AI3 Policy Profiles:

Key policies and proposals for catalyzing private investment in underserved communities

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WORKING DRAFT

June 26, 2014

Contents

PREFACE: How to read these profiles

Our convening at the Ford Foundation on June 26th, 2014, focuses on two urgent needs in low-income communities in the United States: for **quality job creation** and the **development of sustainable built environments**. Based on our independent research, participant feedback from past convenings, and a series of interviews with key impact investing stakeholders, we have developed a list of 10 policies that play – or have the potential to play – a substantial role in catalyzing private investment for achieving these two outcomes. We also identified a promising innovation in the UK with potential for adaptation in the U.S. We present herein brief, two-page overviews of each policy. We hope they will inform your thinking as we discuss opportunities for policy reform.

Our objective in drafting these profiles was to summarize the initiatives concisely, with special attention to four criteria identified as central to evaluating effective impact investing policy: Impact, Fit, Capacity and Opportunity. These criteria are outlined in greater detail in our white paper published in February, Accelerating Impact Investing: A Framework for U.S. Policy Innovation.

For quick reference, the following is a short outline of key points addressed within each section:

I. OVERVIEW
   a. Description of the program/regulation
   b. Program costs

II. IMPACT
   a. Social and/or environmental issue addressed by the policy
   b. Past, current, and/or expected outcomes

III. FIT
   a. Type of policy (i.e. supply development, directing capital, demand development[1])
   b. Extent of overlap and/or complementarity with other related policies

IV. CAPACITY
   a. Public stakeholders critical to the program's success
   b. Effectiveness of public leadership and regulation

V. OPPORTUNITY
   a. Receptiveness/climate for reform
   b. Recommendations for reforms or enhancements

[1] See the policy framework designed by InSight at Pacific Community Ventures and the Initiative for Responsible Investment at Harvard University, in the seminal report, *Impact Investing: A Framework for Policy Design and Analysis*, Rockefeller Foundation, January 2011.

1. Community Reinvestment Act

OVERVIEW

The Community Reinvestment Act (CRA) is a federal law that requires depository institutions to help meet the credit needs of the communities in which they operate. For example, if a bank accepts deposits in a particular neighborhood, each year federal regulators evaluate what steps the bank has taken to serve the residents and businesses of that neighborhood (along with all others where deposits are accepted), assign a rating to the bank, and make that rating available to the public. Ratings include both quantitative measures (loans made, dollars invested, etc) and qualitative factors (i.e. how well the bank is meeting local needs) to arrive at a rating of "Outstanding", "Satisfactory", "Needs to Improve" or "Substantial Noncompliance." In addition to public scrutiny, a poor CRA rating could have certain legal repercussions, including impeding the bank's ability to secure regulatory approval for mergers, acquisitions or new branch openings.

Three-quarters of a bank's CRA evaluation is based on their lending and community development investment activity, which includes single-family and multifamily mortgages, small business loans and equity investments in affordable housing and other community development initiatives in low- and moderate-income communities. CRA does not require a significant appropriation from the federal government (just enough to cover the cost of administering the program at several regulatory agencies), but the program generated roughly $54.8 billion in private investment in community development projects in 2013.

IMPACT

CRA was signed into law in 1977 to reduce discriminatory lending practices and help meet the rising credit needs of low- and moderate-income communities, including home purchase loans, affordable housing development, small business loans and other community and economic development activities. Data are not available on the total number of homes or businesses assisted each year due to CRA. However roughly 20,500 CRA-eligible community development loans were made by a total of 830 financial institutions in 2012. Some of these loans might have occurred without the CRA obligation, although it is impossible to know how many.

CRA requires that all eligible lending must be "consistent with safe and sound banking practices." Several studies have shown that CRA-eligible investments do not lead to excessive risks or meaningful losses at banks, even in times of stress, as with the most recent subprime mortgage crisis. On the contrary, studies show that CRA encouraged safe and sustainable lending that expanded homeownership without the high default levels experienced by non-bank lending (which is not governed by CRA) during the subprime bubble. For example, a study from the Federal Reserve found that only 6 percent of the high-cost, high-risk mortgages made at the height of the subprime bubble were eligible for CRA credit.

FIT

Since CRA is a regulatory program, it does not provide direct subsidy to financial institutions to help cover the added cost or additional risk of CRA-eligible investments. Instead, it encourages banks to find new ways to serve traditionally underserved segments of the market, either by developing new financial products or adapting their existing products to work with federal, state and local subsidies. For example, a bank may receive CRA credit for making an equity investment in Low-Income Housing Tax Credits or a Small Business Investment Company, or providing a loan to a property that receives Section 8 rental assistance or some other subsidy. These types of long-term, reliable federal programs enable private financial institutions to meet their CRA obligations without incurring significant risks or losses.

CRA compliance is overseen jointly by four federal agencies—the Federal Reserve System, the Federal Deposit Insurance Corporation and the Office of the Comptroller of the Currency and the Office of Thrift Supervision—through an interagency body called the Federal Financial Institutions Examination Council (FFIEC). Despite the council's oversight, some stakeholders find it difficult to navigate the fragmented system for compliance. For example, the OCC may approach an issue one way for one bank while the FDIC approaches it an entirely different way.

CAPACITY

Over the past 35 years, banks, regulators and other stakeholders have developed a sophisticated system for tracking and reporting compliance with CRA obligations. Most major banks have entire units dedicated to CRA compliance, along with staff focused on lending and investments in low- and moderate-income communities. In addition, full compliance often requires coordination with residents and local community groups. For example, community organizations can submit written comments to guide a bank's CRA examination or influence a bank's application to merge or acquire another institution.

There are certain protections built into the CRA to prevent fraud or "gaming" of the system. For example, a CRA rating can be downgraded if a regulator uncovers evidence of illegal, abusive or discriminatory lending in violation of fair lending laws. That said, some analysts argued that the current system incentivizes banks to focus only on the most profitable activities that count toward their rating, regardless of their impact on communities. As a result, banks tend to focus on a subset of CRA-eligible products, such as the refinancing of mortgages to creditworthy borrowers, while deemphasizing other, much-needed products, such as mortgages that require subsidy or specialized skills in community development finance.

OPPORTUNITY

Since the mid-1970s, the Community Reinvestment Act has been a remarkably powerful tool for encouraging private investment in low-income communities. However, the law has not had a major update since 1995, even as the financial industry has evolved significantly. Mark Willis of the NYU Furman Center has written extensively on opportunities for bringing CRA into the 21st century, including ways to encourage more efficient and productive investments. For example, many banks receive too much credit for mortgage loans in lower-income neighborhoods – many of which would likely be made anyway – and relatively little credit for affordable multifamily or small business loans with a larger impact on the broader community. He recommends several reforms, including establishing a new "Community Development" test gauging the bank's community development lending, investments, grants and services worth half of a bank's overall CRA rating. Willis also recommends identifying a single regulatory agency to usher in reforms as needed, and giving banks more flexibility to serve the community development needs of the nationwide market, not just the community in which they receive deposits. That change is particularly relevant for newer online and credit card banks with largely national footprints.

Other analysts have also called for CRA to be extended beyond the commercial banking industry to include investment banks, broker-dealers, and other financial institutions with access to the Federal Reserve's discount window. Others have called for an even wider expansion of a CRA-like model, applying to all firms that provide financial services to low- and moderate-income communities, including prepaid cards, check-cashing services, payday lenders and certain insurance companies. In addition, some cities are considering local CRA-like obligations for large corporations to invest in low-income communities—most notably the tech sector in San Francisco. However, any effort to expand the CRA model to additional financial institutions or new industries would likely face significant opposition from affected businesses.

