be

⁶⁰ The FA Awards are given to financial institutions that can demonstrate the ability to: 1) provide affordable and appropriate financial products and services that positively impact their communities; 2) be viable financial institutions; and 3) use and leverage CDFI Fund dollars effectively. The BEA Program provides financial incentives to those banks that help to expand investments in CDFIs and to increase lending, investment, and service activities within economically distressed communities. The BEA Program provides grants to applicants in three categories: 1) investments or technical assistance to qualified CDFI partners; 2) affordable mortgages, small business, education, commercial real estate loans; and 3) deposits, community services, and financial services. Certification and scoring appears to be the method that could most successfully be implemented on a large scale for community development projects in the United States. With existing community development institutions, there is considerable potential for including a thorough certification system for those banks and organizations that, through evaluations, can demonstrate effective allocation of resources to development projects. However, the certification should be based more on actual results determined by evaluations and less on processes and dollar amounts invested. Once banks have the incentive to demonstrate the effective allocation of their resources to community development projects the certification process can be substantially scaled up and improved from their present the standard of practice.

improved and scaled up, which would give organizations more incentive to conduct evaluations that would prove their eligibility for such certification programs.

Evaluation Infrastructure

It is paramount to promote evaluation infrastructure that will allow community development practitioners to share more information and experiences. Much of the information in IRIS and TRASI is applicable to domestic community development projects. However, a database specifically designed for community development projects in the United States would make it easier for community development practitioners to analyze and make decisions based on domestically collected data.

Development projects are extremely sensitive to the environment in which they are being implemented. Development projects in a developing country must be designed with a completely different set of goals, assumptions, cultural considerations, demographics, infrastructure, and institutions than domestic community development projects. In addition, the outcome of a particular development project will vary significantly depending on its location. Therefore, it is important to develop evaluation infrastructure that focuses specifically on domestic community development projects.⁶¹

For an evaluation infrastructure to be built, incentives are needed for practitioners to both evaluate projects and to disseminate the data. One way would be to simply make it a requirement. The government could require organizations to provide evaluation for all federally funded programs and then publish the findings. Alternatively, the government could create a market for evaluation data. The government could purchase evaluation data and project design information for community development projects that have proved successful. Similarly, if incentives were created for banks to have a greater community impact through methods discussed above, such as a certification process or reduced CRA requirements, the banks would be willing to pay for the project design and evaluation information of successful community development projects. As illustrated above, a cost-benefit analysis on projects striving to address certain development issues can reveal large differences in their efficiency. If the impact of a bank's community reinvestment programs were important to the bank, it would appreciate the savings of a program that generates \$17 of benefit per \$1 spent as opposed to \$3. This potential savings would induce banks to pay for the information

61 For example, when analyzing evaluation methods of international development projects for the purpose of applying them to community development, two obvious differences must be considered. First, evaluation methods for international projects were usually developed to assess populations living at poverty levels rarely seen in the United States. It is also unlikely that U.S. residents lack access to clean water, medical facilities, basic infrastructure and institutions. Methods must either be adapted for the United States environment or abandoned as incompatible. Second, discrimination based on gender is much greater in developing countries. As a result, it is important to measure the social impacts by gender in international development projects. In the United States, discrimination is most evident against minorities. Again, this must be considered when adopting international evaluation methods in the United States. These differences do, however, provide an opportunity to adopt innovative techniques for measuring gender discrimination to race-ethnicity discrimination.

that would allow them to implement the more efficient development program.

An evaluation information market would attract other parties besides the government or community development practitioners. Private consultants and specialists who focus on performing evaluations of community development programs would perform evaluations and gather data in return for a fee. As cost-benefit illustrated, there is the potential for significant efficiency improvements in community development programs—perhaps enough so that such consulting fees could be covered.

The U.S. government is beginning to recognize the importance of evaluating development and other social impact programs. In May 2005, the Panel on the Nonprofit Sector (established by Independent Sector) recommended to the Senate Finance Committee that, as a best practice, charitable organizations should establish procedures for measuring and evaluating their program accomplishments on the basis of specific goals and objectives.⁶² In addition, the panel recommended a sectorwide effort to provide information and training focused on appropriate methods of evaluations of social impact programs. Although it appears improbable that detailed federal legislation on performance reporting will be developed, practitioners are focusing more attention on evaluation processes in order to assess their effectiveness.⁶³

In 2009, President Obama's White House Office of Social Innovation and Civic Participation asked Congress to provide \$50 million in seed capital to identify the most promising, results-oriented (determined through evaluations) nonprofit programs and expand their reach throughout the country. The guidelines include the following three principles: 1) share knowledge across stakeholders within and outside government; 2) learn about the best solutions in communities; and 3) continually update principles, standards, and expectations of measurement and evaluation.

Similarly, the U.S. Agency for International Aid (USAID) has its own evaluation requirements for the development projects it invests in overseas.⁶⁴ These evaluation requirements are listed in its Automated Directives System (ADS), chapter 203, "Assessing and Learning." Chapter 203 provides guidance for USAID operating units on agency practices and standards used to determine the attainment of project objectives. The guidelines address how to collect and present impact data; use evaluations to improve development outcomes; identify obstacles that are preventing intended results and how to overcome these obstacles, and disseminate evaluation results to improve the practices of the development community as a whole.⁶⁵

62 Linda M. Lampkin et al., "Building a Common Outcome Framework To Measure Nonprofit Performance" (Washington, DC: Urban Institute, 2007), available at www.urban.org/publications/411404.html.

63 Independent Sector is the leadership forum for charities, foundations, and corporate giving programs committed to advancing the common good in America and around the world. See also, Independent Sector, <http://www.independentsector.org/about>.

64 USAID is the principal U.S. agency to extend assistance to countries recovering from disaster, trying to escape poverty, and engaging in democratic reforms.

65 USAID, Automated Directives System Chapter 203, Assessing and Learning, April 2, 2010.

The USAID directives for evaluations and the work done by the Office of Social Innovation and Civic Participation on improving evaluation methodology should be used to develop a similar department that would assist those in the United States who invest in community development projects to improve their evaluations methodology and eventually their effectiveness in achieving social change.

Conclusion

Evaluating development projects is vital for improving the lives of those affected the most by poverty. Evaluations will allow stakeholders to identify the most effective community development projects, which can then be expanded for a greater impact. The United States should implement new policies that will inspire a revolution in evaluation practices.

The federal government must play a larger role in developing and applying evaluations for community development projects. The federal government is the largest single collector and repository of social impact information and investing.⁶⁶ Evaluation research should be considered a public good, like the construction of a freeway or other infrastructure projects, in that the total benefits from the research may far exceed those experienced by the people involved in the study.⁶⁷ Information from an evaluation can be used to design and implement more effective and efficient community development projects, which will produce greater social impacts and savings in government expenditures. Evaluation research loses most of its value if it is not shared with other community development practitioners. Like many public goods, the government must take the lead because most organizations will not invest in developing and sharing evaluation research because of a “free rider” problem (those who use the information do not contribute to the cost of collecting it).

The federal government also has the ability to standardize evaluation research and reporting procedures for community development projects. It would be helpful to require certain evaluation methods and reporting procedures in order for community development practitioners to receive tax breaks or other financial benefits.

The current CRA provides little incentive for banks to conduct evaluations of community development projects they invest in. As a result, little is known about the true impact of the CRA on low- and moderate-income communities in the United States. Banks do not want to allocate the additional money and time to collect and analyze data. Banks are simply trying to meet their CRA requirements and are not invested in the social impact of the projects. These incentives must be altered to encourage banks to perform evaluations and to invest in more effective community development projects.

66 Ben Thornley and Colby Dailey, “Building Scale in Community Impact Investing through Nonfinancial Performance Measurement,” Federal Reserve Bank of San Francisco, *Community Development Investment Review*, Volume 6, Issue 1, 2010.

67 Franck S. Wiebe, Millennium Challenge Corporation, “Working Paper: Aid Effectiveness: Putting Results at the Forefront,” October 27, 2008.

It is time to create an evaluation environment in the United States that creates incentives for thorough evaluations and shared impact results. The international arena offers a wealth of knowledge that could inform and inspire domestic antipoverty efforts. With more and better social impact evaluations and cost-benefit analyses, we can have a greater impact with fewer resources on U.S. impoverished communities. We must demand proof of the effectiveness of our community development projects and no longer be content with basing our community development strategies on status quo assumptions.

Paul Veldman is currently completing a Master's Degree in Public Administration (MPA) at Columbia University's School of International and Public Affairs (SIPA). He also has experience working with microfinancing institutions in Kenya and currently works with the United Nations Population Fund (UNFPA). Prior to attending SIPA, he worked as an Environmental Impact Consultant in San Francisco. Mr. Veldman holds a B.A. from UC Berkeley.

Appendix A: Examples of Observational Method

The following are examples of observational evaluation methods that are used in the international development field. Many of these examples use a mix of the above observational evaluation techniques.

Progress Out of Poverty (PPI)

Overview. Dr. Mark Schreiner developed the Progress Out of Poverty Indices (PPIs) for the Grameen Foundation. The PPIs attempt to measure how many microfinance clients are in poverty and whether they are moving out of poverty. Although this method has been applied to the microfinance sectors, in theory it could be applied to other industries. The method used in the PPIs is very similar to the method used by major credit card companies when determining the credit risk of potential clients, but adapted to estimate the likelihood of poverty. As of 2008, foundations and organizations have developed approximately 36 PPIs in the following countries: Bangladesh, Bolivia, Guatemala, Ghana, Haiti, India, Kenya, Malawi, Mexico, Morocco, Nepal, Nigeria, Pakistan, Peru, South Africa, The Philippines, and Vietnam.

Data. The PPI is based on a national income and expenditure household survey for a country. This usually involves a sample size of 7,000-50,000 households, which is usually conducted by a government's statistical department every several years.

Methodology. The survey asks questions of households that assess how much a household earns and how much it spends, as well as up to 200 other nonfinancial questions such as: What are the walls of your house made of? Do you own a refrigerator? How many in your household are between the ages of 0 and 17? Analysts then use regression analysis of the survey data to determine which of the nonfinancial questions best predict poverty at the national or international poverty line for a given country. The PPI ultimately consists of ten questions that are predictive of poverty, not co-related (overlapping), easy to ask and not offensive, easy to verify, and discreet. The questions are tailored to local customs and personnel preferences in different countries. Loan officers at micro-financing institution (MFI) ask the questions of clients during the loan application and maintenance process. This approach uses the prospect of receiving a loan as an incentive to beneficiaries to participate in the evaluation process.

Analysis. From the surveys, a threshold is calculated to represent the poverty line. Data are then aggregated to illustrate trends among groups of clients over time, and their progress out of poverty is subsequently measured. This approach only assesses indirect effects and, therefore, cannot be used to measure the MFIs' direct impact on poverty reduction.

Dalberg Approach

Overview. The Dalberg approach was created by the Dalberg Global Development Advisors in 2001 to assess organizations' progress in achieving financial and social goals. As of 2008, Dalberg has implemented more than 400 projects for more than 100 global organizations in over 75 countries around the world. About one-third of projects evaluated have been for international organizations such as the World Bank and the United Nations Development Programme (UNDP); one-third with businesses trying to expand operations into developing countries, and one-third with foundations such as the Bill and Melinda Gates Foundation. This approach provides a more accurate assessment of how an organization's social impact activities are benefiting an individual or community and focuses more on the indirect impacts of an organization's activities and less on its direct impacts.

Methodology. The Dalberg approach divides organizations involved in social entrepreneurial activities into three categories: 1) those striving for standard commercial returns with some consideration for social impacts; 2) those seeking blended capital models where a lower internal rate of return is acceptable in order to achieve social impacts but profitability is still expected; and 3) social-enterprises that may not be commercially viable, but are striving to achieve self-sustainability. Most of the data are self-reported by the client investor or company.

Data. This approach collects data on a program or project's result hierarchy, discussed above. Analysts collect information on the entire process from inputs, activities, outputs, outcomes, to goals.

Analysis. The Dalberg approach is a comprehensive analysis, starting with an evaluation of the social impact theory behind a project's activities. The approach then analyzes a project's inputs and the resulting activities from those inputs. Following this, researchers analyze the outputs of the project's activities and measure their resulting social impacts. Finally, the team compares these results against a counterfactual or benchmark, which is usually a similar business that focuses only on the bottom line and not a social impact. For example, the Dalberg approach would analyze an energy resource project that focuses not only on increased dollar volume purchased locally, but also on how to increase value added locally, and skills, employment, and enterprises built locally. This would be compared against a similar energy resources project that was concerned with just profits.⁶⁸

Movement Above the US \$1 a Day Threshold

Overview. The Movement Above the US \$1 a Day Threshold is a nine-year strategic plan begun in 1997 by the Microcredit Summit Campaign (MSC). The plan is to achieve its goal of reaching 175 million of the world's poorest people through microcredit and ensuring that, between 1990 and 2015, 100 million families rise above the US\$1/day threshold. The

⁶⁸ See www.dalberg.com/case_studies.php, for more information on the Dalberg approach.

movement is based on the partnership of MSC and 15 of the largest MFIs and networks in the world (representing approximately 60 percent of the world's entire microcredit clients in 2008). The MSC found sufficient existing data to make calculations for Bangladesh, India, Pakistan, Vietnam and Sri Lanka.⁶⁹ MSC plans to expand the project to include Africa and Latin America in the coming years. This approach only measures the economic status of the beneficiaries and focuses on the indirect impacts of the microfinancing programs and less on the direct impacts.

Data. The socioeconomic indicators used in the scorecard survey include information on food consumption, children's education, and various household assets. MFIs report the data, but credibility varies. MSC performs offsite third-party verification of source documentation by confirming the consistency of self-reported data.

Methodology. Assessing income improvement among clients includes: 1) analyzing existing data about clients' rise above the \$1/day threshold; 2) administering surveys to establish baseline data for new clients so their progress can be assessed; and 3) commissioning panels of top poverty researchers in various countries to ensure accurate estimates of the total number of clients who rise above the \$1/day threshold. In addition to the three steps, MFI loan officers administer a "poverty scorecard" of 10 questions during the loan application and maintenance interviews with the clients.

Analysis. The scorecard is administered at the clients' entry and periodically over time and hence determines whether, and when, a client passes the threshold. Partnering nongovernmental organizations administer the scorecards.

Social Rating

Overview. Social Rating is a tool pioneered in 2005 by Micro-Credit Ratings International Limited (M-CRIL).⁷⁰ The Social Rating has been applied to MFIs in Bangladesh, India, Vietnam, Cambodia, the Philippines, Kenya, South Africa, Bolivia, and Haiti. This approach provides more information about the direct effects of the MFI's activities and less on the indirect effects.

Data. Data are collected through client interviews targeting four areas: 1) clients' awareness about the financial projects, including knowledge of the interest rates they are charged on loans, the rate paid on their savings, and other details; 2) clients' access to capital and the role the MFI plays, such as whether anyone in the household already has a savings account with another MFI, has outstanding debt from a moneylender, etc.; 3) enterprise-level information including the enterprise's industry sector, whether any employees are non-family

69 www.microcreditsummit.org/movement_above_one_dollar_per_day/ for more information on the Microcredit Summit Campaign

70 M-CRIL provides a rating of MFIs that allows investors and to effectively invest their money to achieve social, ethical, and financial goals.

members, etc.; and 4) poverty information using, among other indicators, the PPI where applicable, and income relative to the poverty line where it is not.

Methodology. The process begins with an MFI providing M-CRIL with annual reports and other operational and portfolio information. M-CRIL reviews the reports, and an independent rating committee of third-party experts reviews the content and quality before the evaluation is finalized. After reviewing the material, M-CRIL staff meet with the MFI's board members and senior management to explain the Social Rating process. Analysts then interview a subset of staff members on all levels about mission, targeting, product development, market segmentation, client retention, human resources, management information system, and internal audit. Following this process, the team visits two to three branches for interviews with loan officers and a random sample of clients big enough to attain results at a 95 percent statistical confidence level. MFI staff who have been trained and who are supervised by M-CRIL often conduct the interviews.

Analysis. M-CRIL conducts client focus groups to obtain information on the effectiveness of the MFI. M-CRIL also performs cross-tabulation, frequency distribution, and qualitative analysis. The above efforts are used to assign a letter rating and accompanying narrative and quantitative report for the MFI. This information is made available to the public.

Appendix B: Examples of Cost-Benefit Analysis

Although cost-benefit analyses do not require as much time and resources as randomized evaluations, they still can be taxing on an organization. Collecting data for calculating the cost-benefit ratios can be difficult and time consuming. The following evaluation toolkits employ some form of a cost benefit analysis.

Acumen Fund, Best Available Charitable Option (BACO) Ratio

Overview. Acumen developed its BACO Ratio methodology in 2004. Acumen Fund seeks to quantify an investment’s social impact and compare it with existing charitable options for that explicit social issue. This helps to inform investors where their philanthropic capital will be most effective and answers the question, “For each dollar invested, how much social output will this generate over the life of the investment relative to the best available charitable option?” In cases where a viable local comparison does not exist, Acumen tries to develop realistic hypothetical options on the basis of other geographies or from plausible “what if” scenarios.

Data. Acumen Fund assesses how another organization performs compared to outcomes Acumen Fund estimates they could achieve by using the same amount of money and implementing the program themselves. For example, Acumen Fund could estimate that it would cost them less than \$0.02 to protect one individual from malaria for one year, compared with \$0.84 via the next best option of investing the money with an NGO that already provides protection from malaria. In other words, Acumen Fund’s investment in this scenario is 52 times more cost-effective than the best available charitable option.

Analysis. The BACO cost calculation is completed against a range of three financial scenarios: full return on investment (principal plus interest); return of only the principal; and complete loss. Similarly, the social impact forecasts are broken down into three scenarios: initial projections (from the original investment plan); conservative projections (developed by Acumen Fund portfolio team, on the basis of moderate growth plans); and revised projections (updated on a real-time basis using actual impact data).⁷¹

Hewlett Foundation Expected Return

Overview. The Hewlett Foundation developed its Expected Return (ER) methodology to evaluate potential charitable investments through a systematic, consistent, quantitative process.

71 Acumen Fund, The Best Available Charitable Option, http://www.acumenfund.org/uploads/assets/documents/BACO_percent20Concept_percent20Paper_percent20final_B1cNOVEM.pdf, January 2007.

Data. The formulae for the ER method is as follows:

Expected return is calculated as such:

$$\frac{\text{Benefit in perfect world} \times \text{likelihood of success} \times \text{philanthropy's contribution}}{\text{Cost}}$$

Where:

Philanthropy contribution includes a *financial contribution* (the percentage of an individual organization's contribution relative to the overall philanthropic contribution needed to achieve the outcome) and the *degree of influence* (how important the investment is to achieving the outcome). The degree of influence can result in philanthropic contribution that is greater than the level of financial share (if the philanthropy is providing other expertise, such as leadership), or it can result in a contribution that is less than financial share (if the philanthropy is relying on the services and expertise of others, and is contributing little other than money).

and where:

The cost includes program cost and percent of overhead cost used to support the program.

Likelihood of success is calculated as such:

$$\text{Likelihood of Success} = \text{strategic accuracy} \times \text{grantee success} \times \text{external conditions}$$

Analysis. Expected Return forces program officers to test their assumptions and theory of change or their logic model against the ER results, quantify high-level trade-offs between investments within an investment portfolio, and ideally make better prospective funding decisions within their investment portfolios. Calculating the likelihood of success forces program officers to consider unidentified risks instead of just focusing on impacts. Similarly, assumptions must be made explicit.⁷²

RAND Corporation

Overview. The Rand Corporation studied the measurement and use of estimated economic value, or "shadow price," in applying cost-benefit analysis to social program evaluation. Although this study is not an evaluation toolkit, its findings and method provide valuable insight on how to perform cost-benefit analyses.⁷³

Data. The RAND Corporation reviewed 39 social programs whose effectiveness has been evaluated with scientifically rigorous methods. A third party then conducted one or more cost-benefit analyses for 22 of the 39 programs.

72 William and Flora Hewlett Foundation, "Making Every Dollar Count: How expected return can transform philanthropy," <http://www.hewlett.org/what-we-re-learning/strategy>, April 10, 2008.

73 Lyn Karoly, "Valuing Benefits in Benefit-Cost Studies of Social Programs," Rand Corporation, http://www.rand.org/pubs/technical_reports/2008/RAND_TR643.pdf, 2008.

Analysis. The study finds that many of the important benefits that accrue from social programs are rarely, if ever, monetized. It also finds that shadow prices for outcomes in cost-benefit analyses do not consistently capture the full range of societal benefits or costs. Even where there is a well-established research base for valuing outcomes, the use of shadow prices is not consistent across studies of social programs. The study also found that program benefits that extend into the future may be monetized, but uncertainty associated with future costs and benefits must be recognized. The findings suggest directions for future methodological work to advance the use of cost-benefit analysis in evaluating the economic returns from social programs.

The Roberts Enterprise Development Fund SROI

Overview. The Roberts Enterprise Development Fund (REDF) created the Social Return on Investment (SROI) in 1996 to analyze the social returns on investment of two of its social purpose enterprises. Although the SROI was developed in the United States to evaluate domestic programs, REDF was one of the pioneering organizations to develop a cost-benefit analysis method for development programs. As a result, many international organizations have adopted the SROI or developed a new method based on it. The SROI was calculated to demonstrate the social, enterprise, and blended value accrued to society compared with the total investments for a given social enterprise program on an ongoing and retrospective basis.

Data. Data are mostly collected through analyses of the financial statements of the participating organization.

Analysis. The SROI measures value creation, which is presented as a continuum ranging from social, to socioeconomic, to economic value creation. The SROI uses a discounted cash flow analysis in an effort to monetize the economic value of social impacts of programs in the REDF portfolio. This monetized social value is then consolidated with the economic value created by the same social purpose enterprises.

The six stages of the SROI analysis are:

Stage 1: Calculate enterprise value, forecast its cash flow, and then discount its free cash flows, using an appropriate discount rate.

Stage 2: Calculate the social purpose value (mirroring the enterprise valuation process). Estimate the future social purpose cash flows, calculate a terminal value (value created beyond the ten-year point), and then discount that value using a discount rate appropriate to social investments.

Stage 3: Calculate the blended value: Add together the enterprise value and the social purpose value, and subtract any accrued long-term debt.

Stage 4: Enterprise index of return: This index summarizes an enterprise's financial performance relative to the investment it required. To calculate, divide the enterprise value (its projected cash flows discounted to a present value) by the investment to date.

Stage 5: Social purpose index of return: This index summarizes the degree of social impact that can be monetized relative to the investment it required. To calculate, divide the social purpose value (determined by the methods described above) by the program's investment to date.

Stage 6: Calculate blended index of return by comparing the blended value and the investment to date. This shows the return on both business and social mission activities relative to the investment to date.⁷⁴

Social Impact Assessment (SIA)

Overview. The SIA is an evaluation tool developed by Global Social Venture Competition (GSVC)⁷⁵ with methods adopted from REDF's SROI and the work of Clark et al. in the Double Bottom line Catalog. GSVC started requiring quantification of projected social impacts during the first round of the competition in 1999-2000, and formalized the SIA guidelines in 2003. As of 2008, 37 countries had submitted 764 full business plans, all of which contained SIAs.

Data. The SIA is based on three major steps: 1) define the social value proposition that is core to the organization's desired social outcomes using the "Theory of Change" tool (meaning that the proposition is strongly based on social impact theory); 2) quantify the social value by listing the top three leading social indicators that are measurable and that will most strongly correlate with the organization's desired social outcomes, and that can be tracked as part of their normal business operations; and 3) monetize the value of the social impact the organization aims to create over the next 10 years. Data are self-reported, and no one verifies the secondary research sources upon which extrapolated outcomes are based.

Analysis. The SIA provides guidelines for a self-directed process for entrepreneurs. The guidelines include developing an impact value chain that specifies financial, human, and other inputs required for operations; activities; measurable outputs produced; and outcomes or changes in terms of the social, environmental, or economic issues being addressed by the venture. Entrepreneurs prioritize outcomes and determine applicable leading indicators that are used to monitor the activities and/or outputs believed to be correlated with desired outcomes. Secondary measures of outcomes that have been correlated with similar ventures support the selection of metrics. If possible, the SIA directs entrepreneurs to assign a monetary value to outcomes, which allows for a discounted "social cash flow analysis" of these values. There are no standard discount rates for such calculations and, therefore, the SIA requires the entrepreneurs to create their own logical discount rates. The SIA is limited in scope because the evaluation is only for future projects and is not used for follow-up verification.

74 Carla I. Javits, "Social Return on Investment (SROI) Collection" (San Francisco: Roberts Enterprise Development Fund, n.d.), available at www.redf.org/learn-from-redf/publications/119, 2000.

75 The GSVC is the largest and oldest student-led business plan competition providing mentoring, exposure and prizes for social ventures from around the world. For more information, see www.gsvc.org/about_gsvc/.

Appendix C: Examples of Processed-based Evaluation

Evaluation of an organization's processes and management lends itself to creating a certification or scoring system based on how well organizations achieve key elements (that is, internal management systems, processes and procedures, and incentives) that have proven to result in successful development projects. Below is a discussion and examples of certification and scoring methods that use process-based evaluations.

Certification. The Fair Trade certification creates the market for impoverished farmers to sell their goods to the consumers with the assurance that the goods were produced in a socially responsible and environmentally sustainable fashion. Companies such as Starbucks have realized the benefits of attracting socially conscious consumers and now advertise that they are Fair Trade certified.

Fair Trade Certification

Overview. Transfair USA has developed a successful certification system for agricultural products grown in other countries. It began in the 1980s, and as of 2008 has certified more than 25 products from over 55 countries. Fair Trade Labeling Organizations International (FLO) certifies and updates certifications. FLO is an organization composed of nonprofit organizations and regional farmers representing approximately 1.4 million FT farmers and workers. The certification provides an evaluation of an agricultural producer's direct and indirect impact on economic social and environmental factors.

Data. A cooperative or producer group interested in receiving the FT certification submits an application. FLO-CERT, a wholly owned subsidiary of FLO, inspects participating farms and registered producers annually or biannually. FLO-CERT also verifies that the pricing premiums generated are invested in socially responsible projects, such as in community development projects, infrastructure, scholarships, or other needs.

Analysis. The certification guarantees to retail buyers that the agricultural products are produced with methods that meet the minimum standards for fair prices, fair labor conditions, direct trade, democratic and transparent organization, community development, and environmental sustainability.

Scoring and rating. Consumers and investors are becoming more socially conscious and as a result are seeking businesses that are socially responsible and that practice environmentally and developmentally sustainable practices. This has resulted in businesses focusing on a "double bottom line." The conventional first bottom line measures a business's fiscal performance—whether it is making a profit. The second bottom line assesses and measures its positive social impact. In addition, some businesses monitor their triple bottom line, which assesses the ecological impact.

Similar to the certification process, scoring and ranking businesses based on their social

impact are other possibilities. Rating an organization's performance can also be achieved with "benchmarking." Benchmarking evaluates an organization's performance relative to its peers. Benchmarks might be based on beneficiaries' perceptions of an organization's philanthropic activities, for example. If enough organizations are surveyed a ranking system can be created by comparing the performances, as determined by the surveys, of the organizations.

The various methods score organizations on a variety of aspects including: governance, impact on the company's employees, the community, the environment and consumers social impact, internal processes, learning and growth, financial risks, economy, society, well-being, and synergy. The following are examples of evaluations toolkits that are used to measure and rate organizations based on the various social impacts, and in some cases environmental sustainability, they achieve.

Human Impact + Profit (HIPTM) Scorecard and Framework

Overview. HIP Investor, Inc., developed the HIP Scorecard and Framework in 2004. It borrows from the SROI framework, among others. Analysts have used HIP to evaluate organizations in Costa Rica, France, Italy, India, The Netherlands, Thailand, United Kingdom, and United States. As of 2008, it has been applied to approximately 60 companies in the following sectors: energy, banking and microfinance, consumer projects and food, high technology, real estate, manufacturing, clean technology, and nonprofit organizations.

Data. The HIP quantifies human, social, and environmental impacts, how those impacts create financial results, and the management systems required to maintain success in the future. This approach focuses on the result-oriented measures of five categories: health (physical and mental), wealth (net assets and income), earth (carbon and environmental), equality (gender and ethnic balance), and trust (lawfulness and transparency). It assesses both direct and indirect impacts by analyzing the customers, employees, and suppliers, and it illustrates to what extent improvements in human impact create higher revenue, lower costs, or tax benefits. These measures are quantified and then an analysis is conducted through company interviews and secondary research. The HIP also assesses five management practices that drive sustainable, profitable growth: vision, measurement, decision making, accountability, and financial alignment.

Scoring. Analysts score organizations on the basis of three aspects: human impact, profit (and how it is affected by the human impact), and management practices (and the organization's relationship to sustainability). The scorecards can then be used for comparisons and to gauge the attractiveness and weightings of investments in a portfolio.

Portfolio Data Management System (PDMS)

Overview. The Acumen Fund in conjunction with Google engineers developed the PDMS in 2005. As of 2008, Acumen has used the system to assess more than 20 companies and more than 40 corporate and private foundations in countries including the United States,

Kenya, Pakistan, South Africa, India, and Tanzania. The PDMS is an online tool that allows investors to track a consistent set of quantitative financial, operational, and social metrics for each company. The PDMS primary focus is on the indirect effects of a company's activities, with less emphasis on its direct effects.