2. Affordable Housing Programs for Government-Sponsored Enterprises

OVERVIEW

Fannie Mae, Freddie Mac and the Federal Home Loan Banks, collectively the Government-Sponsored Enterprises (GSEs), provide liquidity and stability to the U.S. housing finance system, which makes it easier for homebuyers and owners of rental housing to access affordable, long-term, fixed-rate mortgage loans. The GSEs are private companies that receive an array of subsidies from the federal government, including certain tax and regulatory benefits and, in some cases, an implicit government guarantee. During the financial crisis of 2008, that "implicit" guarantee became explicit when the federal government placed Fannie and Freddie under conservatorship. In exchange for these benefits, the GSEs are required to support affordable housing through several discrete programs, including:

- The affordable housing goals at Fannie Mae and Freddie Mac, which set annual targets for the companies to serve low- and very low-income families, minority borrowers and other historically underserved segments of the mortgage market.
- Mandatory contributions from Fannie's and Freddie's mortgage businesses (4.2 cents on every dollar loaned) to the National Housing Trust Fund and the Capital Magnet Fund, which support affordable rental housing for low- and moderate income families. This obligation was established in 2008, but federal regulators are yet to enforce it.
- The Affordable Housing Program at the Federal Home Loan Banks, which dedicates a portion of the system's profits (10% of the net profits from all member banks) to grants and other programs that support affordable housing.

Each of these programs was designed to function without any permanent cost to taxpayers. Last year, the affordable housing goals generated $29.9 million in private investment in affordable rental housing, while the Affordable Housing Program generated roughly $300 million in private investment. The Housing Trust Fund and the Capital Magnet Fund are yet to receive money from Fannie and Freddie, but an initial $80 million capitalization from the federal government into the Capital Magnet Fund in 2011 generated roughly $1 billion in private investment to housing and other community development initiatives. (As an important caveat, both the CMF and AHP totals include support to both homeownership and rentals.)

IMPACT

The affordable housing goals were established in the early 1990s to encourage Fannie Mae and Freddie Mac to serve historically underserved segments of the mortgage market, including affordable rental housing for low-income families. Last year the goals resulted in 674,000 rental units that were affordable to low-income families (meaning they earn less than 80% of area median income) and 169,000 rental units that were affordable to very low-income families (meaning they earn less than 50% of area median income). The Federal Home Loan Banks' Affordable Housing Program resulted in an additional 30,000 affordable rental units last year. The initial capitalization of the Capital Magnet Fund resulted in an additional 7,000 affordable homes. There are no impact estimates available for the Housing Trust Fund, since the program is yet to receive any funding.

Several studies show that these programs—especially the affordable housing goals for Fannie and Freddie—do not push lenders to make loans that are overly risky. Specifically, researchers from the Federal Reserve Bank of St. Louis and the Federal Reserve Board found that the affordable housing goals had a negligible effect on Fannie's and Freddie's losses during the most recent financial crisis, in part because many of the high-risk loans made by the companies were not eligible for credit toward the goals. It's also worth noting that Fannie's and Freddie's rental businesses remained steadily profitable throughout the financial crisis, despite being bound by the affordable housing goals.

FIT

Each of these programs are designed to work alongside other federal programs that support affordable rental housing, including the Low-Income Housing Tax Credit, Section 8 rental assistance and the HOME Investment Partnership program. For example, a typical affordable housing development could receive a long-term, fixed

rate mortgage backed by Fannie Mae and Freddie Mac (which would count toward the goals), an equity investment through the Low-Income Housing Tax Credit and gap financing through the HOME program. If the development serves extremely low-income families or formally homeless individuals, the tenant or owner may also receive long-term rental assistance through Section 8 or another program.

The Housing Trust Fund and the Affordable Housing Program, on the other hand, are intended to help state and local governments augment other federal support to affordable housing. For example, the Housing Trust Fund is designed to allocate money to states, which are given significant discretion over how these funds are used, as long as the end goal is building and preserving homes that are affordable to their lowest-income residents.

CAPACITY

Each of these programs has a distinct set of stakeholders that are essential to its ultimate success. Since Fannie and Freddie don't actually make loans—they purchase them from lenders—the affordable housing goals can only be met if originators in the primary market are willing to make the eligible loans. The Housing Trust Fund and the Capital Magnet Fund each include match requirements, so state and local governments and Community Development Financial Institutions must be able to raise and deploy a significant amount of capital. Of course, that all depends on the capacity of developers, investors and community-based organizations on the ground.

The GSEs are regulated by the Federal Housing Finance Agency (FHFA), an independent federal agency. Under the rules of conservatorship, FHFA has broad authority to make changes to the affordable housing requirements, including setting annual goals and enforcing the mandatory contributions to the Housing Trust Fund and the Capital Magnet Fund. However, any meaningful changes to the structure or scope of these programs would require an act of Congress.

OPPORTUNITY

The debate over GSE reform gained significant momentum in early 2014, with a particular focus on the future of Fannie Mae and Freddie Mac. The most significant reform bill was introduced in March by Sens. Tim Johnson (D-SD) and Mike Crapo (R-ID), which would wind down Fannie and Freddie over a five-year period and establish a new system of privately-issued, government-insured mortgage-backed securities. The Johnson-Crapo bill would also eliminate the affordable housing goals, significantly expand mandatory contributions to the Housing Trust Fund and the Capital Magnet Fund (from 4.2 basis points on new loan originations to 10 basis points on all outstanding loan principal), create a new Market Access Fund to help pilot new financial products that expand access to credit and establish a new incentive-based system for serving underserved markets. The bill would also establish a new affordability requirement for any multifamily security that's insured under the new system.

The Johnson-Crapo bill passed the Senate Banking Committee in May 2014 on a bipartisan vote. However it has struggled to gain traction among civil rights groups, certain affordable housing activists and progressive members of Congress, in part because it eliminates the affordable housing goals for Fannie and Freddie. For these and other reasons, the bill is unlikely to become law. In the meantime, there are significant opportunities for administrative reforms to expand support for affordable housing at the GSEs. For example, FHFA could order Fannie and Freddie to start making contributions to the National Housing Trust Fund and the Capital Magnet Fund, finalize rules on Fannie's and Freddie's "duty to serve" low-income renters, and modify the affordable housing goals to more effectively support affordable rental housing.

3. Low-Income Housing Tax Credit

OVERVIEW

The Low-Income Housing Tax Credit, also known as the Housing Credit, is a federal tax incentive to develop apartments that are affordable to low-income families. For a project to be eligible for tax credits, a certain percentage of the units must be rent restricted and occupied by households earning below a certain income level (either 20 percent of the units at 50 percent of area median income or 40 percent of the units at 60 percent of area median income). Housing Credit apartments must be kept affordable for a period of at least 15 years, and many states require even longer affordability periods.

At current funding levels, the Housing Credit costs the federal government roughly $6.5 billion annually in lost tax revenues. In 2012, that level of federal investment encouraged $9.5 billion in private investment in affordable housing.

IMPACT

The Housing Credit was established in 1986 to help meet the growing need for affordable rental options among low-income families and individuals. Since then, it has been the primary tool for financing affordable housing in the U.S., helping to build or preserve roughly 90,000 homes annually in recent years. It also helps create an estimated 95,000 jobs across the country each year, primarily in small businesses and the construction sector. The Housing Credit was never intended to provide deep levels of subsidy for extremely low-income families, meaning they earn below 30 percent of area median income. Even so, one recent study found that 43 percent of homes financed with the Housing Credit actually house extremely low-income families.

There is compelling evidence that the homes financed through the Housing Credit would not likely have been constructed and kept affordable without federal support. Estimates show that construction costs would have to be reduced by an average 72 percent in order to make rents affordable to the families served by the Housing Credit, making the construction of these apartments virtually impossible without a subsidy.

FIT

The Housing Credit is one of several federal programs aimed at increasing the supply and availability of affordable housing, but it is the only major program that directly subsidizes equity investments in affordable properties. In that way, it is a unique and critical component of the broader system of affordable housing finance.

That said, the ultimate success of the Housing Credit depends on the existence of several other federal programs, as the Housing Credit does not subsidize the full cost of constructing affordable apartments. For example, in order for a typical affordable housing development to pencil out, it may require gap financing through the HOME Investment Partnerships program at the Department of Housing and Urban Development (HUD) and a long-term, fixed-rate loan backed by the Federal Housing Administration, Fannie Mae or Freddie Mac. In addition, since the Housing Credit is not designed to provide deep and permanent subsidies for extremely low-income families or people experiencing homelessness, property owners that serve those populations may also require long-term rental assistance through Section 8 or another program.