Data. Acumen staff enter company-reported data into the PDMS. In some cases, staff verify data on-site. Acumen creates a profile of a company in the PDMS when it is added to its portfolio, and sets targets on the basis of the company's business plan. The PDMS provides the flexibility to define custom metrics across investments and to perform qualitative assessments of the data. The impact potential of a company is based in part on a comparison of the company's outcomes per dollar invested with Acumen's "best available charitable option" (BACO), discussed above.

Scoring. The PDMS provides a qualitative rating of a company's management using a standardized "capabilities assessment" in six areas: alignment with the investors' mission, financial sustainability, potential for scaling up, potential for social impact, management capability, and business model effectiveness. This information is for investor use only and is not available to the public.

Charity Analysis Tool (CHAT)

Overview. New Philanthropy Capital (NPC), a U.K. organization, created CHAT in 2002. CHAT has been updated several times to improve its consistency of application and standardization of documentation.⁷⁶ This evaluation method provides a more in-depth analysis of an organization's indirect impact relative to its direct impact. CHAT has been used to assess 400 to 500 U.K. charities. NPC has performed partial analyses of organizations operating in other countries but does not officially list them as "NPC recommended."

Data. NPC analysts spend 9 to 12 months performing field and desk research and analysis of a specific sector in order to produce a list of 10 organizations that are published in the "NPC recommend" list. An important feature of the CHAT is that it subtracts base case evidence (taking into account what would have happened in the absence of the organizations' interventions) from the results when this information is available. This provides a more accurate measure of an organization's impact.

Scoring. The analysis rates organizations in three categories: results, risks, and capacity. The results section is further broken down into breadth, depth, and change. The risk section is divided into organizational, financial, management, strategy, and evidence of claimed impact. The ratings are summarized in a two-page report that scores the following topics on a scale of 1 to 5: breadth (scale), depth (intensity), and change of impact, risk, difficulty of fundraising, organizational maturity, innovation, scalability, replicability, and geography.

⁷⁶ NPC provides consulting to funders and nonprofits for the purpose of achieving greater impacts.

Compass Investment Sustainability Assessment

Overview. AtKisson, Inc., developed the Compass Investment Sustainability Assessment in 2000 to allow investors to choose companies that can effectively make the transition to achieving social, economic, and environmental sustainability. As of 2008, it has been used to evaluate 13 companies. A streamlined version has been used to assess approximately 75 companies using publicly available data. The companies span France, Germany, Indonesia, Japan, Sweden, United Kingdom, United States, and Thailand.

Data. AtKisson performs the analysis in conjunction with the target company, and it is used to identify the opportunity for the company to improve its score over the lifetime of the investment.⁷⁷ This assessment is an index evaluation of early-stage companies. It assesses progress in five categories: nature, economy, society, well-being, and synergy (how the company and all five categories complement one another to achieve its goals). These five categories are further divided into 20 parameters that are weighted according to the company's focus and area of operation.

Scoring. The analysis results in a point score on a 100-point scale. The following metrics are qualitatively assessed to estimate their direct and indirect impacts: energy usage, material flows, and interaction with the community. The reports are presented to each company and its investors. The assessment is updated every two to three years.

Development Tracking System (DOTS)

Overview. The International Finance Corporation (IFC) developed DOTS in 2005 to help evaluate and improve the social impact performance of organizations in its portfolio. IFC intends to use DOTS to track all of its projects, which are located on every continent. DOTS provides an annual development outcome rating and industry-specific social impact indicators that measure the social impact of investments on stakeholders. The result is a rating of an organization's indirect impacts and a partial analysis of its direct impact.

Data. A team of IFC employees identifies specific goals and performance indicators that apply to a specific project. The indicators must be relevant, able to be aggregated, time-bound, and easy to track. The team measures these indicators against benchmarks and timelines at least once.

Scoring. The analysts rate each project on four categories: financial, economic, environmental and social performance, and private-sector development impacts. The metrics together measure whether the investment has generated additional investments in the area or sector. Analysts assign the performance on these four categories and their interrelation a rating on a six-point scale from highly successful to highly unsuccessful. Results from DOTS are available to organizations that partner with its Advisory Serviced Division but are not publically available.

⁷⁷ AtKisson, Inc., is a consultant company that provides strategic consulting, training and facilitation, assessment, communications and reports, and workshops for organizations that are striving to accomplish sustainable development. <http://www.atkisson.com/wwd.php>.

The Latest Frontiers for Financial Inclusion: Using Mobile Phones to Reach the Unbanked

Tillman Bruett

UN Capital Development Fund

Financial institutions are not winning any popularity contests these days. Banks are derided as the instigators of crisis and pillagers of wealth instead of caretakers of savings and partners in growth that they are meant to be. Even worse, many claim that it was policymakers' obsession with helping uncreditworthy low-income households gain access to mortgages that caused the crisis in the first place. Subtly implicating the poor in the colossal mismanagement of the financial sector by the (primarily) rich and the regulators that enable it is wrong. The truth is that banks and other financial service providers haven't done nearly enough to help the poor. The good news is that this is beginning to change—and we have the world's mobile network operators to thank.

What is financial inclusion?

As much as the citizens of the developed world may disdain banks, they still rely on all sorts of financial service providers for dozens of services such as checking accounts, automated teller machines (ATMs), Point of Sale (POS) devices, credit cards, and insurance just to name a few. In most developed economies more than 90 percent of households use bank accounts to save and to make payments. In many developing economies nearly 90 percent of households lack access to bank accounts and operate in a world of cash and informal borrowing and saving arrangements that are neither transparent nor regulated. The basic premise of financial inclusion is that the only way to bring financial services to the poor is to engage the formal financial sector. While specialized microfinance institutions are part of this, it makes little sense for 90 percent of the population to be excluded from the mainstream financial sector. To borrow from the United Nations, "Inclusive financial sectors are defined by a continuum of financial institutions that together offer appropriate financial products and services to all segments of the population."¹ And this goal is important even in low-income communities in the United States where the percentage of unbanked people can rival the numbers in the developing world.

Much more than microcredit

In the popular imagination, microfinance is microcredit, making small loans to groups of women to support a family business or farm. While this remains an important part of finan-

1 UNCDF and UNDESA. "Building Inclusive Financial Sectors for Development." May 2006.

cial inclusion, it represents a decreasing share of a rapidly growing movement to change the world's financial systems to better serve the financial needs of everyone, including the poor.

Some groundbreaking research has shown that despite a lack of options, poor households across the globe are incredibly active money managers and create mechanisms that imitate formal financial services. In “Portfolios of the Poor: How the World’s Poor live on less than \$2 a day,” the authors assist dozens of low-income households across three countries to track their daily cash flow.² The diaries show that these families are often using ten or more “financial instruments” during the course of the year to allow them to accumulate (and spend) money in the needed amounts to get by. The records also suggest that poor households can grow their way out of poverty if they are able to avoid (or better manage) major calamities that destroy their savings or force them to sell off their possessions. When a family member loses a job, gets sick or dies it can push an otherwise upwardly mobile family back into poverty.

In developing economies low-income families lack government-sponsored social safety nets. To protect themselves, they seek different ways to save and manage money for medical treatment, funerals, school fees and costly family obligations. In other words, the benefit of financial inclusion is not just about providing financial opportunity; it is helping households everywhere to increase financial security.

The problem of distribution

As C.K. Prahalad noted in “The Fortune at the Bottom of the Pyramid: Eradicating Poverty Through Profits,” that for decades companies have learned how to package things small enough and distribute them wide enough to reach the low-income market.³ Satchels of shampoo, small bars of soap and bottles of cola can be found in the most remote places in the world. The global financial services industry needs to do the same. While the microfinance industry has helped show how to package services for the poor, including credit, savings and insurance, it has not been nearly as successful at distributing them widely. When a microfinance institution reaches ten thousand clients and does so profitably, it is considered successful. But there are a billion more to reach.

Microfinance institutions and those that support them look to the business community for lessons on distribution. There have probably been hundreds of studies and articles on the distribution networks of Coke and Pepsi. Almost anywhere in the world you can find a cola in a shop that is painted or decorated with the colours and logos of one or both of the soft drink companies. In the past decade there have been experiments in using the distributors of everything from gasoline to beer to help solve the problem of mass marketing financial services.

2 Collins, Daryl and Morduch, Jonathan, Rutherford, Stuart, & Ruthven, Orlanda. *Portfolios of the Poor*, Princeton University Press. 2009.

3 C. K. Prahalad, *The Fortune at the Bottom of the Pyramid: Eradicating Poverty through Profits* (Philadelphia: Wharton School Publishing, 2005).

The masters of distribution are the mobile network operators (MNOs). For readers who have never been in a developing country or subscribed to a prepaid mobile phone service, it is worth explaining how it works. The prepaid mobile phone services is a “pay-as-you-go” business in which subscribers purchase air time incrementally (or “top up”) as they need it. Subscribers first purchase their own phone and SIM card (which contains their unique mobile phone number) and then buy air time from a local store or street vendor, usually in the form of a scratch card. These air time distributors are ubiquitous in most developing countries—in any small village the local shop is likely to sell air time along with sugar, soap and cola. In most cases, these air time sellers have no contact with the mobile network operator. They are part of a vast, multi-layered distribution network that is often managed by one or more companies that specialize in getting goods and services to the mass market. MNOs are increasing the rate of mobile connectivity in developing countries from below 10 percent to 90 percent in just a few years. And this is exactly what we wish to accomplish with financial services.

If you’ve read the mainstream news in the past year, it is likely that you’ve heard about mobile phones being used for banking. In this case the developing world is far ahead of developed economies. A New York Times article recently noted that while about 50 percent of Americans used on-line banking, only about 10 percent use mobile phone-based banking. In the developing world hundreds of millions have recently begun using their phones through an entirely new method of banking which is called “mobile money.”

Mobile money’s roots date back nearly a decade to the Philippines when two operators, Smart and Globe Telecom, introduced domestic payment platforms that operated through mobile phones. These two companies realized that the mobile phone is a securely connected channel for data not unlike that which is used for ATMs and POS devices around the world. Rather than having to work through traditional and often expensive money transfer services, customers could go to Smart Money or GCash (Globe) agents throughout the country, deposit money into their m-wallet accounts, and then transfer it to someone else using their mobile phone number. This is commonly known as a person-to-person, or “P2P” transfer service. If either the sender or the recipient of a transfer lack a mobile phone the notification will be sent to the nearest agent, the same agent that offers “cash in” and “cash out” services. The technology is not so different from the system used for prepaid air time. Mobile money operates like a system of prepaid debit cards, with m-wallet holders “buying” electronic value (cash in) which remains in their account until they “sell” it (cash out). Because all m-wallets are prepaid, all transactions are performed in real time and balances of all clients are updated instantly so there is very little risk of fraud. The same technology that allows MNOs to track how much air time a subscriber has in real time is ideally suited for managing millions of small financial transactions.

The holy grail of mobile money is Safaricom’s M-Pesa service in Kenya. Safaricom, a subsidiary of the Vodafone Group, launched a mobile money service four years ago that now serves over 12 million Kenyans. Once users add value to their m-wallet, they can use that

electronic value to purchase goods, buy top-up (purchase air time), or transfer funds immediately to another Safaricom user anywhere across Kenya. M-Pesa's subscribers can also exchange the electronic money for cash at an M-Pesa agent or at a number of ATMs around Kenya. M-Pesa was not the first to use mobile phones to provide financial services to the mass market, but the almost "viral" way in which the service has grown has changed the way we look at the world and in particular, financial inclusion.

Banks are also becoming more active in the market. As one example, ANZ Bank launched a subsidiary to complement its banking activities in Cambodia. ANZ's WING service initially focused on providing a reliable and inexpensive money transfer service for garment factory workers, mostly women, who often supported their entire families back in the villages through their wages. This was a customer segment that they never could have served through their bank branch. They also provide WING debit cards that allowed users to get cash at ANZ's ATMs rather than rely only on WING agents. MTN, a large regional mobile network operator in Africa, has partnered with a regional bank, EcoBank, to launch its service across the continent. In late 2010 another MNO, Orange Telecom, launched an m-wallet that is an actual bank account held on the books of Kenya's Equity Bank.

The spread of mobile money is accelerating. In Kenya, there is one mobile money user for every three Kenyans after only four years of operation.⁴ In the small Pacific island nation of Fiji, 25 percent of the population had a mobile money wallet within four months of the service being offered. There are nearly 100 mobile money deployments now active around the globe. The mobile money industry is still in its early phase and there are certainly fears that we are witnessing an "m-bubble" that could burst if MNOs are unable to make the service profitable. Still, it is the most promising solution to financial exclusion to date.

Transformational change

Technology is often the driver of change in policy, industry, and consumer behaviour and leads to a transformational change. As an example, digital music has radically changed the industry, the laws around it, and the way we access music and other media all at the same time. The same is happening with financial services.

Mobile phones and other technological innovations are bringing financial services to the mass market and forging new alliances between telecommunications and banking companies. It would not be surprising to see deeper integration between the two in the future. M-wallets are also changing consumer behaviours and will continue to do so as consumers find new ways to use the service. Wage earners are less tempted to spend all of their cash if they don't receive cash (or have to stand in long bank lines) at the end of the week. Family members supporting others can now send money more regularly in smaller amounts, better managing the family's finances.

⁴ Reports from Safaricom press releases.

Mobile money is forcing regulators and supervisors to deal with a new actor in financial services and reconsider the best way to regulate services. Most regulators have taken a “watch and learn” approach, allowing mobile money services to grow provided that all of users’ money in the system is kept in trust accounts in regulated financial institutions. The global financial crisis has also led to some soul searching by policymakers on how to shape a global financial system that serves the masses rather than itself. In 2010, the G20 took on the issue and developed its own “Principles for Innovative Financial Inclusion” as well as list of key action items for its member countries.⁵ At the top of this list was working with the global standards setting bodies, to review their own policies and how they might help or hinder efforts toward greater financial inclusion.

Perhaps the most important is reviewing the work of the Financial Action Task Force (FATF), affectionately known as the world’s “finance police.” The FATF sets guidelines for the world’s regulators on how to enforce anti-money laundering laws and combat the financing of terrorism. At a very practical level, it sets standards for client identification and customer due diligence. The new buzzword is “proportionate regulation” which means that regulators will consider regulations in proportion to the perceived risk of the financial service to the client and the financial system as a whole. It is now suggesting that regulators provide some flexibility to mobile money providers in verifying a user’s identity.⁶ So far, mobile money has proven to be a low risk activity.

Globalization certainly has its detractors, yet this combination of international bodies, multi-national mobile network operators, and yes, even commercial banks might just be on the right track to reach the next billion with appropriate financial services. And this creative mix of actors and new tools might yield important breakthroughs in reaching the unbanked in low-income communities in the United States as well.

Till Bruett is the Regional Technical Advisor in the Pacific for the UN Capital Development Fund (UNCDF) and manages the Pacific Financial Inclusion Programme (PFIP), a regional financial inclusion initiative to support innovative approaches to improving access to financial services. He is also a partner and co-founder of Alternative Credit Technologies (ACT) and a former adjunct professor at Johns Hopkins School of Advanced International Studies (SAIS) and Georgetown University. He currently lives in Suva, Fiji.

5 G20 Financial Inclusion Experts Group. Adopted in June 2010. Report is available at: http://www.microfinancegateway.org/gm/document-1.9.44743/Innovative_Financial_Inclusion.pdf.

6 FATF 40. Recommendations. Financial Action Task Force. November 2010.

CRA Goes Global: A Good Idea in the United States Could Use a Makeover and a Bigger Audience

David A. Smith

Affordable Housing Institute

Money is like muck; not good except it be spread.

—*Sir Francis Bacon, 1625*

Populist ire that arose from the credit crunch is being directed at banks from all corners of the globe, triggering a series of new laws and schemas, whose combined effect will be to impose on banks greater government control over their economics (more regulation on safety and soundness) and greater government interest in their social outcomes (inclusive banking). Of course, governments have the right to do this—banks make money because governments devise the laws that protect capital and property rights. Furthermore, banks cannot survive without government; it creates the enabling or disabling environment, and as we have just seen all around the world, government is the ultimate liquidity backstop in times of systemic failure. Thus, when economies are suffering, banks cannot retreat behind their credit policies, pull up the drawbridge, and wait out the global recession. For banks, the question should be, How do we do something meaningful and constructive without taking imprudent risks, or being forced by government into taking them?

In the United States, the social mandate for banks is currently formalized in the Community Reinvestment Act of 1977¹ (CRA), now well over 30 years old and showing its age. CRA encourages banks to use their financial sophistication and their capital-accumulation capacity to make the benefits of efficient financial markets more broadly accessible in their local communities, in a manner that is consistent with safe and sound operation. Housing is a core CRA asset class and an important tool for revitalizing low-income communities: housing is what anchors and improves a community, making it more attractive for subsequent investments.

The issues targeted by the original CRA—inclusive banking, redeployment of capital down-market, and the relationship between private commercial risk and public noncommercial risk—are primarily local or national issues. But today's banking world is global, both in capital flows and in multinational institutions, and that should force the field to reinterpret those original CRA goals in a global context.

¹ CRA, Pub.L. 95-128, title VIII of the Housing and Community Development Act of 1977, 91 Stat. 1147, 12 U.S.C. § 2901 et seq. More information available from the Federal Financial Institutions Examination Council (FFIEC) at www.ffiec.gov/cra/default.htm.

At the same time that bankers need to start thinking globally, other nations are acting locally. Nations as diverse as China, South Africa, and India are exploring CRA-like mandates for their banking industries. Many nations look askance at foreign banks, viewing them as exploiters, displacing local entities, heedless of local context or social, cultural, or economic requirements. It will not take much for these nations to impose new restrictions on foreign investment, foreign-to-domestic lending, or multinational banks and banking. Nor will it take them long to create taxes or surcharges that could make such banking unprofitable.

In response, the global banking community should consider a new commitment to community reinvestment, something I call an “inclusive banking charter.” This commitment should rest on four working principles:

1. *The need for community reinvestment.* Banks exist under and are protected by a regulatory umbrella that allows them to make profits. Because the regulatory support derives its legitimacy from all levels of society, and banks' depository capital comes from all levels of society, banks should recycle that capital into the communities from whence it came; otherwise capital flows will be used as a tool of disinvestment in disfavored neighborhoods.
2. *Emerging nations want their own customized forms of inclusive banking and community reinvestment.* Although the inclusive banking goal is universal, applying to all nations, each nation's response involves custom tailoring. Community reinvestment imperatives depend on the relationship between the banking sector—its strength, breadth, diversity, and profitability—and the social-investment sector, particularly in the context of urbanization and affordable housing. Thoughtlessly replicating the current CRA will not do.
3. *The current Community Reinvestment Act in the United States is due for a strategic refresh.* Although the premise of CRA—that banks can and will go down-market on a commercially viable basis, but they need government encouragement to do so as rapidly as society requires—remains as valid today as it was in 1977, so many other things have changed that the original CRA should be updated.
4. *Although a globally enforceable Inclusive Banking Charter (IBC) is impossible, critical inclusive banking/ community reinvestment principles should be globalized.* The CRA is limited to activity within the United States. Any other nation's statutory reach will be similarly bounded. Yet the world has some experience with transnational financial-regulatory agreements that transcend borders, such as Basel II.² As the United States remains the world's largest economy, with the most experience in CRA legislation and regulation, any other nation's IBC ought to take cues from, and learn from, the experience of the U.S. CRA.

2 Issued in June 2004, “The International Convergence of Capital Measurement and Capital Standards: A Revised Framework presents the outcome of the Basel Committee on Banking Supervision.” The English text may be found at <http://www.bis.org/publ/bcbs107.htm>.

The Policy Justification for Responsibly Inclusive Banking

Banks and financial institutions exist under and are protected by a regulatory umbrella that allows them to profit by taking in money from the public (deposits) at cheap rates, and then putting money back out (loans) at higher rates. Banks that use their explicit government charter and backing to profit therefore have a duty to redeploy their capital back to the community where they got it, on a commercially viable basis, with the government absorbing noncommercial risk.

The three-way relationship among banks, government, and socially responsible inclusive banking rests on seven public-policy principles that now have global applicability.

1. ***Banks do business with the public via an asymmetric power relationship.*** Banks interact with the public in three ways: taking in money (deposits), processing money (check cashing and clearance), and putting out money (loans and investments). From the perspective of a financial or economic ecosystem, all three are essential; an economy does not work until capital is continuously cycling. Yet when the customer is poor, the power dynamics tilt in the bank's favor, and a bank may discriminate unwittingly or wittingly. Put crudely, a bank can take money from poor people by allowing them to deposit, can make money off poor people by processing their credit cards or checks, and yet can exclude poor people from credit, doing nothing to alleviate their poverty, and indeed even contributing to it.
2. ***What to a bank may look like “careful credit” could be bigotry in disguise.*** A bank that is ultra-cautious with its outlay of capital but thoughtless of its inflow becomes an agent of exclusion either intentionally or inadvertently. Were they so inclined, unscrupulous or bigoted banks could perpetuate poverty simply by redlining places, people, or ethnic groups in a self-fulfilling prophecy of disinvestment.

That sweeping credit bigotry—those infamous maps with entire sections of town marked in red (or blue in the United Kingdom), as in “not to be lent to”—was the justification for the CRA legislation. Credit bigotry is unacceptable, yet credit prudence is also desirable, and in today's more complex world, it is difficult to distinguish one from the other.

3. ***The public interest conveys a public authority to ensure inclusionary banking.*** To operate, banks need government's security resources (e.g., charters, deposit insurance).³ When these are tapped, usually in the aftermath of exuberant, spendthrift risk-taking, government quite understandably demands recompense, and not just economic but also social.

³ Deposit insurance dates to the Great Depression with the 1933 enactment of Glass-Steagall, which, among other things, established the Federal Deposit Insurance Corporation. The FDIC today insures more than 7,700 US institutions. See “History of the FDIC” (website) at www.fdic.gov/about/history/index.html.

Regulatory penance always follows a short time after excess, and no previous massive expansion of government bank regulatory oversight has ever been rolled back. U.S. deposit insurance arrived in 1933 (in the same Glass-Steagall statute that limited banking's other activities). CRA would not follow for four decades. Now, in three short years, we have seen an explosion of reluctant-but-inescapable government support:

- The Troubled Asset Relief Program⁴ (TARP) and the explicit 2008 backing of Fannie Mae and Freddie Mac in the United States.
- The Bank of England's 2007 rescue of Northern Rock,⁵ and its similar massive investments into Royal Bank of Scotland, Lloyd's, HBOS (the former Halifax Bank of Scotland), and others.
- The European Central Bank's stress tests and their consequences, including the slow-motion domino cascade of European Central Bank support for bond markets in Greece,⁶ Ireland, Portugal, Spain, and who knows who's next?

In each case, government has not merely rescued many banks from their past excesses, it is now actively replenishing their equity capitalization, with central bankers holding macro interest rates at infinitesimal levels while banks then lend the capital at spreads much wider than they enjoyed prior to the crisis.

4. *Banks should fulfill their community service obligation through banking-related activities.*

If government could do something better than the banks, it could and would: government could simply impose a tax and then redirect the proceeds into the desired outcome. But government has learned that it is better to steer and pay than row and do. Government does best not by conducting activities that mimic or even compete with business, but by establishing priorities and providing resources, creating incentives for banks to do banking business: flow capital down-market in the form of lending, investing, and inclusionary access to banking services.

5. *The right credit-access boundary is between commercial and noncommercial risks.*

Banks are in the business of taking commercial risks, a key to which is that counterparty performance is enforceable through the courts and counterparty damages are collectable. Government cannot chide banks for refusing to extend credit unless it relieves them of the noncommercial components of risk (e.g., enforceability of foreclosure

4 Enacted into law on October 3, 2008, as part of the Emergency Economic Stabilization Act of 2008, Public Law 110-343.

5 A good current summary of the events is "The Bank that Failed," *Economist*, September 20, 2007, available at http://www.economist.com/node/9832838?story_id=9832838.

6 See, e.g., "Lessons of the Crisis: Ethics, Markets, and Democracy." Speech by ECB executive board member Lorenzo Bini Smaghi, Mary 13, 2010. Available at www.ecb.int/press/key/date/2010/html/sp100513.en.html.

rights at the local level)⁷ through a suitable and enforceable contractual commitment. Making this distinction is critical because it is not bigotry to withhold credit when one cannot rely on government to be an impartial enforcer.

6. *The right cost-pricing point is at the projected mature-business scale, with subsidies covering the pre-expansion costs.* Related to the credit risk boundary is the question of cost. Left to their own devices, financial institutions will move down-market only by moving up the cost curve—charging poorer borrowers higher rates to compensate for higher real and perceived risks of default. Once the business has become established, however, such lending can return to more normal spreads, restoring affordability. Thus, many businesses that are profitable require a non-recoverable startup cost in knowledge, information or network infrastructure, or initial activity costs. Private for-profit companies invest those costs when the post-scaling profitability justifies the return, but that will not always be so with inclusive banking, or at least, not quickly enough. Government can eliminate this barrier to growth with targeted or time-limited subsidies and tax credits. One example directly relevant to affordable housing is the blending of Low Income Housing Tax Credits with CRA equity investment goals.⁸

7. *Keep score on the basis of results, and make the scores count, with rewards and penalties associated with the scoring.* Rating of the banks' performance should be periodic and quantitative, with the results and reasoning transparent, and with a public opportunity to provide input and comment. Banks with high scores may gain preferential advantages (e.g., in opportunities to do business with the government), while those with low scores may be denied access or disadvantaged vis-à-vis growth and consolidation (e.g., bank mergers).⁹

Inclusive Banking Initiatives Globally

Globalization is pushing a number of changes that create a need for inclusive banking initiatives. Start with urbanization, the great demographic force of the twenty-first century. As more people move to cities, this puts tremendous pressure on those cities to accommodate them. Global-northern cities (e.g. New Orleans, Detroit, or Liverpool) face challenges

7 The archetypal case is Servcon in South Africa, established in 1995 to buy nonperforming loans where foreclosure was proving societally impossible as a result of widespread local government refusal to enforce vacant adverse possession, as a result of a “record of understanding” with the purchase of 50 percent of its shares by the National Department of Housing from the Banking Council, South Africa. A detailed history is available at http://www.dhs.gov.za/Content/housing_institutions/servcon.htm.

8 Low Income Housing Tax Credits (Section 42 of the Internal Revenue Code) were created as part of the 1986 Tax Reform Act and amended numerous times thereafter. For a modern perspective on CRA and its intersection with LIHTC, see David A. Smith, “LIHTC’s Bizarro CRA,” Tax Credit Advisor, March, 2010.

9 An excellent example of reward is South Africa’s Financial Sector, a transformation charter as contemplated under the Broad-based Black Economic Empowerment Act [Act 53 of 2003], described in further detail at http://www.fscharter.co.za/page.php?p_id=137.

of integrated urban renewal, while expanding slums challenge global-south metropolitan areas (e.g. São Paulo, Mumbai, Cairo, Istanbul, or Djakarta). Either way, urbanization means substantial investment in places, including expensive and complicated infrastructure, and that implies long-term capital, most of it debt, all of it reliant on real estate holding its value or appreciating.

In this case, urbanization is bringing together government (provider of law and incentives) and banks (providers of capital and risk assessment). Governments know they cannot solve the rapid urbanization/urban renewal problem alone, and that the solution requires innovation in housing finance. Meanwhile, banks know they can never solve housing affordability on their own because the simple economics of urban land markets dictate that the bottom quartile of below-market earners can never afford true market-quality housing.

Left to the private market, poor people must choose underconsumption, overpayment, or impossible commutes, all of which have their own negative consequences for not just the poor, but the middle class as well. For quality urban affordable housing, government must come to the fore with evergreen (self-renewing or continuously funded) resources. These resources can be cash or non-cash, on budget or off, administered at any of the three levels of government—nation (tax policy), state or province (lending and incentives), or locality (zoning and real estate taxes)—and they must be skillfully blended with suitable financing products and value chains.¹⁰

Second to urbanization is the growing recognition that public-private partnerships can spur successful urban policy while using the banking sector as a source of capital. When first confronted with the challenge of housing affordability, virtually every government chooses direct public intervention as its initial option. It may be called public housing (U.S.), social housing (U.K. and Europe), or some other name, but governments everywhere love to build new units (e.g., Turkey's TOKI¹¹) and rent or sell them to civil servants (e.g., Egypt's Ministry of Housing). Moving to public-private partnership for more than just construction involves a fundamental shift in government's awareness of the limitations of its natural role and the value of partnering.

A third force pointing to a global inclusive banking initiative is the need for a developed residential-banking sector. It takes two to tango. Banks must be willing to play, so they must be ready to engage with government, experienced with residential finance, committed to inclusive banking, and nimble enough to develop customized financial products and new community-banking initiatives and divisions. Indeed, at times a CRA emerges from an imbalance in which the banking sector is much more sophisticated and mature than the

10 Under a commission from the World Bank, the Affordable Housing Institute authored a World Bank Learning Note (WBLN) enumerating 16 types of subsidy resource, eight on-budget and eight off-budget. The WBLN is available free on request to the author at dsmith@affordablehousinginstitute.org. A good description of hybrid value chains can be found in Bill Drayton and Valeria Budinich, "A New Alliance for Global Change," *Harvard Business Review*, September 2010.