CAPACITY

The Housing Credit program is overseen by the U.S. Department of Treasury but almost entirely administered by states. Each year, Housing Credits are allocated to state housing finance agencies on a per-capita basis. These state agencies then award the credits to specific projects through a competitive process. Each state designs their own selection criteria to reflect local priorities, meaning states have significant authority to alter the way the program is implemented from year to year. However, any significant expansion of the program or changes to the basic eligibility requirements would require an act of Congress.

Developers claim the Housing Credits, and while some keep them to reduce their own tax obligations, more often the credits are sold to outside investors through a process called syndication. Syndication provides

developers up-front capital to cover construction costs, since the Housing Credits are issued over ten years. In return, the investors, which are often large financial institutions, are able to offset their tax liability and meet their regulatory obligations under the Community Reinvestment Act.

The Housing Credit has a 26-year track record of success, with little evidence of mismanagement, fraud or abuse. Part of this is by design: private investors, not the government, provide money up front to cover development costs and are on the hook for most financial risks. If the program's requirements aren't met for whatever reason, the tax credits are recaptured and taxpayers get their money back.

OPPORTUNITY

The Housing Credit has a long history of bipartisan support in Washington. Tellingly, the Housing Credit was one of only three corporate tax expenditures preserved in House Ways and Means Committee Chairman Dave Camp's (R-MI) recent discussion draft for comprehensive tax reform, which eliminated more than 100 other tax expenditures.

In addition, the Housing Credit has significant support from affordable housing advocates, state housing finance agencies, homebuilders, community-based organizations and certain financial institutions, among others. As one example of the program's strong base of stakeholder support, Enterprise Community Partners co-founded and continues to lead the A Call To Invest in Our Neighborhoods campaign, or ACTION, a coalition of more than 650 organizations from across the country fighting to preserve and strengthen the Housing Credit.

Despite its long history of success, annual allocations to the Housing Credit are less than many advocates believe is required. For example, developers requested over $2 billion in Housing Credits from states in 2011, well over twice the available authority. Meanwhile, low-income renters face a growing supply gap, with the construction of new affordable rental homes falling well short of increasing demand. Roughly 12 million renters with extremely low incomes are competing for less than 7 million units that are affordable at that income level—more than double the supply gap observed a decade ago.

For these and other reasons, the Bipartisan Policy Center's Housing Commission recently called for annual Housing Credit allocations to increase by 50 percent compared to current levels. The Commission also recommended changes to help the credits flow to states with the highest needs, such as moving from a per capita allocation to a formula-based allocation. One way to accomplish this expansion—proposed recently by the Obama administration—is to allow states to convert unused authority for issuing tax-exempt private activity bonds into additional Housing Credit allocations.

Others have pushed for annual allocations to be doubled over a certain period—likely 5-10 years—to give investors and other stakeholders time to ramp up their capacity. Regardless of the amount, any meaningful increase in Housing Credit allocations must be accompanied by an expansion of federal resources for gap financing, provided through either the HOME Investment Partnerships program or the National Housing Trust Fund. Any push to expand the Housing Credit—or any other public subsidy for affordable housing for that matter—will likely meet strong opposition given the current fiscal environment in Washington.

4. Rental Assistance Demonstration

OVERVIEW

The Rental Assistance Demonstration (RAD) is a federal initiative of the U.S. Department of Housing and Urban Development (HUD) that helps Public Housing Authorities (PHAs) attract private capital to repair and preserve at-risk public housing properties. The program allows PHAs to convert dilapidated projects into privately financed, government-subsidized properties, using the Section 8 program to preserve long-term affordability. By altering the source of the rental subsidy, participating PHAs can access and leverage outside sources of financing—some of which are public, others of which are private.

For example, say a PHA owns a property that requires significant rehabilitation but doesn't have enough in its capital reserve to pay for the repairs. Through the RAD program, the PHA converts the subsidies it receives through public housing programs into a long-term Section 8 contract. With that contract in hand, the PHA assembles a mix of private and public financing—including a mortgage loan and Low-Income Housing Tax Credits—to address the immediate and long-term needs of the project. Those funds help to cover the repair costs, while the Section 8 contract preserves the long-term affordability of the units.

RAD is currently in its pilot phase. No new federal capital funds have been allocated to the program so far, but the initial round of conversions is expected to generate roughly $650 million in private investment.

IMPACT

RAD was established in 2011 to help alleviate the growing backlog of unmet capital needs in the public housing stock, which HUD currently estimates at over $25 billion. HUD has approved the conversion of 60,000 units through RAD, the maximum allowed by Congress for the initial pilot.

The program's rules dictate that all affordable units must be preserved on a one-for-one basis as part of any RAD conversion. While some participating PHAs have chosen to transfer ownership of the properties to private entities—often nonprofits with long track records of success owning and maintaining affordable housing—other PHAs retain full or partial ownership of the property after the conversion is complete.

FIT

RAD is an attempt to address the needs of public housing properties which were not renovated under prior programs such as "Hope VI" or the newer Choice Neighborhoods program, which have received very limited Congressional funding. These programs offer grants and other support to PHAs—often combined with funding from private investors—to transform its severely distressed projects into quality mixed-income communities.

In order for a RAD conversion to be successful, PHAs, developers and owners combine and leverage the full complement of resources that affordable housing developers have utilized for many years, such as Low-Income Housing Tax Credits and permanent mortgage financing from banks and the Federal Housing Administration.

CAPACITY

RAD is overseen by HUD, with local PHAs participating on a voluntary basis. Many PHAs are utilizing the capacity and knowledge of capable developer partners (many of whom are community-based nonprofits), consultants, and investors (for loans, Housing Credits and other sources of capital) to structure and carry out successful conversions under RAD. The participation of private investors and lenders in RAD brings the discipline and rigor that have been hallmarks of the nation's affordable housing delivery system for many years.

OPPORTUNITY

RAD has received mixed responses from key stakeholders in its inaugural year. On one hand, it's clear there is demand for the program; Congress has authorized HUD to convert 60,000 units under RAD, and HUD has received applications to convert over 185,000 units. Notably, the San Francisco Housing Authority recently announced plans to revitalize the city's entire stock of public housing in partnership with local nonprofits through RAD, and many smaller PHAs are likewise planning to convert all or most of their public housing.

On the other hand, some PHAs are reluctant to take up RAD conversions, in part because of a lack of additional federal resources needed to successfully convert higher-need public housing properties. Many of these buildings need significant rehabilitation, and it's often difficult to attract enough private capital into the project without some form of additional capital subsidy.

Several groups have called on Congress to remove the cap on the total units converted through RAD and devote significant federal resources to support the preservation and improvement of all viable public housing properties. During the most recent round of negotiations on the FY 2015 budget, the Senate Budget Committee passed an appropriations bill that would increase the cap to 185,000 units. The bill also includes $10 million to assist in the conversion of apartments that would not be able to address their capital needs without additional subsidy.

5. Jumpstart Our Business Startups (JOBS) Act

OVERVIEW

The Jumpstart Our Business Startups (JOBS) Act is a law enacted in 2010 to encourage the funding of small businesses across the United States. The law does many things, but its most widely discussed provisions are Titles II and III. Specifically, Title II loosens restrictions on general solicitation for private offering. Title III allows for what is generally known as "regulation crowdfunding", where individuals, regardless of income, can invest directly in a business.

Neither provision imposes a cost on taxpayers since the Securities and Exchange Commission (SEC) has been tasked with regulating the space within its current budget, but both have the potential to unleash a significant amount of private capital. Conservative estimates suggest the early marketplace will be about $2 billion annually. This will be spread across several investment types and sectors of the economy, almost certainly including impact investments.

The JOBS Act presents an opportunity for socially-minded businesses and impact investment practitioners to engage a broader audience of investors and other stakeholders. Typically, impact investing funds have been limited to accredited and institutional investors because of the burdensome registration requirements associated with creating funds with smaller investment sizes. The JOBS Act provides fund managers with an opportunity to engage communities across the country, attracting new sources of capital, advocates and stakeholders.

IMPACT

The true impact of the JOBS Act has not been realized, but the start-up and impact investing communities believe the potential is significant. Existing crowdfunding platforms, which generally focus on small-sum donations or zero percent loans, have surpassed the billion-dollar mark and continue to grow at rapid speeds. In 2010, the Money for Good Report estimated that there was a $58 billion market for social investments under $25,000. That market size has likely increased since, but very few of those funds have made their way into the impact investing market due to the limited number of retail products on the market. The JOBS Act will open the door for impact investments in the retail market without forcing funds to achieve sizes in the tens- or even hundreds-of-millions of dollars.