11 The Republic of Turkey's Housing Development Administration (Toplu Konut İdaresi Başkanlığı) recently completed its 500,000th home. See www.toki.gov.tr.

government, and government rightly recognizes that harnessing private expertise will be more effective than trying to compete against it.¹²

Naturally, banks also need customers with enough income to repay a home-purchase or home-improvement loan. When the nation as a whole is extremely poor, as in Haiti or Malawi, the urban poor earn so little that they can afford only the cheapest housing; thus, when a city is flooded with very poor immigrants, what they can afford is too little to be financeable formally. As a result, global-south urbanization often involves the rapid proliferation of slums and informal settlements, where informal and self-built private investment—shacks and slums—has outrun public infrastructure—roads, water, sanitation, and electrical grids.

Finally, for inclusive banking to emerge there must be a national commitment to overcoming a heritage of exclusion. America's CRA was born in part from frustration over housing as a segregationist holdover: although expunged judicially, discrimination nevertheless persisted spatially. Even vigorous enforcement of Fair Housing laws could not make buildings suddenly move or neighborhoods change overnight. During the 1960s, racial segregation in large-city public housing led to education discrimination in places such as Boston, Chicago, and New York. South Boston's violent response to school busing led to public housing integration. Spatial segregation through forced assignment to public housing in Chicago led to a series of civil-rights cases, most notably the *Gautreaux* decision, mandating poverty deconcentration through Section 8 housing subsidy vouchers.¹³ It is not surprising that the four nations most ready for CRA-esque regulation also have national legacies of exclusion: South Africa, the United Kingdom, India, and Brazil.

South Africa

South Africa already has a community-reinvestment initiative, the Financial Sector Charter,¹⁴ which emerged after the comprehensive failure of the African National Congress's first housing initiative, the Gateway program, whose collapse in some ways prefigured America's subprime fiasco.¹⁵ In 2003, political pressure compelled banks to lend in a manner that would have directed lending to particular geographies and at highly concessionary rates, nearly guaranteeing banks would lose money if they complied. Pulling together as an industry, the banking sector volunteered, at a Financial Sector Summit, a unilateral industry-

12 Such reasoning lies behind the U.S. CRA, South Africa's Financial Sector Charter, and the U.K.'s inclusionary zoning requirement, referenced later in this article.

13 An excellent study of Boston desegregation is the Pulitzer Prize-winning *Common Ground* by J. Anthony Lukas. *Gautreaux* legislation is *Hills, Secretary of Housing and Urban Development, v. Gautreaux et al.*, 425 US 284 S.Ct. 1538, 47 L.Ed. 2d 792, decided April 20, 1976. Full text is available at <http://supreme.vlex.com/vid/hills-v-gautreaux-19984031>.

14 The Broad-Based Black Economic Empowerment Act [Act 53 of 2003], described at www.fscharter.co.za/page.php?p_id=137.

15 Under Gateway, formerly excluded blacks were lent money to buy new homes, with variable-rate loans. When rates rose, defaults became epidemic, and when the banks sought to foreclose, they were confronted with repayment boycotts and township local police refusing to enforce repossession. The resulting nonperforming loans were dumped into an RTC-like entity, Servcon.

wide pledge and started a process of engaging with government and stakeholders, leading to a mooted Community Reinvestment Act being taken off the table. Under the resulting Financial Sector Charter, banks voluntarily:

- Negotiated lending and investment goals with quantitative targets;
- Agreed to report their performance publicly and transparently;
- Subjected themselves to consequences (prohibited from certain kinds of government contracting) for subpar performance or rewards for superior performance (preferred access to government contracts).

The charter ran for five years. Induced to apply their creativity to lower-income households, banks discovered that they could in fact make money in the market, with a wide array of both depository and lending products, as the banks substantially exceeded their cumulative capital targets. Their performance under the charter demonstrated its catalytic impact, focusing minds on numerous transformational issues, such as basic savings accounts and other inclusionary deposit-taking initiatives, low-income housing finance, financing of small and medium enterprises (SMEs), employment equality, and demographic representation on bank boards. In short, the charter experience successfully expanded banks' profitability frontiers down-market and turned a segment of the unbanked or underbanked into marketable customers.¹⁶

The story has one cautionary element. The charter is unilateral (a pledge by the banks without a formal quid pro quo from government), negotiated (developed via an open-ended process of engagement), and time-limited (five years). New targets are needed, but in 2008, the banking-government re-engagement stalled and is yet (as of January 2011) to be revived, although there are hopeful signs. The takeaway lesson is this: a good framework is evergreen but periodically adjustable.

United Kingdom

Despite being eminently suitable for a CRA, the United Kingdom has nothing of the kind (and the concept is greeted with horror by bankers). Through the 1970s, U.K. building societies (akin to U.S. savings and loans) "blue-lined" areas of no lending. During the 1980s, the Thatcher government intervened with regeneration schemes, including an inclusionary-zoning ordinance known as Section 106.¹⁷ Under the ordinance, developers seeking approval for urban-core redevelopment must ensure a certain percentage of homes are affordable (usually they are sold to the local authority and become government-owned council housing).

To American eyes, Section 106 is clumsy and ineffective: it is a zero-sum game, with no additional resources provided to developers in exchange for their financial concessions of

16 The charter experience is well detailed in "FSC Update," Access Housing, June 2009, published by the Centre for Affordable Housing Finance in Africa, a division of FinMark Trust, and accessible at www.finmark.org.za/documents/AHNL_June09.pdf.

17 Section 106 of the Town and Country Planning Act 1990.

affordability. Adding to the stalemate is the U.K.'s curious principle of not taxing undeveloped urban land, making open-ended land-banking a viable strategy and leaving warehoused parcels vacant squares on the urban landscape.

Logic dictates that quite soon (in legislative terms) the government will turn to banks to revitalize downtown areas, as it can unite three post-crunch developments:

- The new Conservative / Liberal Democratic coalition government is touting a Big Society led by private-sector initiatives, with a renewed emphasis on social enterprises as the delivery mode.¹⁸
- Banks, having been replenished with public money, are now announcing major profits.¹⁹
- The U.K. recently pioneered the social impact bond, a derivative tied to a nonprofit's measurable successful performance on a difficult social problem, such as juvenile crime recidivism.²⁰

Given these developments, look for the government to come to terms with the capital challenges and to table some mixture of mandates and incentives that will be later seen as the inauguration of a CRA process.

India

Despite *Slumdog Millionaire* and tourist impressions, India is predominantly rural, with only 28 percent of its land urbanized. However, given its enormous size and the speed of its urbanization, India's urban housing needs are the world's largest (outstripping even China) and most urgent. India needs housing at all levels of affordability: new construction for the upper middle class (townhouses and subdivisions), lower-middle-income high-rises to be built on greenfield sites like Tata's Nano House,²¹ and slum upgrading and formalization.

The country has a long history of societal exclusion: of Indians by the British, and of Indians by other Indians. Even today, the Dalits, formerly the untouchables, suffer discrimination in employment and housing. The exclusion has spatial consequences: India's richest urban neighborhoods may be less than a kilometer from the poorest, but they are separated by guards and gates, highways and railways. Now the government has launched a massive national campaign to eliminate slums. Rajiv Awas Yojana ("Rajiv's Housing Program," named

18 See, e.g., "Over to You," *Economist*, November 22, 2010.

19 See, e.g., Bloomberg.com, "Wall Street Sees Record Revenue in '09-10, Recovery from Bailout," December 12, 2010, available at www.bloomberg.com/news/2010-12-13/wall-street-sees-record-revenue-in-09-10-recovery-from-government-bailout.html.

20 See <http://www.socialfinance.org.uk/>, with the first Social Impact Bond having been placed in September, 2010 in the criminal justice sector (seeking to reward reductions in recidivism). Social impact bond payoffs have much in common with India's TDRs and the US's LIHTC – a future payment contingent on successful outcomes, which can then be factored for cash today by those non-government Mission Entrepreneurial Entities willing to risk their blood, toil, tears and sweat in tackling the challenge.

21 Tata builds the 'Nano home,' *Telegraph*, May 7, 2009.

after assassinated prime minister Rajiv Gandhi), is the successor to its current slum upgrading program, Jawaharlal Nehru National Urban Renewal Mission.²² At the level of formal housing with mortgageable title, India is sprouting housing finance companies (HFCs) like mushrooms, all regulated by the National Housing Bank. These HFCs will need capital, both to establish and expand their enterprises, and also periodically to liquefy their books of business.

Against this backdrop, India has a formal down-market banking requirement, Priority Sector Lending, which directs banks to deliver a portion of their net bank credit into 14 priority sectors.²³ Affordable housing loans qualify, as does microfinance and credit for other antipoverty national priorities, such as small-scale industries, small business, and agriculture. The Priority Sector Lending is in some respects similar to CRA and to the Affordable Housing Goals of the GSEs.²⁴

India's inclusive banking efforts are different from those in the United States and United Kingdom, and more resemble those in South Africa because when inclusive residential lending reaches informal housing, new challenges arise. The cornerstones of the U.S. system are the mortgageable titles that can be pledged as ready resale collateral and (as is evident in South Africa) the implicit guarantee of local judicial enforcement of the lender's right of recovery.²⁵ Thus the Indian government, if it wants to induce banks to provide meaningful capital into slum upgrading and slum formalization, will need to absorb the noncommercial risks.

India can take a page from the U.S. playbook with its own variations of the Federal Housing Administration (FHA) mortgage insurance. The insurance kicks in only after default,²⁶ normal lender remedies, and a collection failure attributable to government. This is symbiotic ecosystemic evolution: government co-evolving the policy ecosystem even as it imposes a social obligation that compels banks to evolve their economic ecosystem. Such collaboration characterizes successful inclusive-banking policy expansion.

Brazil

Through the mid-1990s, Brazil experienced periods of hyperinflation. This experience squelched any development of long-term stable interest rates essential to the emergence of a proper housing finance system. The result was nonexistent residential finance; the wealthy bought homes for cash or with personal loans, not mortgages. Monetary policy stabilized

22 For more information, see "Status Note on Rajiv Awas Yojana" (pdf), issued by the Government of India 2010, available at mhupa.gov.in/W_new/NOTE_RAJIV_AWAS_YOJANA.pdf. For more information on JNNURM, operated under the Ministry of Housing and Urban Poverty Alleviation, see its Web site, https://jnnurmmis.nic.in/jnnurm_hupa/index.html.

23 Details are available Federal Bank of India, "Priority Sector FAQs" at www.rbi.org.in/scripts/FAQView.aspx?id=8.

24 See "HUD's Affordable Lending Goals for Fannie Mae and Freddie Mac." Issue brief (Washington, DC: Department of Housing and Urban Development, January 2001). Available at www.huduser.org/publications/pdf/gse.pdf.

25 For the time being, we will overlook the current U.S. situation, where millions of foreclosed homes have no ready buyers and hence are not resale collateral, as being temporary.

26 See, e.g., 24 CFR 221, subparts C and D.

after the 1994 Plano Real and the 2001 election of Lula da Silva, as the inflation rate declined to 6-10 percent.²⁷ The nation as a whole has a robust banking sector, but it is commercial finance, not residential. Against that, under a 2003 law (Resolução 3109 Conselho Monetário Nacional²⁸) banks must earmark 2 percent of their deposits for micro-credit loans, but they are unenthusiastic participants and use of the resource is low.

Meanwhile, Caixa Econômica Federal, the government-owned savings bank, has grown to be the second largest bank in Brazil and originates roughly 70 percent of all Brazilian mortgages. Caixa and other state-influenced organizations can and do offer much lower rates for target customer groups, but the result is a crazy-quilt of finance alternatives that discourage even formal buyers of quality homes from tapping mortgage finance. Reorienting Caixa or converting its lending function into that of secondary market liquidity rather than primary origination—in other words, a post-crunch recapitalized GSE mode—would seem an essential step to rationalizing residential banking, as would broadening Resolução 3109 along the lines of India's evolving Priority Sector Lending.

Other Countries Where Inclusive Banking Initiatives Could Emerge

Other countries where inclusive banking initiatives could emerge include Australia, China, and Mexico. Each has its challenges:

- *Australia* has no analog to CRA, having only recently adopted a uniform national consumer-credit code analogous to the U.S. Home Mortgage Disclosure Act (HMDA), supplanting inconsistent state-level codes.
- *China* is experiencing both rapid urbanization and runaway development and price appreciation in a remarkable alliance between municipalities (which control land) and state-owned enterprises (flush with cash). These two groups are jointly plunging into high-end urban development fueled by high leverage, low rates, and grossly inflated values.
- *Mexico* has a long legacy of ejido land (a communitarian approach far short of fee-simple title), which has slowed its development of effective settlement procedures and hence the emergence of mortgages other than those deriving from its government mortgage bank SHF (the Sociedad Hipotecaria Federal,²⁹ analogous to U.S.'s Federal Housing Administration).

27 The Plano Real is described in Benedict Clements, "The Real Plan, Poverty" (CITY: International Monetary Fund), and Clements, "Income Distribution in Brazil," *Finance and Development*, September 1997, available at www.imf.org/external/pubs/ft/fandd/1997/09/pdf/clements.pdf.

28 Described in "Apêndice - Textos técnicos e acadêmicos" at www.bcb.gov.br/htms/Deorf/r200312/monografia.asp?idpai=REVSFN200312.

29 Created on October 11, 2001, via a decree enacting the Organic Law of Sociedad Hipotecaria Federal, regulating Article 4, fifth paragraph, of the Mexican Federal Constitution. See "About HFS" at www.shf.gob.mx/English/AboutSHF/Paginas/default.aspx.

CRA is unlikely to emerge in small countries, where the domestic banking sector is not strong enough to innovate voluntarily and the government is more interested in enticing international banks to enter than in squeezing them once they do.

Principles for an Inclusive Banking Charter That Can be Applied Globally

The CRA has generated important systemwide benefits, including:

- Knowledge transfer between banks and community development entities. Activity under CRA has taught banks how to lend down-market, how to partner with government in public-private ventures that blend economic and social resources, and how to slice commercial risk (which banks should take) from noncommercial risk (which governments should absorb).
- Financial product innovation by banks into new business spaces (e.g., lending for affordable rental, investment in Low Income Housing Tax Credits or New Markets Tax Credits).
- New business activities and profit centers (e.g., community development banks).

All of these innovative byproducts have permanently and positively influenced affordable housing lending and investment. They have also helped government make subsidies smarter, not just bigger.