FIT

Efforts to facilitate capital access in the U.S. for historically disadvantaged entrepreneurs, businesses, and geographies remain fragmented, complex and inefficient. The evolving role of the Internet aided by the JOBS Act holds promise in organizing marketplaces, increasing information flow, decreasing transaction costs and enhancing access to capital.

The field is committed to avoiding this fragmentation in response to the JOBS Act, by focusing on the standardization of offerings, transparency at all levels of the investment process, and widespread adoption among existing investors.

CAPACITY

The JOBS Act charges the SEC, in conjunction with Financial Industry Regulatory Authority (FINRA), to develop the rules necessary to implement Titles II and III and create a new and dynamic marketplace. Delays at the SEC have pushed back full implementation of the JOBS Act.

In October 2013, the SEC released draft rules for public comment, which included the estimated cost of an issuance of $40,000-$44,000. Advocates argue this would make accessing crowdfunding prohibitively expensive for many low-income communities. The SEC and FINRA are currently finalizing the rules, which should be released before the end of 2014.

OPPORTUNITY

The JOBS Act received strong bipartisan support in Congress, encouraged from the outside by tech entrepreneurs like Ron Conway and Steve Case. However, there are many concerns about the investment marketplace created by Titles II and III. Many public advocates have expressed concern about the lack of consumer protections and the ability for anyone to take an equity stake in companies with only modest regulatory oversight.

One of the many opportunities presented by the JOBS Act is for capital to flow more smoothly to low-income and low-wealth communities by breaking down barriers that keep money concentrated in a a limited number of communities. If regulations are too burdensome, the cost of raising capital from the crowd will be too high for community-focused organizations, which are typically restricted to raising low-cost debt to sustain operations.

One way to accomplish this is for the SEC to author final rules for crowdfunding that allow regulated social intermediaries like CDFIs and their investees to bypass some of the reporting and regulatory requirements that drive up the cost of accessing capital through the JOBS Act.

There are also opportunities for existing government programs to consider using public dollars to incentivize private investment in social programs through crowdfunding. For example, the National Park Service might want to improve the facilities at a campground and, in exchange for free or discounted park entry for a period, crowdfund a portion of the expense.

6. Community Development Financial Institutions Fund

OVERVIEW

The Community Development Financial Institutions Fund (CDFI Fund) was created in 1994 to promote access to capital and credit in underserved urban and rural areas. The program has two primary roles. First, it certifies CDFIs, which are independent, specialized financial institutions that direct at least 60 percent of their financial activities to low-income neighborhoods. Second, the program provides financial and other support to CDFIs, including financial assistance (FA) awards (up to $2,000,000) to help provide loans, financial counseling and other services, and technical assistance (TA) awards (up to $100,000) to cover basic operations and capacity-building efforts. The CDFI Fund also administers the New Markets Tax Credit (NMTC) Program, which is featured in a separate AI3 policy brief.

The CDFI Fund carries out several more targeted programs as well. For example, the CDFI Bond Guarantee program helps eligible CDFIs and their partners issue government-backed bonds that are purchased by the Federal Financing Bank, providing CDFIs with long-term, fixed-rate capital to support the communities they serve. Other programs provide assistance to banks and thrifts to expand investments in underserved communities, support small and emerging CDFIs and enhance assistance to Native American communities.

Since its creation, the CDFI Fund has awarded over $1.9 billion to community development organizations and financial institutions. Congress appropriated $24.6 million to the CDFI Fund to cover administrative costs in FY2014.

IMPACT

In 2013, CDFIs originated more than 24,285 loans totaling $2 billion, including over 8,000 small business loans and financing for nearly 18,000 affordable housing units. Those loans helped create an estimated 35,000 jobs. In addition, CDFIs also provided about 294,000 individuals with financial literacy or training that year.[2] Since 2004, the CDFI Fund has tracked these outcomes through its Community Investment Impact System, a repository of mandatory reporting through the program.

FIT

As a centerpiece of U.S. market infrastructure in impact investing, the CDFI Fund is designed to work in concert with several other community and economic development programs. Some federal programs, such as the New Markets Tax Credit (NMTC) and the Community Reinvestment Act (CRA), explicitly tap the power of CDFIs to serve low-income communities. For example, banks often receive "credit" toward their CRA obligations by investing in CDFIs.

Other federal programs complement the work of CDFIs by providing other forms of financial assistance to the communities in which they work. For example, the Low-Income Housing Tax Credit (LIHTC) supports equity investments in rental housing developments that are affordable to low-income families, frequently providing the take-out financing for CDFI loans. As another example, a recent study identified 42 different public programs that could help CDFIs promote healthy food and lifestyles in low-income communities.[3]

CAPACITY

The CDFI Fund is administered through the Treasury Department's Office of Domestic Finance. There are currently more than 800 CDFIs registered through the program from across the country, including loan funds, credit unions, venture capital funds and banks.

CDFI investments span several industries. According to the Opportunity Finance Network, the trade group for CDFIs, about 29 percent of outstanding investments by member CDFIs went to housing for organizations, 24 percent to housing for individuals, 15 percent to community services, 13 percent to the business sector, 7

[2] http://www.cdfi.org/policy-and-advocacy/

[3] http://www.cdfifund.gov/what_we_do/resources/Financial%20Resources%20Catalogue%20PDF.pdf

percent to the consumer sector, 6 percent to commercial real estate, 3 percent to microenterprise and 3 percent to other sectors.

OPPORTUNITY

The CDFI Fund enjoys strong bipartisan support in Washington, in part because of its long track record of success and growth (e.g. in 2004 the CDFI Fund provided approximately $50 million in FA and TA awards). However, demand for CDFI capital far outpaces the amount of capital available to these organizations. In 2013, CDFIs requested more than $403 million in total funding through the program, compared to just $150 million in available funds.[4] The Opportunity Finance Network reported an anticipated $650 million shortfall between the capital that CDFIs have and the community-level demand for their funds in 2013.

A range of policy incentives could help address this unmet demand, for example by providing tax credits for investing in CDFIs, expanding CRA-like requirements to other categories of financial institutions focused on CDFIs, or providing a safe harbor for certain CDFI investments within ERISA. Many CDFIs struggle to access mainstream capital markets despite long and successful track records.

Policymakers could also enhance the CDFI Fund by creating additional, specialized programs that target discrete sectors in which CDFIs operate, as occurred with the interagency Healthy Food Financing Initiative, which accounts for about 15 percent of CDFI Fund awards. For example, there will be a tremendous need for new community infrastructure resulting from the expansion of health care services under the Affordable Care Act, which CDFIs could be incentivized to focus on (and build the capacity to capitalize) through the addition of a discrete category of awards.

[4] CDFI Fund FY2015 Budget Request, http://www.treasury.gov/about/budget-performance/CJ15/06.%20CDFI%20Fund%20CJ.pdf

7. Employee Retirement Income Securities Act

OVERVIEW

The Employee Retirement Income Securities Act (ERISA) of 1974 established standards of conduct for private pension plan fiduciaries. It requires pension funds to be managed "for the exclusive purpose of providing benefits to participants and their beneficiaries." While ERISA only applies to private pensions, other large fiduciaries including public pension plans, which are governed by state law, often look to ERISA's more extensive body of case and administrative law for guidance on fiduciary matters.[5] In practice, ERISA governs an institution's legal duties of loyalty and impartiality, which requires them to administer funds in the sole interest of beneficiaries, and the requirement that they act with prudence and care in making investment decisions, which is based on the premise that portfolio diversification is central to performance.

ERISA is regulated primarily by the U.S. Department of Labor (DOL) and, within DOL, the Employee Benefits Security Administration (EBSA). EBSA oversees approximately 718,000 private pension plans, including 498,000 participant-directed, 401(k)-style individual account plans, at a cost of $186.5 million annually (FY14 enacted budget).