Engineering a policy that applies these benefits to countries around the world will be difficult. Transnational policies are rare, but not nonexistent. Protocols such as Basel II or other conventions, such as accounting standards, can serve as models going forward. Encouraging banks to participate will be difficult too. If a bank dislikes a nation's inclusive banking rules, it can choose not to do business there. Companies weighing the potential costs of inclusive banking will reject compliance only when they think they can afford to lose that country's market. While it may not be an option for any global bank to boycott the United States, ignoring a small country may represent only a trivial reshuffling of priorities. However, from the small nation's perspective, a global bank's boycott could seriously crimp their access to the capital markets.

Finally, there are the obstacles that exist for any type of inclusive banking: corruption, weak enforcement, a large unbanked and underground economy, and nonexistent or unreliable earnings and credit histories. Even where inclusive banking is possible and feasible, national variations will be great, and they will change over time. Therefore, the system must allow for such periodic national adjustment.

These challenges notwithstanding, pressure for some action is building. Commerce and crime have traditionally gone international long before regulation and government.³⁰ Scale of criminal activity, however, impels governments to coordinate their response lest jurisdictional arbitrage encourage unethical or illicit activity to migrate to its underpoliced havens. This has occurred in global agreements (e.g., Basel II), global conventions (e.g., the United Nations' Global Compact³¹), and in wider reciprocal agreements eventually knitting into a global framework (e.g., corporate income tax treaties, anti-money-laundering statutes in the global war on terrorism).

Under transnational structures, broad coalitions of those who see themselves as the forces of good either pledge to adhere individually to coordinated policies, or adopt standards of business and then invite others to follow either voluntarily or through compliance pressure. It is no large leap, for example, to extend the corporate compliance apparatus from purely defensive activity (e.g. anti-money-laundering or Foreign Corruption Practices Act³²) to affirmative activity such as inclusive and community banking.

Elements of a Transnational Inclusive Banking Charter

A global inclusive banking charter should have global applicability and as much global standardization as possible, while allowing for national variation and changing national priorities. One policy model to consider is the U.S. Low Income Housing Tax Credit, a federal program administered by the states. The national statute specifies incentives, income targets, permissible uses, and minimum requirements. Everything else is left to individual states, which are instructed to design their own transparent plans to allocate their credits. States then score applicants consistent with their plan and report the results. In this instance, substitute "Inclusive Banking Charter" for "federal," and "individual country" for "state," and it becomes evident how an overarching program might be implemented by multiple, separate sovereign nations.

In broad brush strokes, a global inclusive banking charter would have a number of elements, such as creating an incentive for outcomes (e.g., capital volume), not efforts or processes. It would be self-scored (probably by independent third parties hired by each bank) but externally auditable through transparent, publicly available quantitative reports. The charter would, like the CRA, encourage innovation but not compel unsound lending and not require banks to deliver invisible subsidies (e.g., through concessionary rates). In each

30 An early example of the need for globalized action against organized crime was the multi-decade campaign against the Barbary Pirates, starting in 1783 and continuing until the second war with Algiers, in 1815. See Gerard W. Gawalt, "America and the Barbary Pirates: An International Battle against an Unconventional Foe" (Washington, DC: Library of Congress, Thomas Jefferson Papers), available at http://memory.loc.gov/ammem/collections/jefferson_papers/mtjprece.html.

31 A voluntary initiative under the aegis of the United Nations, first announced by then-Secretary General Kofi Annan at Davos on January 31, 1999, then officially launched on July 26, 2000 at U.N. headquarters. For more information, see www.unglobalcompact.org/index.html.

32 The Foreign Corrupt Practices Act of 1977, as amended, 15 USC §§ 78dd-1 et seq, more information available at <http://www.justice.gov/criminal/fraud/fcpa/>.

nation, government would have to be an active partner, not only in creating the policy framework, but in sharing the risk of these socially redeemable financial transactions. For example, governments could assume noncommercial risk (e.g., judicial failure to enforce reclamation of adverse possession after foreclosure). Government would also have the sole responsibility for any long-term subsidy necessary for affordability.

In time, the market that would grow up from these new policies would evolve on the basis of market size, population (including at low-income levels), and the commercial-bankability possibilities. Banks might start by making loans at cost, or marginally below market, and with credit policies marginally more liberal than normal. Over time, the below-market rates and above-market credit policies would blend into true market lending, not because the capital became more expensive, but because the market matured. If markets follow their normal course, such as we saw in the evolution of the affordable housing economy in the United States, banks would begin to make a decent profit on this activity on a risk-adjusted market-return basis. And in the long run, it would not depend on subsidy to make lending possible.

Another policy to consider in formulating the charter would be to look to how CRA has, and has not, worked over the past 30 years. On the basis of that experience, I recommend the following:

- ***More institutions encompassed.*** All major financial institutions, not just deposit-taking banks, should be subject to the charter. Any major entity that has explicit or systemically implicit government backing—that is, insurance companies, investment banks, and commercial banks, to name the obvious—should have a community reinvestment obligation.
- ***More capital forms recognized.*** Rather than a bright-line division into debt and equity, think in terms of spending and risks accepted. Myriad capital forms—guarantees, swaps, securitized strips, credit enhancement, indeed every fragmented capital slice that has a commercial purpose—should be eligible for inclusion as a qualifying capital deployment.
- ***More alignment with economic distress, less with geography as its proxy.*** If the data technology will permit, instead of a geographically bounded definition of a target area (the service area in the parlance of the CRA), develop one aimed at socioeconomic need. (India is GPS mapping every slum in the country,³³ over 6,500 of them, and is planning on conducting detailed on-the-ground censuses.)
- ***More innovation credited.*** In addition to broadening the eligibility of spends and risks for charter credit, give bonus points for innovation.
- ***Eliminate the churning incentive.*** Currently, CRA gives credit to new investments and not for “holding” an existing investment. This creates an incentive to constantly make

33 "For accurate data, government plans to map slums," *The Times of India*, February 15, 2010, accessible at <http://timesofindia.indiatimes.com/india/For-accurate-data-govt-plans-to-map-slums/articleshow/5574451.cms>.

new investments (or the appearance of a new investment). The inclusive banking charter should treat capital deployed in an existing investment as being as valuable as a new spend.

- *Uniform examination.* For curious historical reasons, the CRA is regulated by four independent entities (the Federal Deposit Insurance Corporation, the Office of the Comptroller of the Currency, the Office of Thrift Supervision, and the Federal Reserve System), a structure that invites inconsistency. There should be one examining body for the inclusive banking charter, and by implication it needs to be supra-national.

Why Banks Themselves Should Take the Lead

If banks do not extend their thinking to help government, government will demand that help eventually. When it does, government will be acting with only the best of motives—healthy capital flows and healthy communities—but it can do harm nevertheless out of ignorance or unsophistication. Banking is complex, jargon-intensive, and fast-moving. To the less informed, good credit discipline can look like bigotry or redlining. Refusal to assume noncommercial risk (e.g., of government counterparty performance) can be interpreted as blackballing. In its zealous efforts to stamp out prejudice, government could do much more harm than good. Banks should and can forthrightly acknowledge a social responsibility to bank expansively (reaching out to those as yet underbanked) but sensibly, and to work with government to craft programs that make government responsible for noncommercial risk, and for permanent subsidy.

For the banks, the devil one designs for oneself is far better than the one a frustrated government can impose. For banks' own survival and self-preservation, they must help evolve the regulatory ecosystem. Global inclusive banking is part and parcel of what banking is supposed to do.

David A. Smith is founder and Chairman of Recap Real Estate Advisors (www.recapadvisors.com), a Boston-based national company providing financial services for residential real estate, with particular expertise in affordable housing. He is also founder and President of the Affordable Housing Institute (www.affordablehousinginstitute.org), a nonprofit consultancy that works around the world to create and implement affordable housing financial products and programs that enable mission-oriented affordable housing entities to scale capital. Recipient of a \$1 million grant from the Bill and Melinda Gates Foundation, AHI works to turn global slums into financial assets through pro-poor slum upgrading and home improvement finance. AHI's work has taken Smith to Brazil, Colombia, Egypt, India, Ireland, Kenya, Mexico, Panama, the Philippines, South Africa, Sri Lanka, and Turkey.

Why Latin America Urgently Needs CRA, and Why CRA Won't Work for Latin America

Tova Maria Solo

When I speak of a Community Reinvestment Act (CRA) for Latin America, I mean a mechanism that monitors and makes bank activities public. Thanks to CRA, we know where banks lend, to whom they lend (by income, race-ethnicity, and gender), and to what degree these customers reflect the profiles of the banks' depositors. We can detect discriminatory policies toward the poor in both lending and deposits. The CRA has also created incentives for banks and other financial institutions to increase their presence in and their services to low-income neighborhoods.

CRA was conceived in the 1970s mainly to identify and to combat "redlining" in U.S. communities. Redlining was a common banking practice of labeling certain neighborhoods undesirable (mainly black and low-income areas). By withholding their services, banks accelerated the physical and economic deterioration in these stigmatized communities, the "urban ghettos," as they were known at the time. This disinvestment contributed to "urban blight" and white flight to the suburbs, which in turn led to more urban blight and more urban ghettos. CRA offered a tool to quantify and characterize financial services in poor communities, and to push banks to offer coverage to all, regardless of race, income, or geographic location.

To the degree that CRA has resulted in greater investments in low-income communities in the United States, it has counted on a tradition of community activism and local government, reinforced by a decentralized housing policy that came into being after CRA. David Erickson, in his recent book *The Housing Policy Revolution*, describes this "policy revolution" in support of local community efforts and argues that its impact extends beyond the CRA itself to a range of programs that it set in motion, such as the Financial Industry Regulatory Authority (FINRA) and others. The same argument can be applied to Latin America.

Why a CRA Is Needed in Latin America

A drive across any of Latin America's cities reveals why. The drive begins in elegant neighborhoods with stately homes and gracious apartment buildings, well-lit parks, broad sidewalks and paved roadways. These are the neighborhoods that are home to the wealthiest 10 percent of the population and occupy about 25 percent of the urban map.

The drive continues through the "middle class" neighborhoods where another 40 percent live. Here the street scene varies. Some neighborhoods have streetlights, sidewalks, and parks. In others, street paving may be uneven and storm water drainage may not exist, leaving puddles and garbage piled at the curbs (if there are sidewalks) and at corners. But in general, the middle class enjoys all the basic services: running water and sewers, roads, transportation,

and electricity. (I refer to these as “network” services in the remainder of the article.) The housing itself tends to be standardized: modest but comfortable units and low-rise apartment buildings repeated along planned cul-de-sacs. The housing is generally built by professional developers and financed by local banks. The wealthy and middle class make up “the better half,” or the “formal” sector.

Moving now into the rest of the city, where the poorer half resides, things change. The view is urban blight on a grand scale. Houses range from tin-roofed shanties to unpainted block constructions with exposed re-bars. There are few, if any, shopping centers or public buildings, and very few “finished homes.” No-man’s land for developers and banks, these neighborhoods are referred to in the urban issues literature as examples of “progressive development,” whereby the transformation from squatter shanty to completed and fully-serviced home evolves block by block and may take more than three generations to be finished in the US sense. Banks do not make loans to the typical low-income self-help builder in Latin America. Instead, the owner-builder (or the “maestro”) buys materials as he or she can afford them, which explains the piles of cement blocks that often rise up in the yards of the low-income households. Of course the price of cement block increases when purchased in small numbers, so the owner-builder pays a premium. The owner-builder pays a second premium, ranging from 10 percent to 20 percent per month, for materials bought on credit. With time, progressive development can lead to respectable housing, but costs for the owner-builder can be ten times the cost for a mortgage on the same house, and neighborhood features remain few and network services scattered. Although running water reaches about half of the low-income neighborhoods, where there are connections, the actual hours of operation are far from regular. The large plastic barrels in front of homes are a dead give-away that residents rely on cistern trucks for at least some of their water supply. And if they have no water connections, it is a sure bet they also have no sanitary sewer connections and may not have electricity either.

A full quarter of Latin America's urban population is estimated to have no running water. Only half of urban families are believed to have domestic sewer connections. The lack of services is not owing to poverty. Ironically, the 25 percent of Latin American families that buy water from cistern trucks generally pay not only a far higher price than the families with running water, but they pay what could easily cover the installation and operation of full water and sanitation services. Furthermore, the low-income neighborhoods have solid records of repayment. Nongovernmental organizations (NGOs) have financed community services on micro-credit terms, emphasizing quick repayment (fewer than two years) and high interest rates (25 to 40 percent annually). Even with the high interest, monthly payments are still less than current service payments. Clearly, both communities and banks could benefit if financing were available but banks do not offer financing for neighborhood improvements. They of course finance service connections and infrastructure costs as part of a mortgage loan, backed by a house. But traditionally banks require some form of collateral for loans and no one has figured out how to use infrastructure to guarantee a bank loan because no

one has ever managed to repossess a street or aqueduct or sewer system. Micro-credits, as developed by NGOs, are issued on a “personal guarantee,” and apply high interest rates and short repayment periods to cover their risks.

In any case, we will never know the reasons how lending practices are related to the low community service and housing standards in Latin America without tracking the availability of loans and financing. A significant reason why CRA is needed in Latin America is thus to quantify the investments in infrastructure services and their distribution and to raise awareness across the board. Data are crucial to identifying and tracking the problem, and to resolving a key question: Does the lack of services in certain communities result from underinvesting?

Macroeconomic studies by the World Bank show a dramatic decline in overall investment in infrastructure in Latin America over the past two decades. In particular, private investment in infrastructure lags well behind other developed countries. Country-specific data show a similar pattern of distorted investments. An analysis of housing in Guatemala shows that in 2004, 80 percent of the total housing investment (public and private) went to families in the upper 15 percent of the income bracket. Another 16 percent of investment went to the one-fourth of families whose incomes place them in 50-75 percent income bracket. The lowest earners (60 percent of Guatemalan families) shared the remaining 4 percent. The investment patterns may not be the result of deliberate redlining, but the results are the same. Investments in the poorer half of Latin America's urban communities are seriously lagging.

Stimulating Private-Sector Lending and Investment

A CRA in Latin America could stimulate private-sector lending and investment in low-income communities. CRA may not be the banks' favorite regulation given that it rates them on their performance with low-income groups. But it has generated more business for the financial sector. Not only does the CRA offer a glimpse of what the competition is doing (or ignoring) in lower-income neighborhoods, but it also provides communities with basic information on how funds are being distributed, and what services cost. This stimulates a dialogue between lower-income groups and commercial banks, a dialogue that has produced legislation and tools for the community-based financial sector (for example, for Community Development Financial Institutions [CDFIs] and local development grants programs).