IMPACT

Institutional fiduciaries in the US manage over $22 trillion in assets, with pension funds accounting for over $15 trillion, insurance companies for over $6 trillion, and private foundations and college endowments for approximately $1 trillion. These fiduciaries have made a limited number of investments seeking both financial returns and ancillary social benefits, including the creation of jobs and economic opportunity in local communities, revitalization of neighborhoods, and innovation in environmental sustainability. These are often referred to as economically targeted investments (ETIs), which are mandated or encouraged by the laws or pension fund policies of 30 states.[6]

ERISA influences impact investing primarily through DOL's guidance on the law, which has been construed as being either broadly enabling or constraining of investments that target financial and explicit social returns. ETIs have been the subject of particular scrutiny. In 1994, DOL reinterpreted ERISA hoping to encourage more ETIs, ruling that these investments would not violate fiduciary duties as long as they provided the same rate of return at the same level of risk as comparable investments. However, a subsequent reinterpretation in 2008 had the opposite effect on ETIs, establishing a "rigid rule" stating that ETIs should be rare and, when considered, documented through a contemporaneous written analysis showing they were "economically indistinguishable" from investments that satisfy primary obligations. The 2008 DOL guidance included a number of examples of investments that violated its new interpretation, including a bond to "finance affordable housing for people in [the fund's] local community". While its "return is at least as favorable... as other bonds with the same risk rating," DOL wrote, "its size and lengthy duration raises a potential risk regarding the plan's ability to meet its predicted liquidity needs."

The 2008 "rigid rule" also appears to have stifled socially responsible investments (SRI) by retirement funds more broadly. For example, Vanguard discourages the use of SRI funds in 401(k)s, citing ERISA as one explanation for the action.

FIT

ERISA is arguably the most influential but least targeted of all policies associated with impact investing. ERISA affects the supply of capital to impact investing broadly, but is silent on the place or sector in which that capital is deployed. The policy functions only as a regulatory check on the investments of the pension funds that it directly governs. Policies that intersect directly with ERISA include those that govern non-private pension funds and take their lead in some sense from ERISA, including the *Uniform Prudent* Management of Institutional Funds Act, which has been adopted in all 50 states in order to harmonize fiduciary standards, and the Taft-Hartley Act, which covers union plans. All other policies

[5] David B. Brandolph, Public Plans and Social Investing: When Doing the Right Thing Is Not Enough, February 26, 2013, *Bloomberg BNA Pension & Benefits Daily*.

[6] InSight at Pacific Community Ventures and The Initiative for Responsible Investment at Harvard University. (2012, February). *Impact at Scale: Policy Innovation for Institutional Investment with Social and Environmental Benefit*. Retrieved April 2014, from http://www.pacificcommunityventures.org/uploads/reports-and-publications/ImpactReport_FINAL2.10.12.pdf

compliment ERISA only to the extent they make an impact investment more or less "economically indistinguishable" from their alternatives, thereby meeting ERISA's "rigid rule."

CAPACITY

EBSA's Office of Regulations and Interpretations, and Division of Fiduciary Interpretations within that Office, is solely responsible for carrying out the Agency's regulatory agenda and interpretive activities.. EBSA has the discretion to implement all of the ideas for ERISA reform described below, through administrative rulings and regulatory interpretations.

OPPORTUNITY

ERISA reform is often positioned as an important step in enabling pension funds to make impact investments. To be sure, the presence of ERISA has *not* stopped institutional investors from making impact investments. However, ERISA gives significant pause to pension funds and other fiduciaries who are unfamiliar with impact investing and who believe it is unproven or likely to be an unreasonably time consuming endeavor for investment advisors and staff. Moreover, as a highly visible, flagship policy that anchors what mainstream investors deem "appropriate" in portfolio management, any reform to ERISA would send an unmistakable message regarding the federal government's commitment to scaling impact investing.

A relatively simple first step, and one with widespread support in the impact investing community, would be to roll back DOL's 2008 guidance and revert to the 1994 interpretation. Advocates believe this would remove a pervasive barrier to impact investing and reopen the door to making prudent ETIs and other socially-minded investments. A longer-term, more ambitious proposal for reform is to establish a safe harbor provision exempting particular classes of impact investments from the highest levels of scrutiny under ERISA, while not jeopardizing the fund manager's core fiduciary responsibilities.

In addition, a number of countries have rules that mandate disclosure on environmental, social, and governance issues by pension funds. In Australia, for example, pension funds must disclose "the extent to which labour standards or environmental, social or ethical considerations are taken into account in the selection, retention or realisation of the investment". In the UK, a fund's Statement of Investment Principles is required to include "the extent (if at all) to which social, environmental, or ethical considerations are taken into account in the selection, retention and realization of investments". The SEC mandates similar disclosures by US listed companies and mutual funds. Advocates believe a requirement in ERISA for pension funds to make similar disclosures would elevate the prominence of impact investing in the deliberations of pension fund trustees and managers more broadly.

8. New Markets Tax Credit

OVERVIEW

The New Markets Tax Credit (NMTC) is a federal tax incentive for private investors to bring capital into low-income and distressed neighborhoods. The program allows individual and corporate investors to reduce their federal income tax burden in exchange for a qualified equity investment in a Community Development Entity (CDE), which uses that money to fund businesses and real estate projects in underserved communities. At least 85 percent of those investments must be in neighborhoods with a poverty rate of at least 20 percent or a median income that's below 80 percent of the area median. To qualify as a CDE, an organization must be a domestic corporation or partnership with the primary mission of serving low-income communities or families, along with other requirements to ensure ongoing accountability to the communities they serve.[7]

Each year Congress authorizes allocations through the NMTC, which are administered jointly by the Treasury Department's CDFI Fund and the Internal Revenue Service. CDEs or their investors receive tax credits equal to 39 percent of their total investment over the course of seven years, and the original investment can be redeemed at the end of that compliance period.[8] In 2013, the government allocated $3.5 billion in tax credit authority through the program, translating into roughly $1.4 billion in lost federal tax revenue over the next seven years. Seventy five percent (75 percent) of 2013 allocatees indicated their primary focus was to provide loans to or investments in businesses and 24 percent of allocatees had a primary focus of investing in real estate projects.[9] During 2012, CDEs raised private equity investments of $5.2 billion.[10]

IMPACT

Since its enactment in 2000, the NMTC program has made 836 awards allocating a total of $40 billion in tax credit authority to CDEs.[11] Between 2003 and 2012, CDEs reported making nearly $31.1 billion in NMTC investments in low-income communities, resulting in the creation or retention of an estimated 561,000 jobs.[12]

Because of scarce resources, there is a very high level of competition for NMTC allocations. In 2013, 310 CDEs applied for allocations but only 87 received them. Some have argued that this competition, combined with legal complexity and other barriers to participation, can dissuade smaller groups from participating in the program.[13] That said, 44 percent of the allocatees in 2013 serve non-metropolitan counties and rural areas, while 30 percent were federally-registered Community Development Financial Institutions (CDFIs).

Seventy-five percent of 2013 allocatees indicated that their primary focus was to provide loans to or investments in businesses, and 24 percent of allocatees had a primary focus of investing in real estate projects. It's worth noting, however, that some analysts have voiced concern about certain rules in the program—particularly its seven-year compliance period—that could make investments in real estate more attractive than investments in small businesses.

FIT

The NMTC plays an intermediary role in the market by directing capital to entities that serve the target population. It is one of several "place-based" initiatives through which the federal government supports public and private investment into low-income communities, including regulations through the Community Reinvestment Act (CRA) and the Obama administration's "Promise Zones" initiative. Projects receiving NMTC

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[7] InSight at Pacific Community Ventures and the Initiative for Responsible Investment at Harvard University. "Case Study 1: New Markets Tax Credit," *Impact Investing: A Framework for Policy Design and Analysis,* January 2011, pg. 34.

[8] http://www.occ.gov/topics/community-affairs/publications/insights/insights-new-markets-tax-credits.pdf pg. 2.

[9] The American Taxpayer Relief Act of 2012 allocated $3.5 billion each to 2012 and 2013.
See: http://www.occ.gov/topics/community-affairs/publications/insights/insights-new-markets-tax-credits.pdf pg. 20, footnote 74.

[10] NMTC Coalition, "The New Markets Tax Credit Progress Report 2013." pg. 6.

[11] CDFI Fund, "New Markets Tax Credit Program," *Community Development Financial Institutions Fund, http://cdfifund.gov/what_we_do/programs_id.asp?programID=5.*

[12] Ibid., pg. 2.

[13] De Luca, et al., CBO, "The New Markets Tax Credit: A Critical Assessment," A Report to the Members of the 111th Congress. May 2011, pg. 9.

support often work in concert with other programs—for instance, certain investments in CDEs can also qualify a bank for CRA credit. Depending on the project, CDEs could also take advantage of other federal programs, including historic rehabilitation and renewable energy tax credits or FHA or USDA loan programs.[14]

CAPACITY

The CDFI Fund and IRS jointly oversee the implementation of the NMTC program. Under the auspices of the Treasury, the CDFI Fund is responsible for CDE certification and the actual allocation of tax credits each year. The IRS is responsible for ensuring a CDE's—and their investor's—compliance with the program's regulations.[15] Private investors participating in the program include banks (regulated and unregulated), corporations, charitable organizations and insurance companies.[16] Individuals can also invest in NMTC investments, however this is typically rare due to specific tax rules.

There is little evidence of waste, fraud or abuse in the NMTC program. Part of this is because of the high level of competition, as allocations tend to go to CDEs with proven track records. In addition, there are strong protections built into the program. If at any point during the seven-year compliance period a CDE violates key eligibility rules, the government can recapture 100 percent of the credits along with interest and penalties.

OPPORTUNITY

Despite a proven track record of success and broad bipartisan support, the NMTC program is yet to be made a permanent part of the tax code, leaving lawmakers to extend and fund the program on an annual basis. While Congress has decided to extend the program three times in the past three years, lawmakers have failed to renew the program for multiyear periods, which was the program's original intention. As a result of any recent congressional action to extend this and dozens of other expired tax provisions, the NMTC program has now expired. This uncertainty deters forward-looking investors from committing capital and discourages CDEs from undertaking long-term approaches to addressing to entrenched issues.

For these and other reasons, in June 2013 Sens. John Rockefeller (D-WV) and Roy Blunt (R-MO) introduced bipartisan legislation to permanently extend and strengthen the NMTC by making annual adjustments for inflation and allowing it to be offset against the alternative minimum tax. A similar bipartisan bill was introduced in the House in April 2014 by Representatives Jim Gerlach (R-PA) and Richard Neal (D-MA). A two-year extension of the NMTC was also approved in the Senate Finance Committee earlier this year on a bipartisan basis, but it has not yet been voted on.

In addition to the need to extend the program in the long term, advocates point to the need for increased funding levels. The current allocation falls short of need – for example, in 2013 developers and community groups submitted nearly $26 billion worth of applications for $3.5 billion in credit authority. For every one project that received a credit allocation in 2012, it is estimated at least nine fundable projects were rejected.

Stakeholders and policymakers have offered several other proposals for reforming the program. For example, the Congressional Budget Office recently recommended requiring CDEs to invest 100 percent of their qualified equity investments into low-income communities, instead of the current requirement of 85 percent. CBO also recommended reworking the awarding process to place greater emphasis on a CDE's community impact, as opposed to its management capacity, capitalization, and business strategy.[17] Others have proposed ways to break down programmatic barriers that keep smaller investors from participating, including a streamlined "NMTC-Light" for investors with less than $2 million to commit and the creation of a large, national intermediary that could serve as a bridge financing partner to smaller investors.

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[14] http://www.occ.gov/topics/community-affairs/publications/insights/insights-new-markets-tax-credits.pdf, pg. 4.

[15] IRS, "Internal Revenue Service's Responsibility." *New Markets Tax Credit,* May 2010, pg. 6.

[16] In 2013, regulated financial institutions provided 49 percent of QEI investment dollars, with "other corporate entities" providing the next biggest portion – 22 percent. See "NMTC 2013 Progress Report"

[17] De Luca, et al., CBO, "The New Markets Tax Credit: A Critical Assessment," A Report to the Members of the 111th Congress. May 2011, pg. 9

9. Program-Related Investments

OVERVIEW

Program-Related Investments (PRI) is a carve-out from the rules governing prudent investment by foundations created as part of the Tax Reform Act of 1969. The legislation was enacted as a response to many foundations' growing interest and demand for a way to make patient, low-cost and/or higher-risk investments to further their programmatic goals. Under the U.S. federal tax code, private foundations are mandated to give out 5% of their total assets in grants each year in order to maintain tax exempt status. The PRI category allows foundations to count below-market-rate debt or equity investments made in support of their stated mission as part of this 5% distribution. In order for a foundation's investment to qualify as a PRI, the Internal Revenue Service must determine, a) the primary purpose of the investment is to accomplish a charitable purpose as defined by the US tax code; b) the financial return is the mechanism to create social benefit, not the goal of the investment in itself; and c) the investment is not associated with political lobbying.[18] Between 1990 and 2009, PRIs cumulatively totaled $3.7 billion.[19] According to the Statistics of Income (SOI) Division of the IRS, PRIs have grown steadily over the past two decades, reaching over $700 million in 2009 alone. [20,21]

IMPACT

PRIs are made across sectors to achieve a variety of social and environmental outcomes. Pioneered by the Ford Foundation, PRIs have funded affordable housing projects and small business development in low-income areas, as well as land preservation initiatives, energy efficiency programs and alternative energy production. They have played a significant role in the community development field, helping to catalyze the development of intermediary financial organizations – including community banks and loan funds – that pool public, private and philanthropic capital to invest in low-income communities.[22] Between 2000 and 2010, investments in housing, community development and education comprised over 70 percent of all PRIs made.[23] Following the release of new guidelines from the IRS in 2012, foundations have increasingly been making PRIs in social enterprises.[24]

Beyond producing social and environmental impact, PRIs serve an important purpose as an investment tool. Earning below-market rates of financial return,[25] they are often used as concessionary or "first-loss" capital, de-risking certain deals for public- and private-sector investors who would otherwise not participate. In effect, this longer-term and higher-risk capital directs private investment to areas of limited or idiosyncratic market activity, such as affordable housing or healthcare services for the poor. PRIs also play a key role in building the capacity of investee companies, filling funding gaps, boosting recipients' cash flow and increasing access to capital, all helping to ensure long-term sustainability.

FIT

PRI legislation is a supply development policy, helping to spur private investment into fund intermediaries or directly into recipient organizations. In practice PRIs are often used in combination with other policies intended to direct private capital to areas of public need. These polices include, among others, the Community Reinvestment Act (CRA) and the New Markets Tax Credit (NMTC), which offers a tax incentive to private entities investing in businesses and real estate projects in underserved communities. By way of example, a foundation might use PRI to make a catalytic investment in a complex deal alongside private investors participating for the

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[18] "Program-Related Investments, United States." *Breaking the Binary*. World Economic Forum and the Schwab Foundation, 2013. Pg. 37.
[19] *Breaking the Binary,* 38.
[20] Una Osili et al., *Leveraging the Power of Foundations: An Analysis of Program-Related Investing (The Lilly Family School of Philanthropy at Indiana University, 2012).* http://www.philanthropy.iupui.edu/files/research/complete_report_final_51713.pdf, pg. 12.
[21] While the SOI reported $701 million in PRIs in 2009, this data conflicts with the Foundation Center dataset, which reports the amount in 2009 as only $389 million. According to the Lilly Family report, this discrepancy could be due to misreporting of PRI activity in the SOI data (*Leveraging the Power of Foundations,* 13)
[22] *Breaking the Binary,* 37.
[23] *Leveraging the Power of Foundations,* 3.
[24] *Breaking the Binary*, 37.
[25] To qualify as a PRI, the IRS requires rates to be below market on a risk adjusted basis, but the actual rate of return or earnings on PRIs can vary. While PRIs are often made with the expectation of a rate of return between 0 and 3 percent, the rate may be higher depending on the level of risk involved. See "Answers to the 10 Most Asked Questions about PRIs," https://www.missioninvestors.org/tools/answers-to-the-10-most-asked-questions-about-pris#3

tax incentive under the NMTC program. The PRI would increase the attractiveness of such a deal for a private investor, as it would lower the risk involved.