Our experience in Central America, Mexico, and Colombia proved that banks were extremely interested in data on their own industry and its coverage of low-income groups—the bottom 60 percent. Informally, bank managers admit that the industry has become stymied by its limited clientele. As one former president of a Mexican bank confided,

The top 10 percent command a lot of money, a higher proportion of GDP, than the bottom 50 percent, but there's only so much they want to spend on financial services. And now that all but one Mexican bank are owned by non-Mexicans, they see the way to build the bottom line as cutting costs

and inventing new and more dubious products. What we really need are new markets, but a fellow who comes over from Spain or Italy to manage a bank for two years just doesn't have the time to learn about the reality of Mexico.

During my work in Guatemala, I saw a good example of how information-sharing can stimulate bank action. In 2002, Jose Luis Gandara, the Guatemalan Vice Minister of Housing, brought a group of stakeholders to Washington, DC, to visit the World Bank and to attend the National Community Reinvestment Coalition (NCRC) conference. The group included the director of community micro-credits from a large Guatemalan NGO, Genesis Empressarial, and the president of the Guatemalan Bankers' Association, who is also president of one of the largest banks in Guatemala, the G&T Continental. The presentation by the director of micro-credits on loans for community improvement caught the attention of the president of the G&T Continental. Shortly thereafter, the bank opened its own micro-credit department, staffed by the former directors of Genesis Empressarial.

In Colombia, the dialogue took a different turn. As they shared their data on service distribution for the first time ever, the banks declared their interest in serving poor communities but explained to the community representatives that the risks of robbery and violence kept them away. Together with the bank regulators they hammered out an agreement by which banks could open branches inside police stations in low-income communities and rural towns. As we discussed the great interest the banks were showing in the new data, Colombia's then Minister of Finance confided to me, "They remind me of kids at a swimming pool. They all want to get into this new market. But no one wants to be the first one in. They'd rather someone else jump first. Let him find out how deep it is and where the rocks are." Maybe, I suggested, they needed the government to act like a life guard and blow a whistle for them all to jump.

In Guatemala, the data gathering and sharing led to the creation of a national stakeholders' council on housing and to an ongoing dialogue about how to increase investments in home improvement and community upgrading through private-sector participation. The group is currently focused on creating a facility to sell insurance to banks for loans to low-income communities for home improvement and community upgrading. Guatemala's program is the first to address the issue of group lending through micro-credit; investment in network service would require formation of a group to borrow and repay the investment. NGO experiences in Guatemala and in the rest of Central America suggest that the risks involved in lending to low-income groups are low. Poor families tend to pay off debts quickly. Furthermore, even with high micro-credit interest rates, monthly payments for network service installation and use is well below the monthly cost for water from cistern trucks.

Stimulating More and Improved Financial Services for Low-Income Communities

In Latin America, the high percentage of "unbanked" residents (that is, those without bank accounts) means that up to 75 percent of the population is out of luck (and out of

pocket) not just for loans, but savings accounts, and making deposits, payments, and other transfers. This exclusion hurts the poor as much as discrimination in lending does. World Bank studies carried out with the Mexican government in 2002 and 2003 show that living on a "cash" cash flow in Mexico City can cost the unbanked up to 25 percent of monthly income. Further World Bank studies in Mexico, Colombia, and Brazil from 2002-2005 show that the percentage of unbanked ranging from 66 percent (Brazil) to 78 percent (Mexico), compared with 2 percent in Spain and Germany and 8 percent in the United States. The same studies show that the majority of the unbanked want savings and payment services more than loans. A CRA for Latin America would have to track bank depositors as well as borrowers.

To add further evidence that Latin America could benefit from a CRA, consider the impact of the lack of investments in social, economic, and environmental development when 60 percent of the population is involved. While it would take a bit of analysis, it does not take much imagination to see how the situation of Latin America's urban poor could be vastly improved with access to credit and banking services. The slums of Latin America pose health hazards and raise morbidity rates for the entire community. This, in turn, reduces national capacity for productivity, and when 60 percent of the population lives on a cash economy, it makes for a very inefficient financial system. All told, the financial exclusion of half the urban population creates a serious counterweight to regional economic development. Latin America's need to bring its marginalized populations into the mainstream is no less urgent than that of the United States in the 1970s.

Why a CRA Won't Work in Latin America

Although I would energetically advocate for a CRA in Latin America, I recognize that it will take much more than a simple passage of legislation to rectify the inequities and stimulate increased investments in poor communities. So let's look at why a CRA won't work in Latin America.

For starters, Latin America's political system, like Europe's, is not based on geographic representation. Neighborhoods cannot point to their particular congressperson because political parties vote for representatives. While this helps eliminate "pork" in legislation and guarantees representation of a broader range of political interests, it also makes it harder for local issues to get a national hearing. At the local level, the fact that "unserved" communities are not counted as part of the urban map means they cannot register for municipal elections. Only the neighborhoods that already have network services are considered "urban." The others are by definition rural. The neighborhoods that stretch alongside rivers and in gullies in Latin America's major cities do not belong to the city and are not the responsibility of the mayor or city council. If a person lacks a water connection, then they also lack an urban address, and with that, the right to vote in a municipal election.

Another reason CRA will not happen soon in Latin America is the possibility that the existing situation suits the municipalities politically. When low-income families cannot buy access to network services, the government, in this case the municipality, becomes the only

available provider. Therefore, the party in power locally decides who will get water, sanitation, and energy—and who will not. This translates into gratitude, loyalty, votes from the lucky families who are connected, and in turn political clout. If the “informal belts” surrounding Latin American cities could buy their own water and sanitation, they would vote for mayor and city council representatives. While this might be considered a good thing in the long run, it has not occurred to any local or national governments, perhaps because the present situation better serves their purposes.

This makes for a final ironic reason why a CRA would not work in Latin America. Because the state provides the services, the service is cheap. Traditionally the public sector runs deficits for its public works. A commercial bank could not finance such works and not get paid back. In many Latin American countries, network hook-ups and service charges are subsidized by the government on the basis of income, which makes it difficult for private builders and banks to compete. Studies of private network provision routinely conclude that nongovernment networks cost less than government services, although comparison is always complicated by lack of transparency and subsidies in the public sector. Nonetheless, the popular view is that if the government provides a service, it comes free, although it may take time and will certainly be less than perfect when it arrives than a network which is privately financed and built. Still, some communities are ready to pay the extra cost. The director of micro-lending at Genesis Empresarial told the story of a low-income community that applied for funds to install an electrical network to enable the community to purchase power from the national energy company. Why, she asked the community leaders, would you want to borrow at micro-finance rates when the government will install the network for free? The answer: “We know we could get the electrical services for free if we wait for the government, but we’d rather pay to have the services now, not in five, ten, or twenty years.”

A community development organization might enjoy fighting these limits and finding financing for community investments. But a tradition of grassroots and community organization does not exist in Latin America, despite the large number of internationally backed NGOs. If the unserved communities could manage to form a political union, like an NCRC, they could represent a powerful political block in each country. A CRA could provide the information necessary to argue for and to create incentives for banks and local governments to support investments in low-income communities. But politics of interest is not part of the Latin American tradition. I can recall only one political movement purporting to speak for the low-income communities: “El Super Barrio” from Mexico City in the 1980s. Super Barrio was a political force that managed to end the long-standing monopoly of the Partido Revolucionario Institucional (PRI) in Mexico City’s politics, ushering the Partido Revolucionario Democrático (PRD) into the mayor’s office. But Super Barrio has since disappeared from the map. To match CRA’s achievements, Latin America needs to develop strong local voices or to develop its own variety of support institutions. So here’s a last reason CRA isn’t happening in Latin America: If the municipalities won’t do it, and if the communities can’t do it, would the banks propose a CRA for Latin America? It is hard to imagine banks looking for more regulatory requirements.

A vicious circle? Absolutely. Latin America desperately needs legislation that monitors and discloses who benefits from banking services and who does not, and that prods the private sector to correct existing discrimination. But as long as Latin America's communities have no voice or political power, and while local governments are comfortable with the situation and banks will not argue for their own regulation, Latin America will be unable to take advantage of what a CRA has to offer.

Tova Maria Solo is an architect/planner with degrees from Harvard and MIT. She has over 35 years of experience working on urban development issues at both the community and national levels. She retired last January from the World Bank where her last assignment was Senior Urban Specialist for Latin America and the Caribbean.

Using the Framework of the Community Reinvestment Act to Support Rural Communities in China

Prabal Chakrabarti

Federal Reserve Bank of Boston¹

The Chinese economic success story has become a globally envied phenomenon. Rapid growth has raised living standards, reduced poverty rates, and created jobs. But as cities have prospered, the progress of rural China has remained stagnant. In recent years, the Chinese government has undertaken steps to spur growth and productivity in its underdeveloped rural areas, referred to by the Chinese as “counties.” In particular, the Chinese central bank, the People’s Bank of China, is now looking abroad for ways to increase access to capital in underserved areas. In India, they looked at the role of microfinance. In the United States, they took a close look at the Community Reinvestment Act (CRA), the over 30-year-old U.S. banking law that requires banks to reinvest in communities where they take deposits. The Xi’an branch of the People’s Bank of China reached out to the Federal Reserve Banks of Boston and San Francisco to learn more and engage in a dialogue about how CRA might be applied in China. The discussion was a study in contrast, but also uncovered some surprising areas of commonality.

Urban and Rural Inequality: The Role of Lending

China experienced a high average annual GDP growth from 1978 to 2010. Much of this growth has taken place along China’s coastal region and in its cities. Construction cranes have become the native birds of Chinese cities, especially in coastal cities such as Shanghai, Tianjin, Dalian, Shenzhen, and Guangzhou. The story of Chinese growth, however, is primarily an urban one. The picture in, and plight of, rural China is quite different. Home to 60 percent of China’s population, China’s rural areas remain impoverished. Income gaps between city and country are staggering, as urban residents earn 3.3 times more than their rural counterparts.²

One contributing factor to this disparity is the lack of access to credit and capital for Chinese farmers and for other small enterprises. Despite its population and the presence of rural “small towns” with upwards of several hundred thousand people, there is a dearth of lending in county areas. According to one source, rural areas are home to fewer than one-sixth

1 The views in this article do not represent those of the Federal Reserve Bank of Boston, nor the Federal Reserve Board of Governors, nor the People’s Bank of China. The author acknowledges the information provided by Sun Tianqi, Director of Financial Research at the Xi’an branch, and thanks him accordingly. However, the article expresses solely the views of Prabal Chakrabarti, and any statements, opinions, or errors are his.

2 Andrew Jacobs, “China’s Army of Graduates is Struggling,” *New York Times*, p. A1, December 12, 2010.

of all bank branches, and lending per capita in rural areas is one-tenth that of Chinese cities.³ Five large banks dominate China's banking system, and their activity is concentrated in cities. Currently, few banks serve the rural market, such as rural credit cooperatives.

Rural unemployment has remained stubbornly high, and while the government has promoted entrepreneurship, it is hard for the population to obtain loans. Many individuals turn to family and friends, or to pawnshops or private moneylenders who charge exorbitant rates of interest. Some underground lenders charge interest rates of 200-300 percent.⁴

As noted, Chinese banking officials have looked to microfinance for solutions. The People's Bank of China recently announced a microfinance initiative in rural China. They also instituted other reforms with the Agricultural Bank of China, created a new Postal Savings Bank to lend to farmers and rural enterprises, and started a pilot project that allowed individuals to set up privately owned credit cooperatives.⁵

Bridge to the Community Reinvestment Act

Recognizing that lack of credit was a common problem, Chinese banking officials began searching for comparative examples to address rural access to capital. Sun Tianqi, Director of the Financial Research Division of the Xi'an branch of the People's Bank of China, first contacted the Boston and San Francisco Banks in mid-2009 to request permission to translate their joint publication *Revisiting the CRA: The Future of the Community Reinvestment Act*.⁶ Sun was aware of the CRA as a possible model, having been an active reader of Federal Reserve publications on its websites. In particular, Sun was motivated by the act's stipulations that banks lend in areas where they take deposits, and he believed the act would shed light on how to regulate this desired behavior in China.

Based in a booming city of 8 million people, the Xi'an branch might, at first glance, be a surprising place to look at lack of access to capital. But like the San Francisco Federal Reserve district, Xi'an branch covers a massive geographic area, making up one-third of the territory in China, including five provinces in Northwest China. While Xi'an has become a center for the solar power industry in China, and has certainly partaken in the real estate boom, the wider region is a far cry from the development seen in China's coastal regions.

In early 2010, the Xi'an branch invited the Federal Reserve Banks of Boston and San Francisco to bring a delegation and put together a workshop on CRA on April 19, 2010. The Federal Reserve delegation, led by Sandra Braunstein, Director of Consumer and Community Affairs at the Federal Reserve Board, embarked for China.

3 "China Tries to Make Lending Easier In Rural Areas," *International Herald Tribune*, Business Section, February 19, 2007.

4 "China will legalize private lending to help rural areas," *Asia Economic Institute* citing People's Bank of China. http://asiaecon.asiaeconomicinstitute.org/special_articles/read_sp/12535/0/56.

5 *Ibid.*

6 Federal Reserve Banks of Boston and San Francisco, "Revisiting the CRA: The Future of the Community Reinvestment Act" (San Francisco: Federal Reserve Banks of Boston and San Francisco, 2008), available at www.frbsf.org/publications/community/cra/index.html.

The People's Bank of China (PBC) Presents the Chinese Context

Held in the regal setting of the Shangri La Hotel, the workshop audience comprised participants from Chinese regulators and banks and the financial news agency. Representatives spoke from the People's Bank of China's Beijing and Xi'an branches. Audience members included bankers from the county branches of the Industrial and Commercial Bank of China, the Agricultural Bank of China, the Bank of China, and the Construction Bank of China. A representative of the China Banking Regulatory Commission also attended.

The Chinese central bankers began by framing the magnitude of the challenge of spurring development in a county-area population that comprised more than 70 percent of China's population in 2009, and accounted for half of China's gross domestic product.⁷ They described the key role finance plays in lending to small- and medium-sized enterprises and providing agricultural loans. However, the underdeveloped financial system and lack of lending institutions, they said, has led to underperformance.

They described a bifurcated system of lending in counties. State-owned commercial banks hold the majority of deposits, yet rural credit cooperatives make most of the loans. Many state-owned banks reported loan-to-deposit ratios of less than 20 percent, while two-thirds of the rural credit co-ops reported loan-to-deposit ratios of more than 60 percent.

The stated causes of low lending were financial, economic, and technical. Notably, Chinese authorities' greater emphasis on reducing risk in banking led to greater centralization and fewer opportunities for local branches to retain deposits and make lending decisions. The exact degree of local versus central decision making was a matter of some debate. The underlying economy in rural areas was also a significant barrier. Lenders perceive small businesses as risky, with uncertain revenue, and farmers are unable to pledge adequate collateral.