CAPACITY

Since the late 1990s, program-related investing has grown significantly, as evidenced by the increases in total dollars invested and total number of investments made.[26] Several major U.S. foundations have recently announced sizable commitments to PRIs: the Gates Foundation committed $1.5 billion; the MacArthur Foundation, $300 million; and the Robert Wood Johnson Foundation, $100 million.[27] However, less than one percent of all U.S. foundations make PRIs every year, and the reasons are manifold.[28] Complications with the policy exist at all levels: the creation and oversight of regulations by the IRS, the implementation of the practice by foundations, and the existence and capacity of eligible recipient organizations.

Within the IRS, knowledge of PRI regulations is limited, particularly when it comes to more innovative investment strategies. Furthermore, the IRS has been criticized for its outdated PRI standards, which continue to consider a wide range of impactful investments "jeopardizing," like energy retrofits and solar panel installation for the charitable purpose of protecting the natural environment. On the other hand, experts acknowledge that the IRS's insistence on a strict separation between charitable and commercial purposes is understandable. In short, regulatory change to PRI is probably infeasible.

At the foundation level, PRI is often viewed as too complicated, expensive, or inflexible in the face of evolving philanthropic practice – although those familiar with making PRIs argue they are easier to utilize than many foundations realize. Even to would-be practitioners, however, PRI requires a level of investment acumen uncommon among grant-makers, and the cultural divide between the programmatic and asset management sides of a foundation is not always easily bridged. Moreover, the uncertainty foundations have about the specific PRI carve-outs is very real. Legal counsel or private letter rulings from the IRS can verify an investment's eligibility, but the cost and time required to obtain these can be prohibitive for small to mid-size foundations.[29]

OPPORTUNITY

The most feasible and effective opportunities for further leveraging PRI seem to be in changing the internal perception of the practice, and improving foundations' investment capacity. Some practitioners have recognized the need for greater signaling and clear support from the White House to publicize PRI and encourage foundations to participate.[30] Others have suggested that large foundations provide assistance and opportunities to smaller foundations, either through co-investment or underwriting the start-up structural and legal costs of PRI funds. Other proposals, including from the U.S. National Advisory Board, involve expanding the range of investments that qualify as PRIs, and clarifying and modernizing IRS regulations. In particular, the requirement that an investment must not be "significantly intended to produce income," makes some foundations hesitant to consider investments that present clear opportunities for profit.

The most significant opportunities may be legislative. One proposal, the Philanthropic Facilitation Act of 2013 (H.R. 2832), was introduced to no effect in Congress in 2013, and would create a voluntary application process permitting a "potential PRI recipient" to receive a determination letter from the IRS upon which all foundations (or other potential investors) may rely. According to its backers this would remove the burden from foundations to prove compliance.[31] Another idea focuses on bringing foundations into alignment with most other fiduciary investors by transferring responsibility for policing investment prudence to the states – which rely on a regularly updated *Uniform Prudent* Management of Institutional Funds Act – and away from the more antiquated stewardship of the IRS.

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[26] *Leveraging the Power of Foundations,* 2.
[27] The U.S. National Advisory Board, *Private Capital, Public Good: How Smart Federal Policy Can Galvanize Impact Investing – and Why it's Urgent* (Draft). June 2014, pg. 10
[28] *Leveraging the Power of Foundations*, 33.
[29] Sorenson Center, "The Philanthropic Facilitation Act of 2013 (H.R. 2832)"
[30] *Private Capital, Public Good*, pg. 10

[31] Sorenson Center, "The Philanthropic Facilitation Act of 2013 (H.R. 2832)"

10. Small Business Investment Company Program

OVERVIEW

The SBIC Program within the U.S. Small Business Administration (SBA) is a fund that provides government-backed private funding to capitalize small businesses, with the goal of helping them grow and create jobs. The SBA makes long-term investments in privately-owned and managed investment firms licensed as Small Business Investment Companies (SBICs), which in turn make debt and equity investments in small businesses. In order to qualify for assistance through the program, a small business must have 500 or fewer employees or less than $21.5 million in revenues, depending on the industry. For every $1 an SBIC raises from a private investor, the SBA can provide up to $2 of government-guaranteed debentures, subject to a cap of $150 million.[32]

SBIC debentures are not funded with tax dollars, but from the periodic sale of SBA Guaranteed Certificates in the public markets to private investors.[33] However, federal appropriations support the operating costs of the SBA and all its programs. In 2012, Congress appropriated $23 million for the SBA to make, service and liquidate SBIC loans. That year, the SBIC program leveraged an estimated $10.3 billion in private investment.[34]

IMPACT

The SBIC Program was created in 1958 to support small business growth in the U.S., with the dual benefit of creating or sustaining jobs and stimulating the economy. The program addresses the lack of readily available investment capital for small businesses, which are largely regarded as the backbone of the American economy.[35] Support from the federal government—in the form of loans and guarantees from the SBA—allow SBICs to attract private investment capital from pension funds, foundations, banks (especially those investing for CRA credit) and high-net-worth individuals.

Since 1958, the SBIC program has directed over $67 billion to U.S. small businesses, of which 64 percent came from private capital and 36 percent came from government subsidy.[36] At the end of FY2013, the SBIC Program included 292 funds collectively representing $10.3 billion in private capital and $9.5 billion of SBA leverage.[37] The SBICs deployed $3.5 billion in financing to 1,068 small businesses in 2013, creating or sustaining an estimated 73,585 jobs.[38]

Recent innovations in the program have included the creation of Impact, Early Stage, and Energy Savings SBICs. In 2007, the SBA launched the Energy Saving Debentures program as part of the Energy Independence and Security Act. The program allows the SBA to issue debentures to SBICs licensed after September 30, 2008 that invest in small businesses "'primarily engaged' in business activities that reduce the use or consumption of non-renewable energy sources."[39] In 2011, the SBA launched the Impact Investment SBIC Initiative as part of the Start-Up America Initiative, committing $1 billion over 5 years to funds licensed as "Impact SBICs," which are required to invest at least 50 percent of their capital in companies located in LMI, rural, or otherwise economically distressed regions, and/or operating in the clean energy or education sectors.[40] The Early Stage SBIC program, also launched in 2011 as part of the Start-Up America Initiative, allocates $1 billion over 5 years for funds investing in emerging companies seeking venture capital between $1-4 million.

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[32] SBA Office of Investment and Innovation, "The SBIC Program," *Office Overview 2014*

[33] http://www.worldlawdirect.com/article/3041/small-business-investment-companies-sbic.html

[34] "Private Capital of Operating SBICs by Fund Type" *Small Business Investment Company (SBIC) Program Overview As of December 31, 2013*, p. 1.

[35] According to the Small Business Investment Alliance (SBIA), Small businesses in the U.S. often struggle to obtain critical financing in the range of $250,000 – $5 million in equity or subordinated loans from private investors. See: http://www.sbia.org/?page=sbic_program_history

[36] SBA Office of Investment and Innovation, "The SBIC Program," *Office Overview 2014*

[37] "Private Capital of Operating SBICs by Fund Type" *Small Business Investment Company (SBIC) Program Overview As of December 31, 2013*, p. 1.

[38] "Economic Impact: SBIC Financings to Small Business Reported" *Small Business Investment Company (SBIC) Program Overview As of December 31, 2013*, p. 2.

[39] https://www.federalregister.gov/articles/2012/04/19/2012-9454/small-business-investment-companies-energy-saving-qualified-investments#h-9

[40] http://www.sba.gov/sites/default/files/files/External%20Impact%20Memo%202012-09-26%20final.pdf

FIT

The SBIC program is one of numerous SBA loan products ultimately intended to grow small businesses (with total disbursements of around $75 billion annually). While other federal agencies support small business growth SBA plays by far the most important role. A 2008 Urban Institute study found the SBA to be "the most significant federal source of financing for small businesses not in rural areas."[41] The study further stated that the SBIC program has little duplication among federal programs, though the Community Development Financial Institutions (CDFI) Program is one source of potential overlap.[42]

Complementary policies include the Community Reinvestment Act (CRA), which requires banks to make investments in the communities where they take deposits. SBIC investments automatically qualify for CRA credit, which helps SBICs attract investment capital. In addition, SBICs are exempt from the Volcker Rule of the Dodd-Frank financial reform law, which bars commercial banks from making certain speculative investments.

CAPACITY

The SBA has significant discretion under existing authority in implementing the SBIC program, as demonstrated by the recent launch of the special-purpose impact and early-stage pilot initiatives.

Implementation of the SBIC program has improved in recent years: in 2012, funds received SBIC licenses in just over 5 months on average, compared to nearly 15 months in 2009.[43] Streamlining internal approvals processes helped the program produce over $1.9 billion in SBA-guaranteed leverage commitments – a new record – to its funds in FY 2012. Also in recent years, the Office of Operations reduced turnaround times for existing SBICs on key decisions by over 50 percent.[44] Additionally, intermediaries familiar with the Impact SBIC program suggest that the SBA has succeeded in creating a fast-track for its special categories of funds, reducing approval times by as much as three months. The SBA has demonstrated willingness – and has the capacity -- to play a meaningful role in accelerating impact investing.

OPPORTUNITY

Most enhancements to the SBIC program can be implemented using the SBA's administrative authority. And because the SBIC program enjoys broad bipartisan support, reforms are likely to be noncontroversial. The SBA is already taking action to maximize the use and impact of the SBIC program, for example through the impact SBIC initiative, although the special effort has seen more limited take-up than expected.

There is interest in identifying and incentivizing the delivery of measurable impacts across all SBIC programs. Some have proposed awarding Impact SBIC licenses on the basis of a firm's demonstrated impact outcomes (as opposed to requiring an initial application upfront). The Obama Administration has suggested increasing the amount of SBA debentures made available to successful SBIC managers.[45] Some proponents for reform have expressed the need to more closely integrate SBIC programs with other federal policies that spur investment in small businesses, including CRA and the CDFI Fund. Finally, many have stressed the need for additional and higher quality data collection on impact, including the quality of jobs created and sustained as a result of SBIC investment.

[41] 2008 Brash, *Public Sector Duplication of SBA Loan and Investment Programs*, p. 1.
[42] Ibid., 46.
[43] Mills, Karen G. "Message From the Administrator," The Small Business Investment Company (SBIC) Program Annual Report FY 2012.
[44] The Small Business Investment Company (SBIC) Program Annual Report FY 2012, pg. 6.
[45] http://www.law360.com/articles/525896/sbic-relief-act-will-be-good-for-advisers-and-business

International Example: Social Investment Tax Relief (UK)

OVERVIEW

In July 2014, the UK government is expected to pass a new tax relief policy for social investment as part of the 2014 Finance Bill. Social investment tax relief (SITR) focuses on individual investors who invest equity and some forms of subordinate debt in social enterprises. Investors will be eligible for an income tax deduction equal to 30 percent of up to £1 million in investments in social enterprises for the year the investments are made. Investors will also be able to defer applicable capital gains tax if the return is reinvested in a social enterprise, and will be exempt from a capital gains tax on the sale of the investment. These investments must be held for three years to receive benefits.

Investments must be made in unlisted social enterprises—defined as Community Interest Companies, community benefit societies, and charities—with fewer than 500 employees and no more than £15 million in gross assets. Each social enterprise is restricted in how much money it can raise, roughly equivalent to £290,000 over three years, and returns are capped at commercial rates. The Revenue & Customs office is responsible for approving the eligibility of social enterprises to participate. The UK is currently working on guidance for companies issuing social impact bonds to be eligible under this policy.[46]

IMPACT

This program is one of the UK government's major efforts to increase the ability of social enterprises to access capital. In June 2013, Prime Minister Cameron stated that he hoped this tax relief could spur £500 million in additional investment in social enterprise.[47] There is much enthusiasm for the new tax relief scheme, but the relatively small size of the investments, limited definition of applicable investees, and direct nature of the investments are likely to pose significant challenges to scale and usage.

FIT

The SITR is based heavily on the recently-revised Enterprise Investment Scheme (EIS), which provides tax relief to equity investors in small and medium-sized enterprises and spurred £1 billion in investment in the tax year ending March 2012.[48] The mirroring of EIS by SITR may reduce some transaction costs and make it easier for investors to understand and utilize the tax relief. Another impact-focused tax relief program, Community Investment Tax Relief (CITR), encourages investment in underserved communities through Community Development Financial Institutions (CDFIs; there are 60 such institutions in the UK).[49] SITR is expected to be complementary to CITR, with limited overlap in investors and investees, and no changes are expected to CITR.

SITR also piggybacks on existing regulatory requirements around legal forms defining applicable social enterprises. Charities, Community Interest Companies (CICs), and community benefit societies (Bencoms), are all legally defined corporate forms that explicitly include some understanding of social purpose as part of their incorporation. There is no interest at this time in setting up a separate certification program for eligible enterprises. Enterprises that do not currently fall under these three legal forms will be able to convert to CICs.[50]

CAPACITY

The success of the EIS bodes well for the UK government's internal capacity to implement the program, and for investors to use it. SITR is a part of the Cameron government's larger platform around the social investment market, so there is significant, high-level leadership focused on the success of the policy.[51] Constraints on the size and type of investment, and lack of clarity around demand for the kind of investment that SITR incents, may

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[46] https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/298220/Social_investment_tax_relief__SITR__draft_guidance.pdf

[47] http://www.bloomberg.com/news/2013-06-06/cameron-pledges-tax-breaks-on-social-investments.html

[48] http://www.fundweb.co.uk/news-and-analysis/alternatives/eis-investments-jump-to-record-highs/2004682.article

[49] http://www.cdfa.org.uk/about-cdfis/

[50] https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/298220/Social_investment_tax_relief__SITR__draft_guidance.pdf

[51] https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/321483/2014_Social_Investment_Strategy.pdf

be significant hurdles in practice. Expansion of the policy to larger/different types of investees is complicated by EU state aid laws that regulate what relief the UK can offer to support domestic businesses. A broader tax relief policy requires EU clearance and the inevitable bureaucratic and political wrangling that this implies.

OPPORTUNITY

The US has a lengthy and productive history of utilizing tax credits and other forms of tax relief to support private investment in public purpose projects, including the Low-Income Housing Tax Credit, New Markets Tax Credit, Renewable Energy Investment Tax Credit, and tax-exempt Private Activity Bonds. There is ample evidence to suggest that these credits have been successful in supporting positive social outcomes and meeting investors' needs, and most have a long history of bipartisan support.

The creation of a SITR in the US, narrowly defined as supporting social enterprises, would require coordination with relevant existing tax credits as well as the creation of some common legal definition, and perhaps certification process. Unlike the UK, there is a limited regulatory structure at the national level around social enterprise, though the US CDFI certification process, the SBA's SBIC certification process, or state-level Benefit Corporation legislation could be a potential analogue. Such a tax credit would require legislative change to amend the tax code, as well as additional legislative and/or executive support to build additional infrastructure.

On the other hand, the US has a robust understanding of social and impact investment that goes beyond social enterprises. A more broadly defined impact investing tax credit, while still requiring additional regulatory activity, may allow for a broader array of targeted investors and a bigger scale of potential investments, for example in CDFIs. In this case, a focus on defining eligible products and vehicles, rather than enterprises, might be particularly effective.

A critical first step would be to create a federally-regulated register of approved impact investments, similar to the 501(c)(3) status required for tax-deductions on donations to social organizations. The Department of Treasury, Securities and Exchange Commission, or some other federal regulator would be charged with overseeing the register and establishing clear eligibility criteria, taking into account proven social outcomes, projected financial returns, the financial health of the organization and other factors.

Further analysis is necessary to determine the scope and potential costs of such a proposal. Among other factors, this analysis will require reasonable assumptions about a) expected investor interest; b) expected investment dollars that will be diverted from other, fully taxable investments; c) government cost savings from the social benefits; and d) reasonable caps and other restrictions on the tax benefits for government-approved impact investments. The tax benefit could either be fixed for all eligible impact investments or vary depending on the level of social impact and other considerations, as determined by the federal regulator.

An SITR-like tax credit would likely make the tax code more complex than it is already. While Congress has engaged in a few conversations around a tax code overhaul, they are unlikely to make significant headway presently, and some proposals have called for a simplification of the tax code that would lessen the prospects of introducing any new incentives. In the event of a tax code revision, depending on the political environment, there may also be a tension between shoring up existing credits and pushing for new ones.