Members of the People's Bank of China (PBC), led by Guisheng Liu, president of the Xi'an branch, spoke of their efforts to transform the delivery of financial services in counties. Since 2005, the central government advocated for increased lending. China announced new policies to encourage financial institutions to reinvest deposits at certain shares. The Ministry of Finance is now providing incentives in the form of subsidies to "innovative rural finance institutions" with a bonus for better-than-average growth.⁸

Throughout, PBC staff had a desire for a more market-driven approach to serving the credit needs of the county population, while accepting that bank funds would continue to flow to urban centers in search of higher returns. They saw the U.S. experience with CRA as potentially useful in shaping their policy. Moreover, Chinese companies are expected to display corporate social responsibility.⁹

The Chinese audience had several questions upfront. They were interested in learning

7 The share of the Chinese population differs from the 60 percent figure because Chinese counties overlap with, but are not quite the same as, rural areas; they contain some large towns and even small- to mid-sized cities.

8 Presentation by LIU Guisheng, PBC Xi'an Branch, April 19, 2010.

9 During the April 2010 session, the American delegation heard about Chinese companies, like a major soft drink manufacturer, that donated profits for earthquake recovery, which had just occurred in Qinghai in western China.

more about what kinds of institutions were covered, bank compliance, any implications of the subprime crisis, and the then-current proposals for a new consumer agency and changes to consumer regulations. In a familiar note, Chinese farmers, it seemed, had made poor choices owing to a lack of financial literacy, or had fallen prey to aggressive practices by money lenders. This situation could matter even more, as China had recently lifted its ban on private money-lending. Finally, they noted that any CRA-like regime was merely one tool to be coordinated with other rural finance policies and with other antipoverty subsidy policies.

Essential Elements of CRA That Might Apply in China

Making the point that CRA is not a stand-alone regulation and is examined along with other consumer-related rules, Sandra Braunstein provided an overview of the entire consumer regulatory scheme. Braunstein oversees these regulations for the Federal Reserve Board, including the Equal Credit Opportunity Act and the Home Mortgage Disclosure Act. Data are a major tool for the CRA by making volume and terms of lending transparent, and so Braunstein emphasized how CRA examiners use Home Mortgage Disclosure Act Data and small business data. The Chinese audience was quite interested in the data collection and many of the regulatory laws.¹⁰

Chinese regulators are concerned with the relative financial illiteracy of their rural borrowers, many of whom were getting into deep debt through usurious practices of money lenders. According to People's Bank of China staff, many less-educated rural residents had little understanding of how debilitating the agreements they were entering into might turn out to be. Braunstein covered much of the structure that protects consumers, but also highlighted the efforts by Board staff to test disclosure documentation through focus groups, with the goal of making the fine print on financial forms shorter, consistent, and easier to understand.

As expected, some ideas underpinning the CRA resonated more clearly than others for the Chinese. One element that resonated clearly was the idea that CRA was designed in part to address the exodus of deposits without recycling the money into loans. Among the many measures used by CRA examiners, the loan-to-deposit (LTD) ratio is one measure by which institutions are judged, comparatively and in context, on how well they meet the credit needs of their community. Chinese representatives asked whether a specific LTD ratio was required to meet a threshold for an outstanding rating. The U.S. system relies heavily on examiner judgment rather than prescriptive rules. China was considering establishing a target, such as through a financial incentive. A specific LTD target would not be the goal in the United States, as it would be considered a form of capital allocation.

CRA in the U.S. makes distinctions between size of institution, with greater scope of responsibilities for larger banks. This also resonated with the Chinese, with their recognition of the presence of branches of very large commercial banks and the smaller rural cooperatives.

¹⁰ Following the workshop, Sun and his staff translated the *Consumer Regulation Handbook* of the Federal Reserve Board.

Chinese regulators would have to determine whether to set different standards for different institutions (like “subbranches” of a major bank versus incorporated rural credit cooperatives).

Chinese regulators considered the explicit consideration in the CRA of safety and soundness essential. Of concern to China is the continued stability of its commercial and state-owned banks, and the health of its rural credit cooperatives. PBC speakers raised as a concern the dearth of financially viable projects, citing high costs and low returns. With agriculture the main industry, exposure to natural disaster, market risks, and low productivity hamper investments. A relevant issue was the role of CRA and the subprime crisis. But, as I underscored, the subprime crisis was not a failure of safety and soundness of the CRA, given that CRA lending has outperformed non-CRA regulated subprime lending.

One of the fundamental elements of CRA, the underlying concern with race, seemed to translate less well. Richard Walker of the Boston Fed provided the context of CRA as a tool against redlining, and relayed the community history of protest that pushed regulators to implement and enforce CRA. Although the CRA does not explicitly mention race, its origins grew out of racial disparity. This is quite different than the Chinese problem, which is more concerned with unequal growth between rural and urban.

CRA in the United States also relies on a rich network of nonprofit groups and intermediaries, as highlighted by David Erickson, drawing from his book *The Housing Policy Revolution: Networks and Neighborhoods*.¹¹ While China has rural cooperatives and possible collaboration among banks, it is difficult to imagine the same rich web of private and nonprofit players that partner in the U.S. system. Erickson also highlighted the role of tax credits, such as those for low-income housing and other federal subsidies, which are layered with CRA money to produce targeted outcomes. Yet China also employs industrial zones, so one could envision special treatment for rural areas akin to the U.S. empowerment zones.

Parts of the U.S. system of examination remained difficult to convey to the Chinese participants. For example, the concept of an assessment area, the geographic area used to evaluate a Bank’s CRA performance, was difficult to explain.¹² This is, in fact, not surprising, as the assessment area is itself a confusing and much criticized element of the U.S. system. In the United States, examiners do not themselves define assessment areas. Banks self-define them according to a plan they submit to regulators. Chinese officials asked what would and would not constitute an assessment area, and what factors a bank might choose to define their area.

The requirements for an outstanding or satisfactory CRA rating was also difficult to convey. Audience members consistently asked, in general, what loan-to-deposit ratio would suffice to

11 David J. Erickson, *The Housing Policy Revolution: Networks and Neighborhoods* (Washington, DC: Urban Institute Press, 2009).

12 Assessment areas must include geographies where bank has its main office, branches, and deposit-taking ATMs, as well as surrounding geographies where the bank has originated or purchased a substantial share of its loans. It may not reflect illegal discrimination or arbitrarily exclude low and moderate income geographies. (Taken from “A Bankers Quick Reference Guide to CRA,” Revisiting the CRA: Perspectives on the Future of the Community Reinvestment Act (Federal Reserve Banks of Boston and San Francisco, 2009)

achieve certain levels. Federal Reserve regulators pointed out that owing to different context and needs, changes in the economic cycle, and a host of other factors, no single ratio is viewed as acceptable or not. Moreover, the host of ratios and factors used, like the share of lending to lower income borrowers, argue against focusing on any single across the board measure.

More broadly, the Chinese perceptively picked up on the troublesome nature of defining “community,” for example, in the community development lending test and in the bank obligation to meet the credit needs of their communities. According to Liu Ping, Deputy Director General of the Financial Research Institute of the Beijing Head Office, China itself is struggling to define the “county.” For example, when issuing licenses to commercial banks, should Chinese officials request loans be given to high-income individuals living in urban areas within the counties, or should the loans be restricted to low- and moderate-income individuals? The American CRA faces similar questions. Erickson gave the hypothetical example of a luxury hotel being constructed in a low-income area. Should it qualify? The answer? It depends. Perhaps the hotel creates permanent jobs for low- and moderate-income individuals living in close proximity. Once again, the judgment of the examiner comes into play.

China sees lending as the primary driver, yet Liu drew attention to the CRA’s service and investment tests as possibly new considerations.¹³ She raised several other questions as well, including how to establish the correct incentive and punitive measures and how to establish the corresponding examination and supervision system, which would be coordinated with the China Banking Regulatory Commission.

Implementation may require other steps. For example, Susan Krause-Bell of Promontory Financial Group highlighted the lack of a credit scoring or credit data infrastructure in much of China. She also pointed to the collateral restrictions. Chinese farmers cannot pledge their land as collateral. She highlighted that other gaps in data make it difficult to evaluate risk and structure and price loans. Liu also talked of the underdeveloped credit environment, focusing on reforming the framework for personal insolvency as one way to improve the system.

Efforts Underway in China to Implement a CRA-Like System¹⁴

As a macro financial regulator, the PBC attaches great importance to balancing urban-rural development and strengthening financial support to county-level financial institutions, advancing financial reform, and improving financial services in rural areas. A brief description of some policies and reforms being considered by the PBC and the Chinese government is below.

¹³ Presentation of Ms. LIU Ping PBC Beijing Head Office, April 19, 2010.

¹⁴ This section draws heavily from material provided by Sun Tianqi, PBC.

Institutional Policies

As noted previously, China has embarked on efforts to support the rural sector for much of the past decade. Rural credit cooperatives are one area of activity. The central banks lend directly to rural credit cooperatives. From 1999 through 2007, the PBC allocated central bank lending in support of agriculture of 128.8 billion yuan (\$19.5 billion) which revolved to the accumulated amount of 1.2 trillion yuan (\$182 billion). As of September 2010, the outstanding central-bank lending to the Rural Credit Cooperatives (RCC) was 69.1 billion yuan (\$10.5 billion). Thanks to central bank lending, RCC's agricultural loans, especially the loans to farmers, grew rapidly, averaging an annual growth rate of 22 and 25 percent, respectively. This rate was 8 and 12 percentage points higher than the growth of loans made by financial institutions in China overall.

The efforts include granting a favorable reserve requirement ratio to the RCCs to help channel more funds to the agricultural sector. At present, the ratio for RCC is 10 percent, 6 percentage points lower than large commercial banks. In particular, RCCs with fewer assets and a high proportion of agriculture-supporting loans enjoy a ratio that is 7 percentage points lower than large banks. It is estimated that the favorable reserve requirement ratio has allowed RCC to maintain 461 billion yuan (\$70 billion) worth of funds. A similar policy regarding reserve ratios applies to village and township banks. RCCs also are supported by establishment of a nationwide clearing center for RCCs, which helps them gain access to the Large Value Payment System (LVPS) and local clearing system in a timely manner.

The Agricultural Bank of China is another lever to spur rural access to credit. People's Bank has guided the Agricultural Bank in setting up a special "agriculture-countryside-farmers" department to improve availability of financial services across these three dimensions. Not content to reform existing financial institutions, the People's Bank also looks to create new ones. The bank is undertaking pilot projects of new rural financial institutions, including micro-credit companies, village banks, and rural funding cooperatives to try to establish a multi-tiered rural financial service system.

As noted earlier in the comments of Susan Krause Bell, the data infrastructure is weak. Efforts have been made to advance the development of credit reference system in rural areas and promote the use of bankcards and improve the rural financial environment.

Land Reform

The Chinese are also considering rural land reform. Hernando De Soto and others have made a strong case for the importance of a good title to land.¹⁵ Yet this is not easy in China. According to bank staff, they are working to standardize the transfer of land contracting and associated operation rights, and to reform the institutional arrangements of rural land use. A pilot project has experimented with extending credit against the collateral of rural land

15 See Hernando De Soto, *The Mystery of Capital: Why Capitalism Triumphs In the West and Fails Everywhere Else* (New York: Basic Books, 2000).

contracting and operation rights, as well as rights to use rural housing sites. In principle, this effort shares similar challenges with extending mortgage credit on Native American land in the United States, where ownership and title are also complicated.

Educating the rural population about financial concerns is an important concern, particularly as it relates to private money lenders. Co-sponsored by China Foundation for Development of Financial Education (CFDFE) and the PBC, a “Rural Financial Education” project has been advanced nationwide since 2008. The project is a nonprofit, volunteer effort designed to make basic financial and investment information and education available to the rural public and financial practitioners in rural areas. This project will be conducted for 10 years in 21 provinces in central and western China, and with a goal of reaching 80 million farmers.

A CRA-like Mandate through Incentives

In September 2010, the PBC and the Chinese Banking Regulatory Commission jointly released circular no. 262 entitled, “Issuance of Assessment Methods for Encouraging County-Level Financial Institutions to Use a Certain Proportion of New Deposits in Local Loans (Trial).” The measures recommend that county-level financial institutions should direct any new deposits towards local development. Financial institutions that meet the criteria would enjoy a one-percentage-point reduction in the reserve requirement ratio and also subsidized interest rates on refinancing loans from PBC.

Direct financial incentives from the Ministry of Finance are also available. The incentives are designed to spur financial institutions to increase agricultural loans by applying preferential taxes and fare subsidies.¹⁶ Specifically, if the year-on-year growth rate of outstanding agricultural loans exceeds 15 percent at year’s end, the financial institution receives 2 percent of the amount in excess of 15 percent. The amount would be counted as income in that year. This additional income improves its operation and development ability. If growth does not exceed 15 percent, no reward is granted. Both the central and local actors share the incentives. The pilot program was launched in 18 of 34 provinces in China. In 2009 and 2010, the Ministry of Finance has granted rewards of 860 million (\$130 million) and 2.08 billion RMB yuan (\$315 million) respectively, to county-level financial institutions.

CRA-like Assessment

Based on local conditions, the research department of the PBC’s Xi’an branch has made up a “credit + service + macro environment assessment system” (CSE) for county-level financial institutions. Including the macro environment was an idea that emerged from the CRA workshop in Xi’an in April 2010. Under this CSE framework, if the macro environment is poor, a satisfactory rating will be given to the financial institution even if it has a low LTD ratio.

¹⁶ The program is called Pilot Operation of Rewarding County-level Financial Institutions Which Realize the Growth of Agricultural Loans since 2008.

Throughout the implementation of these policy reforms and new measures, the People's Bank will need to examine the diversified needs of financial services in rural areas and put in place risk prevention measures. According to PBC staff, the initiative will not operate in isolation, as the Chinese effort will combine both direct and indirect financing, integrate the strengths of the banking, insurance, and securities sectors and feature active participation of private capital.

Conclusion

For the author, one of the most intriguing things about this exchange, beyond the tremendous diligence of the PBC staff to research and prepare for the workshop, was its timing. The current U.S. context contains a great deal of 'China-envy' around its economic growth and infrastructure spending, the Beijing Olympics, and the performance of Chinese students in Shanghai on globally comparative exams. In a country lurching toward economic stability after the financial crisis, we still hear the flawed argument that CRA-regulated lending, rather than gaps in the regulatory system, was to blame. Yet at a time when advocates of CRA in the U.S. have had to play defense, the world's new economic superstar sees it as a model for how to keep growth both sustainable and equitable.

Prabal Chakrabarti is Assistant Vice President at the Federal Reserve Bank of Boston, where he leads a dynamic team of research and outreach professionals who work to foster economic growth and access to capital for lower income communities. He has researched, written and presented on the Community Reinvestment Act, foreclosures, venture capital in secondary cities, and inner city businesses. He holds degrees from the University of Illinois, New College (Oxford), and MIT.